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THE LAW OF BUSINESS STRUCTURES

Farouk HI Cassim (managing editor)
Maleka Femida Cassim • Rehana Cassim
Richard Jooste • Joanne Shev • Jacqueline Yeats

Preface

As university lecturers and legal practitioners we have found that there is a definite need for an advanced commercial law book on business structures, suitable principally for commerce students at all tertiary institutions. Like law students, commerce students are required to grapple with the complexities of the law of business structures and to acquire a respectable degree of knowledge and understanding of the subject and its intricacies. *The Law of Business Structures* will undoubtedly fulfil this need. Both law students and commerce students, including accounting and auditing students, will find the book useful in guiding and assisting them in the study of the law of business structures. In addition, those who teach the law of business structures will find this book to be a useful guide and teaching aid.

We hope that *The Law of Business Structures* will also serve the needs of practitioners, whether attorneys, accountants, auditors or company secretaries, who require a reliable and ready source of information on the law of business structures, and particularly on the new Companies Act 71 of 2008.

The Law of Business Structures contains a fairly detailed treatment of the law of partnerships, business trusts, close corporations and companies, whether large or small, and whether formed for a profit-making or a non-profit-making objective. The centrepiece of the book is undoubtedly company law. The reason for the strong focus on company law is quite obvious. Company law in South Africa has been thoroughly and extensively overhauled. Basic and fundamental corporate law doctrines and concepts were deemed to be outdated, obsolete or archaic and to have outlived their usefulness, because they were no longer appropriate to the contemporary economic and business environment. An additional policy factor led to this sea change, namely, the need to harmonise South African company law with that of our main trading partners internationally, in order to ensure that South African companies are not competing at a disadvantage because of an outdated and restrictive company law regime. Hence, the new Companies Act 71 of 2008, with its many innovative legal concepts and new underlying philosophies, was passed. The reader will find in the chapters on company law a detailed discussion and explanation of core company law topics. We have however gone beyond core company law by including a discussion of modern corporate governance best practices, insider trading and market manipulation.

Readers of this book will not need to be reminded that the two-year transitional period for pre-existing companies is drawing to a close. It is becoming increasingly important for practitioners and students of the subject to familiarise themselves with the provisions of the Companies Act of 2008.

We have purposively avoided excessive theoretical analysis, but without refraining from careful and detailed explanations and analyses of important legal concepts and principles. Case law has been kept to a minimum. However, law and commerce students know full well that legal principles cannot be fully understood without a knowledge and comprehension of the leading cases on a particular topic. Accordingly the reader will find a discussion of the important cases on the subject.

We have included a glossary of important terms, which is intended to provide some background and guidance to students who are new to this area of law. We have also included sample questions at the end of each chapter (with the exception of chapter 23 dealing with transitional arrangements). The purpose of these questions is to test the student's knowledge and understanding of the content of each chapter. We trust that students and lecturers will find these questions both useful and challenging.

The Law of Business Structures thus provides a comprehensive but also a simplified treatment of the different types of business structures in South African law. It is by no means an exhaustive treatment, since this field of law is simply much too large.

Publishing a book of this sort calls for much editorial skill, efficiency and hard work on the part of the publishers. We take pleasure in thanking Linda van de Vijver and her team for their laborious efforts and exertions in the publication of this book. We would also like to thank them for compiling the index, the table of cases and the table of statutes.

We would, furthermore, like to acknowledge our indebtedness to our students who have given us insight into the difficulties that students of this area of law generally experience.

Finally, we would like to thank our families and loved ones for their enduring support, encouragement and patience, without which this book could not have been written.

The law is stated as at 31 August 2012.

Farouk HI Cassim, Managing Editor, on behalf of the authors
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Glossary

A

accounting officer: a person appointed by a close corporation to report on the annual financial statements if neither an audit nor an independent review of the financial statements is required

accounting records: accounts, deeds, writings and other documents as may be prescribed

acquiring party (when used in respect of a transaction or proposed transaction): a person who, as a result of the transaction, would acquire (direct or indirect) control or increased control over all or the greater part of a company, or over all or the greater part of a company's assets or undertaking

acting at arm's length: acting independently (ie without outside influence)

affected person (in the context of business rescue): a shareholder, creditor or employee of a company or a registered trade union representing the employees of the company

affected transaction a term used to describe a number of transactions listed in s 117(1)*(c)* of the Companies Act 71 of 2008, eg a merger, or a scheme of arrangement

alter ego: literally this means 'the other self'. The alter ego doctrine is used by the courts where the directors of the company or its controlling shareholders treat the company as extensions of themselves instead of treating the company as a separate person. The courts use this doctrine in order to impose personal liability on the directors or controlling shareholders

alterable provision: a provision of the Companies Act 71 of 2008 in which it is expressly contemplated that the Act's effect on a particular company may be altered by that company's Memorandum of Incorporation, whether by negation, restriction, limitation, qualification, extension or other alteration in substance or effect

alternate director: a person elected or appointed to serve as a member of the board of a company as a substitute for another director who has been elected or appointed to the board of directors

alternative dispute resolution: conciliation, mediation or arbitration

amalgamation or merger: a fundamental transaction whereby the assets and liabilities of two or more companies are, in terms of an agreement, pooled together in a single company (or more than one company), which may either be a newly formed company or one of the combining companies

annual general meeting (AGM): a meeting of the shareholders of a company which is held once a year and at which particular business is required to be conducted

anonymous partners: a partnership in which a partner does not directly participate in the management of the business of the partnership. Anonymous partners are not directly liable to creditors of the partnership. They are liable only to their co-partners for their proportionate share of partnership debts and liabilities

anti-avoidance measure: a court (on application by the Companies Commission, the Takeover Regulation Panel or a securities exchange) may declare any agreement, transaction, arrangement, resolution or provision of a company's Memorandum of Incorporation or rules to be primarily or substantially intended to defeat or reduce the effect of a prohibition or requirement established by an *unalterable provision* of the Companies Act 71 of 2008, and may declare it void to that extent

appraisal right (or appraisal remedy): the right of dissenting minority shareholders, who do not approve of certain triggering events, to have their shares bought out by the company in cash, at a price reflecting the fair value of the shares, which value may in certain cases be determined by a court

audit: an examination, in accordance with prescribed or applicable auditing standards, of *(a)* financial statements with the objective of expressing an opinion as to the fair presentation or compliance thereof with a specific financial reporting framework and any applicable statutory requirements; or *(b)* financial and other information, prepared in accordance with specific criteria, with the objective of expressing an opinion on that information

audit committee: a sub-committee of a company's board of directors, appointed by that company's incorporators, board of directors or shareholders, which plays an important role in *(a)* identifying financial risks; *(b)* managing these risks; *(c)* ensuring the integrity of internal financial controls; and *(d)* ensuring the integrity of integrated reporting

auditor: a person who performs an audit in terms of prescribed or applicable auditing standards

authorised shares: the maximum number of shares that a company is permitted by its Memorandum of Incorporation to issue

B

beneficial interest: in relation to a company's securities, other than an interest held in unit trusts or a collective investment scheme, the right of a person through ownership, agreement, relationship or otherwise, alone or together with another person, to *(a)* receive or share in any distribution in respect of the company's securities; *(b)* exercise, or cause to be exercised, any or all of the rights attaching to the company's securities; or *(c)* dispose or direct the disposition of the company's securities, or any part of a distribution in respect of the securities

beneficial shareholder: the person who is entitled to the rights attached to the shares of a company, which shares are held and registered in the name of another person who is the registered shareholder

bewindtrust: a trust in which the assets administered by the trustees are owned by the beneficiaries

board committee: except to the extent that the Memorandum of Incorporation provides otherwise, the board of directors may appoint any number of committees and may delegate any of its authority to these committees; the board remains liable for the proper performance of the duty delegated

board of directors: the organ of a company that is responsible for managing the business and affairs of a company

bona fide**:** in good faith

business judgment rule: the rule that protects directors from liability for mere errors of judgment or poor business decisions, provided they have taken an informed decision, without any self-dealing on their part or on the part of a related person, and provided that the directors have reasonable grounds for believing that they were acting in the best interests of the company

business rescue: proceedings to facilitate the rehabilitation of a financially distressed company

business rescue plan: the rescue plan drawn up by the business rescue practitioner that is designed to resolve the company's financial distress

business rescue practitioner: a duly qualified person who is appointed to supervise the company during the business rescue process and to draw up a business rescue plan

C

capitalisation shares: shares issued by converting profits into shares, and issued to shareholders instead of paying a dividend

capitalise: to convert profits into share capital (capitalisation shares)

cash merger: a merger transaction in which certain shareholders receive cash in return for their shares. These shareholders are in effect 'cashed-out' so that they do not hold any shares in the merged company

Chartered Accountant (South Africa): a member of SAICA who is qualified as an accounting professional, also referred to as a CA(SA)

chief executive officer: the chief representative of the company

Chinese Wall: an information barrier. In the context of insider trading, it is a technique or, metaphorically, a wall designed to prevent confidential price-sensitive information from reaching the different departments of a multi-function company, such as a merchant bank or a stock broking company

class rights: rights attaching to a particular class of share

commanditarian partner: a partner who contributes a fixed sum of money to the partnership and refrains from actively participating in the management of the partnership business on the understanding that his or her liability for partnership debts and liabilities is to be limited to the amount contributed by him or her

Companies Commission (Companies and Intellectual Property Commission) (CIPC): a regulatory agency whose functions are, inter alia, to register companies and intellectual property rights, to establish and maintain a companies register and other relevant registers, and to enforce the Companies Act 71 of 2008

Companies Tribunal: a regulatory agency set up by the Companies Act 71 of 2008, whose functions include the adjudication and voluntary resolution of disputes

company secretary: the chief administrative officer of the company, who must provide guidance to the board of directors on their duties and similar matters, keep minutes of meetings etc

compliance notice: a notice issued by the Companies Commission or the Takeover Regulation Panel to any person who it on reasonable grounds believes has contravened the Companies Act 71 of 2008 (or who assented to, was implicated in, or benefited from a contravention of the Act), requiring the person to cease or correct certain actions; to take any action required by the Act; to restore assets or their value to a company or to any other person; to provide a community service; or take any other steps reasonably related to the contravention and designed to rectify its effect

compromise (in the context of Compromises): an agreement between the company and its creditors or a class of creditors to terminate disputes over the rights of the parties which are to be compromised

contingent/conditional rights: entitlement to these rights is dependent on a future and uncertain event which may or may not occur (as opposed to 'vested rights')

convertible share: a share in a company which can be changed into a share of another class

corporate governance: the systems, structures and processes associated with management, decision-making and control in organisations. In South Africa the corporate governance principles and practices are set out in the King Report on Governance for South Africa 2009 ('King III Report') and the King Code of Governance for South

Africa 2009, which came into effect on 1 March 2010

corporate opportunity: in the context of directors' fiduciary duties, the duty of a director not to usurp or appropriate for himself or herself any property, asset, opportunity or information that properly belongs to the company

corporate veil: the metaphorical veil or curtain that separates the company from its shareholders and directors and protects them from liability for the wrongful acts of the company or for the debts and the liabilities of the company

corporeal/incorporeal: a corporeal is something which has a physical form (eg land, a motor car); it is visible and tangible; an incorporeal is something which does not have a physical existence (eg a share, a debenture, a patent)

cumulative preference share: a share in a company which gives the holder thereof a prior right to both arrear and current preference dividends

curator: someone who attends to the affairs of another, eg a mentally disabled person

D

D and O Insurance: directors' and officers' insurance against claims based on negligence in the performance of their duties

***de facto* director:** a person who acts as a director of a company even though he or she is not formally appointed as a director or whose appointment as a director is defective in some way or other

***de jure* director:** a person validly and formally appointed to the position of a company director who has freely consented to that appointment

debenture: a particular kind of written acknowledgement of indebtedness by a company, irrespective of its form (the holder is a creditor of the company)

debt instrument: a form of debt owing by a company, eg a debenture

defensive name: a name that is registered by a person with a direct and material interest who registers the name to protect it from use by another company

deferred share: a share in a company which entitles the holder thereof to a dividend only after the ordinary shareholders have received a certain sum of money

delinquent director: a director who has been declared by a court to be delinquent on one of the grounds set out in the Companies Act 71 of 2008. Such a director is disqualified from being a director of a company. The court order of delinquency may be subject to any conditions the court considers appropriate

deregistration (of a close corporation): the removal of the close corporation from the register of close corporations

derivative action: legal proceedings brought by a person on behalf of a company in order to protect the legal interests of the *company*

designated auditor: the individual registered auditor or registered auditors that is or are selected by the firm to be responsible and accountable for a particular audit

de-subsidiarisation: an action which results in a company no longer being a subsidiary of another company

director: a member of the board of a company, or an alternate director of a company, including any person occupying the position of a director or alternate director, by whatever name designated

distribution: a distribution is defined in s 1 of the Companies Act 71 of 2008 as a direct or indirect transfer by a company of money or property other than its own shares to its shareholders or to the shareholders of another company in the same group of companies. A distribution includes a dividend but is wider than a dividend. A payment by a company for the repurchase of its own shares or the shares of another company in the same group of companies is also a distribution

disqualification: the grounds upon which a person is disqualified from holding office as a director or prescribed officer of a company, set out in the Companies Act 71 of 2008. A disqualification, unlike ineligibility, is not absolute as a court has a discretion to permit a disqualified person, in certain limited circumstances, to accept an appointment as a director or prescribed officer

dividend: a distribution by a company (usually of profits)

doctrine of constructive notice: the doctrine that presumes that persons have knowledge of a document lodged with the Companies Commission that is open to public inspection, irrespective of whether they have actual knowledge of the contents of such document

domestic company: a small private company where there is an underlying partnership intention between the shareholders to which a court may give effect

domesticated company: a foreign company whose registration has been transferred to the Republic of South Africa

E

employee share scheme: a scheme devised by a company to incentivise staff by making it possible for them to acquire shares in the company

enlightened shareholder value approach: the school of thought that holds that shareholders' interests retain primacy and that directors may prioritise the interests of other stakeholders only if this is likely to promote the success of the company for the benefit of the shareholders in general

***ex officio* director:** a person who is a director of a company as a consequence of holding some other office, title, designation or similar status in the company

executive director: a director who is involved in the day-to-day management of the company and is a full-time salaried employee of the company. He or she is generally under a contract of service with the company

expropriation: a forced acquisition

external auditor: a registered auditor

external company: a foreign company registered in a foreign country that carries on business or non-profit activities (as the case may be) within the Republic of South Africa

F

fiduciary: a person in a position of trust, eg a director, a member of a close corporation, or a trustee of a trust who has the power to act for another, which power must be exercised for the benefit of that other person

fiduciary duties: the duties of honesty and good faith imposed by law on fiduciaries, who are persons who exercise legal power on behalf of someone else. Examples of fiduciaries include a director of a company, and a partner or agent who acts on behalf of his or her principal

financial distress (in the context of business rescue): a company that is reasonably unlikely to be able to pay all its debts as they become due and payable in the following six months, or a company that is reasonably likely to be insolvent within the next six months

financial reporting standards :the reporting standards prescribed in Regulation 27 of the Companies Regulations and s 29(4) of the Companies Act 71 of 2008

Financial Reporting Standards Council :a group of persons responsible for advising the Minister on matters relating to financial reporting standards

financial statements: these include *(a)* annual, provisional, group and consolidated financial statements; *(b)* interim and preliminary reports; and *(c)* financial information in a circular, prospectus or provisional announcement of results, which a creditor, holder of securities, the Commission, the Takeover Regulation Panel or any other regulatory authority may reasonably be expected to rely on

financial year: annual accounting period

foreign company: an entity incorporated (or registered) outside the Republic of South Africa

fundamental transactions: these transactions fundamentally alter the nature of the company, and include amalgamations or mergers, disposals of all or the greater part of the assets or undertakings of companies, and schemes of arrangement

G

group of companies: companies having a holding/subsidiary relationship

guarantee: a form of security whereby a person undertakes to pay the debt of another person if that person defaults in paying the debt

I

***in fraudem legis*:** fraudulent; a deliberate attempt to disguise a transaction in order to evade the provisions of a statute

***in securitatem debiti*:** as security for a debt

incorporation: the formation of a company or a close corporation

incorporator: the person or persons who incorporate or form a company, ie the founder or founders of a company

independent accounting professional: a person who *(a)* is a registered auditor in terms of the Auditing Profession Act 26 of 2005; *(b)* is a member in good standing of a professional body that has been accredited in terms of the Auditing Profession Act; or *(c)* is a person qualified to be appointed as an accounting officer of a close corporation in terms of the Close Corporations Act 69 of 1984; and *(d)* does not have, and is not related to any person who has, a personal financial interest in the close corporation, a related company or an inter-related company; and *(e)* is not, or has not in the previous three years, been involved, or related to any person who has been involved, in the day-to-day management of the business of the close corporation

independent non-executive director: a director who does not have a relationship with the company outside his or her directorship. He or she is free of any relationships which could materially interfere with the independent exercise of his or her judgement

independent review: an examination of financial and other information in terms of ISRE 2400 that aims to provide a moderate level of assurance regarding that information

independent reviewer: a person who performs an independent review in terms of ISRE 2400

independently compiled and reported: when financial statements are prepared by an independent accounting professional on the basis of financial records provided by the company or close corporation, in accordance with any relevant accounting standards

ineligibility: the Companies Act 71 of 2008 sets out grounds on which a person may be declared ineligible to be a director or prescribed officer of a company. An ineligible person is absolutely prohibited from being a director, unlike a person who is disqualified from holding office as director

***inter vivos* trust:** a trust created by a person during the person's lifetime which comes into existence during that person's life-time

internally compiled: not independently compiled and reported

issue at a discount: the issue of par value shares below their par or nominal value

J

joint and several liability: when two or more debtors are each liable severally (ie separately), and are all liable jointly, with the effect that the creditor has the option of suing one or more of the debtors severally or all of the debtors jointly for payment of the debt

juristic person: a legal person that does not have a physical existence but possesses its own legal personality which enables it to acquire rights and incur obligations that are separate and distinct from those of the directors and shareholders of the company. Foreign companies and trusts are defined in the Companies Act 71 of 2008 as legal persons

L

lifting the corporate veil: when the directorship or shareholding in a company is considered for some legal purpose, but this does not necessarily entail ignoring the separate identity of the company or treating the liabilities of the company as those of its shareholders or directors (see further piercing the corporate veil)

limited liability of shareholders and members: the concept that the shareholders of a company or members of a close corporation are not, as such, liable for the debts of the company or a close corporation

liquidator: the person(s) appointed by the Master of the High Court to wind up the affairs of a company

M

managing director: the person who is the direct and immediate representative of the board of directors

market abuse: constitutes the offence of insider trading and market manipulation, in terms of the Securities Services Act 36 of 2004

market manipulation: the attempt to interfere with the operation of the stock market, described in the Securities Services Act 36 of 2004 as constituting the offence of engaging in a prohibited trading practice and the making or publishing of false, misleading or deceptive statements, promises and forecasts

member of a company: a member of a non-profit company

Memorandum of Incorporation: the sole founding or governing document of the company, setting out the rights, duties and responsibilities of shareholders, directors and others within and in relation to the company, together with various other matters

moratorium (in the context of business rescue): the automatic stay or freeze on legal proceedings, on the execution of judgments against the company or its property or assets, and on the legal rights of creditors of the company

N

no par value shares: shares that do not have any par value or nominal value attached to them

nominee: the holder of securities who holds them on behalf of another person known as the beneficial owner

nominee director: a director who is appointed to the board of directors by a shareholder who controls sufficient voting power in the company for this purpose, or by a third party, such as a bank or financier, so that the nominee director can represent their interests on the board

***nominee officii*:** in an official capacity

non-executive director: a part-time director who is not employed full-time by the company. He or she is not involved in the day-to-day management of the company, but is appointed to the board for the purpose of bringing an independent and external perspective to the management of the company, particularly on policy issues

non-profit company: a company that is formed for a public benefit object, or an object relating to a cultural or social activity, or a communal or group interest. It is essential that its income and property cannot be distributed to its members or directors

Notice of Incorporation: a notice by which the incorporators of a company inform the Companies Commission of the incorporation of the company for the purpose of having it registered

O

oppression remedy (or relief from oppressive or prejudicial conduct): an application to court by a shareholder or a director of a company who has been oppressed or unfairly prejudiced, or whose interests have been unfairly disregarded, as a result of any act or omission of the company or a related person; the manner in which the business of the company, or a related person, is being or has been conducted; or the manner in which the powers of a director or prescribed officer of the company or a person related to the company are being or have been exercised

ordinary resolution: a resolution supported by more than 50 per cent of the voting rights exercised on the resolution (ie 50% + 1) or such higher percentage of voting rights as determined by the company's Memorandum of Incorporation at a shareholders' meeting or by written resolution

owner-managed company: a company in which every shareholder (or every person who is a holder of or has a beneficial interest in any securities of the company) is also a director. Ownership and control is not split in owner-managed companies

P

paid-up capital: funds received by a company on the issue of its shares

parent company: an alternative term for a holding company

par value shares: shares of a company that have a nominal or par value attached to them. This value bears no realistic relationship to the market value of the shares

participating preference share: a preference share in a company, which entitles the holder thereof to share in the dividends of the company with ordinary shareholders, after the preference shareholders' preference dividend has first been paid

perpetual succession: legal continuity. This term is used to describe the status of a business structure such as a company or close corporation whose legal existence is unaffected by changes in its shareholders or members

personal liability company: a profit company that satisfies the criteria for a private company and additionally states in its Memorandum of Incorporation that it is a personal liability company. The directors, including past directors, of a personal liability company are jointly and severally liable, together with the company, for any debts and liabilities of the company that are or were contracted during their respective periods of office

piercing the corporate veil: the corporate personality of the company is disregarded and the protection afforded to shareholders and directors from liability for the debts and wrongful acts of the company is removed. Personal liability is attributed to a shareholder or director who abuses the principles of separate legal personality. See further lifting the corporate veil

pledge of shares: a way in which payment of debt can be secured. The debtor transfers (cedes) the shares to the creditor to cover the debt if the debtor defaults

pluralist approach: the approach that companies have a social responsibility to society and that its directors have a duty to balance the interests of shareholders and stakeholders, and to give independent value to the interests of stakeholders (other than shareholders) whose interests are not necessarily subordinate to those of shareholders

post-commencement finance (in the context of business rescue): new finance given to a financially distressed company that is under the business rescue process

pre-emptive right: a right of first purchase which gives the shareholder the right to subscribe for a proportionate amount of a new issue of shares before the shares may be acquired by others

preference shares: a class of shares that confers on its holders a preferential right to the payment of dividends before ordinary shareholders receive their dividends. The additional rights of preference shareholders, such as priority as to the return of their capital on a winding-up or the right to participate in additional dividends over and above their preferential dividend, depend on the company's Memorandum of Incorporation or the terms of issue of the shares

pre-existing company: a company formed in terms of the Companies Act 61 of 1973 that still existed when the Companies Act 71 of 2008 came into force

pre-incorporation contract: in terms of s 21 of the Companies Act 71 of 2008, a written agreement entered into before the incorporation of a company by a person who purports to act in the name of, or on behalf of, the proposed company, with the intention or understanding that the proposed company will be incorporated, and will thereafter be bound by the agreement

prescribed officer: a person who *(a)* exercises general executive control over and management of the whole, or a significant portion, of the business and activities of the company; or *(b)* regularly participates to a material degree in the exercise of general executive control over and management of the whole, or a significant portion, of the business and activities of the company

price stabilisation: a defence to market manipulation, which usually involves trading by issuers, underwriters or those participating in the offer of securities to prevent the offer from failing

private company: a profit company that is not a state-owned company and that, by its Memorandum of Incorporation, both prohibits the offer of any of its securities to the public and restricts the transferability of its securities

probation order: a director may be placed under a probation order by a court on various grounds set out in the Companies Act 71 of 2008. Such a director may not serve as a director except to the extent permitted by the order of probation. The probation order may be subject to any conditions the court considers appropriate

profit company: a company that is formed for the purpose of financial gain for its shareholders. The four types of profit companies are the public company, the private company, the personal liability company and the state-owned company

proprietary interest: an interest in the property of, for example, a company (the proprietary interest a person holds in a company is a 'share')

prospectus: the detailed information document which must be distributed to prospective shareholders when a company offers its shares to the public

proxy: a person appointed by a shareholder or a member to attend, participate in, speak and vote on his or her behalf at a shareholders' meeting or a members' meeting where that other person is unable to be present

public company: a profit company that is not a state-owned company, a private company, or a personal liability company. A public company may offer its securities to the public, and need not restrict the transferability of its securities

public interest score: a score calculated at the end of each financial year *(a)* to determine whether or not a company or close corporation requires an audit or independent review, the appropriate financial reporting standards for the financial statements, and the person eligible to report on the financial statements; *(b)* to determine whether or not a company is required to appoint a social and ethics committee; and *(c)* for the purposes of the provisions of the Companies Act 71 of 2008 dealing with business rescue and particularly the tariff of fees for business rescue practitioners

public offer: an offer of the securities of a company to the public, including a section of the public. It may require the issue of a prospectus or some other form of information disclosure in terms of the Companies Act 71 of 2008 or exchange requirements

puppet director: a person who has been placed on the board of directors with the intention that he or she should simply follow the instructions of his or her controller

Q

quorum: the minimum number of qualified persons whose presence at a meeting is necessary before any business may be validly transacted at the meeting

R

ratification (of an unauthorised act): validation of an unauthorised act or contract after it has been carried out

record date: the date that must be set by the board of directors of a company for the purposes of determining who is entitled to receive notice of a shareholders' meeting, to participate in and vote at a meeting, decide matters by written consent or electronic communication, to exercise pre-emptive rights, to receive distributions and to be allotted or exercise other rights

registered auditor: individual or firm registered as an auditor with the IRBA

registered office: the office of a company (or external company) that is registered in terms of s 23 of the Companies Act 71 of 2008 where, amongst other things, service of process of court may be effected and where the company's accounting records must be kept

registered shareholder: the person in whose name a company's shares are held and registered, for the beneficial interest of another person

registration certificate: the certificate (or where relevant, an amended certificate) issued by the Companies Commission as proof of the incorporation and registration of the company (when the term is used in relation to a company incorporated under the Companies Act 71 of 2008)

registration number: the unique number assigned by the Companies Commission to a company upon its registration

rehabilitation (of an insolvent): removal of the status of being an insolvent

reportable irregularity: for the purposes of an auditor, any unlawful act or omission committed by any person responsible for the management of the business structure, which *(a)* has caused or is likely to cause material financial loss to the structure or to any member, shareholder, or creditor; *(b)* is fraudulent or amounts to theft; or *(c)* represents a material breach of any fiduciary duty owed by such person;

for the purposes of an independent review, any act or omission committed by any person responsible for the management of a company, which *(a)* unlawfully has caused or is likely to cause material financial loss to the company or to any member, creditor or investor of the company; *(b)* is fraudulent or amounts to theft; or *(c)* caused the company to trade under insolvent circumstances

reserved name: a company name that is reserved for use by the company at a later time

resolution: a formal decision of the board of directors or the shareholders of a company, as the case may be

retroactive: applicable from a prior date to the present, eg legislation passed today which is applicable from an earlier date (retrospective)

ring-fenced (RF): the term describes a company whose Memorandum of Incorporation restricts or prohibits the amendment of any of its provisions. To alert third parties to these restrictions the company's name must be suffixed with the letters 'RF'

rules: rules made by a company relating to its governance in respect of matters that are not addressed in the Companies Act 71 of 2008 or in its Memorandum of Incorporation

S

SA GAAP: South African Standards of Generally Accepted Accounting Practice, as adopted by the Accounting Practices Board

share: incorporeal movable property that is a measure of a shareholder's financial and non-financial interest in a company. A share entitles the shareholder to certain interest in the company, its assets and dividends (or distributions)

scheme of arrangement: a fundamental transaction (usually used in the context of a reorganisation of a company) which results in a binding agreement between the company and the holders of its securities

securities: this term has a much wider meaning than 'shares', and includes any shares, debentures or other instruments, irrespective of their form or title, issued or authorised to be issued by a profit company

security: (1) an instrument which gives the holder a right related to the assets of a company, eg a share or a debenture; or (2) an external means to enable a person to enter into a contract to secure the contractual performance of the other party to the contract (eg a mortgage bond, a pledge, a suretyship, a guarantee)

securities register: a register of the issued securities which a profit company must maintain and which contains information about each class of securities that has been issued. A non-profit company is required to maintain a register of members

shadow director: a person in accordance with whose directions or instructions the directors of the company are accustomed to act

share capital: the money raised by a company through the issue of shares

share option: a right to acquire a share at a certain price within a certain period

Share Transactions Totally Electronic ('STRATE' or 'Strate'): the electronic settlement system used in the listed trading environment

shareholder: a person who holds at least one share issued by a company and whose name is entered as a shareholder in the securities register of the company

shareholder agreement: agreement entered into between the shareholders of a company concerning any matter relating to the company provided that it is consistent with the Companies Act 71 of 2008 and the company's Memorandum of Incorporation

shareholder approval: in the absence of anything to the contrary, approval of a majority (more than 50%) of shareholders at a properly convened meeting, or the unanimous consent of all shareholders

shareholders' meeting: a meeting of the shareholders of a company at which the shareholders are given an opportunity to debate and vote on matters affecting the company

sole proprietorship: a business run by a sole person in that person's own name, and not as a company, close corporation or business trust

special resolution: a resolution supported by at least 75 per cent of the voting rights exercised on the resolution, or such different percentage of voting rights as determined by the company's Memorandum of Incorporation at a shareholders' meeting or by written resolution

stakeholder-inclusive approach: the approach adopted by the King III Report that holds that the board of directors should strive to achieve the appropriate balance between its various stakeholders in the best interests of the company

state-owned company: an enterprise that is registered as a company in terms of the Companies Act 71 of 2008, and that is either listed as a public entity in Schedules 2 or 3 of the Public Finance Management Act 1 of 1999, or is owned by a municipality in terms of the Local Government: Municipal Systems Act 32 of 2000 and is otherwise similar to such an enterprise

statutory merger: see amalgamation or merger

subscribe for securities (eg shares): apply to a company for securities in the company

T

Takeovers Regulation Panel (TRP): a juristic person established by the Companies Act 71 of 2008 to regulate takeovers and offers

Takeover Regulations: regulations prescribed by the Minister, in consultation with the TRP, which apply to takeovers and offers

temporary director: a person appointed by the board of directors to serve as a director on a temporary basis until a vacancy has been filled by a director who is elected by the shareholders

testamentary trust: a trust created in a person's will which comes into existence after that person's death

Transitional Arrangements: the provisions of Schedule 5 to the Companies Act 71 of 2008 that deal with the arrangements for the transition of pre-existing companies as at the date on which the Act came into operation, ie 1 May 2011

treasury share: a share in a company that has been repurchased by the company. A treasury share is held by the company for re-issue at a later stage, instead of being cancelled on its repurchase by the company

triangular merger: a merger involving three companies whereby the target company, instead of merging with the acquirer, merges with the wholly-owned subsidiary of the acquirer. The effect is that the target company becomes the whollyowned subsidiary of the acquirer

triple bottom line: the approach adopted by the King III Report that companies should act with economic, social and environmental responsibility and that the board of directors is responsible not only for the company's financial bottom line, but also for the company's performance within the triple context in which it operates

trust *mortis causa*: see testamentary trust

Turquand rule, also called the 'indoor management rule': the rule that entitles an innocent third party entering into a contract with a company to assume that the company has complied with all its internal formalities and formal requirements

U

uberimmae fidei**:** utmost good faith

ultra vires**:** an act or transaction that falls outside the powers of the company. An act that is *ultra vires* is by definition beyond the legal capacity of a company

unalterable provision: a provision of the Act that does not expressly contemplate that its effect on any particular company may be altered, whether by a company's Memorandum of Incorporation or by its rules. This includes a negation, restriction, limitation, qualification, extension or alteration in any other manner, whether in substance or in effect

universal partnership: a universal partnership of profits which consists of all profits from whatever source that is made by the partners, or a universal partnership of property in which the partners undertake to contribute all the property owned by them

uncertificated securities: securities which are dematerialised and are therefore not evidenced by a share certificate but rather in the form of electronic records

unclassified shares: authorised but unissued shares, the terms of which have not yet been determined

underwriting undertaking: a undertaking whereby someone agrees to take up shares in a company which are not taken up by others

undistributed profits: profits that are retained by a company and not distributed to shareholders as a dividend or as capitalisation shares

V

vested rights: rights to which a person is unconditionally entitled (as opposed to conditional or contingent rights)

vicarious liability: liability of one person for the act of someone else

void: a complete nullity that cannot be validated or ratified

voluntary winding-up of a close corporation: winding-up or liquidation of a close corporation or a company at the instance of the entity itself

voting power: the voting rights that a particular shareholder (or securities holder) may exercise on any matter to be decided by the company, expressed as a percentage of the total voting rights on that matter

voting rights: the rights of a shareholder (or securities holder) to vote on any matter to be decided by the company

W

wasting asset: an asset that deteriorates or decreases in value over time, eg a mine, a machine

winding-up: the legal process in which the financial and administrative affairs of a company are 'wound-up' ie finalised equitably and in an orderly, regulated fashion

written resolution: consent by shareholders in writing to a resolution without holding a shareholders' meeting; also known as a 'round robin resolution'

Chapter 1
Introduction and Overview [*]

Farouk HI Cassim

1.1 Introduction

One of the first steps to be taken by persons who set out in business is to decide on the legal entity or type of business structure best suited to their business. This is an essential decision that will affect the risk to which they will subject their personal estate, the ease with which they will be able to raise capital that may be required for the growth and the expansion of the business that they decide on, the legal formalities that they must comply with, the legal continuity of their business and, of course, their tax liability.

Apart from the essential legal attributes of each type of business structure, some of the factors that must be considered when choosing the type of business structure are:

- Who bears the risk?
- How is the capital raised?
- What is the management structure?
- Who exercises control over the business activities of the structure?
- Does it have perpetual succession?
- Can it accommodate growth and expansion?
- The taxation liability of the particular type of business structure; and
- The legal and administrative formalities and the costs associated with these.

1.2 The forms of business structures

In South African law, there are five established forms of business organisations or business structures:

The sole trader or sole proprietorship

A single investor personally owns all the assets of the business and is alone personally liable for all the debts and liabilities of the business.

The partnership

A number of investors together as joint co-owners own the assets of the partnership and are ultimately jointly and severally liable for the debts of the partnership.

The company

This entails the formation and the registration of a company, known as the incorporation of the company. The company is a separate legal person and its shareholders as a general principle have limited liability.

The close corporation

This structure is very similar to a company but with some essential differences (discussed further below).

The business trust

In South African law, a trust is not a separate legal person, although in practice, it may enjoy the benefits of separate legal personality and limited liability. Under the Companies Act 71 of 2008 ('the Act'), however, a trust is regarded for the purposes of the Act as a juristic person with separate legal personality.

A less formally regulated type of business structure is the stokvel. A stokvel is an informal investment vehicle encompassing a mutual benefit or savings society. Many stokvels have a large membership and control very large sums of money, although there are, of course, smaller stokvels. There are many different types of stokvels ranging from simple grocery stokvels to savings clubs, investment groups and burial societies. Stokvels are similar to rotating credit and savings organisations.

The core essential features of each type of business structure are as follows:

1.2.1 The sole trader (or sole proprietorship)

Sole traders are alone the legal owners of their businesses. They are in control of the business. Sole traders provide their own capital and alone bear the legal responsibility for running the business. They alone share in the profits of the business and they alone are liable for the losses incurred by the business. Employees or assistants incur no personal liability for the debts and liabilities of the business unless they explicitly undertake personal liability. Sole traders are personally liable in full for the debts of the business.

Since sole traders do not enjoy limited liability. if the business runs into financial difficulties, all their personal assets must be utilised for the payment of the debts of the business. The personal assets of sole traders are not distinguished from their business assets. In general there are no registration requirements for sole traders.

This depends on the type of business that is to be conducted. The distinct disadvantages of this type of business structure, apart from personal liability for the debts of the business, are the limited potential for growth and expansion because of limited capital and, even more important, the lack of legal continuity or perpetual succession. This means that in the event of the death of the sole trader, the business comes to an end and may continue in law only if a new business is formed. Apart from limited potential for growth and the lack of perpetual succession, there is, in certain circumstances, a much heavier and more onerous tax liability, which is calculated on the basis of a sliding scale applicable to individuals which, in the financial year 2012-2013, could go up to a maximum tax rate of 40 per cent on income in excess of R617 000.00. In contrast, a company or a close corporation would pay income tax at a rate presently set at 28 per cent. However, sole traders do not need to have their financial statements audited.

1.2.2 The partnership

In the case of an ordinary partnership, a number of partners, which prior to the Act had to consist of a minimum of two and a maximum of 20 persons, form an association to conduct business with the object of making a profit. As a general rule, all the partners participate in the management of its business, and all partners must share in the net profits of the partnership. A partnership is formed by a partnership agreement, which may be in writing or in an oral agreement, or may even be implied from the conduct of the parties.

A partnership in South African law does not have a separate legal personality, with the result that the partners jointly are the legal owners of the assets of the partnership (in undivided shares). Immovable property owned by the partnership must be registered in the names of the partners. In a partnership the liabilities of the partnership are the liabilities of the individual partners. The partners are thus ultimately liable, jointly and severally, for the debts and liabilities of the partnership to the extent that the partnership is unable to pay. Net profits are shared in accordance with the proportion agreed upon by the partners or the value of their contributions, or failing such agreement or valuation, then equally. If the partners had made no agreement on the proportion in which the profits are to be shared, the profits are shared in accordance with the value of the contributions made by each party, and where this is not possible, for instance where one party contributed labour or skill, then the profits are shared equally. A partnership is a business structure that is aimed at the making and the sharing of profits. Accordingly, the intention of the partnership must be to conduct business in common with the object of making a profit. This does not mean that a profit must be made. It means that the making of profits must be an object of the partnership. There can be no valid partnership without a profit-making objective. It follows that a partnership cannot be formed for a charitable or social purpose, such as a social club. Like sole traders, partnerships are not required to register as such. [1] There is no register of partnerships or sole traders. With effect from 1 May 2011, when the Companies Act came into effect, the

maximum limit of 20 persons for a partnership was abandoned. While a partnership must still consist of at least two persons, it may now consist of a larger number of persons. However, for strong practical reasons it may be sensible to limit the number of partners. A partnership does not have perpetual succession. Any change in the membership of a partnership, whether due to the death, insolvency, resignation or retirement of a partner, or the admission of a new partner, results in law in the automatic dissolution of the partnership and the formation of a new partnership. The entry or the exit of a partner thus disrupts the legal continuity of the partnership. This is a major disadvantage, particularly for a large partnership. A partnership as such is not subject to income tax. Instead, the profits of the partnership that have accrued to the individual partners are taxed in their hands. For the purposes of value-added tax (''VAT''), however, a partnership is treated as a separate entity, ie for VAT purposes a partnership is deemed to carry on an enterprise as a 'person' separate from the membership of the partnership.

Like sole traders, partnerships do not need to have their financial statements audited.

1.2.3 The company

It is surprising that there still is no standard or generally acceptable definition of a company. A company is generally understood to refer to a structure that is endorsed by law with the capacity to acquire legal rights and be subject to legal duties.

The distinctive features of a company, in sharp contrast to a sole trader or partnership, is that a company (and also a close corporation, discussed below) has a separate legal personality distinct from the shareholders or members who compose it.

As a separate legal person, the company itself, and not its shareholders, is the legal owner of the business that it carries on and of any property or asset purchased by it. The courts have repeatedly ruled that property owned by the company belongs exclusively to the company itself and not to its shareholders, not even to its sole shareholder in the case of a one-man company. [2] Property owned by a company is registered in the name of the company and not in the names of the shareholders of the company. Likewise, the profits made by the company belong to the company and not to its shareholders. As a separate legal person, a company may sue or be sued in its own name. (For a full discussion see Chapter 4: The legal concept of a company.)

From this, it follows that the debts and liabilities of the company are, as a general principle, the debts and liabilities of the company itself and not those of its shareholders. This gives rise to the concept of the limited liability of the shareholders of the company. Limited liability connotes that the shareholders or members of a company or a close corporation are not personally liable for the debts and liabilities of the company. In its most basic form, limited liability means simply that, as a general principle, if a company cannot pay its creditors, the creditors cannot claim payment from the shareholders or members of the company or of the close corporation.

Limited liability is clearly an important legal privilege of the shareholders of the company. It was developed in English law during the nineteenth century and is thus a relatively recent development. There are however a number of circumstances in which a court or statute may disregard the separate legal personality of the company and hold its shareholders personally liable for the debts and the liabilities of the company.

The two legal concepts discussed above, namely separate legal personality and limited liability, are separate and distinct. They must not be confused.

Apart from separate legal personality and limited liability, companies have perpetual succession or legal continuity. This means that the legal existence of the company is unaffected by changes in the shareholders. The company continues to exist despite changes in the individual shareholders that comprise it. A company may consequently exist indefinitely. It is not unknown for a company formed in the eighteenth century or earlier still to be in existence. A company ceases to exist only when it is formally wound up. The perpetual succession of a company also enables the shareholders of a company to sell their shares in the company without affecting the legal existence of the company.

As a result of the transferability of shares and the ability to offer its shares to the public, a public company is able to raise capital for growth and expansion simply by the device of offering more shares to the public. In a private company restrictions must be imposed on the transferability of its shares. The essential difference between a public company and a private company is that a public company is usually formed to raise large sums of money from the public in return for shares issued to them. A private company would usually be formed where the shareholders contribute their own funds to the capital of the company in return for shares that cannot be freely transferable.

There are further advantages that companies are able to offer. Large companies offer the advantage of a structured management. In large public companies ownership and control may be split, so that management of the affairs and the business of the company is left in the hands of a small group of persons, known as the board of directors. The company is managed not by the shareholders but by the board of directors. In large companies there are too many shareholders for them to be managers as well. The shareholders of large companies tend also to be too widely dispersed throughout the country for them to play an active role in the management of the company's affairs. The facility of a structured management offers to shareholders the advantage of being part of a company and of participating in its profits and growth without having to be burdened with the daily management of the company.

Another advantage of a company, as well as of a close corporation, relates to tax. Companies and close corporations are currently subject to tax at a rate of 28 per cent, but sole traders or partners could pay tax at a maximum marginal rate of 40 per cent on income exceeding R617 000 per annum.

It is not surprising that companies and, in particular, close corporations are the most popular forms of business structures. As a result of the Act, more flexibility has been accorded to companies. For instance, it is now possible to form a public company with one shareholder. In contrast, a partnership requires a minimum of two persons. Moreover, unlike a partnership, companies may have non-profit objects. The Act provides for a diversity of companies that may be formed to suit differing needs.

A sole proprietor may, by forming a private company, enjoy all the benefits of this type of legal structure and still remain fully in control of the company or the close corporation, as the case may be.

1.2.4 The disadvantages of a company

There are, however, a number of disadvantages of conducting business through the legal form of a company. These disadvantages may perhaps be seen as the price that must be paid for the valuable advantages of separate legal personality, limited liability and perpetual succession. Unlike a sole proprietorship or a partnership, the formation of a company (or a close corporation) requires compliance with a number of legal formalities. The company must be registered with the Companies and Intellectual Property Commission (the 'Companies Commission'). The formation of a company requires a constitution, known as the Memorandum of Incorporation, which must be lodged or filed with the Companies Commission. The procedure for the formation of a company and the types of company that may be formed are set out in the Act (see Chapter 5: Types of companies, and Chapter 6: Formation of companies).

After its formation, the company is subject to regulation throughout its existence. Apart from the regulatory burden, there are many other administrative burdens, and transparency and accountability requirements, that companies must comply with, the financial cost of which is borne by the company.

Public companies and certain significant private companies and even some close corporations must have their annual financial statements audited.

These advantages and disadvantages must be carefully balanced before choosing a company as a legal form for a business.

1.2.5 The close corporation

The close corporation was introduced by the Close Corporations Act 69 of 1984 in order to make it easier for a sole proprietor or a small partnership, by forming a close corporation, to obtain the benefits of separate legal personality, limited liability and perpetual succession.

The close corporation closes the gap between a sole trader or a partnership and a company. The provisions of the previous Companies Act 61 of 1973 and arguably also the 2008 Companies Act are much too complex and burdensome for the small business. A company is perhaps inappropriate to the needs of a small business even though the 2008 Companies Act does attempt to cater for the needs of the small business.

The close corporation is designed mainly for the small, unsophisticated business. This is commendable, as small businesses form the backbone of the economy. The close corporation is in a way more sophisticated than a sole proprietorship or a partnership but much less complicated than a company. This is partly because ownership and control are not split in a close corporation. All the members of a close corporation are, in the absence of any express contrary agreement entitled to participate in the management of a close corporation.

In order to keep this type of legal structure small, simple, flexible and less expensive than a company there are no shares in a close corporation and no board of directors or directors for that matter. Membership of a close corporation is limited to a maximum of ten natural persons. While there is a restriction on the number of members of a close corporation, there is no restriction on the size of the business run by the close corporation or on its turnover or number of employees. Its annual financial statements need not be audited unless it meets certain criteria dependent on the average number of its employees during the financial year, the amount of liability to third parties and the annual turnover of its business. As in the case of a private company, there is no need for this type of structure to have an annual general meeting of its members.

Like a company, a close corporation must be registered with the Companies Commission (formerly the Registrar of Close Corporations). The close corporation must have a constitution, referred to as the founding statement, and a voluntary or optional association agreement to regulate the internal relations of the members of the close corporation. The members of a close corporation have much flexibility and freedom to decide on how the internal affairs of the structure are to be conducted.

The founding statement of a close corporation is also designed to be a straightforward and simple document.

The success of this type of legal structure is shown by the fact that there are many more registered close corporations than public or private companies. The Companies Act has however made a number of amendments to the Close Corporations Act in order to harmonise the law relating to close corporations with the new law on companies and also to improve accountability and transparency.

The Companies Act preserves the close corporation for an indefinite period as a legal form for business until it is deregistered or dissolved. But from the effective date of the Act, namely 1 May 2011, no new close corporations may be formed, nor may any new conversions from companies to close corporations take place, although close corporations may convert to companies with the written consent of the members of the close corporation holding at least 75 per cent of the members' interests in the close corporation. For now, companies and close corporations will co-exist.

1.2.6 Some important differences between private companies and close corporations

(i) A private company has directors and shareholders; close corporations have only members but not directors.

(ii) There are no shares in a close corporation; members instead hold an interest in a close corporation.

(iii) There is no maximum limit to the number of shareholders of a private company; a close corporation is limited to a maximum of ten natural persons.

(iv) Like a partnership, but unlike a company, every member of a close corporation is an agent of the close corporation.

(v) Companies and close corporations may be shareholders in a private company, but a company may not be a member of a close corporation.

(vi) As a result of changes made by the Act, neither a private company nor a close

corporation needs to have its annual financial statements audited unless they satisfy certain criteria relating to the number of their shareholders or members, turnover, third party liability and number of employees. The audit of annual financial statements depends, in short, on the public interest score of the structure. An audit must be done if the public interest score of the structure exceeds 350 points. If its financial statements for the year were internally compiled, a public interest score of 100 points would suffice to necessitate an audit.

1.2.7 The business trust

A trust may be defined as a legal relationship created in a written trust deed or written trust instrument in terms of which the person who wishes to form a trust, known as the founder or settlor or donor, hands over the control and ownership of assets to another person, known as the trustee or administrator, to be administered for the benefit of persons who are designated in the trust deed or trust instrument as beneficiaries. From this definition, it follows that a trust is a device designed for the protection of the beneficiaries of the trust.

There are three parties to a trust, who need not necessarily be three different persons. The formation of a trust requires a founder or settlor, who must transfer assets to the trustees, who must administer or manage the trust assets for the beneficiaries of the trust. In the case of an ordinary trust, the trustee manages the trust assets with the object of protecting and preserving them. A trust is generally used for two purposes:

(i) the preservation of wealth;
(ii) the protection of the trust assets from the claims of creditors of the beneficiaries.

The founder or settlor determines unilaterally which of his or her assets are to be transferred to the trustee, who the beneficiaries are to be and what each beneficiary is to receive. [3]

A trust that has been set up by means of a will or testamentary document is called a testamentary trust or a *trust mortis causa*. If, on the other hand, it has been set up by means of a contract entered into during the lifetime of the founder, it is called an *inter vivos* trust. From this it should also be clear that there must be a written document. A business trust, in contrast with an ordinary trust, is a trust that gives authority to the trustees to use the trust assets for the purposes of carrying on some trade or business for profit instead of merely protecting or preserving the trust assets.

It is thus the founder of the trust who determines what assets are to be handed over to the trust and what the object of the trust is to be. The trustee must administer the trust in accordance with the object of the trust. The trustee must of course be given the right of control over the trust assets. It is important that the trustee is also given adequate powers to manage and to administer the trust.

The South African law of trusts is derived mainly from English law. The courts are, however, moulding and evolving the legal principles relating to trusts so that they are in harmony with the principles of South African law. [4] Unlike in English law, in South African law a trust does not have a separate legal personality, except where a statute specifically treats a trust as a separate legal person, which it does, for instance, for purposes of insolvency law or for tax purposes. Under the Act a juristic person is defined to include a trust for purposes of the Act. Since a trust does not have a separate legal personality, it does not have its own rights and liabilities in the way that a company or a close corporation does. The result is that in law it is the trustee who is the legal owner of the trust assets.

However, in view of the common-law principle now embodied in the Trust Property Control Act 57 of 1988, that trust assets must be kept separate from the personal assets of the trustee and that trust assets do not form part of the personal estate of the trustee, [5] a trustee may not use trust assets for his or her own personal benefit. In the event of the insolvency of the trustee, no part of the assets of the trust may be used to pay the claims of the trustee's own creditors.

In the same way, the creditors of the trust may not claim payment from the private estate of the trustee. [6] If a trustee should die during his or her tenure as a trustee, his or her personal heirs are not entitled to inherit the assets of the trust. In this way, the disadvantage of a trust not having a separate legal personality is overcome in practice.

The advantage of limited liability may also be applied to a trust, since the liability of the trust for its debts and liabilities is limited to the amount and the extent of the trust assets. The lack of perpetual succession may be overcome by appropriate provisions in the trust instrument that provide for the continuity of the trust despite a change in or the death of a trustee or beneficiary. A business trust may thus continue irrespective of the identity of the trustees or the beneficiaries. The advantages of conducting business through a trust are that the trust is not as heavily regulated as a company or a close corporation. Unlike membership of a close corporation, the number of beneficiaries of a trust is not limited to a maximum of ten natural persons. Furthermore, there is much flexibility in setting up and administering a business trust. For instance, it need not have its annual financial statements audited unless explicitly required to do so by the terms of the trust instrument or ordered to do so by the Master of the High Court.

It may also be possible for a business trust to be structured in such a way that it obtains tax advantages. The modern trend however is to remove from the trust the tax advantages that it has enjoyed in the past. A business trust must, of course, like any other business structure formed to conduct business, register for income tax purposes and for VAT, should it meet the prescribed criteria for registration. A trust pays a higher rate of income tax and capital gains tax than the other legal forms of businesses discussed in this chapter. The tax advantages of a trust and more specifically the business trust have rapidly eroded.

Questions

1. Discuss the advantages and disadvantages of the five established legal forms of business structures.
2. Explain, with examples, the legal concepts of separate legal personality, limited liability and perpetual succession.

[*] I acknowledge with thanks the assistance for research from funding received from the South African Research Foundation.

[1] Except perhaps to the extent that a business name may be registered in terms of ss 79 and 80 of the Consumer Protection Act 68 of 2008.

[2] *Dadoo Ltd v Krugersdorp Municipal Council* 1920 AD 530; *S v De Jager* 1965 (2) SA 616 (A).

[3] *Crookes NO v Watson and Others* 1956 (1) SA 277 (A).

[4] *Braun v Blann and Botha NNO and Another* 1984 (2) SA 850 (A).

[5] Unless the trustee is also a beneficiary of the trust, in which event his or her share of the trust assets must naturally form part of his or her personal estate.

[6] *Magnum Financial Holdings (Pty) Ltd (In liquidation) v Summerly* 1984 (1) SA 160 (W).

Chapter 2
Partnerships

Farouk HI Cassim and Maleka Femida Cassim

Questions

2.1 The definition of a partnership

The definition of a partnership is important in order to determine whether a particular association of individuals is in law a partnership.

A partnership is a relationship resulting from an agreement or a contract. In general terms, a partnership is a legal relationship that is formed when two or more persons carry on business together with the object of making a profit. Before turning to the definition of a partnership, it should be noted that the word 'partnership' is used in three different senses to refer to-

(i) the specific type of contract or agreement between the parties to it;
(ii) the particular legal relationship that exists between certain persons who form a business association; and
(iii) the type of business structure that the parties have established. [1]

According to *Pezzutto v Dreyer and Others* [2] a partnership amounts to the carrying on of a business, to which each of the partners contributes, in common for the joint benefit of the parties with a view to making a profit. This definition appears to have been based on s 1(1) of the UK Partnership Act 1890, which defines a partnership as 'the relation which subsists between persons carrying on business in common with a view to profit'.

It seems from the dictum in *Pezzutto v Dreyer* that the primary meaning of the word 'partnership' refers to a contract of a particular kind, but that it is also used to denote the relationship between the parties arising from the contract. [3] In considering the definition of a partnership, it is important to bear in mind that a partnership is not a legal person distinct from the partners that compose it. The rights and liabilities of a partnership are the rights and liabilities of the partners themselves. [4]

The above definition of a partnership also implies that the mere fact that property or assets are owned in common in undivided shares by the parties to an agreement and that profits are made by them does not necessarily mean that the contract is one of partnership. For a partnership to be established, the parties must have been carrying on a business in common with a view to profit. This vital factor distinguishes a partnership from co-ownership. If the agreement entered into by the parties is meant simply to regulate their rights and duties as co-owners of a property or a piece of land, without any intention to carry on business in common, the agreement is not an agreement of partnership.

While partners must of necessity be co-owners of partnership assets, co-owners are not necessarily partners. In the case of co-ownership, each co-owner simply holds a share in the undivided property. Accordingly, co-ownership cannot be equated with partnership. In *Oblowitz v Oblowitz* [5] the court stressed that co-ownership, unlike a partnership, does not necessarily involve community of profit and loss; and, more importantly, co-ownership need not necessarily exist for the purpose of making a gain or a profit, while this element is fundamental to a partnership. Despite these distinguishing criteria, the distinction between a partnership and co-ownership is not always an easy one to make.

From this, it is clear that not all such commercial agreements result in a partnership. To take another example, a person whose only contribution to the partnership is in the form of a loan of money which is repayable with interest cannot be a partner, even if the parties to this agreement call it a partnership. The question whether or not it is a partnership agreement depends upon what the true relationship is and not on the label that the parties attached to their relationship. [6] Calling a joint venture a partnership will have no effect on the true nature of the relationship between the parties if, in reality, it is not a partnership. It is the essentialia that would determine whether the contract is a partnership contract.

2.2 The essential elements of a partnership

Since a partnership is based on an agreement between two or more parties to enter into a legally binding relationship, it is contractual in its nature. [7] The requirements of a valid contract must consequently be satisfied, such as entering into a lawful agreement, having legal capacity to contract, reaching consensus or agreement on the terms of the contract, possibility of performance of the contract, and compliance with any relevant formalities. While there must be an agreement, [8] the agreement need not be put into writing - it may be an oral contract or even be implied from the conduct of the parties. [9]

No formalities are prescribed for the formation of a partnership, although it is advisable for the parties to put their agreement into writing in order to avoid any dispute or disagreement over the terms of their relationship.

The essentialia of a partnership were expounded as follows in *Joubert v Tarry and Company*: [10]

> Now, what constitutes a partnership between persons is not an easy matter to determine ... But I think we are safe if we adopt the essentials which have been laid down in Pothier on *Partnerships* ... These essentials are fourfold. First, that each of the partners brings something into the partnership, or binds himself to bring something into it, whether it be money, or his labour or skill. The second essential is that the business should be carried on for the joint benefit of both parties. The third is that the object should be to make a profit. Finally, the contract between the parties should be a legitimate contract ... Where all these four essentials are present, in the absence of something showing that the contract between the parties is not an agreement of partnership, the Court must come to the conclusion that it is a partnership.

What this in effect means is that the presence in an agreement of the four essentials will only *prima facie* establish the existence of a partnership. The presence of the essentialia is not necessarily conclusive. It depends also on the absence of a contrary intention of the parties. [11] In *Joubert v Tarry*, the court cautioned that even when the four essentials of a partnership are present, there may still be a possibility of the contract between the parties not being a partnership.

The essentials of a partnership as outlined in *Joubert v Tarry* have been accepted in a large number of cases. [12]

In *Pezzutto v Dreyer and Others* [13] the court, following *Bester v Van Niekerk*, [14] stated that the fourth essential requirement of a partnership, namely that the contract between the parties should be a legitimate contract, is a general requirement that applies to all contracts. It is consequently not an essential element of a partnership contract in particular. It should therefore not be included in the category of the essentialia of a partnership. But in *Purdon v Muller* [15] the court was of the view that it is too late to call the essentialia into question.

Each essential element is discussed in turn:

2.2.1 Contribution by each party

Each partner must contribute or undertake to contribute something to the partnership. The contribution may consist of money or money's worth, movable or immovable property, corporeal or incorporeal property (such as shares or intellectual property rights), or the right to the mere use, without ownership, of property or an asset. Labour, skill or expertise would also constitute a contribution. According to *Pezzutto v Dreyer and Others*, [16] the contributions of the parties need not be the same in character, quantity or value. While the contribution need not be capable of exact pecuniary assessment, as, for instance, when one party contributes labour or skill, it must nevertheless be something of appreciable or of commercial value.

It has been held that a guarantee given by a surety for the repayment of an overdraft is a sufficient contribution. [17]

The contribution must be exposed to the risks of the partnership business. [18] This entails that the contribution must be placed at the disposal of the partnership and be used in the partnership business. For instance, a loan of money by a partner together with payment of interest and/or a share of profits is not a contribution, since the money loaned to the partnership must be repaid to the lender, irrespective of whether the partnership business is successful or not. This type of arrangement is a contract of loan not a contract of partnership. A partner who has contributed money is not a creditor of the partnership. In contradistinction, the person lending the money to the partnership is a creditor - not a partner. It is of course possible for a partner's contribution validly to consist of only the interest on a capital sum and not the capital itself.

2.2.2 Carrying on a business in common for the joint benefit of the parties

The partnership business must be carried on in common for the joint benefit of all the parties.

Partnerships must be formed to pursue business activities. They cannot be formed for social clubs or societies or for charitable purposes. A 'business' is however very widely defined to mean anything that occupies the time, attention and the labour of a person for the purpose of making a profit. [19]

The business need not be a continuous one. A single undertaking or single business transaction may be of such a nature that it can correctly be described as a business. [20] Thus, a joint venture in respect of a single undertaking can amount to a partnership, provided that the esssentialia are present. [21] There must however be some sort of business. A mere exploratory visit overseas or making preliminary investigations prior to setting up the business or making feasibility studies and surveys would not constitute the carrying on of a business.

The partnership business must be carried on in common or in association with one another, for the joint benefit of all the partners. [22]

Joint participation in a common business is what is required for a partnership. The benefits obtained from the partnership must be for the joint benefit of all the partners. In other words, each partner must have the right to share in the profits of the business, even if their shares of profits are not equal. No partnership is established if the parties are free to obtain individual benefits from the business. Likewise, no partnership is created if the parties agree that the profits of a business shall accrue to one party only. This type of partnership is known as a leonine partnership and is not recognised in South African law as a valid partnership.

Similarly, no partnership is established if one of the partners to it is free to conduct the partnership business independently of or separately from the other parties. The question is whether the parties are carrying on separate businesses or a joint business. There must be mutuality of the rights and duties of the partners. [23] The legal position is quite different where one of the partners, or group of partners, is conducting business as an agent who manages the partnership on behalf of the others. In this event, there could be a partnership. [24] The other partners could be 'sleeping' or dormant partners [25] who nevertheless still undertake the risks of a partnership. It is not an essential requirement that all the partners must take an active role in the affairs of the partnership.

Apart from the requirement of a partnership business in common for the joint benefit of all the partners, it seems that the partnership business must involve each

partner in a personal and not a representative capacity. In *Hughes v Ridley and Others* [26] the court was faced with a partnership agreement that had contemplated that the partnership business was to be conducted through the medium of a limited company. The immediate conceptual difficulty that arises here is that a company is a separate legal person. Consequently, if two persons agree that they wish to form a company, that each is to become a shareholder and to make a specific contribution to the company and that the company is to carry on the business, the agreement cannot be consistent with a partnership. The two individuals would not be carrying on the business jointly and for profit because it is the company - a separate legal person - that would be doing so.

2.2.3 The object of making a profit

The object of the partnership must be the acquisition of financial gain. This must be a substantial and not merely incidental object of the partnership. Not only must the object be to make profits - such profits must also be shared with each partner. This division of profits is essential, although profits need not be shared equally. As stated above (in 2.2.2), no partnership would be established if the parties were to agree that the profits made in the business would accrue only to one party. This would make it a leonine partnership which is not recognised as a valid partnership. A leonine partnership is one in which one partner bears all the loss while another partner receives all the profits.

The profit-making objective is essential. It must not be understood to mean that a profit must in fact be made. This requirement means that it must be the intention of the parties that profits (or financial gain) be made. There must be a profit motive or an expectation of profits or, to put it differently, profits must have been in the contemplation of the parties.

The profit-making objective has the effect of excluding social clubs, sports clubs or charitable organisations from forming a partnership. By 'profits' is meant net profits and not gross profits. By sharing in net profits, the partners are necessarily sharing in losses and expenses incurred in the partnership business. In *Blumberg & Sulski v Brown & Freitas* [27] the court held that the sharing of gross profits does not create a partnership. However, it is not essential that partners share in net losses (ie where the business makes an absolute loss). In this case, X had no say in the management of a farm; he was not responsible for any losses, and had no share in any loss. He had a share of gross profits - not net profits. Since there was no sharing of gross losses, no partnership could be established in this case. In brief, there was no community of profit and loss.

2.2.4 A legitimate contract (or lawfulness)

There must be a valid agreement. As previously discussed in 2.2, this is a general requirement of all contracts, and not only for a partnership agreement.

The partnership agreement may be put into writing or it may be an oral one or even be implied from the conduct of the parties. Thus, in *Fink v Fink*, [28] H and W, who were married out of community of profit, jointly commenced a dairy business on a small scale, on property owned by H. H and W contributed money, property, labour, services and skill, but W was in daily management of the business while H pursued his full-time occupation as an electrician. Profits from the dairy business were reinvested in the expansion of the business. The court found that based on the conduct of H and W there was an implied partnership agreement between H and W. W's assistance in the business was not merely a matter of domestic assistance from a wife. Her services had gone beyond those expected of a wife.

As a result of the Companies Act 71 of 2008 ('the Act'), with effect from 1 May 2011, the maximum limit of 20 persons for a partnership has fallen away. There is now no longer any maximum limit to the number of partners that a partnership may have. It is nevertheless advisable to place a sensible limit to the number of partners in order to prevent the mischief arising from large trading firms carrying on business with a large fluctuating body of members. Persons contracting with such firms would not know whom to sue in the event of litigation. [29] Moreover, the lack of perpetual succession becomes more problematic in the case of a large partnership.

2.2.5 The subjective intention to form a partnership

In *Purdon v Muller* [30] the court pointed out that the presence in an agreement of the four essential elements of a partnership will *prima facie* establish the existence of a partnership. [31] Such presence is not however conclusive but must yield to a contrary intention as revealed in the agreement itself. In the ultimate analysis, the question is always one of construction. This dictum was approved in *Pezzutto v Dreyer and Others*, [32] where the court similarly stated that where the four requirements of a partnership are found to be present, a court will find a partnership established unless such a conclusion is negatived by a contrary intention disclosed on a correct construction of the agreement between the parties. The essence of these dicta is that the essential elements of a partnership are a necessary but not a sufficient condition of a partnership.

If the parties have the subjective intention to form a partnership, which of course must be the real and genuine intention of the parties, and, in addition, all the essential elements of a partnership are satisfied, the court will find the agreement to be a partnership agreement. If however the essential requirements are not satisfied, or if they are, but the conduct of the parties and the surrounding circumstances under which the agreement was entered into reveal that the parties did not have the intention to enter into a partnership agreement, no partnership agreement will have been established.

In *Pezzutto v Dreyer* the court stated that in determining whether an agreement creates a partnership, the court will have regard, inter alia, to the substance of the agreement, the circumstances under which it was made and the subsequent conduct of the parties. The fact that the parties regard themselves as partners is an important though not decisive consideration. The essential elements must also be present.

It is clearly not an easy or a mechanical task to determine whether a partnership exists.

2.3 The juristic nature of a partnership

2.3.1 General

The failure of South African law to recognise the separate legal personality of a partnership is perhaps its most remarkable defect. The popularity of this type of business structure is nevertheless due to the ease with which it may be formed and the absence of burdensome statutory regulation.

The legal or juristic nature of a partnership was summed up as follows in *Ex Parte Buttner Brothers*: [33] 'The rights and liabilities of a partnership are the rights and liabilities of the partners, and are enforceable by and against them individually.'

According to this statement, in South African law, a partnership is not a separate legal entity distinct from the partners that compose it.

As we shall see, statute has to some extent made inroads into this general principle, particularly in the field of insolvency law, tax law and procedural law. The effect of these exceptions, in the words of Hahlo and Kahn, [34] is that they give rise to a 'juristic ghost'.

Apart from these few isolated statutory instances, a partnership is not a separate legal entity - it is a mere association of individuals. [35] The debts of the partnership are legally the debts of the partners, and as far as third parties are concerned, the assets of the partners are indistinguishable from the assets of the partnership. [36]

Since a partnership is not a legal entity, the partners are the legal owners or co-owners in undivided shares of partnership property or partnership assets.

Partners act in a dual capacity, both as principals in their capacity as partners and as agents on behalf of their co-partners, provided that they act within the limits of their authority. [37] A partner virtually embraces the character of both principal and agent. [38] While agency law is an important feature of partnership law, agency is not the foundation of partnership. Agency is deduced from partnership rather than partnership from agency. [39] (See further 2.6 on representation).

Unlike a company or close corporation, a partnership does not enjoy perpetual succession. Any change in the partners of a partnership, whether due to the death, resignation, retirement or insolvency of a partner, would automatically result in the dissolution of a partnership.

Similarly, a partnership cannot be convicted of a criminal offence since it cannot have criminal intent. The criminal liability of the partners arises from the Criminal

Procedure Act 51 of 1977, or alternatively, a partner would incur criminal liability in his or her own individual capacity (or in certain circumstances for crimes committed by a co-partner where the law prescribes vicarious liability).

2.3.2 Exceptions to the juristic nature of a partnership

There are some limited and exceptional circumstances in which a partnership is treated not as an association of individuals but as if it were a separate legal entity. These exceptional circumstances are derived largely from statute. They are as follows:

2.3.2.1 Litigation

The rules of court, ie the High Court and Magistrates' Courts Rules, [40] permit partnerships to sue or be sued in their own names during the subsistence of the partnership. For instance, High Court Rule 14(2) states simply that a partnership or a firm or an association may sue or be sued in its own name. High Court Rule 14(5)*(a)* provides that a plaintiff suing a partnership (and the same applies in favour of a defendant if the partnership is the plaintiff) may include in any civil summons a notice calling for particulars of the full name and residential address of each partner at the date of accrual of the cause of action. There is consequently no need to state the names of the partners in the summons. A partner served with this notice is deemed to be a party to the proceedings. Service of summons on a partnership is effected by service at the place of business of the partnership, or if there is no such place, on a partner. Judgment against a partnership must be given against the partnership and not against a partner individually. [41]

Execution must first be levied against partnership assets before being levied against the assets of an individual partner. If a person has obtained judgment against a partnership but has not called on the partnership to forward the names of the partners, he or she may only execute judgment against the partnership estate, and not against the private estates of the partners.

From this brief discussion, it is clear that for the purposes of civil proceedings by or against a partnership, the partnership is treated as if it were a legal person.

2.3.2.2 Insolvency

The Insolvency Act 24 of 1936 alters the common law by treating a partnership for sequestration purposes as a separate entity quite apart from the estates of the individual partners. The Insolvency Act departs from the common-law principle that the debts of the partnership are ultimately the personal debts of the partners. Section 13 of the Insolvency Act makes provision for the sequestration of the partnership estate as distinct from the private estates of the individual partners. [42]

Section 2 of the Insolvency Act defines a 'debtor' as including a partnership or the estate of the partnership, with the result that the partnership estate may be sequestrated separately from the private estates of the individual partners. When the

partnership estate is sequestrated, the private estates of the individual partners must also be sequestrated. This is done simultaneously but separately or independently of the partnership estate. [43] This is subject to the proviso that a partner may avoid the sequestration of his or her private estate if he or she gives an undertaking to pay the debts of the partnership within a period determined by the court and gives satisfactory security for such payment.

In order to ensure the fair and equitable treatment of the partnership estate and the private estate of the partners, the Insolvency Act requires that creditors of the partnership estate must prove their claims against the partnership estate only. The creditors of an individual partner are likewise precluded from proving their claims against the estate of the partnership. They must prove their claims against the private estates of the partners. Any residue or surplus in the private estate of individual partners after payment of the claims against the individual partners may, if necessary, be used to pay the claims of creditors of the partnership.

The Insolvency Act provides furthermore that the proportional share of a partner in the balance of the partnership estate, after partnership creditors have been paid, may be used to settle the claims of creditors of the individual partner.

The Insolvency Act requires that separate liquidation accounts be drawn up for the partnership estate and the individual partners.

However, a partnership estate may not be rehabilitated.

2.3.2.3 Taxation

For income tax purposes, a partnership is not a taxpayer in terms of the Income Tax Act 58 of 1962. The Act does not recognise a partnership as a separate legal person or a taxable entity. Individual partners are taxed on the income that accrues to them proportionately. Each partner individually has a taxable income. [44]

However, for the purposes of payment of value-added tax, a partnership is deemed to carry on an enterprise separately from the members of the partnership. [45] A partnership must consequently register as a vendor for the purposes of the Value-Added Tax Act provided the prescribed thresholds for registrations are satisfied.

2.3.2.4 Common-law exceptions

The common law sometimes recognises exceptions to the general principle that partnership is not a separate legal person. For instance, a principle that implicitly regards a partnership as a separate entity is the rule that a creditor of the partnership must *during the subsistence of the partnership* claim payment of a debt owed to him or her by the partnership by bringing an action against all the partners jointly, and is not entitled to claim payment of the debt from an individual partner. In other words, while the partnership is in existence, the partners are joint co-debtors and co-creditors in relation to partnership contracts. However, in *Standard Bank of South Africa v Lombard* [46] the court decided that partners could bind themselves to a partnership creditor in such a way that each partner is individually liable *in solidum* to the creditor for the whole of the partnership debts, even during the subsistence of the partnership. The court swept aside the contention that since a partnership was not a legal person separate from the individual partners, the partners could not validly bind themselves as sureties for the partnership because they would in effect be standing as sureties for themselves.

It is noteworthy that *after dissolution of the partnership*, the partners each become jointly and severally liable for the debts of the partnership, that is, a creditor may sue any individual partner for the full amount of the partnership debts.

2.4 The types of partnerships

In South African law, three types of partnerships may be distinguished:

(i) the ordinary partnership (which is covered by the general discussion in this chapter);
(ii) the universal partnership; and
(iii) the extraordinary partnership.

2.4.1 The universal partnership

There are two types of universal partnerships:

(i) a universal (or general) partnership of all property; and
(ii) a universal partnership of all profits.

2.4.1.1 The universal partnership of all property

In a universal partnership of all property, the parties agree to contribute all their property and possessions which they own at the commencement of the partnership, as well as property and possessions they may acquire in future from whatever source, irrespective of whether such property is acquired from commercial undertakings or otherwise. [47]

This type of partnership is used mainly in the case of putative marriages, where the parties mistakenly believe that they are lawfully married. The essentialia of a partnership must also be satisfied. In *Annabhay v Ramlall* [48] the court was of the view that this type of partnership must be entered into expressly and that it could not be entered into tacitly or impliedly.

This view was however rejected by the Supreme Court of Appeal in *Butters v Mncora*, [49] where the court had no difficulty accepting as valid a tacit universal partnership. (This case is further discussed below.) A universal partnership may, in the light of this decision, be entered into expressly, impliedly or tacitly by conduct.

Two recent decisions of the Supreme Court of Appeal have also removed any lingering doubt over the validity of a universal partnership in modern South African law. This type of partnership has neither fallen into disuse nor is it an unimportant type of partnership.

In *Ponelat v Schrepler* [50] P, the plaintiff, and S, the defendant, had lived and worked together sharing a joint household in a cohabitative relationship for about 16 years. P had contributed approximately R10 000 to the joint household from the sale of her furniture and personal effects. In addition, she had contributed to the joint household her earnings as a beautician, although she had stopped working soon after she and S had started living together. She had thereafter taken over responsibility for running the joint household, a task she had performed for about 16 years. A few years ago, P and S had become engaged to be married. S ran an electrical business to which P had contributed administrative assistance. By the time the couple had moved to a farm at the coast, P was actively involved in its management and in making improvements to the farm. Their relationship came to an end in 2005, with P moving out of the common household. There was little doubt on the facts that P's contribution throughout the years had surpassed the services ordinarily expected of a wife in her situation.

The court held that the essential elements of a partnership applied equally to a universal partnership, which the court described [51] as a partnership in which the parties agree to put in common all their property, both present and future. A universal partnership could exist in a marriage. It does not follow that a universal partnership cannot exist between partners who are engaged to be married. For a universal partnership to be found to exist, the necessary requirements for its existence must be met, regardless of whether the parties are married, engaged or cohabitating.

In this case, the parties were found to have had the necessary intention to form a universal partnership. P had contributed her salary, time, labour, skill and expertise, while S had contributed his business and finance. The essential requirements of a universal partnership were established. Instead of a purely pecuniary profit objective it sufficed that the parties had some other material gain, such as the joint exercise for the saving of costs, as their objective. The court accordingly found that the parties had entered into a tacit universal partnership brought about by the conduct of the parties. P was consequently able to claim a share of S's assets.

In *Butters v Mncora*, [52] on similar facts, the plaintiff and the defendant had lived together as husband and wife for about 20 years without ever having been married. The court held that there was a tacit universal partnership between the parties and that the respondent's share was 30 per cent. Her contribution had consisted of supporting the appellant and his children and in maintaining the common home.

The respondent had established that even though she and the appellant had lived together as husband and wife, they were nevertheless partners. The court found the essential requirements of a partnership to have been established. It stated that in the context of a universal partnership of all property that extends beyond commercial undertakings, the contributions of the parties need not be confined to a profit-making entity. In this case, the partnership had encompassed the family and the security business of the parties. The partnership enterprise included both the commercial undertaking and the non-profit-making part of their family life.

In view of these two recent decisions, the following principles may be laid down:

(i) A universal partnership may validly be formed.
(ii) Universal partnerships of all property extending beyond commercial undertakings still form part of South African law.
(iii) The essential elements of a partnership apply also to a universal partnership.
(iv) If a partnership enterprise extends beyond commercial undertakings, the contributions of the parties need not be confined to a profit-making entity.
(v) A universal partnership is not the same as a marriage in community of property. There are numerous differences between the two.

2.4.1.2 The universal partnership of all profits

The second type of universal partnership recognised in South African law is a universal partnership of all profits. In this type of universal partnership, the parties agree to put in all profits that they may acquire from every commercial or business activity or undertaking during the subsistence of the partnership.

Unlike an ordinary partnership, this type of partnership is a general partnership of all profits, not necessarily confined to a specific business activity.

2.4.2 The extraordinary partnership

There are two types of extraordinary partnerships:

(i) the anonymous partnership (also known as the silent or sleeping partnership); and
(ii) the commanditarian partnership, often referred to as the partnership *en commandite*.

2.4.2.1 The anonymous partnership

In an anonymous partnership, all the parties agree to share the profits of a business which is carried on by one or more of the partners in their names while the partner/s whose names are not disclosed remain anonymous partners. The anonymous partner is a partner, but the essence of the arrangement is that this fact is carefully concealed from the outside world, since the name of the anonymous partner is not disclosed to third parties. A further requirement of this type of partnership is that the anonymous partner must not actively participate in the business of the partnership. [53]

Anonymous partners are silent or sleeping partners to the extent that they do not actively play a role in the conduct of the partnership business, although, like any other partner, they must make their contributions to the partnership and share in the net profits of the partnership. They are also liable to the extent of their pro rata share of partnership losses.

However, since they are anonymous to third parties and are not held out as partners, they are not directly liable to third parties for the debts of the partnership. [54] Their liability for their proportional share of partnership losses is owed only to their fellow partners.

Anonymous partners lose their protection against liability to third parties when they are publicly held out as partners or when they act as ordinary partners. In this event, they would incur liability to creditors of the partnership.

It should be noted that the fact that a person is an anonymous partner need not be kept a secret from third parties. Mere interference by anonymous partners in the partnership business is not by itself sufficient to deprive them of protection against liability to creditors of the partnership. [55] This occurs only if they have been held out as partners or have acted as ordinary partners.

2.4.2.2 The partnership en commandite

Like an anonymous partnership, the partnership *en commandite* is also carried out in the name of one or more of the partners. The partner whose name is not disclosed undertakes to contribute a fixed sum of money to the partnership on condition that he or she receives a fixed share of the profit.

Like the anonymous partner, the commanditarian partner does not participate actively in the partnership business. The crucial difference however is that commanditarian partners are not liable for more than the fixed sum of money that they contributed or agreed to contribute to the partnership. In contrast, anonymous partners are liable for their full share of partnership losses and liabilities, even if this exceeds the amount of their contributions.

The commanditarian partnership is useful for investors of money who do not wish to participate actively in the management of the partnership business, but who want the assurance of knowing that they will not be liable for more than the amount of their contribution. This type of partnership consequently comes close to the concept of limited liability of the shareholders of a company. [56]

To sum up: both the commanditarian and the anonymous partner are undisclosed partners and are not held out to the public as partners. Both do not participate actively in the management of the partnership business. They are not directly liable to creditors of the partnership, but are liable only to their co-partners. Neither may claim their contribution in competition with creditors of the partnership. [57] If the partnership becomes insolvent, the anonymous or commanditarian partner will get paid his or her contribution only after the creditors of the partnership have been paid.

The essential difference between the commanditarian partnership and the anonymous partnership is that the former is liable only to the extent of the agreed amount, ie the amount of the capital contributed by him or her.

In every extraordinary partnership, there must at least be one person who is an ordinary partner, who may act on behalf of the partnership and who is fully liable to the creditors of the partnership.

2.5 The rights and duties of the partners among themselves

The legal relationship between partners among themselves is regulated by the partnership agreement and by the common-law principles laid down by the courts. It

must be emphasised that these legal principles are default rules and would apply only if the partnership agreement does not alter them or it is silent on the matter. It must also be borne in mind that while the partnership agreement may be binding on the parties to it, it is not necessarily binding on the creditors of the partnership.

2.5.1 The sharing of profits and losses

It is an essential element of a partnership that each partner shall be entitled to share in the net profits of the partnership. By 'net' profits is meant the balance of the profits left over after expenses and other liabilities are paid. In other words, it refers to the gross income less the expenses and losses.

It is advisable for the partnership agreement to regulate the method of calculating the profits of the partnership business and the proportion in which each partner is entitled to share in the profits, as well as the proportion in which net losses will be shared by the partners.

There is no legal principle that in the absence of agreement, partners share equally in the profits of the partnership business. There is no presumption of equality. [58] The partners are entitled to determine by agreement the share of each partner, subject to the essential requirement that each partner receives a share of net profits. Subject to this requirement, they are free to agree on any proportion.

In the absence of agreement, profits are shared in proportion to the value of the respective contributions of each partner. If the value of the contributions made by each partner cannot be determined, the profits are shared equally. In *Fink v Fink* [59] the court thus ruled that in the absence of agreement, the partners share the profits (and losses) in proportion to the amount which each partner contributed to the partnership. The courts stated further that where it is not possible to calculate or determine the value of each partner’s contribution, for instance where a partner’s contribution consisted of labour and skill, the partners must share the profits equally.

The sharing of net losses is not essential to a valid partnership. [60] The absence of an agreement to share net losses is in itself unimportant. [61] A partnership agreement may validly exempt a partner from sharing in net (or absolute) losses, as long as at least one partner in the partnership remains liable if the partnership suffers a net loss. A distinction must be drawn between (gross) losses and net losses. Since the sharing of net profits entails the sharing of losses, ie of expenses and other debts and liabilities, there is an implicit sharing of losses. In the absence of contrary agreement, net losses are shared in the same proportion as profits. [62] There is, of course, nothing to prevent the parties from agreeing to share losses and profits in different proportions.

A partner must not prevent co-partners from receiving their share of the profits; nor must a partner avoid bearing his or her agreed share of the losses.

2.5.2 The right to participate in the management of the partnership business

As a general principle, all the partners have equal rights in the management and the conduct of the partnership business. Each partner thus has a say in the management of the partnership.

The importance of the right to participate in the management of the partnership business must not be underestimated because, unlike the shareholders of a company who enjoy limited liability, the partners are ultimately jointly and severally liable for the debts and the liabilities of the partnership business. If the partners are to be personally liable, they ought at least to be given a say in the management of the partnership.

Partners have implied authority to enter into contracts that fall within the scope of the partnership business and in this way to bind the other partners to contracts that they have entered into on behalf of the partnership.

The partners, may however, by agreement limit or exclude one or more of them from the management of the partnership business, or restrict the implied authority of a particular partner. This in effect is what the partners agree to do in the case of an anonymous or a commanditarian partnership. The partners may, for instance, appoint a sole managing partner even in the case of an ordinary partnership.

2.5.3 The duty to exercise reasonable care

In the conduct and management of partnership affairs, a partner must exercise reasonable care. Partners owe one another a duty to exercise reasonable care. If a partner is negligent, ie fails to exercise reasonable care, he or she may be held liable in damages to the partners for loss caused by his or her negligence.

The practical difficulty with the enforcement of this duty is that the standard of care expected of a partner is unclear. In theory the standard of care is that which a partner exercises in the management of his or her own affairs. The special skills and expertise of a partner may also be taken into account in determining whether he or she has been negligent. However, where a partner contributes to the partnership a skill or services, the standard of care is that which is reasonably to be expected of a person performing similar functions.

2.5.4 The duty of good faith, honesty and loyalty

Partners are fiduciaries in a fiduciary relationship to one another. Partners must-

(i) avoid putting themselves in a position where their duties to the other partners conflict with their personal interests;
(ii) avoid making a profit from their positions as partners;
(iii) avoid diverting to themselves business opportunities that belong to the partnership; and
(iv) avoid competing with the partnership business by carrying on a business similar to the partnership business. [63]

The fiduciary duties of partners also include the duty to accept and fulfil all

obligations under the partnership agreement, and the duty to make full disclosure. In certain circumstances, these fiduciary duties may continue to apply even after the dissolution of the partnership, until the winding-up of the partnership.

The partners' mutual trust and confidence in one another is of fundamental importance to partners. In *Wegner v Surgeson* [64] the court stated that the relationship between partners is very much the same as that between brothers, which is equivalent to saying that partnership is a contract *uberrimae fidei* (a contract of utmost good faith). The mutual confidence and trust that partners must have in relation to one another is the foundation or life-blood of the partnership. [65]

A relationship of utmost good faith requires full disclosure of material information that is relevant to the partnership. This encompasses the disclosure by a partner to his or her co-partners of any prospects of profit and of business opportunities, as well as the disclosure of facts that may influence the co-partners’ decisions regarding the partnership, or that may affect partnership affairs.

In *Wegner v Surgeson* it was held that a partnership cannot be deliberately dissolved in order to enable a partner to escape from his or her duty of good faith. In this case the defendant had given notice of dissolution of a partnership and had at the same time and without the knowledge of his co-partner applied for a renewal of the lease of the partnership property in his own name and for his own benefit. The renewal of the lease was granted after the dissolution of the partnership. The court ruled that a partner who uses his position as a partner, or any property or information belonging to the partnership, for the purpose of obtaining for himself, without the consent of his co-partner, any property or benefit which is required for the partnership or falls within the scope of the partnership business, must account for it to the partnership. It is of the essence of commercial morality that partners are not allowed to misuse their positions as partners by obtaining secret profits for themselves. This duty cannot be evaded by intentionally dissolving the partnership. A partner cannot with impunity renounce the partnership unreasonably so as to benefit himself or herself and injure his or her fellow partners. The renewal of the lease was held to be an asset of the partnership.

Two cases may be used to illustrate the strict application of the rule that partners must not without consent of their partners make any profit for themselves which they ought to have made for the partnership. In *Bentley v Craven*, [66] Bentley, Craven and two others were partners in a sugar refinery. Craven purchased sugar on behalf of the partnership, which he was able to do at a discount to the market price of the sugar. Craven however kept the discount for himself by selling the sugar to the partnership at market price. He was ordered by the court to disgorge to the partnership all the profits that he had made in his dealings with the partnership even though the partnership itself would not have been able to purchase the sugar at a discount.

In *De Jager v Olifants Tin ‘B’ Syndicate*, [67] De Jager was a member of a partnership which was formed for the purpose of prospecting for tin. The partnership had

acquired the right to prospect for tin on farm W. While prospecting for tin on farm W, De Jager discovered tin at a spot which De Jager thought fell within the boundaries of farm W but which turned out to fall within the boundaries of farm T. The partnership was at the time negotiating for an option over farm W. De Jager, without informing his partners of his discovery, acquired for himself the option over W which would have made it easier for him to mine for tin on T. In addition to obtaining the right to mine tin on T, De Jager also obtained for himself the option to mine for tin on W. The court found that the acquisition by De Jager of the prospecting rights came within the scope of the partnership business and that the partnership was entitled to claim from De Jager the benefits of his discovery. The legal principle laid down by the court was that no partner may acquire and retain for himself or herself any benefit or advantage which was within the scope of the partnership business and which it was his or her duty to acquire for the partnership. All such benefits must be accounted for and be shared with fellow partners.

It is a question of fact whether a particular benefit falls within the scope of the partnership business. The benefit must be directly, or in certain circumstances may even be indirectly, connected with the partnership business.

This principle is illustrated by the facts of *Goldberg v Trimble & Bennett*. [68] In this case, G, T and B had entered into a partnership for the purpose of purchasing and thereafter selling certain shares. The shares were those of a company whose chief asset consisted of a number of valuable stands in Johannesburg. T and B purchased half of these stands from the company for their own benefit without informing G. The court held that the transaction was in conflict with the interests of the partnership and with the fiduciary relationship existing between partners. T and B were liable to account to G for one-third of the profits made by them.

The court stated [69] that if a partner acquires property intimately connected with the partnership business, and it is detrimental to the partnership's interests for him to hold such property for himself, then even though it did not fall directly within the scope of the partnership business, he will be held to have acquired it for the partnership. The facts of this case illustrate a benefit acquired by a partner which only indirectly fell within the scope of the partnership business, since the value of the shares depended on the value of the stands. The object of the partnership was not to acquire the stands but to acquire the shares in the company which owned the stands. The court nevertheless held that T and B had placed themselves in a position in which their own interests were in conflict with their duty to the partnership. [70]

In *Transvaal Cold Storage Co Ltd v Palmer* [71] the court affirmed the legal principle that if a partner (or agent) acquires any profit or benefit in the course of or by means of his position as a partner, without the consent of the other partners, such profit or benefit will be deemed to have been received for the partnership and must be accounted for and paid over to the partnership. (See further Chapter 14: The duties and the liability of directors.)

2.5.5 Partnership property

Partnership property consists of all the property and assets, whether movable or immovable, corporeal or incorporeal, that the partners have contributed to the partnership or that are subsequently acquired for the partnership business or by the partnership during its existence.

Partnership property is owned jointly by the partners in undivided shares. The partners hold partnership property as co-owners. The partners may, however, agree that certain assets contributed to the partnership will not be owned jointly. This applies for instance, where a partner has contributed the use, but not the ownership, of a particular asset. The differences between a partnership and co-ownership have been discussed above (see 2.1).

Since partners are co-owners of the partnership property in undivided shares, a partner may not use partnership property to the exclusion of the other partners. In *Munro v Ekerold* [72] a partnership owned shares in a company. The constitution of the company provided that the voting rights in respect of the shares owned by the partnership had to be exercised by E. E had always voted as he pleased and even contrary to the wishes of his co-partner, M. The court held that M was entitled to an order that E exercises the voting rights in respect of the shares in accordance with the desires of both partners.

Likewise, a partner may not use partnership property for personal or private purposes unless the partners consent to this (or if limited and occasional use of partnership property would not conflict with the carrying on of the partnership business). But he or she may, of course, use partnership property for the purposes of the partnership business.

The partner's right to use partnership property does not enable him or her to alienate, mortgage or encumber partnership assets, unless such assets are sold in the usual course of the partnership business. In all other cases a joint decision by the partners is required.

2.5.6 Partnership accounts

Partners who are given the right to manage the partnership business must render an account of their administration of the partnership business. The duty to keep accounts may be imposed on one partner, to whom all the other partners must make relevant information available. Accounts must be rendered annually in general, and also on dissolution of the partnership, and must be supported by vouchers, documents and the books of the partnership business. [73]

Partners are entitled to have access to partnership accounts at all times unless otherwise agreed. The partnership books must, at the insistence of a partner, be kept

at the principal place of business. They cannot, for instance, be kept at the residence of a partner merely for the latter's own convenience. [74]

A partner is *prima facie* entitled to a full investigation of the partnership books [75] and, in the absence of contrary agreement, to be assisted by qualified auditors.

2.5.7 Compensation, refunds and indemnities

As a general principle, partners are not entitled to remuneration for services rendered to the partnership, nor are they entitled to interest on capital contributed to the partnership. The underlying reason is that a partner's benefit is derived from his or her share in the profits of the partnership business. Nonetheless it is permissible for the partners to agree that a particular partner is to be paid interest on capital contributed, or is to receive a salary or a fee for certain partnership duties or special services rendered to the partnership, or is to be compensated for providing to the partnership the use of certain assets.

Regarding expenses and indemnification, a partner is entitled to a proportionate refund for expenses personally incurred in the course of conducting partnership business and, similarly, to an indemnification for losses personally sustained.

2.6 Contracting on behalf of the partnership

2.6.1 General

From a legal perspective, the character of a partner is much more complex than that of an agent. [76] A partner must not be equated with an agent.

Since a partnership is not a separate legal entity, in contracting on behalf of a partnership each partner, unlike an agent, has a dual capacity or a double character, as both a principal and an agent in the same transaction. Each partner is an agent of his or her co-partners. Consequently, when partners enter into a contract on behalf of the partnership they act in their capacity, firstly as principals (in binding themselves) and second, also as agents to bind their co-partners to the contract to the extent of their authority. Partners have not only the powers of an agent; they are all ultimately jointly and severally liable for the debts and liabilities of the partnership. [77]

The agency that partners have on behalf of their fellow partners arises not necessarily by express agreement but by operation of law as soon as the partnership agreement has been entered into. Each partner, by operation of law, is given implied authority to do all acts that are necessary or incidental to the partnership business. [78] This means that the authority arises automatically, and there is no need for a partner to obtain the consent of his or her fellow partners, or their co-operation. The transaction entered into by the partner must, however, fall within the scope of the partnership business. This is a difficult question of fact.

As previously stated, each partner has a right to participate in the management of the partnership business unless otherwise agreed upon. For instance, an anonymous

or commanditarian partner does not actively play a role in the conduct of the partnership business. The right of a partner to participate in the management of the partnership business may also be excluded or limited in an ordinary partnership, by agreement of the partners.

Each partner accordingly has implied authority to enter into contracts that fall within the scope of the partnership business, unless this is negated or qualified by the agreement of the partners.

Partners may, of course, only bind their fellow partners to the extent of their authority. Such authority may be (i) actual authority, which consists of express or implied authority; or (ii) it may be ostensible authority, also referred to as apparent authority or authority by estoppel; or (iii) it may be authority given *ex post facto* after the contract has been entered into, in the form of ratification by the partners of the unauthorised contract. Authority is discussed further in 2.6.2.

In order for a third party (ie the other party to the contract) to hold the partners liable on a contract entered into by a partner, the third party must prove the following:

(i) the existence of the partnership;
(ii) that the partner who entered into the contract had authority to contract on behalf of the other partners; and
(iii) that the partner who entered into the contract did so in the name of or on behalf of the partnership.

2.6.2 Contracting in the name of or on behalf of the partnership

In contracting for a partnership, a partner must inform the other party to the contract that he or she is acting on behalf of the partnership. [79] It must be the intention of both the partner and the other party that the rights and duties under the contract will be granted to and imposed on the partnership, [80] as opposed to the partner himself or herself. It is uncertain and still remains to be seen whether a future court would authoritatively rule that the English law doctrine of the undisclosed principal [81] is recognised by our law and that it applies to partnerships. There is authority for the view that it does apply to partnerships. [82]

In *Cullinan v Noordkaaplandse Aartappelkernmoerkwekers Koöperasie Bpk* [83] the court stated (in the general context of the law of agency) that the English law doctrine of the undisclosed principal has been incorporated into our law and must be regarded as accepted law, but it does not apply where there is more than one undisclosed principal. The doctrine states that if an agent contracts with a third party without disclosing that he or she is acting for and on behalf of a principal, the third party is entitled to hold either the principal or the agent personally liable on discovering that the agent is acting for a principal. In view of the liability imposed personally on the agent it is not advisable for a partner to contract on behalf of a partnership without disclosing that he or she is contracting for and on behalf of a partnership.

2.6.3 The authority of a partner

It is for the third party to prove that the partner who entered into the contract on behalf of the partnership had authority to do so or that the transaction in question fell within the scope of the partnership business. [84]

The authority of a partner, or an agent for that matter, may be (i) actual authority, which as stated above (in 2.6.1) could be express authority or implied authority; or (ii) ostensible authority; or (iii) the contract could simply be ratified by the other partners.

Actual express authority is authority given in so many words whether orally or in writing. For instance, a partner's express authority may be to sign cheques for the partnership business on behalf of all the co-partners or on specific occasions, to order goods for the partnership business. Where the contracting partner has acted with express authority it is irrelevant whether the contract fell within the scope of the partnership business. In other words, a partner may have express authority to enter into transactions that are outside the usual scope of the partnership business.

Regarding implied authority, the guiding principle is that each partner *prima facie* has authority to perform all such acts as are necessary or incidental to the proper conduct of the partnership business. [85] (See 2.6.1). The limits of a partner's implied authority are set by the nature and purpose of the partnership business and the partnership agreement. Implied authority may be inferred from the partnership agreement, or from the usual dealings of the partnership, or general commercial usage. It is a question of fact, depending on the circumstances of each case.

The implied authority of a partner may, as discussed in 2.6.1, be restricted or completely excluded by agreement between the partners. When a partner exceeds his or her authority by ignoring the restriction, the restriction of authority will not be effective against a third party who was unaware of it. Instead, the third party may hold the partners liable on the basis of the ostensible authority of the contracting partner. [86] The private or secret restriction on the implied authority of a partner does not affect the third party, unless the latter was aware of the restriction or suspected that a restriction was imposed.

In *Goodrickes v Hall* [87] it was held that the purchase of a liquor licence for a partnership formed to run a restaurant was done in furtherance of the partnership business, and fell within the scope of the implied authority of a partner, particularly since the partners had contemplated obtaining a liquor licence. A transaction

between a partner and a third party may bind the other partners if it falls within the scope of the partnership business. Even if the relevant partner did not have actual authority (due to a private restriction on his or her authority), the contract will nevertheless be binding on the partnership as a result of ostensible authority. This applies as long as the third party was in good faith.

Ostensible authority is no authority at all - neither express nor implied authority. It is an oxymoron. Liability is based on an equitable concept that precludes or estops the principal (ie the partners) from denying the agent's (ie the contracting partner's) authority. Ostensible authority arises where the principal has made a representation, whether by words or conduct, to the third party that the agent has the necessary authority to act on behalf of the principal, and if the third party reasonably relies on this representation, the principal will be estopped (or prevented) from denying that the agent had authority.

From the point of view of the third party, it makes no difference whether a partner has actual or ostensible authority, since the partners will in either event be bound by the act of the contracting partner. But as between the partners *inter se* (among themselves) it makes a very important difference. As ostensible authority is no authority at all, the contracting partner would have exceeded the limits of his or her authority and would consequently have incurred liability to the other partners for any damages suffered by them, unless they have ratified the unauthorised act. If, on the other hand, the partners are not bound at all by the unauthorised act of the contracting partner, the third party will have a right of action against the contracting partner based on a breach of warranty of authority or misrepresentation.

The following requirements must be fulfilled in order to establish ostensible authority:

(i) The partners must have made a representation (whether by words or conduct), or must have permitted it to be represented, that the contracting partner has authority to enter into the contract in question. It is not enough that only the contracting partner had represented that he or she had authority to act on behalf of the other partners.
(ii) The third party must have relied on the representation, ie he or she must have been induced by the representation to enter into the contract. For this to happen, the third party must have known of the representation.
(iii) Such reliance must have been reasonable in the circumstances.
(iv) The representation must be such that it could reasonably be expected that a third party would rely on it.
(v) The third party must have suffered some damage or prejudice as a result of such reliance. [88]

Failing actual or ostensible authority, there is still the possibility of ratification of the unauthorised contract. As stated above, ratification is authority given after the

contract has been entered into. Ratification of the contract may be done expressly or impliedly, for instance, where the partners knowingly accept the benefits of the unauthorised contract.

Ratification operates retrospectively to the date of the unauthorised contract or transaction. The result is that it is an *ex post facto* conferral of authority. The contract becomes binding on the partners as if the contracting partner originally had authority to enter into the contract at the time when the contract was entered into. It is important, however, that the contracting partner had the intention to contract on behalf of the partnership and not in his or her personal capacity. Moreover, ratification must be of the whole of the contract and not be limited to a ratification of only a part of the contract.

2.7 The liability of the partners to third parties

Although the partners are ultimately jointly and severally liable for the debts of the partnership, [89] *during the subsistence* of the partnership a creditor cannot sue a partner individually for payment of the partnership debts. The legal proceedings must during the subsistence of the partnership be brought against all the partners jointly or (as discussed in 2.3.2.1) the partnership as such must be sued. In *Mahomed v Karp Brothers* [90] it was held that while a partnership is in existence, no judgment on a partnership obligation may be taken against the individual partners personally or separately. If execution of judgment is necessary, it cannot be levied against the personal assets of an individual partner but must first be levied against partnership property before proceeding against the personal assets of an individual partner (for any residue of the judgment). The court in *Mahomed v Karp Brothers* went further by ruling that so long as the partnership is in existence, the plaintiff could not sue both the partnership and the individual partners. The legal action must be brought against the partnership estate only.

A distinction must be drawn between the liability of partners during the subsistence of the partnership and their liability on dissolution of the partnership. *On the dissolution* of the partnership, a creditor of the partnership becomes entitled to sue any individual partner for the full amount of the partnership debt. In other words, partners become jointly and severally liable for partnership debts on dissolution of the partnership. Where a creditor sues the partners of a dissolved partnership as individuals jointly and severally, if execution is necessary, this may take place against the assets of each partner. (A partner who pays more than his or her proportionate share of the debt does, of course, have a right of recourse against the other partners.) In *Lee en 'n Ander v Maraisdrif (Edms) Bpk* [91] the court held that it was not necessary for the plaintiff to wait until liquidation of the partnership estate before claiming the full amount of the partnership debt from an individual partner. Execution of judgment may take place against the private assets of a partner after dissolution and before liquidation of the partnership estate. [92] (See also 2.3.2.4).

2.8 Delictual liability

A partner may act in many capacities. Whether the partnership incurs vicarious liability depends on the (nature of the) capacity in which a partner acts. [93]

The general principle is that the partners are vicariously liable for a delict committed by a partner while acting in the ordinary course of the partnership business or while performing some act on the authority of his or her co-partners. It follows from this vicarious liability that the other partners incur liability to the same extent as the liability imposed on the partner who committed the delict or the wrongful act or omission.

The partners are vicariously liable for such a wrongful act, provided that it was committed in the ordinary course of the partnership business or committed while the partner was performing an act authorised by the co-partners. [94] However, the delinquent partner who committed the wrongful act remains personally liable for the damages suffered by the plaintiff.

No delictual liability would be imputed to the co-partners if a partner committed the delict while on 'a frolic of his [or her] own'. The wrongful act here would have been committed outside the ordinary course of the partnership business.

2.9 Criminal liability

As previously stated (in 2.3.1), at common law a partnership cannot be criminally liable for an offence committed by a partner, since a partnership is not, in South African law, a separate legal person. [95]

Criminal liability is imposed at common law on the particular partner who committed the criminal offence and the partners who were accomplices or who colluded in the act. The common-law principle was that in the absence of statutory provision, co-partners are not liable for the criminal acts of a partner.

However, in terms of s 332(7) of the Criminal Procedure Act 51 of 1977, if a partner commits a criminal offence while carrying on the business of the partnership or in furthering or endeavouring to further the interests of the partnership, [96] all the partners are rebuttably presumed to be guilty of the criminal offence unless they prove that they did not take part in committing the offence and could not have prevented it.

The reverse onus presumption contained in s 332(7) of the Criminal Procedure Act is problematic. It is open to legal challenge on the ground that it is unconstitutional, since it presumes a person to be guilty unless he or she is able to rebut this presumption on a balance of probabilities.

2.10 Legal proceedings between the partners among themselves (*inter se*)

As previously discussed (in 2.5), partners owe one another a number of reciprocal duties and have reciprocal obligations that arise out of the partnership agreement. In order to enable a partner to enforce these duties or to sue another partner, partners may rely on the *actio pro socio*, which is a personal action that may be instituted against a partner by his or her co-partners personally. [97] The action is not brought in the name of the partnership. This is logical, as it would otherwise give rise to the difficulty that the defendant partner is both plaintiff and defendant in the matter. [98]

The *actio pro socio* may be instituted during the subsistence of the partnership to implement or enforce the terms of the partnership agreement, or even to obtain dissolution of the partnership. It may also be brought after dissolution of the partnership (to obtain distribution of any undistributed partnership asset or assets). [99] The mere fact that a partner has brought the *actio pro socio* against fellow partners does not automatically dissolve the partnership. If dissolution is not requested, the partnership would continue to exist. [100]

By means of the *actio pro socio*, a partner may obtain as against a co-partner an order of specific performance of the partnership agreement and/or performance of personal obligations, [101] and in this way, for instance, compel a partner to perform his or her promised contribution to the partnership. A partner may also claim damages from co-partners for a breach of the partnership agreement, or may restrain a partner from acting in a manner that is inconsistent with good faith or with the partnership agreement, or obtain a declaration of rights.

A settlement of the partnership accounts may be required before a partner may institute the *actio pro socio*. This depends on the nature of the claim. It is generally required for actions for payment of a partner's share in the profits owed to him or her in connection with partnership affairs, or for transfer of a share of partnership property allegedly due to a partner.

Apart from the *actio pro socio*, partners may also rely at their option on the *actio communi dividundo* to procure, after dissolution of the partnership, a distribution or a division of partnership assets that are jointly owned by the partners. [102] This action is available to those who hold common property in undivided shares. The *actio communi dividundo* applies to a division of corporeal property as well as incorporeal property or intangible things.

In *Robson v Theron* [103] it was held that if a partner (the continuing partner) retains the goodwill of a dissolved partnership business, another partner (the retiring partner) may by means of the *actio pro socio* or the *actio communi dividundo* obtain payment of his or her proportional share of the goodwill from the co-partner.

The *actio communi dividundo* may be used to obtain a division of joint property and/or the payment of profits or reimbursement of expenses incurred in connection with the joint property (*Robson v Theron*). The court has a wide equitable jurisdiction in ordering a division of the joint property.

2.11 The dissolution of a partnership: general

The dissolution of a partnership must not be confused with its liquidation or winding-up. Dissolution and liquidation are not synonymous. The dissolution of a partnership is usually though not necessarily the first step towards liquidation of the partnership.

Dissolution alters the partnership relationship to the extent that the partners cease to carry on business together. However, the partnership relationship is not terminated by dissolution. It continues until its liquidation. Dissolution is followed by liquidation unless a new partnership is formed to take over the assets and the liabilities of the dissolved partnership. In this event, there is no liquidation of the partnership.

The liquidation of the partnership entails the realisation of partnership assets, payment to creditors, the return of capital to the partners and the distribution of surplus assets among the partners.

2.12 The causes and grounds of dissolution

A partnership may be dissolved for the following reasons:

2.12.1 Mutual agreement or effluxion of time

A partnership is essentially based on a contractual agreement between the parties to it. Just as the formation of a partnership agreement requires the consent of all the partners, a dissolution of the partnership by agreement requires the consent of all the partners.

A partnership may be dissolved at any time with the unanimous assent of all the partners. A mere majority of the partners is not sufficient for this purpose. The agreement to terminate the partnership may be express or it may be implied from the conduct of the partners. [104] The conduct of the partners may be such as to evince an intention to abandon the partnership agreement. A court may for instance infer the dissolution of a partnership when the partnership business has come to an end - for example, on the completion of the business undertaking or on the sale of the partnership business.

Likewise, if the partners have agreed in their partnership agreement that the partnership would terminate on the expiration of a specified or fixed period of time, the partnership would automatically be dissolved on the expiry of this period of time, unless the parties agree to extend the duration of the partnership.

A partnership formed to complete a specific project or a single project or undertaking, such as to build a railway line or to salvage a ship or to promote a prize fight, would be dissolved on the completion of the project.

2.12.2 Change of membership

As a general principle, any change in the membership of the partnership results in the dissolution of the partnership. It destroys the identity of the partnership. This change of membership may occur as a result of the death of a partner, or the retirement or resignation of a partner. Dissolution may however be subject to the partnership agreement.

In the event of the death of a partner, the partnership agreement may validly provide that the surviving partners would continue the partnership. [105] The effect is that a new partnership is formed by the surviving partners. It may also be possible for the partnership agreement to provide that on the death of a partner, the partnership would continue for the benefit of the estate of the deceased partner (provided that the continuance is authorised in the will of the deceased partner). In this event, the formation of a new partnership becomes unnecessary. In the absence of any such contrary provision in the partnership agreement, the death of a partner automatically, by operation of law, results in a dissolution of the partnership, and the surviving parties do not continue as partners.

Dissolution of a partnership will also occur when a partner retires, whether in terms of the partnership agreement or a subsequent agreement. Even though the partnership agreement may provide that on the retirement of a partner the partnership will continue, a new partnership must nevertheless be formed. The previous partnership that existed before the retirement of a partner must be dissolved and a new partnership must be formed. The new partnership is not liable for the debts of the old partnership unless this is agreed upon, with the consent of the members of the old partnership and its creditors.

A person cannot become a partner without the consent of all the partners. A partnership is dissolved whenever a new partner is admitted, and a new partnership is formed.

2.12.3 The insolvency of a partner

Every partnership is dissolved automatically by operation of law on the insolvency of a partner or on the insolvency of the partnership.

This has been discussed in 2.3.2.2. Briefly, the Insolvency Act 24 of 1936 defines a 'debtor' to include a partnership, so that a partnership may be sequestrated even though it is not a separate legal person. When the partnership estate is sequestrated, the private estates of the partners are separately but simultaneously sequestrated, [106] unless a partner undertakes to pay partnership debts and liabilities and gives satisfactory security, in which case, his or her private estate would not be sequestrated.

The sequestration of the estate of a partner or the estate of the partnership results in the dissolution of the partnership. If a partner is a company or a close corporation, its winding-up or liquidation would also result in the dissolution of the partnership.

But, presumably, if the company or close corporation is placed under business rescue in terms of the Companies Act, this would not result in the dissolution of the partnership.

2.12.4 Alien enemy

A partnership is automatically dissolved when the partners are domiciled in different countries that are at war with one another. A declaration of war or a *de facto* state of war [107] has the effect of dissolving a partnership by operation of law. Similarly, if, after the outbreak of war or a declaration of war, an alien partner is resident in enemy territory, the partnership would be automatically dissolved. [108]

When partners become alien enemies they do not forfeit their rights. Instead, the legal enforceability of their rights is suspended until they cease to be enemies. The basis of dissolution is that, as a result of the outbreak of war, the objective of the partnership is legally impossible to attain. In this case, the partnership is taken to have been automatically dissolved.

2.12.5 Frustration

A partnership would be dissolved where the business cannot be carried on at all. This may be the case, for instance, where a patent or a mine which the partnership was intended to work proves to be valueless. In such cases, the substratum of the partnership is gone. [109] A partnership may also be dissolved where there is no reasonable likelihood or expectation of making a profit or if the business of the partnership cannot as a matter of fact be carried on at a profit. [110]

The basis of dissolution is that the partnership business has become impossible to achieve due to an event that has caused frustration of the contract or as a result of supervening impossibility of performance.

2.12.6 The partnership business may only be carried on at a loss

Since a partnership is formed for the object of making a profit, if there is no prospect of making a profit, the partnership should properly be dissolved. (See also 2.12.5).

2.12.7 Notice of dissolution

A partnership at will or one that is formed for an indefinite or undefined period may be dissolved at any time by a partner giving notice of dissolution, [111] even if the other partners wish to continue the partnership. A partnership for an indefinite period

lasts as long as the partners have consented. [112] Such partnerships may be instantaneously dissolved without a reasonable period of notice. [113]

The notice of dissolution must however be given in accordance with the provisions of the partnership agreement. If the partnership agreement stipulates notice of dissolution, this must be complied with. If, on the other hand, the partnership agreement contains no provision for notice of dissolution to be given, all that is required is that such notice be given in good faith and at a reasonable time. Notice must not be given when, having regard to the interests of the partnership as a whole, it is inconvenient. [114]

A partner may not with impunity renounce the partnership unreasonably in order to benefit himself and injure the other partners. [115] A partner who gives notice of dissolution in order to obtain for himself a business which the partnership was contemplating to acquire for itself, will not have given notice in good faith.

Notice must not be given for an improper purpose; nor must it be given in bad faith. In *Parr v Crosbie* [116] the court stated that, if a partner renounces a partnership with a secret motive so that he alone may enjoy a gain which he knows awaits him, he may be compelled to share his gain with his partners. Partners cannot retain for themselves a personal benefit that they may be able to obtain as a result of the dissolution. [117]

A partner who renounces a partnership unreasonably may be held liable to his or her co-partners for any damage that the renunciation may have caused them. [118]

Notice of dissolution may be given orally or in writing, or it may be tacit, for example, a major quarrel between the partners. It is prudent to give written notice to avoid difficulties of proving a dissolution of the partnership.

2.12.8 By order of court for just cause

Irrespective of whether or not there is a fixed period for the duration of a partnership, a court may, on the application of a partner, grant an order for the dissolution of a partnership for a just or lawful cause (*justa causa*). The conduct must be such as to make dissolution of the partnership just and equitable. What exactly a just or lawful cause is is a question of fact that depends on the circumstances of each case. As a broad general principle, it is conduct that irreparably destroys the mutual trust and confidence of the partners.

It is not every little quarrel or friction or neglect that entitles a partner to a dissolution of the partnership. There must be something more than a partnership squabble. A partnership, it is said, is like a marriage - there must be 'give and take'. [119] What is required is a breakdown in the relationship between the partners or a loss of confidence and trust between the partners. It is also important that the partner

seeking dissolution of the partnership must not have caused the destruction of the mutual trust and confidence of the partners by his or her own conduct.

Dissolution by order of court has been made in the following instances:

(i) Where a partner has persistently failed to perform his or her duties as a partner. This would probably not apply to an anonymous or a commanditarian partnership;
(ii) Where a partner due to illness (which would include mental illness or classification as a mental health care user) has become incapable of performing his or her duties under the partnership agreement;
(iii) The breach of an essential term of the partnership agreement;
(iv) A failure by a partner to keep proper books and to furnish proper accounts to the other partners;
(v) Where there is no reasonable prospect or likelihood of making a profit in the partnership business, and the partnership business cannot be carried on at all due to its substratum falling away;
(vi) When the relations of the partners have become strained or where there is animosity and constant quarrelling;
(vii) A lack of probity or improper conduct;
(viii) Wilful and persistent breach of the partnership agreement. [120]

At the basis of many of these instances of dissolution by order of court is the loss of ability of the partners to work together.

As stated above, a partner who alleges that the mutual trust and confidence of the partners has broken must not by his or her own conduct have contributed to the breakdown in the partnership relationship. In *Curtis & Curtis v Beart*, [121] Beart, the manager of a partnership business, had been mismanaging and neglecting the business. He had unreasonably refused to take his hat off while on the business premises and had regularly consumed alcohol with customers of the partnership business. This was compounded by the failure of the partnership to make any profit. The court ordered the dissolution of the partnership on the ground that Beart's persistent misconduct had destroyed the confidence and the co-operation of the partners and also because there was no reasonable expectation of the partnership business making a profit. The court found that the persistent negligence of a partner would constitute misconduct that would destroy the confidence and the mutual co-operation of the partners. This is a ground for terminating or dissolving the partnership.

2.13 The consequences of a dissolution of the partnership

The dissolution of the partnership has an effect not only on the partners among themselves, but also on creditors and other third parties. Dissolution brings an end to the partnership as a going concern without at this stage terminating the partnership relationship. The partnership relationship continues until and so far as may be necessary for the purposes of liquidation or winding-up of the partnership, which usually follows upon dissolution.

The dissolution of the partnership does not release the partners from their legal duties as partners. Thus, even after dissolution, irrespective of their motives, partners have a right to inspect the partnership books and documents and in so doing to be assisted by an accountant or auditor, [122] unless this right has been excluded by agreement between the partners. More importantly, even after dissolution the fiduciary duties of the partners continue to apply. The fiduciary duties, such as the duty of good faith and perfect fairness, do not terminate on dissolution. However, the partnership agreement is terminated on dissolution and is no longer binding, subject to a contrary agreement by the partners.

Dissolution has further important legal consequences. On dissolution, the implied authority of the partners to enter into contracts that fall within the scope of the partnership business is automatically terminated. A partner may, however, have implied authority to bind his or her co-partners for the purpose of liquidating the partnership estate, or for the purpose of completing any transactions begun but unfinished at the time of dissolution of the partnership. The same applies where the partner's transactions are a necessary result of transactions which occurred during the existence of the partnership.

Moreover, in order to prevent the partners from being bound by the ostensible authority of a partner arising from past dealings, it is advisable for the partners to give notice of the dissolution of the partnership to creditors and to the public in general.

In relation to third parties, dissolution does not release the partnership from its obligations. The rights of third parties remain the same and continue to be binding on the partners. The partners' obligations to third parties continue notwithstanding the dissolution of the partnership.

However, the most important consequence of the dissolution of a partnership is that, whereas during the subsistence of the partnership creditors may not sue individual partners for the payment of partnership debts (see discussion in 2.7 and 2.3.2.4), after dissolution the ordinary partners become jointly and severally liable for the debts and the liabilities of the partnership. A creditor may consequently sue any partner (this will usually be the wealthiest partner) for all the debts of the partnership, without having to also claim payment from the other partners. [123] The partner who has made payment is thereafter left to recover, from his or her co-partners, their proportionate share of the partnership debts and liabilities. There is, of course, nothing to stop a creditor from claiming payment from all the partners.

Regarding the obligations of third parties to the partnership after dissolution, these remain the same, in that debtors are liable to make performance to the partnership. All the former partners should jointly institute a claim to enforce a right acquired by the partnership prior to dissolution.

2.14 Liquidation

After dissolution, the partnership must be liquidated or wound up, unless in the particular circumstances the partners have agreed that a new partnership would take over the assets and the liabilities of the dissolved partnership. As previously stated (in 2.11), liquidation entails the realisation of partnership assets, the payment of partnership debts and liabilities, the return of capital contributed and the distribution of the surplus, if any, to the partners.

If the partnership agreement provides for the liquidation of the partnership and the final distribution of assets, this must be complied with. If there is no such agreement (whether in terms of the partnership agreement or a subsequent agreement), the partners may appoint a liquidator or, alternatively, a liquidator may be appointed by the court on request by the partners. [124]

The duty of the liquidator is to realise all the assets of the partnership, including any goodwill, and to obtain payment of debts owed to the partnership. In *Robson v Theron* [125] it was held that when two partners dissolve a partnership by agreement and one partner *de facto* retains the goodwill of the partnership for his own use and benefit, the retiring partner is entitled at common law to payment of his half-share of the goodwill from the continuing partner. This may, as discussed in 2.10, be done by means of the *actio pro socio* or the *actio communi dividundo*. It is not necessary that it should be a term of the agreement of dissolution that one partner would retain the goodwill of the partnership.

After realisation of all the assets of the partnership, the liquidator must pay and settle the debts and the liabilities of the partnership. The liquidator must first pay creditors of the partnership, excluding the partners. Thereafter the debts owed to individual partners must be paid. [126]

The partners are also repaid the capital that they have contributed to the partnership, provided, of course, that there are adequate surplus assets for this purpose. In this respect, partners may not compete with creditors of the partnership simply because each partner is jointly and severally liable for all the debts of the partnership. [127] Thus where there is a surplus, the partners receive their capital contributions and a share of the surplus. If, on the other hand, the partnership has made a loss, the partners may have to make further contributions to the partnership. If partnership assets are insufficient to pay creditors, the partners must make up the deficiency by contributing their agreed proportionate share of the loss.

Surplus assets of the partnership, after all creditors have been paid (and capital contributions have been repaid to partners), are distributed among the partners in accordance with the partnership agreement. If the partnership agreement is silent on this matter, surplus assets are distributed in proportion to the partners' share of the profits of the partnership. This may depend on the amount of their contributions to the partnership. Where this cannot be calculated, such as where a partner has contributed labour, skill or expertise, surplus assets are shared equally.

When the liquidation of the partnership has finally been completed, the legal relationship between the partners comes to a formal end. [128]

Questions

1. Alpha, Beta, Gamma, Delta, Kappa and Omega wish to set up a Greek restaurant business called 'Zorbas'. They enter into an oral agreement in terms of which it is agreed that:
   - Alpha will be the head chef of the restaurant, and will be entitled to 20 per cent of the profits of the business.
   - Beta will be the manager and restaurant host, and will also be entitled to 20 per cent of the profits of the business. Beta will not share in net losses of the business.
   - Gamma will allow the use of his property, rent-free, as business premises, and will receive 20 per cent of the profits of the business. Gamma will also receive a salary of R10 000 per month for accounting services rendered to the partnership.
   - Delta will finance the business by contributing an amount of R1 million, but will not participate in the management of the business. She will receive 30 per cent of the profits of the business, and her liability for partnership debts will be limited to a maximum amount of R1 million.
   - Kappa will loan a further R2 million to the business, which is repayable with interest in the form of 10 per cent of the profits of the business.
   - Omega will be the head waiter of the restaurant, and will be remunerated at a rate of R10 000 per month.
     - *(a)* Has a valid partnership agreement been established, and if so, between which of the above parties?
     - *(b)* Assume that a partnership has been formed. Alpha, without informing his partners or obtaining their consent, enters into an agreement with X (Pty) Ltd for the purchase of new furniture for the restaurant and signs the agreement of sale as 'Alpha on behalf of Zorbas'. Discuss whether the partners will be bound by the agreement.
     - *(c)* Would your answer to *(b)* differ if the partners had discussed whether they should purchase new restaurant furniture and the other partners, disapproving of the idea, had instructed Alpha not to do so? Explain fully.
     - *(d)* Zorbas fails to pay X (Pty) Ltd the purchase price for the furniture of R200 000. X (Pty) Ltd wishes to institute legal proceedings for payment of the amount of

R200 000. Advise X (Pty) Ltd whether legal proceedings may be instituted against the partnership in its own name or whether the legal proceedings must be instituted against the partners.

(e) Zorbas eventually goes insolvent. Explain how creditors of Zorbas would be paid the debts owing to them.

2. Mammoth Mining is a partnership that has carried on the business of general mining for decades. Due to the high cost of mining tin, it was unanimously decided by the partners six weeks ago that the partnership would immediately give up all its activities in connection with the mining of tin, and would concentrate on the mining of platinum. It was also decided by the partners that

Dr Drake would investigate the prospects of mining platinum on Farm A. While Dr Drake is carrying out his investigations, he discovers platinum on Farm A. He also discovers, on the adjoining Farm B, that there is a very rich deposit of tin, but no platinum. Dr Drake reports on his finding in connection with Farm A, but says nothing to his co-partners about his findings on Farm B.

(a) Dr Drake decides, in view of the partners' decision to give up all the partnership's tin-mining activities, to obtain the mining rights to tin on Farm B for himself. Advise Dr Drake whether and under what circumstances he may be entitled to do so.

(b) If Dr Drake dissolves the partnership by giving notice of dissolution, and then acquires the platinum-mining rights on Farm A for himself, would his co-partners have any legal remedies against him? Explain fully.

(c) If the partners had decided merely to scale down, but not to terminate, the partnership's tin-mining activities, would your advice in *(b)* be different?

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[1] *Ex Parte Buttner Brothers* 1930 CPD 138.

[2] 1992 (3) SA 379 (A) 390D.

[3] EH Scamell & RC I'Anson Banks *Lindley on the Law of Partnership* 15 ed (1984) 14.

[4] *Strydom v Protea Eiendomsagente* 1979 (2) SA 206 (T).

[5] 1953 (4) SA 426 (C).

[6] *Stekel v Ellice* [1973] 1 All ER 465.

[7] *Pooley v Driver* 1876 (5) Ch D 458.

[8] For instance, a partnership cannot be imposed by a testator on the heirs of his estate (*Ex parte Grobler and Others* 1916 TPD 414) since there is no agreement.

[9] *Fink v Fink* 1945 WLD 226.

[10] 1915 TPD 277 at 280-1.

[11] *Purdon v Muller* 1961 (2) SA 211 (A). This is discussed further in 2.2.5.

[12] See, for instance, *Bester v Van Niekerk* 1960 (2) SA 779 (A); *Purdon v Muller* (n 11) 218C-G.

[13] Supra (n 2) 390B.

[14] Supra (n 12).

[15] Supra (n 11).

[16] Supra (n 2).

[17] *Laughton v Griffin and Others* 1893 (14) NLR 84; see B Bamford *The Law of Partnerships*

and Voluntary Association in South Africa 3 ed (1982) 4.

[18] *Wulfsohn v Taylor* 1928 TPD 99.

[19] Per Jessel MR in *Smith v Andersen* 1879 (15) Ch D 247 at 258; *Standard General Insurance Co v Hennop* 1954 (4) SA 560 (A) 565A.

[20] *Commissioner for Inland Revenue v Stott* 1928 AD 267.

[21] *Bester v Van Niekerk* (n 12) 783-4; *Pezzutto v Dreyer and Others* (n 2).

[22] *Novick v Benjamin* 1972 (2) SA 842 (A) 851.

[23] *Smith v Andersen* (n 19) and *Novick v Benjamin* (n 22) 851.

[24] *Cox v Hickman* (1860) 8 HL Cas 268, followed and approved in *Wulfsohn v Taylor* (n 18).

[25] These would be partners who contribute capital but who do not participate in the management and the conduct of the partnership business, as discussed in 2.4.2.

[26] 2010 (1) SA 381 (KZP) 386F-I.

[27] 1922 TPD 130.

[28] 1945 WLD 226.

[29] *Smith v Andersen* (n 19) 273 (per James LJJ).

[30] Supra (n 11).

[31] Supra (n 11) 218A.

[32] 1992 (3) SA 379 (A) 389.

[33] Supra (n 1).

[34] HR Hahlo & E Kahn *The Union of South Africa: The Development of its Laws and Constitution* (1960) 702.

[35] *Strydom v Protea Eiendomsagente* (n 4).

[36] *Michalow NO v Premier Milling Co Ltd* 1960 (2) SA 59 (W) 61D.

[37] RC l'Anson Banks & N Lindley *Lindley and Banks on Partnership* 18 ed (2002) 36.

[38] *Laughton v Griffin and Others* (n 17) 89-90.

[39] *Holme v Holland* 1872 L.R. 7 EX 218 at 234.

[40] Uniform Rule of Court 14(2) and Magistrates' Courts Rule 54(1) enacted respectively in terms of the Supreme Court Act 59 of 1959 and the Magistrates' Courts Act 32 of 1944.

[41] High Court Rule 14(5)*(h)*.

[42] *Michalow NO v Premier Milling Co* (n 36) 61-2; *Ex Parte Cohen* 1974 (4) SA 674 (W).

[43] Section 13 of the Insolvency Act.

[44] *Chipkin (Natal) (Pty) Ltd v Commissioner, South African Revenue Service* 2005 (5) SA 566 (SCA); *Sacks v Commissioner for Inland Revenue* 1946 AD 31.

[45] Section 51(1)*(a)* of the Value-Added Tax Act 89 of 1991.

[46] 1977 (4) SA 292 (SCA).

[47] Bamford (n 17) 19; *Annabhay v Ramlall* 1960 (3) SA 802 (D) 805.

[48] Supra (n 47).

[49] 2012 (4) SA 1 (SCA).

[50] 2012 (1) SA 206 (SCA).

[51] At 213D.

[52] 2012 (4) SA 1 (SCA).

[53] *Eaton & Louw v Arcade Properties (Pty) Ltd* 1961 (4) SA 233 (T).

[54] *Eaton & Louw v Arcade Properties (Pty) Ltd* (n 53).

[55] *SACCA Ltd v Olivier* 1953 (3) SA 136 (T).

[56] See Chapter 4: The legal concept of a company.

[57] *Venter v Naude NO* 1951 (1) SA 156 (O).

[58] *Fink v Fink* (n 9).

[59] Supra (n 9).

[60] *Dickinson & Brown v Fisher's Executors* 1916 AD 374.

[61] *Purdon v Muller* (n 11) 220.

[62] *Purdon v Muller* (n 11); *Fink v Fink* (n 9).

[63] These fiduciary duties are discussed at length in Chapter 14: The duties and the liability of directors.

[64] 1910 TPD 571 at 579.
[65] *Hellmore v Smith* 1886 (35) Ch D 436.
[66] 1853 (18) BEAV 75.
[67] 1912 AD 505.
[68] 1905 TS 255.
[69] 267-8.
[70] Although the Supreme Court of the Transvaal reversed this decision on the facts (in *Trimble & Bennet v Goldberg* 1906 TS 1002), the Privy Council subsequently restored the decision of the court *a quo*.
[71] 1909 TS 4.
[72] 1949 (1) SA 584 (SWA).
[73] *Silver v Silver* 1934 NPD 396.
[74] *Setzkorn v Wessels* 1962 (2) SA 218 (D).
[75] *Romersa v Buch* 1917 TPD 266.
[76] *Potchefstroom Dairies and Industries Co Ltd v Standard Fresh Milk Supply Company* 1913 TPD 506.
[77] *Potchefstroom Dairies* (n 76).
[78] *Muller en 'n Ander v Pienaar* 1968 (3) SA 195 (A); *Braker & Co v Deiner* 1934 TPD 203.
[79] *Davison's Estate v Auret* (1905) 22 SC 10.
[80] Or to be more precise, on all the partners, since a partnership is not a separate legal person. The word 'partnership' is used in this context for ease of reference.
[81] This doctrine must not be confused with an unnamed principal.
[82] *Eaton & Louw v Arcade Properties (Pty) Ltd* 1961 (4) SA 233 (TPD); decision upheld by the Appellate Division 1962 (3) SA 255 (A), where it was held that the doctrine of the undisclosed principal applies to South African law. The doctrine does not however apply to an anonymous partnership or a partnership *en commandite* since such a partner has no authority or even ostensible authority to enter, on behalf of the partnership, into a contract with a third party.
[83] 1972 (1) SA 716 (A).
[84] *Meyer v Mosenthal* 1925 TPD 281 at 284.
[85] *Braker & Co v Deiner* 1934 TPD 203 at 206, where the court ruled that where a summons has been issued against the partnership, a partner has implied authority to consent validly to judgment, even though this is done without the knowledge of the other partners, provided that there is no collusion between the partner and the judgment creditor.
[86] *Goodrickes v Hall and Another* 1978 (4) SA 208 (N).
[87] Supra (n 86).
[88] See *Freeman and Lockyer v Buckhurst Park Properties (Mangal) Ltd* [1964] All ER 630 (CA); *NBS Bank Ltd v Cape Produce Co (Pty) Ltd* 2002 (1) SA 396 (SCA). See Farouk HI Cassim et al *Contemporary Company Law* 2 ed (2012) and Chapter 7: Corporate capacity, agency and the turquand rule for a fuller discussion.
[89] *Geldenhuys v East and West Investments (Pty) Ltd* [2005] 2 All SA 105 (SCA) 106i.
[90] 1938 TPD 112.
[91] 1976 (2) SA 536 (A).
[92] *Mahomed v Karp Brothers* 1938 TPD 112.
[93] *Rodrigues and Others v Alves and Others* 1978 (4) SA 834 (A).
[94] *Rodrigues and Others v Alves and Others* (n 93), where R, while about the business of the partnership, negligently allowed a fire to spread to neighbouring property. His co-partners were held to be vicariously liable for his negligence.
[95] *Palmer and Another v The Attorney-General and Another* 1934 TPD 50.
[96] For instance, bribing or attempting to bribe a customs officer.
[97] *Shingadia Brothers v Shingadia* 1958 (1) SA 582 (FC).
[98] *Shingadia Brothers v Shingadia* (n 97) 583.
[99] *Robson v Theron* 1978 (1) SA 841 (A).
[100] *Oosthuizen v Swart* 1956 (2) SA 687 (SWA).
[101] *Robson v Theron* 1978 (1) SA 841 (A).

[102] *Robson v Theron* (n 101).

[103] Supra (n 101).

[104] *Fink v Fink* (n 9).

[105] *Dickinson & Brown v Fisher's Executors* 1916 AD 374.

[106] This does not apply to an anonymous or a commanditarian partnership.

[107] In the case of a *de facto* state of war, an order of dissolution may have to be granted by the court (as opposed to an automatic dissolution).

[108] If a partner is an enemy subject who is not domiciled or resident in an enemy country, the partnership is not automatically dissolved. But it may be dissolved by order of court, on application by the other partners.

[109] *Curtis & Curtis v Beart* 1909 TH 141.

[110] *Curtis & Curtis v Beart* (n 109).

[111] Bamford (n 17) 81.

[112] *Wegner v Surgeson* 1910 TS 571.

[113] However, if the partnership agreement stipulates a notice period, this must be complied with, failing which the relevant partner would be liable for any damage incurred.

[114] Bamford (n 17) 81-2.

[115] *Wegner v Surgeson* (n 112) 577.

[116] (1886) 5 EDC 197.

[117] *Wegner v Surgeson* (n 112).

[118] *Wiehan and Others v Marais* 1965 (1) SA 398 (T); *Wegner v Surgeson* (n 112).

[119] *Purdon v Muller* (n 11); *Purdon v Muller* 1960 (2) SA 785 (E) 785.

[120] See further Bamford (n 17) 82.

[121] 1909 TH 141.

[122] *Romersa v Buch* 1917 TPD 266.

[123] *Lee en 'n Ander v Maraisdrif (Edms) Bpk* 1976 (2) SA 536 (A); *Bester v Van Niekerk* (n 12).

[124] The partners themselves may also liquidate a partnership, without the appointment of a liquidator, depending on the circumstances.

[125] 1978 (4) SA 841 (A).

[126] The liquidator must draw up a final account between the parties.

[127] *Silbert & Co v Evans & Co* 1912 TPD 425.

[128] There must not have been any *mala fide* misappropriation by any partner of partnership assets.

Chapter 3
Business Trusts

Richard Jooste

3.1 Introduction

A form of business vehicle which has become more and more popular in recent times is the 'business' or 'trading' trust. Its popularity is due to the distinct advantages that it enjoys when compared to the other available business structures, namely, the sole proprietorship, the partnership, the company and the close corporation.

3.2 Nature of a business trust

A trust has been described as 'the legal institution where an intermediate person, the trustee, holds property as owner thereof in accordance with the expressed wishes of another person, the settlor or founder, not for his or her personal benefit but for the benefit of named or ascertainable beneficiaries or for an impersonal object'. [1]

The trust in this description, other than one created for an impersonal object (a charitable trust), is sometimes referred to as an ownership trust. The ownership of the trust assets vests in the trustee or trustees who administer the assets for the benefit of others. Sometimes a trust is created whereby ownership of assets is vested in the beneficiaries, and not in the trustees, but trustees are appointed to administer the assets on behalf of the beneficiaries. Such a trust is known as a *bewindtrust*. The *bewindtrust* has few of the advantages of an ownership trust and its usefulness is limited. The trust that is used mostly as a business vehicle or for estate planning purposes is the ownership trust.

A business trust is simply an ownership trust in which the trustees carry on a business-related endeavour as trustees. The business and its assets are owned by the trustees in their capacity as trustees and the trustees carry on the business for the benefit of the beneficiaries of the trust. The principles of law applying to trusts in general apply equally to business trusts.

A business trust may be used for various purposes, for example, for trading or holding property or for realising property (a 'realisation' trust). A business trust can also readily be used to combine a business endeavour with an estate planning goal. Regarding the latter, it must be noted that an ownership trust, if properly structured, has tremendous potential for the saving of estate duty which can be significant, being levied at a rate of 20 per cent of one's dutiable estate.

What could be referred to as a 'public business trust' is the 'collective investment' trust which is governed by the Collective Investment Scheme Act 45 of 2002. This kind of trust corresponds with the 'unit trust' which was governed by the now repealed Unit Trusts Control Act 54 of 1981. What is basically envisaged here is an arrangement whereby the public are invited to invest in a trust fund for which members of the public will receive proof of the investment, in the form of a certificate or otherwise, of their pro rata transferable share in the trust fund. This chapter will not deal with such a trust, but with what is referred to earlier, which could be termed a 'private ownership business trust'.

The courts have accepted the validity of a business trust. There have been various cases that are authority for this.

A trust does not have to be in writing but it should obviously be so in order to avoid uncertainty and disputes. So it may be oral. When it is in writing the document is known as a trust deed or a trust instrument, which will set out the terms of the trust (for example, the powers of the trustees, who the beneficiaries are, how the capital and income of the trust is to be distributed and the nature of the business to be carried on by the trustees).

3.3 No legal personality

It is important to note that a 'trust' is not a separate entity. It is not a juristic person like a company or a close corporation (although it is for the purposes of the Companies Act 71 of 2008 ('the Act')). In other words, it does not have legal personality like a company or close corporation, although for certain purposes, for example, taxation, it is treated as a 'person'. Another example is that, in terms of the Deeds Registries Act 47 of 1937, a trust is deemed to be a person for the purpose of registration of immovable property. The effect of this provision is that a transfer of immovable property acquired by trustees in their capacity as trustees is to be registered in the name of the trust.

So the rights (whether they be ownership rights or any other rights) and liabilities relating to the business do not vest in the trust but in the trustees in their capacity as

such. They do not vest in the trustees in their personal capacities. If a trustee dies or goes insolvent, the assets of the trust do not fall into the insolvent's personal deceased or insolvent estate. Although the trust is not a separate legal entity, a trust can be sequestrated and the trust assets will fall into the trust's insolvent estate. This is another example of the trust being treated as a person. Because of the peculiar nature of the trustee's right of ownership of trust assets and the fact that a trust is sometimes treated as if it is a 'person', it is understandable why a trust is often referred to as if it is a separate entity. To understand the law governing trusts, however, it is very important to remember that a trust is not a legal person.

3.4 The law governing trusts

The law governing trusts is mainly common law. The Trust Property Control Act 57 of 1988, which came into force on 1 March 1989, is a short statute which is devoted largely to establishing firmer control over trustees by the master of the High Court and is by no means a codification of the law governing trusts.

Care must be taken not to confuse a trust in South Africa with a trust in England. A trust in England is based on the principle of dual ownership, ie equitable and legal ownership, which is foreign to South African trust law. The law governing trusts in England is different from the law in South Africa.

The Business Names Act 27 of 1960 prohibits the despatch to any person of any trade catalogue, trade circular, business letter, order for goods or statement of account unless it has on it: the name, title or description under which the business is carried on; the place where the business is carried on; and the full names of every natural person carrying on the business. [2] The Act applies to a trust and to the trustees carrying on a business.

3.5 Legal basis of a trust

In determining the legal basis of a trust, one must distinguish between a testamentary trust and an *inter vivos* trust. A testamentary trust is a trust created by a testator in his or her will. An *inter vivos* trust is a trust created by a person referred to as the creator/founder/settlor/donor during that person's life-time. Both a testamentary and an *inter vivos* trust could be a business trust but a testamentary business trust is rare. A business trust is almost always an *inter vivos* trust.

The Appellate Division has held that the testamentary trust is an institution *sui generis* (ie of its own kind) and there is no need to equate it with some Roman-Dutch law institution to justify its existence. However, the Appellate Division has equated the *inter vivos* trust with the Roman-Dutch law institution of *stipulatio alteri* (a contract for the benefit of a third party).

The position is therefore that a testamentary trust is created by a valid testamentary act, whereas an *inter vivos* trust is created by a special type of contract known as a *stipulatio alteri* or a contract for the benefit of a third person. The contract is between three parties, the founder, the trustees and the beneficiaries (the beneficiaries being the 'third party'). Labelling an *inter vivos trust* a *stipululatio alteri* has been criticised by some who say that it should be seen as a *sui generis* contract (a contract of its own kind). Be that as it may, an *inter vivos* trust is, in terms of present law, a *stipulatio alteri*.

The act of creation of a testamentary trust, namely, the execution of the will, takes place *inter vivos* but the trust is only established once the testator dies. The testator bequeaths property to a trustee on terms requiring him or her to assume control of the property and to administer it for the benefit of the beneficiaries stated in the will. A testamentary trust exists as from the date of the testator's death and actual transfer of the property is not essential for the trust to come into existence. It is better to draw the entire testamentary trust deed separately from the will and then incorporate it by reference into the will. This assists in showing the intention to create a trust and facilitates valid changes up to death.

An *inter vivos* trust exists from the moment of execution of the agreement. The fact that the agreement is creating a trust does not in itself call for compliance with any special formalities. [3] An agreement creating an *inter vivos* trust can, generally, be created orally. To avoid disputes it should, however, be in writing.

3.6 The essentials of a trust

In order to create a valid trust the following are essential:

(i) The founder [4] must intend to create a trust. Effect will not be given to a 'trust' if it does not reflect the true intention of the parties. This is known as the 'substance over form' principle. If in fact no trust has been set up the consequences can be serious. For example, you will have failed to disclose, as your own, the income and capital gains which were assumed to have accrued to the trust, resulting in additional tax, penalties and interest becoming payable. Criminal prosecution for tax evasion is also a possibility. Also, because the 'trust' assets are in fact and in law yours, they will be exposed to your creditors.

The intention to create a trust must be expressed in a way which will create an obligation. In the case of an *inter vivos* trust, both the founder and the person(s) to be trustee(s) must have the intention to create a trust. However, the use of the words 'trust' and 'trustee' does not necessarily mean that a trust has been created. All the facts and the entire trust deed have to be examined to determine the intention.

(ii) The trust property must be defined with sufficient certainty.

(iii) The trust object must be lawful.

(iv) A trust without a beneficiary is invalid. If the intended beneficiary is not named or determinable, the trust will fail. If the beneficiary is ascertainable but cannot take or the object of the trust is not clearly defined, the trust fails. It is possible for part of a trust to fail and part to be valid.

A trustee may not act as such without the written authority of the Master, but lack of such authority does not invalidate the trust.

Transfer of the trust property to the trustee is also not an essential of a valid trust, as long as the trustee has a right to transfer.

The fact that a trust deed has been filed with the Master of the High Court does not in itself give validity to the trust.

A trustee is essential in the creation of an *inter vivos* trust, but the loss by an existing trust of its trustee does not invalidate the trust.

The mere fact that letters of appointment are held by the 'trustees' does not mean that a valid trust has been formed.

Care must be taken that what one has created is a trust and it is not construed as a partnership. A trust and a partnership can in terms of form closely resemble each other. A trust and partnership are, in law, vastly different creatures with vastly different consequences flowing from their creation, so one must be very astute in this regard. The tax treatments are also very different.

3.7 Sham trusts

Settlors of trusts must not treat the trust property as their own. The danger is that the trust could be set aside as a 'sham'.

3.8 Flexibility of a trust

A trust is a very flexible institution, one of the attributes that make it attractive.

The flexibility of a trust is such that a trustee may also be a beneficiary and the founder of a trust may also be a trustee and beneficiary; in fact he or she may be the sole beneficiary. The only restriction is that the founder may not be the sole trustee and the sole beneficiary because every trust requires the element of holding or administering property in part at least for a person or object other than the trustee himself. As was stated by Cameron JA in *Land and Agricultural Bank of South Africa v Parker and Others*: [5]

> Though a trustee can also be a beneficiary, the central notion is that the person entrusted with control exercises it on behalf of and in the interests of another. This is why a sole trustee cannot also be the sole beneficiary; such a situation would embody an identity of interests that is inimical to the trust idea, and no trust would come into existence.

It is important to note that Cameron JA is not saying that it is inimical to the trust idea that the trustees and the beneficiaries have identical interests in so far as the object of the trust is concerned. Thus in *Nel and Others v Metequity and Another* [6] both the trustees and the beneficiaries were wholly-owned subsidiaries of the same company and the trust was held to be valid.

It is also to be noted, however, that the founder cannot set up a trust by transferring assets to himself as sole trustee, though he or she may do so by a transfer in trust to him- or herself and another. Once the trust is in existence, however, it will not be extinguished merely because the founder becomes the sole trustee, provided he or she is not also the sole beneficiary.

3.9 The rights of beneficiaries

A beneficiary of a trust may be entitled to all or part of the income and/or capital of the trust. The right of a beneficiary to income or capital of a trust depends on the trust deed.

The right, which is a personal right, is either a conditional (contingent) or unconditional (vested) [7] right. The passing of time is not a condition. So, for example, if a trust is to accumulate the trust income and to distribute the accumulated income to a beneficiary in five years' time, the beneficiary has an unconditional (vested) right to the income. This means that if the beneficiary dies in the interim, the right to the income will form part of his or her deceased estate. If not - for example, if the right is to pass to someone else - then the beneficiary's right is a conditional (contingent) right. Another example of the right being conditional would be where the trust deed provides that the income or capital will be distributed if the beneficiary gets married. Until the beneficiary gets married, the right is a conditional (contingent) right. Once the beneficiary gets married, the right becomes a vested right.

Where the right to income or capital is dependent on the exercise of the trustee's discretion, the right will be a contingent one (see below regarding discretionary trusts).

Whether a right to income or capital is a vested or contingent right becomes particularly important in the contexts of insolvency and the taxation of income or capital gains accruing to a trust.

All beneficiaries of a trust have a personal right to the proper administration of the trust which they can enforce against the trustees. This applies even to a beneficiary with a contingent interest in the trust.

The rights of the beneficiaries of a business trust can be structured in such a way that they can be sold.

3.10 The discretionary trust

Many trusts are structured as so-called 'discretionary' trusts, and business trusts will invariably be discretionary trusts.

Where the trust instrument provides that the trust capital and/or income is to be distributed at the discretion of the trustee, the trust is referred to as a discretionary trust. A trust could, of course, be only partly discretionary, which would be the case where only part of the trust capital and/or income is subject to the trustee's discretionary power. The degree to which the trustees have a discretion is dependent on the terms of the trust deed. The trustees may be given the discretion whether to make a distribution or not and if they decide to do so they may then have to make a distribution in equal shares to the beneficiaries. On the other hand, they may have the discretion to make the distribution in unequal shares and in fact to exclude from a distribution altogether one or more of the beneficiaries (the latter would be termed a fully discretionary trust). A discretion may also relate to whether a benefit is

to be retained on loan account or distributed. Although a discretion may be 'unlimited' the trustees must always act with the care, diligence and skill that can reasonably be expected of a person who manages the affairs of another. They are also bound to exercise their discretion impartially and independently.

Where a beneficiary's right to trust capital and/or income is dependent on the exercise of the trustee's discretion, the right is of a contingent nature (ie it is not a vested right) and therefore is not transmissible to the beneficiary's successors on death or insolvency.

An important question that arises in relation to discretionary trusts is the extent to which the determination of the beneficiaries can be left to the discretion of the trustee. In this regard a distinction must be drawn between testamentary and *inter vivos* trusts.

In the case of a testamentary trust, a trustee can be given a discretionary power to appoint beneficiaries from the ranks of named persons or from a clearly defined class of persons. [8] In similar vein, the trustee can be given power to create further trusts provided the beneficiaries are to come from the ranks of persons named by the testator or from a class of persons [9] defined by the testator. In keeping, however, with the fundamental rule of our law that, generally, a person may not delegate his or her testamentary power, a trustee of a testamentary trust cannot be given an unfettered discretion to appoint as beneficiaries whomsoever he or she pleases.

In the case of an *inter vivos* trust, as in the case of a testamentary trust, a trustee can clearly be given a discretionary power to appoint beneficiaries from the ranks of named persons or from a clearly defined class of persons. Because the rule against delegation of testamentary power has no application, an unfettered discretion to appoint as beneficiaries whomsoever the trustee wishes would not be invalid for this reason. However, it would be wise to avoid the grant of so wide a power as it would almost certainly be held to be inconsistent with the nature and essentials of a trust.

Trusts are structured as discretionary trusts for the flexibility they provide and also for tax and estate duty planning purposes. Fiscal legislation has developed to an extent where the saving of income tax and capital gains tax through the use of a trust is virtually non-existent. However, as the rights of beneficiaries of a discretionary trust to trust income and/or capital are not vested in the beneficiaries (the rights do not fall into their deceased estates if they die), it is certainly possible to save estate duty. Careful structuring of the trust is, however, necessary. A business trust can, accordingly, carry with it this added benefit, together with the other benefits it confers.

3.11 Who may be a beneficiary?

Any person, born or unborn, natural or juristic, may be a beneficiary of a trust. Where the beneficiary who has been designated is not a juristic person, for example, a company, another trust or partnership or an unincorporated association, such designation is valid. The beneficiaries are respectively the company, the trustees, the partners or the association’s committee.

The founder or the trustee of a trust may be a beneficiary of the trust. It is, of course, possible to have more than one founder of a trust and for the founders to be trustees and beneficiaries. This is often the case with a business trust.

The danger of naming, for example, ‘blood relations’ or persons ‘related by affinity’ as beneficiaries is the potential difficulty of tracking them down. This could lead to serious difficulties; for example, the consent of such beneficiaries to the amendment of an *inter vivos* trust may be needed.

It is possible for a trust to be a beneficiary of another trust. A trust deed may provide that instead of the trustees making a distribution to a beneficiary, the distribution may (in the trustees’ discretion usually) be made to another trust of which he or she is the beneficiary or one of the beneficiaries. Care must be taken, if this is done, to confirm that the other trust is valid, including from the point of view of the power of appointment.

If trustees are given the power to create further trusts, the power of trustees to appoint beneficiaries must not be unfettered. If the power is unfettered, then in the case of a testamentary trust there would be delegation of testamentary power and in the case of an *inter vivos* trust it would fail on the ground of vagueness (see above regarding discretionary trusts).

3.12 Trustees

The office of trustee is governed by the Trust Property Control Act 57 of 1988 as well as principles of common law. The following important aspects are highlighted:

(i) The first trustees of a trust are usually appointed by the founder of the trust. However, the founder of a trust can empower any person, or body, to appoint trustees.

(ii) Whereas there are no prescribed qualifications for trustees, the trust deed can clearly disqualify certain persons from acting. In the case of a testamentary trust, those persons who wrote the will or witnessed the will, and their spouses, are disqualified. [10] The trustee must have full contractual capacity.

(iii) Section 7(2) of the Trust Property Control Act empowers the Master, if he or she considers it desirable, notwithstanding the provisions of the trust deed, to appoint as co-trustee of any serving trustee any person whom he or she deems fit. The Master does not have to afford a hearing to any interested parties before acting in terms of s 7(2). [11] An interested party may, however, apply to court for relief. [12]

(iv) An important caution has been issued against the abuse of the trust form in *Land and Agricultural Bank of South Africa v Parker and Others*. [13] In his judgment Cameron JA cautioned against the abuse of a trust where the separation of beneficial interest from control is not followed. He went on to say that while this blurring of ownership and beneficial interest might require legislative intervention, the Master and the courts were not powerless to restrict such abuses. Cameron JA held that, accordingly, acting in terms of the Trust Property Control Act, the Master should insist on the appointment of an independent outsider as a trustee to every trust in which *(a)* the trustees are all beneficiaries and *(b)* the beneficiaries are all related to each other. This insistence on an independent trustee has been criticised.

(v) A trustee must, before assuming control of the trust property, and upon payment of the prescribed fee, lodge with the Master the trust instrument or a certified copy thereof.

(vi) A trustee has authority to act as such only once authorised in writing by the Master, and if the trustee acts before that, his or her acts are a nullity and cannot be ratified subsequently by authorised trustees.

(vii) A trustee will not be given authority to act by the Master unless security for the proper performance of his or her functions has been provided or such security has been dispensed with by the court or the Master. Even if the trust instrument has exempted the trustee from providing security, the Master is empowered to call for security. Pending the furnishing of security, the Master may authorise the trustee to perform certain specified acts.

(viii) A trustee can be removed from office by the Master or the court. A person can apply for the removal of a trustee of a trust, but only if he or she is a beneficiary of the trust.

(ix) A trustee must invest trust funds if so instructed and authorised by the trust instrument. The making of investments may be subject to limitations in the trust instrument or a matter for a trustee's discretion. It is not for the court to determine how a trustee is to exercise his or her discretion. A trustee must pay due regard to the interests of the income beneficiaries and capital beneficiaries.

(x) A trustee's common-law duty of care requires him or her to invest trust funds as a *bonus et diligens paterfamilias*. As has been pointed out, [14] the high standard of conduct required of a trustee prompted the finding in *Sackville West v Nourse* [15] that a trustee investing trust assets may not expose them to any risk whatsoever. The court found a trustee to have been negligent and accordingly liable for breach of trust on account of a speculative investment that resulted in a loss of trust capital and interest.

As Du Toit says, [16] this strict approach was developed in circumstances where the impact of inflation on investment was negligible, requiring-

> that trustees should invest in so-called no-risk 'trust investments' only, which traditionally included immovable property; first mortgages of immovable property; government, provincial or municipal stock and fixed deposits with a reputable bank, trust company or building society. Inflation, however, has become a significant economic factor. Consequently, present-day investment in, for example, fixed income securities may well prejudice both income and capital trust beneficiaries through a decline in the real income from trust property and/or in the real value of trust capital. It appears, therefore, that, in countering the ravages of inflation, avoidance of all risk in the investment of trust property is almost impossible, particularly in unstable modern economic times.

In *Administrators, Estate Richards v Nichol* [17] the court, as Du Toit says, [18] provided-

> a proper perspective on the latter contention by suggesting that the question of the prudence of a particular investment can be answered only with due consideration of the facts and circumstances of each case. Such evaluation may reveal investment in riskier investments such as shares or unit trusts to be prudent.

The court elaborated as follows:

> An investment considered prudent in earlier times may rightfully be regarded as quite imprudent in the context of modern conditions. The ongoing and rapid decline in the value of money brought about by inflation ... may well result in a sharp decline in the value of monetary security within a relatively short period of time. In order to preserve the capital of the trust in real terms and so ensure the continued production of income ... a trustee ... is of necessity obliged to invest in real assets with potential for capital growth. Such an investment, viz one where the capital is not fixed, necessarily involves some element of risk; but the risk may be unavoidable if the capital of the trust is to be preserved in real terms. The acceptance of this element of risk as being unavoidable if the trust is to serve its purpose has inevitably led in more recent times to a change in investment thinking which involves a movement away from the more conservative approach developed in an age when inflation was either non-existent or of little consequence. In principle, therefore, I can see no justification at this stage for a hard and fast rule which precludes the investment of trust funds in quoted shares or licensed unit trusts riskier than traditional 'trust investments'.

However, the *Nichol* court, no doubt cognisant of the limits set by s 9(1) of the Trust Property Control Act with regard to a trustee's duty of care, sounded a word of warning as a counterbalance to this approach: [19]

> [I]t must not be overlooked that every investment in shares (and unit trusts) carries with it the inherent risk of capital loss. A trustee exercising due diligence and care will bear this in mind when purchasing shares both in regard to their selection and the balance of his share portfolio. He will accordingly avoid investments which are of a speculative nature. The extent to which it will
>
> be prudent to invest in the share market must necessarily depend on the circumstances of each case. Generally speaking, however, a trustee will as far as is practicable seek to spread the investments of the trust over various forms of undertaking in order to obtain a balance of stability and growth in the capital value of the trust and the income it produces.

As stated by Du Toit [20] the decision in the *Nichol* case does not, therefore-

> warrant the inference that trustees now enjoy an unfettered discretion in the investment of trust funds. The powers of investment conferred by a trust instrument, the operational period of the trust and the qualities and expertise of the trustee are all factors guiding a trustee's investment choice. It may well be prudent for a trustee to invest, even today, in any one or more of the traditional trust investments. However, should the factors mentioned above justify investment in, for example, shares and/or unit trusts, the investment strategy should be tested against the guidelines formulated in the *Nichol* case: namely, the facts and circumstances of the particular case; caution when the choice of investment is made; avoidance of overly speculative investment; the spread of investment over various market sectors; and the striking of a balance between stability and growth.

It will be appreciated that the trust deed of a business trust will often specifically give the trustees the power to engage in risky or speculative ventures and/or investments.

(xi) Where there is more than one trustee, the trustees must act jointly unless the trust deed provides otherwise. If they fail to act jointly in entering into an agreement, the agreement is invalid and unenforceable.

(xii) If a trust deed requires a certain number of trustees and the number drops below the required number, the remaining trustees cannot act (even unanimously), unless the trust deed so provides.

(xiii) Unless the trust deed contains provisions to the contrary, joint unanimous conduct in the alienation, handling and management of trust assets is a prerequisite. [21] However, trustees may delegate certain functions to specific trustees or outsiders subject to the retention of ultimate responsibility and the obligation of proper supervision. [22]

(xiv) A trustee only has such powers as are determined by the trust instrument and these differ from one trust to another. The powers are strictly interpreted and therefore it is prudent and common for trust instruments to confer very wide powers on trustees, particularly if it is envisaged that the duration of the trust will be lengthy. If a power is not expressly conferred by the trust instrument, it is possible that it may be conferred by necessary implication. Powers may be specifically limited by the trust instrument. The exercise of a trustee's powers is under the control of the Master. So, for example, trustees do not have the following powers unless they are given by the trust instrument or can be necessarily implied from the trust deed: the power to alienate property other than tangible assets; the power to mortgage property; the power to let property; the power to borrow money on behalf of a beneficiary; the power to guarantee a loan by a third party to a beneficiary; the power to run a business.

(xv) In the performance of his or her duties and the exercise of his or her powers, a trustee must act with the care, diligence and skill which can reasonably be expected of a person who manages the affairs of another. It has been held that the standard requires a trustee to show greater care in administering trust property than might be expected of him or her when dealing with his or her own property. An exemption clause in a trust instrument which seeks to exempt a trustee or indemnify him or her against liability for breach of trust where he or she fails to show the degree of care, diligence and skill required, is void. If the beneficiaries consented to or confirmed the actions of the trustee, this would be a valid defence against an alleged breach of trust. If a trustee acts in breach of trust, negligently or without authority, the trustee may be liable for the loss caused to the trust.

(xvi) Each of the trustees is required to exercise an independent judgment as to what constitutes the best interests of the trust.

(xvii) A trustee is entitled to such remuneration as is provided in the trust instrument and, failing such a provision, to reasonable remuneration, which shall, in the event of a dispute, be fixed by the Master.

(xviii) Administration expenses are payable from the trust assets with day-to-day expenses generally being paid from trust income and expenses relating to the trust's property being paid from trust capital. The trust instrument may vary this format, and if so must be adhered to. Trustees are entitled to reimbursement if they pay for trust expenses out of their own pockets and the fact that they are remunerated does not detract from this right. [23]

(xix) A trustee, by virtue of his or her fiduciary position, has a duty to keep proper accounts and owes the utmost good faith towards all beneficiaries, whether actual or potential. The duty of good faith is no different in kind from that which falls on an agent. A trustee is required to account for everything in good faith – to keep regular accounts of all transactions on behalf of the trust, not only of payments and disbursements, but also of receipts; and to render such accounts to the beneficiaries at all relevant times, without any suppression, concealment, or overcharge. This involves a trustee in keeping the trust's property separate; in keeping its accounts up to date and allowing the inspection of its books; and in giving information when necessary. In carrying out his or her duty to account to beneficiaries, a trustee must not overlook the difference between the rights of capital beneficiaries, on the one hand, and income beneficiaries, on the other. The two types of beneficiaries have conflicting interests and trustees must strike a balance between the interests of the two groups.

(xx) The onus is on the trustee of a trust to register the trust for tax purposes.

(xxi) A trustee's trusteeship comes to an end when the trustee is removed; the trustee resigns; the trustee dies; the trust deed so provides; the constitution under which the trustee is appointed is revoked; and the trust is terminated.

3.13 Variation or revocation of a trust

A distinction must be drawn between a testamentary and an *inter vivos* trust.

In line with the approach that a testamentary trust is to be regarded as a will and the rule that effect should be given to the testator's wishes, the general rule is that a court has no inherent jurisdiction to consent to the variation or revocation of a testamentary trust.

The courts have, however, reluctantly on occasion indicated a willingness to authorise a variation when circumstances unforeseen by the testator occur, as a result of which the testator's wishes or instructions cannot be given effect to because they are no longer practical or realistic. There is no general common-law rule, however, stating that changed circumstances justify a deviation from the provisions of a will, and the attitude of the courts in this regard is unpredictable.

Section 13 of the Trust Property Control Act has gone some way towards remedying the common-law situation, but the cry for a general power to be given to the courts has not been heeded. Section 13 provides:

> If a trust instrument contains any provision which brings about consequences which in the opinion of the court the founder of the trust did not contemplate or foresee and which-
>
> *(a)* hampers the achievement of the objects of the founder; or
> *(b)* prejudices the interests of beneficiaries; or
> *(c)* is in conflict with the public interest,
>
> the court may, on application of the trustee or any person who in the opinion of the court has a sufficient interest in the trust property, delete or vary any such provision or make in respect thereof any order which such court deems just, including an order whereby particular trust property is substituted for particular other property, or an order terminating the trust. [24]

With regard to the power of the trustee to vary or revoke the trust by virtue of a power given to him or her in the trust deed, see below under variation or revocation of an *inter vivos* trust. Cameron et al [25] are of the view that the position is the same with testamentary trusts.

Because of the equation of the *inter vivos* trust with the *stipulatio alteri*, issues relating to the variation of the trust deed must be resolved in accordance with the principles of contract.

The founder of an *inter vivos* trust may vary or revoke the trust if he or she has reserved the right to do so in the trust deed. It sometimes happens that there may be a 'testamentary reservation' clause in the founder's will which enables him or her to vary or revoke the trust deed in the will.

It appears that the trustee can vary the trust in terms of a right to do so reserved in the trust deed. It appears that there would be no objection to giving such power in circumstances defined by objective criteria, but if the power of revocation were committed wholly to the discretion of the trustee, this would contravene public policy and be unacceptable. It has yet to be decided whether the trustee can be given the power to revoke the trust entirely.

The founder of the trust and the trustee clearly cannot agree to vary the trust if the beneficiaries have already accepted. Where the beneficiaries have not yet accepted, the power of the founder to revoke or vary with the consent of the trustee has been accepted by the Appellate Division.

It will be recognised that if a nominal founder has been used to form a trust and the trustees and beneficiaries later wish to vary or revoke the trust by agreement, there will be a serious problem if the founder cannot be traced.

If the founder has become incapacitated or is dead, the trustees and beneficiaries cannot vary or revoke the trust deed by agreement.

The founder, trustees and beneficiaries (if they have accepted) can vary the trust deed even if the trust deed states that it cannot be varied.

What has been said above regarding the power of the court to vary or revoke a testamentary trust, both in terms of the common law and in terms of s 13 of the Trust Property Control Act, is equally applicable to the variation or revocation of an *inter vivos* trust.

3.14 Advantages and disadvantages of a trust

The advantages of using a trust as a business vehicle are the following:

(i) The founder, the trustees and the beneficiaries are not exposed to the creditors of the trust (except in limited circumstances). In this respect, therefore, the business trust is in the same position as a company and a close corporation. One must remember that this is not the case with a *bewindtrust* where the beneficiaries, being the owners of the trust assets, are liable to the trust creditors for satisfaction of their claims.

(ii) The business trust, like a company and a close corporation, has the attribute of perpetual succession. This means that a change in trustees or beneficiaries does not affect the continuation of the trust. A business trust can continue indefinitely.

(iii) A business trust is not heavily regulated like a company (the Companies Act) or close corporation (the Close Corporation Act). The Trust Property Control Act deals only in a minor way with trusts.

(iv) A business trust enjoys more confidentiality than a company or close corporation.

(v) A business trust is not required by law to have an audit (some companies require an audit, close corporations do not and nor do partnerships).

(vi) A business trust provides estate planning opportunities not available with the other business vehicles.

The disadvantages of a trust are the following:

(i) A trust is treated as a person for tax purposes and is taxed at a higher rate (a flat 40 per cent) than any other taxpayer. With careful planning, however, a trust need never pay tax, as the tax burden can be split among the beneficiaries.

(ii) The law governing trusts is still in a state of development and is therefore, in

certain respects, uncertain. This aspect should not, however, be over-emphasised, as business trusts function very well in practice.

Questions

1. The trust deed of the Nadal business trust requires that there shall be three trustees and that all trustees' decisions must be unanimous. Tom, Dick and Harry are appointed trustees. Tom and Dick have letters of authority from the Master to act as trustees, but Harry is still waiting for his. Can Tom and Dick act as trustees in the meantime and enter into contracts with third persons? Would a third person be able to enforce such a contract? Would your answer be different if Harry, despite not having a letter of authority from the Master, took part in the unanimous decision to enter into the contract? If Harry had a letter of authority but was not involved in the decision to enter into the contract, would the contract be enforceable by the third person? If the trust deed only required a majority decision of the trustees as opposed to a unanimous decision, would a decision by Tom and Dick be valid if reached before Harry received his letter of authority? Discuss.
2. Why is using a business trust as a business vehicle more appealing than using a company?
3. Why is a discretionary business trust more appealing than a non-discretionary one?
4. In what circumstances could the founder of a business trust and its trustees, together, amend or vary the trust deed?
5. Can the trustees of a discretionary business trust be given a complete discretion in determining who the beneficiaries of the trust will be?

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[1] PA Olivier *Trust Law and Practice* (1990) 4.

[2] Section 3.

[3] A common misconception is that an *inter vivos* trust must be notarially executed.

[4] The founder can be a natural or legal person. See, for example, *Investec Bank Ltd v Lefkowitz* 1997 (3) SA 1 (A), which involved the creation of a trust by the bank.

[5] 2005 (2) SA 77 (SCA) para [19].

[6] 2007 (3) SA 34 (SCA) 37.

[7] The word 'vested' can have a number of other meanings. See Cameron et al *Honoré: The South African Law of Trusts* 5 ed (2002) 471-2.

[8] See *Braun v Blann and Botha NNO and Another* 1984 (2) SA 850 (A); *Administrators, Estate Richards v Nichol* 1996 (4) SA 253 (C).

[9] For example, the blood relatives of the deceased.

[10] Section 6 of the Wills Act 7 of 1953.

[11] *Moore NO v Mrs Du Toit, Assistant Master of the High Court of the Province of KwaZulu-Natal* [2010] JOL 24740 (KZP).

[12] Section 23 of the Trust Property Control Act.

[13] 2005 (2) SA 77 (SCA). See also *Nel and Others v Metequity Ltd and Another* 2007 (3) SA 34 (SCA).

[14] F du Toit *South African Trust Law: Principles and Practice* 2 ed (2007) 87.

[15] 1925 AD 516 at 535.

[16] Du Toit (n 14) 87.

[17] 1999 (1) SA 551 (SCA).

[18] Du Toit (n 14) 88.

[19] 558H-I. See Du Toit (n 14) 88.

[20] Du Toit (n 14) 88.

[21] *Coetzee v Peet Smith Trust en Andere* 2003 (5) SA 674 (T) 679.

[22] Ibid.

[23] See Cameron et al (n 7) 345-8.

[24] See *Ex parte President of the Conference of the Methodist Church of Southern Africa NO: In re William Marsh Will Trust* 1993 (2) SA 677 (C), in which a successful application for variation was made in terms of s 13. This case was followed in *Minister of Education and Another v Syfrets Trust Ltd NO and Another* 2006 (4) SA 205 (C), in which the Trust Property Control Act was again successfully invoked. See also *Curators, Emma Smith Educational Fund v University of KwaZulu-Natal and Others* 2010 (6) SA 518 (SCA); *Ex parte BOE Trust Ltd et al in re JP De Villiers Trust* (WCC) unreported case no 211/09.

[25] Cameron et al (n 7) 413.

Chapter 4
The Legal Concept of a Company

Rehana Cassim

4.1 Introduction

The foundation of company law is the concept that a company has a separate legal personality. Several consequences flow from this concept, such as the privilege of limited liability bestowed on shareholders; perpetual succession of a company; the fact that the property, profits, debts and liabilities of the company belong to it and not to the shareholders; and the fact that a company may sue and be sued in its own name, to name a few. But the separate legal personality of a company has often been abused. This has been recognised by both the courts and the legislature, which have made exceptions to this sacrosanct principle in order to curb extreme cases of abuse, in the form of the doctrine of 'piercing the corporate veil'. These issues are explored in this chapter.

4.2 Legal personality

4.2.1 The concept of separate legal personality

At the heart of company law is the concept of a company as a separate legal person. What is a legal person? All human beings are legal persons, which means they have the capacity to acquire legal rights and incur legal duties. But the essential difference between a legal person and a human person is that a legal person is merely a legal concept and as such has no physical existence.

A legal or juristic person cannot perform acts that are inherently human in nature - such as entering into a marriage, occupying land, appearing in court in person, or being appointed the guardian of a minor, since the relationship between guardian and ward is a personal one that necessitates personal contact and a human relationship. But even though a legal person is merely a legal concept and as such has no physical existence, it does possess its own legal personality to acquire rights and incur obligations that are distinct from those of the directors and shareholders of the company. This is the essence of the concept of separate legal personality.

The separate legal personality of a company is affirmed by the Companies Act 71 of 2008 ('the Act') which states that, from the date and time that the incorporation of a company is registered, the company is a juristic person and has all the legal powers and capacity of an individual, except to the extent that a juristic person is incapable of exercising any such power or having any such capacity, or except to the extent that the company's Memorandum of Incorporation provides otherwise. [1] A registration certificate issued by the Companies and Intellectual Property Commission is conclusive evidence that all the requirements for incorporation have been complied with. [2] The company is incorporated as from the date, and the time, if any, stated in the registration certificate. Thus, once the registration certificate has been issued, the company acquires its own separate legal personality, and it exists continuously until its name is removed from the companies register. [3]

The Act applies both to juristic persons formed under the Companies Act of 2008 and under the Companies Act of 1973. [4] For purposes of the Act, a 'juristic person' is defined in s 1 of the Act as including a foreign company [5] and a trust, irrespective of whether it was established within or outside South Africa. This means that for the purposes of the Act, a foreign company and a trust are juristic persons. In South African common law a trust is not a juristic person, but for purposes of the Act a trust is regarded as being a juristic person. The Act also applies to close corporations that have been converted into a company under the Act.

An understanding of the concept of the separate legal existence of a company is crucial to the understanding of company law as a whole. The leading case on the separate legal personality of a company, which is probably the most famous case in and the cornerstone of company law, is that of *Salomon v Salomon & Co Ltd*, [6] which is discussed below.

4.2.2 *Salomon v Salomon & Co Ltd*

The facts of *Salomon* are that Mr Aron Salomon was a sole trader for many years, and had carried on a prosperous business as a leather merchant and wholesale boot manufacturer. He wished to expand his business, and wanted to enjoy the benefits of

limited liability and perpetual succession. [7] Accordingly, he sold his business to a company with a nominal capital of 40 000 shares of £1 each. Salomon, his wife, daughter and four sons were shareholders in the company, with each of them subscribing for one £1 share in the company. Salomon and two of his sons were directors of the company. In payment of the purchase price of £39 000 the company issued 20 000 fully paid shares of £1 each to Salomon, £9 000 was paid in cash and for the balance of £10 000 the company issued debentures secured over its assets to Salomon. [8] The terms of the sale were approved by all the shareholders of the company. Salomon thus held 20 001 out of the 20 007 shares issued by the company. He was a secured creditor, a controlling shareholder, a director and an employee of the company. The company's business failed and a year later it went into liquidation. It was found that if the amount realised from the assets of the company were to be applied in payment of the debentures held by Salomon there would be no funds left for payment to the ordinary creditors.

The liquidator objected on behalf of the trade creditors and contended that the company was a sham and a scheme designed to enable Salomon to conduct his business in the name of the company and thereby to limit his liability for the debts of the company. It was also contended that since Salomon owned all but six of the shares issued by the company, he and the company were one and the same person and that consequently the company's debts were his debts.

The House of Lords unanimously found in favour of Salomon. The House of Lords found that the company had been validly formed and registered. It was therefore a legal person. The court stated that once the company was legally incorporated, it was a completely different person with its own rights and liabilities. The motives of those who took part in the formation of the company were irrelevant in discussing what those rights and liabilities were. [9] The court held further that there was no requirement in the Companies Act (of 1862) that required the subscribers to the memorandum to be independent or unconnected, or that required them to take a substantial interest in the company. [10] The court remarked that it was a common practice to have nominee shareholders in a company who did not intend to take part in the company. [11]

The House of Lords concluded that the secured debentures issued by the company to Salomon as part of the purchase price for his business were valid as against the company's creditors, and that the business belonged to the company and not to Salomon, who was not liable for the debts of the company. Salomon was thus a secured creditor. Of fundamental importance to the outcome of the case was that there was no fraud on the part of Salomon, nor any fraud on the creditors of the company.

Salomon v Salomon & Co Ltd legitimated the one-man company. It was the first case to establish the principle that a company is a separate legal person quite distinct from

its shareholders and directors; and that shareholders are in principle not liable for the debts and liabilities of the company. The principles laid down in *Salomon's* case comprise the very gist of the concept of separate legal personality. Important legal consequences flow from the separate legal personality of a company, as discussed below.

4.2.3 Legal consequences of separate legal personality

4.2.3.1 Limited liability

Limited liability means the liability of shareholders for the company's debts is limited to the amount they have paid to the company for its shares. The shareholders are as a general principle not liable for the debts of the company. They are under no obligation to the company or its creditors beyond their obligations based on the value of their shares. The claims of creditors of the company are confined to the assets of the company - the creditors of the company cannot obtain satisfaction of their debts from the personal assets of the shareholders of the company. A person is not, solely by reason of being an incorporator, shareholder or director of a company, liable for any liabilities or obligations of the company, except to the extent that the Act or the company's Memorandum of Incorporation provides otherwise. [12] It is the shareholders that enjoy limited liability - not the company, which is fully liable for its debts.

The concept of limited liability is a characteristic at the core of company law. Because they enjoy the privilege of limited liability, business people are able to limit the risk of investing funds into a business venture. Thus the concept of limited liability encourages the growth and expansion of companies, which is of crucial importance to the economy because successful companies generate wealth and employment and are good for the economy.

4.2.3.2 Perpetual succession

A company enjoys a potentially perpetual existence, which means that, notwithstanding changes in its shareholding, through a transfer of shares, by death or any other cause, the company retains its legal identity and continues to survive. In other words, the existence of a company is not affected by any changes in its shareholders.

4.2.3.3 Property and assets of the company belong to the company

The company's property and assets belong to the company itself and not to the shareholders. Even a shareholder holding all the shares in a private company does not have a proprietary interest in the company's assets.

Only once the company is liquidated do the shareholders have a right to share in a division of the company's assets.

The principle that property purchased by a company belongs to the company itself, and not to its shareholders, is clearly illustrated by the leading case of *Dadoo Ltd v Krugersdorp Municipal Council*. [13] Under certain legislation enacted in the then Transvaal province, Indians were prohibited from owning immovable property in the Transvaal. In 1915 a company called 'Dadoo Ltd' was formed with two Indian shareholders: Dadoo, who owned all the shares in the company save for one share, and Dindar, who owned the other share in the company. The company purchased property in Krugersdorp and subsequently let the property out to Dadoo in his personal capacity, where he carried on a general dealer's business. The Krugersdorp Municipal Council contended that the company had contravened the statute prohibiting Indian people from owning immovable property in the Transvaal. The then Appellate Division rejected this argument on the ground that the statute did not apply to companies, even if all the shares of the company were held by South Africans of Indian origin. The court held that ownership by Dadoo Ltd was not ownership by its Indian shareholders, and that property vested in the company cannot be regarded as vested in its shareholders. [14] It followed that the statute in question had not been contravened by the company.

4.2.3.4 Profits of the company belong to the company

The company's profits belong to the company itself and not to the shareholders. The shareholders have a right to profits only when the company declares a dividend. Not even a sole shareholder of a company may help him- or herself to the profits of the company, and should he or she do so, he or she would be guilty of the criminal offence of theft. [15]

4.2.3.5 Debts and liabilities of the company belong to the company

It follows that, if the profits of the company belong to the company itself, so do the debts and liabilities of the company. [16] Except in certain exceptional circumstances, the shareholders of a company cannot be compelled to pay the debts of the company. [17] If the company is liquidated, this will not generally result in the shareholders' estates being sequestrated and, should the estates of the shareholders be sequestrated, this will not generally result in the liquidation of the company. As discussed, the Act states that a person is not, solely by reason of being an incorporator, shareholder or director of a company, liable for any liabilities or obligations of the company, except to the extent that the Act or the company's Memorandum of Incorporation provides otherwise. [18]

4.2.3.6 A shareholder has no right to manage the company's business or to enter into transactions on its behalf

Membership of a company does not qualify a shareholder to manage the company's business or to bind the company to a contract. Only those persons who are authorised as representatives to bind the company may do so. Contracts entered into by a company are the company's contracts and not the contracts of its shareholders.

4.2.3.7 Company can sue or be sued in its own name

If a company sustains a loss for which it has a legal right of action, a shareholder of the company does not have a direct right of action for the loss. The company itself must institute the action, as it is in law capable of suing or being sued in its own name.

4.2.3.8 Company may contract with its shareholders

A company may enter into transactions with its shareholders because it is a person separate from its shareholders. A company may also employ one of its shareholders as an employee under a contract of service. Even if an individual owns all the shares in a company and is the sole director of the company, and thus has total control over the company, he or she may be employed by that company under a contract of service. [19]

4.3 Exceptions to the principle of separate legal personality

Metaphorically, once a company is formed, a veil or a curtain is drawn between the company and its shareholders and directors, which separates the company from its shareholders and directors and protects them from liability for the debts and wrongful acts of the company. When the corporate veil is pierced, the protection afforded to the shareholders and directors is removed and the substance of the company is examined, rather than the form in which it has been cast. Piercing the corporate veil is thus an exception to the principle of separate legal personality. The focus then shifts from the company to the natural person behind it or in control of its activities as if there were no division between such a person and the company. [20] In this way personal liability is attributed to someone who misuses or abuses the principle of corporate personality.

The case of *Le'Bergo Fashions CC v Lee and Another* [21] provides an example of an instance where the court pierced the corporate veil. The facts of this case are that the first respondent, Lee, had signed a restraint of trade agreement in her personal capacity not to compete with the applicant, but had then used her company, the second respondent, of which she was the sole shareholder and director, to compete with the applicant. The company had not been a party to the restraint of trade agreement and the question before the court was whether the restraint of trade obligation could be imposed on the company. The court found that Lee had effectively carried on the business of the company. In their daily activities, Lee and the company had acted as one *persona*, and by her conduct and business activities she had not treated the company as a separate entity but merely as an instrumentality or conduit for promoting her business affairs. [22] The court held that this was sufficient to sustain the argument that Lee had been guilty of improper conduct in using the company as a facade behind which she had engaged in business in breach of the restraint of trade agreement. [23] Thus, even though the company had not been a party

to the restraint of trade agreement, the court held that its competition with the applicant had amounted to intentionally assisting Lee to breach her undertaking in the restraint clause, which was wrongful in law and could thus be interdicted. [24] Accordingly, both Lee and the company were interdicted from competing with the applicant. This is unusual because the company had not been a party to the restraint of trade agreement. Thus one instance when a court would permit the separate corporate personality of a company to be disregarded is when a natural person who is subject to a restraint of trade uses a company as a front to engage in the activity that is prohibited by a restraint of trade agreement.

Jones v Lipman [25] is a further illustration of the court disregarding the separate legal personality of the company. Lipman had concluded a contract to sell land to Jones. Thereafter Lipman asked to be released from the contract, but Jones refused, intimating that, if necessary, he would sue for specific performance. Pending completion of the sale, Lipman formed a company of which he and a clerk of his solicitor were the sole shareholders and directors, and conveyed the land to the company in order to defeat Jones's right to specific performance. The court ordered specific performance against both Lipman and the company. The court described the company as a sham or a creature or a mask of Lipman and held that the company was used as a device by Lipman in order to evade his contractual obligations. The court consequently held that the remedy of specific performance could be granted in this case.

4.3.1 The distinction between 'piercing' the veil and 'lifting' the veil

It is important to draw a distinction between the concepts of 'piercing the veil' and 'lifting the veil' or 'looking behind the veil' as these concepts are often confused, even sometimes by the courts. Courts sometimes refer to the phrase 'piercing the veil' when the effect is to lift the veil, and conversely. When the court pierces the veil, it treats the liabilities of the company as those of its shareholders or directors, and disregards the corporate personality of the company. On the other hand, when the court lifts the veil it is merely taking into account who the company's shareholders or directors are. This does not necessarily entail ignoring the separate identity of the company or treating the liabilities of the company as those of its shareholders or directors.

4.3.2 The approach adopted to piercing the veil in our common law

When will the courts pierce the corporate veil? This has been a controversial and undecided issue in our law. Piercing the veil is an exceptional procedure and a drastic remedy. In most instances the courts uphold the separate existence of a company despite arguments that they should not do so. There must be compelling reasons for a court to ignore the separate legal existence of a company. But the grounds on which courts will pierce the corporate veil have been difficult to state with certainty. The courts have not generally followed consistent principles in determining when they will depart from the principle that a company is a separate

legal person. The position has not been reached in our law where it is possible to state with any degree of accuracy the circumstances in which the court will pierce the veil. Accordingly, the common-law instances of piercing the corporate veil are far from settled. There is a need for a firm guiding principle in our law as to when a court will pierce the corporate veil.

The approach of our courts to piercing the veil was laid down in the leading case of *Cape Pacific Ltd v Lubner Controlling Investments (Pty) Ltd* [26] in which the then Appellate Division laid down a number of general principles relating to the common-law instances of piercing the veil. These are as follows:

(i) The Appellate Division asserted that it is a salutary principle that our courts should not lightly disregard a company's separate personality, but should strive to give effect to and uphold it. [27] Thus a court has no general discretion simply to disregard a company's separate legal personality whenever it considers it just to do so. [28]

(ii) The court stressed that it was not formulating any general principles with regard to when the corporate veil should or should not be pierced, and that each case must be decided on its own facts which, once determined, are of decisive importance. [29] This implies that we do not have a set of categories of instances governing when a court will pierce the veil.

(iii) The court stated that, where there is fraud or dishonesty or other improper conduct, a balancing approach must be adopted where the concept of separate legal personality must be weighed against those principles in favour of piercing the veil. In such an approach a court would be entitled to look to substance rather than form to arrive at the facts. [30]

(iv) The Appellate Division stressed that even if a company has been legitimately established and operated but is later misused, the corporate veil may nevertheless be pierced. [31]

Piercing the veil ought to be used as a remedy of last resort. [32] It should not be resorted to if another remedy on the same facts could successfully be employed in order to administer justice between the parties - the veil must only be lifted in exceptional circumstances. [33]

In *Hülse-Reutter v Gödde* [34] the Supreme Court of Appeal acknowledged that the circumstances in which a court would pierce the veil were far from settled, and stated that much depended on a close analysis of the facts of each case, considerations of policy and judicial judgment. [35] But what is clear, the court emphasised, is that as a matter of principle there must at least be some misuse or abuse of the distinction between the corporate entity and those who control it which results in an unfair advantage being afforded to those who control the corporate entity. [36]

To sum up, it is clear from these judgments that our courts uphold the independence of the corporate entity as an almost inviolable concept and that they will not easily or readily disregard the separate identity of the company. It is only in exceptional circumstances that the corporate veil will be disregarded. But the law is not settled with regard to the circumstances in which the corporate veil will be pierced and much will depend on a close analysis of the facts of each case, policy considerations and, of course, judicial judgment.

4.3.3 *Quasi*-partnerships

Where parties form a company but have an underlying partnership intention, the courts may nevertheless recognise this intention and take cognisance of the individuals behind the corporate veil. Such companies are known as *quasi*-partnerships. [37] Some factors that may indicate that the parties had formed a *quasi*-partnership are that their association was formed on the basis of a personal relationship involving mutual confidence, an agreement or understanding that all or some of the shareholders will participate in the conduct of the business, or an agreement that the profits of the company will be distributed in the form of salaries instead of by way of dividends. The recognition of an underlying partnership intention applies predominantly to small private companies.

4.3.4 Agency/alter ego doctrine

In the normal relationship between a company and its directors or shareholders, the company is the principal and the directors and shareholders are agents of the company. But in certain circumstances it may be that, on the particular facts, the normal relationship between a company and its directors or shareholders is in fact inverted, whether expressly or impliedly, so that the company is the agent and the directors or the shareholders are the principal.

This may occur for instance where the directors or controlling shareholders do not treat the company as a separate entity, but treat it as if it were merely a means of furthering their own private business affairs. In this instance the company may be regarded as the 'agent' or the 'alter ego' (ie the other self) or 'instrumentality' of its directors or controlling shareholders. Since the directors or shareholders manage the company in such a way as not to separate their personal affairs from those of the company, the company does not carry on its own business or affairs, but acts merely to further the business or affairs of its directors or controlling shareholders. There is thus an abuse of the company's separate legal existence where the directors or shareholders strive to obtain the advantages of separate legal personality of the company without treating the company as a separate legal person. [38]

Note that, in treating the company as the agent of its directors or controlling shareholders, the separate legal personality of the company is still recognised. Hence

the corporate veil is not pierced. But liability is imposed personally on the directors or shareholders in their capacity as the principal of the company. This is an example of lifting the veil. The practical effect of piercing the corporate veil is achieved by establishing an agency relationship, without having to pierce the veil.

4.3.5 Company groups

Each company in a group of companies is in law regarded as a separate legal entity with its own separate legal personality and rights, privileges, duties and liabilities separate from those of the other subsidiary companies. [39] The fact that a group of companies effectively forms one economic unit does not mean that the separate identity of each company is ignored and that the group is treated as one entity. [40] But in certain instances a court will pierce the corporate veil in a group of companies and treat the group as a single entity as opposed to a collection of different separate corporate entities. However, courts are not entitled to disregard the separate legal personality of a company in a group of companies simply because it considers that justice so requires. The mere fact that a group of companies constitutes a single economic unit does not in itself justify the treatment of the group as a single entity. Note that the position may be different where the subsidiary is a facade or sham.

Rather than piercing the corporate veil in company groups, it is more common for the courts to invoke principles of agency and to treat the subsidiary as the agent of its holding company. If it can be shown that a subsidiary company acted as the agent of its holding company, then on ordinary agency principles, liability will attach to the holding company and not to the subsidiary. For instance, where the profits of the subsidiary company are treated as those of the holding company, or where the holding company is in effectual and constant control of the subsidiary company, this may indicate that there is an agency relationship between the holding company and the subsidiary. But there is no presumption that a subsidiary company is the agent of the holding company and whether or not a subsidiary was acting as the agent for the holding company would depend on an analysis of all the facts.

4.3.6 Piercing the corporate veil under the Act

Section 20(9) of the Act states:

> If, on application by an interested person or in any proceedings in which a company is involved, a court finds that the incorporation of the company, any use of the company, or any act by or on behalf of the company, constitutes an unconscionable abuse of the juristic personality of the company as a separate entity, the court may-
>
> *(a)* declare that the company is to be deemed not to be a juristic person in respect of any right, obligation or liability of the company or of a shareholder of the company or, in the case of a non-profit company, a member of the company, or of another person specified in the declaration; and
>
> *(b)* make any further order the court considers appropriate to give effect to a declaration contemplated in paragraph *(a)*.

For the first time in our company law, a statutory provision has been enacted in the

Companies Act that permits a court to disregard the separate juristic personality of a company. Such a provision is not new: s 65 of the Close Corporations Act 69 of 1984 ('the Close Corporations Act') permits a court to deem a close corporation not to be a juristic person. The advantage of a statutory provision relating to piercing the corporate veil is that it gives more certainty and visibility to the doctrine of piercing the veil. But a danger is that it may result in the rigidity of the doctrine, particularly if the courts interpret the provision in a highly technical way.

The consequence of a court declaring a company not to be a juristic person is that the company will cease to have a separate legal personality in respect of certain rights, obligations or liabilities of the company, or of a shareholder of the company or, in the case of a non-profit company, a member of the company, or of another person specified in the declaration.

Does s 20(9) of the Companies Act override the common-law instances of piercing the corporate veil? It is suggested that where the requirements of s 20(9) are not met and cannot be relied on, the common-law remedy of piercing the veil will probably still apply, because s 20(9) does not override the common-law instances of piercing the corporate veil. The principles developed at common law with regard to piercing the corporate veil will also serve as useful guidelines in interpreting s 20(9) of the Act and in deciding whether there has been an unconscionable abuse of the juristic personality of the company.

At common law the remedy of piercing the veil (as discussed above in 4.3.2) is to be used as a last resort. But in the light of s 20(9) of the Act it is questionable whether piercing the veil in terms of the Act is to be used as a last resort. It may well be that reliance may be placed on s 20(9) of the Act despite other remedies also being available. Courts may now also have a wider discretion to pierce the corporate veil under s 20(9) of the Act, compared to their discretion under the common law. Nonetheless, consideration must be given to the fact that piercing the veil is an exceptional remedy that must be used sparingly.

The test for piercing the corporate veil envisaged in s 20(9) of the Act concentrates on the abuse of the juristic personality of the company as a separate entity, and whether that abuse constitutes 'unconscionable abuse'. Unconscionable abuse of the juristic personality of a company may occur-

(i) on the incorporation of the company;
(ii) as a result of the use of the company as a legal entity;
(iii) as a result of any act by, or on behalf of, the company.

However, the term ‘unconscionable abuse’ is not defined in s 20(9) and the section does not provide any guidance as to the facts or circumstances that would constitute an ‘unconscionable abuse’ of the juristic personality of the company as a separate entity. This is probably the most troublesome aspect of s 20(9).

Section 20(9) of the Act is worded similarly to s 65 of the Close Corporations Act. However, a difference between the two sections is that s 65 of the Close Corporations Act deems a corporation not to be a juristic person in instances of a ‘gross abuse’ of the juristic personality of the corporation as a separate entity, whereas s 20(9) of the Act deems a company not to be a juristic person where there is an ‘unconscionable abuse’ of the juristic personality of the company as a separate entity.

It is useful to consider some examples in our common law where the courts have regarded the abuse of the juristic personality of a close corporation as a separate entity to be a ‘gross abuse’ under s 65 of the Close Corporations Act. In *Haygro Catering BK v Van der Merwe* [41] the court held that the members of a close corporation, together with the close corporation, were jointly and severally liable for the debts of the close corporation where the name of the close corporation had not been displayed anywhere on the corporation’s business premises, documents or correspondence, in contravention to s 23 of the Close Corporations Act. The court found that the failure to display the name of the corporation constituted a gross abuse of the juristic personality of the corporation as a separate entity.

A further example of a gross abuse of juristic personality arises from the case of *Airport Cold Storage (Pty) Ltd v Ebrahim*. [42] Some of the factors that the court considered relevant in coming to the conclusion that there had been a gross abuse of the juristic personality of the corporation include the following:

(i) The close corporation had formed part of a conglomerate of associated family businesses that had been conducted with scant regard for the separate legal personalities of the entities concerned.
(ii) The close corporation had not kept proper books of account.
(iii) The close corporation had operated without having appointed an accounting officer.
(iv) The close corporation had voluntarily assumed a debt owing by the family business when it was incorporated and had acquired significant debts from the start of commencing business, which had amounted to reckless trading.

The court found that, when it suited the defendants, they chose to ignore the separate juristic identity of the corporation. They could not ‘now choose to take refuge behind the corporate veil’ [43] of the corporation in order to evade liability for its debts. Accordingly, the court granted a declaratory order in terms of s 65 of the Close Corporations Act to the effect that the corporation was deemed not to be a juristic person, and held the defendants liable jointly and severally to the plaintiff for the amounts owing to the plaintiff by the corporation.

Is there a difference between 'gross abuse' and 'unconscionable abuse'? How far does the abuse have to go before it is considered to be 'unconscionable'? One might argue that any abuse of the juristic personality of a company would be unconscionable. These are issues that the courts will have to grapple with in giving content to the meaning of the phrase 'unconscionable abuse'. The principles developed with regard to piercing the corporate veil in the context of s 65 of the Close Corporations Act, and at common law generally, may serve as useful guidelines in this regard. In declaring that a company is deemed not to be a juristic person, a court is given a wide discretion by s 20(9) of the Act to make any further order which it considers appropriate to give effect to such declaration.

4.3.7 Imposing personal liability on the directors of a company

In certain instances, the Act imposes liability on the directors and prescribed officers of the company for the loss, damages or costs sustained by the company. Such instances have often been described as instances of piercing the corporate veil, but they are more accurately described as instances of lifting the veil. In these instances the courts do not have a discretion whether or not to pierce the veil, as is the case in the common law. Some of these instances are as follows:

(i) Acting without authority

Where a director acts in the name of the company, signs anything on behalf of the company, purports to bind the company or authorises the taking of any action by or on behalf of the company, despite knowing that he or she lacks the authority to do so, he or she will be personally liable for any loss, damages or costs sustained by the company as a direct or indirect consequence of his or her actions. [44]

(ii) Reckless trading

A director will be liable for any loss, damages or costs sustained by the company as a direct or indirect consequence of having acquiesced in the carrying on of the company's business, despite knowing that the business was being carried on recklessly, with gross negligence, with intent to defraud any person or for any fraudulent purpose. [45]

(iii) False or misleading statements

A director will be liable for any loss, damages or costs sustained by the company as a direct or indirect consequence of the director having signed, consented to or authorised the publication of *(a)* any financial statements that were false or misleading in a material respect, or *(b)* a prospectus or written statement required when secondary offers are made to the public that contains untrue statements, or a statement to the effect that a person had consented to be a director when no such consent had been given, despite knowing that the statements were false, misleading or untrue. [46]

(iv) Contravening the Companies Act

Any person who contravenes any provision of the Act is liable to any other person for any loss or damage suffered by that person as a result of that contravention. [47]

Questions

1. Monty is the owner of a timber estate. He sold the timber estate to a company for R1 million. This amount was paid to him in the form of one million fully paid shares in the company. The company does not issue any further shares to anyone else. Monty then insured the timber against fire by means of insurance policies that were taken out personally in his name. A month later the timber was destroyed by a fire. Is the insurance company liable to pay Monty on the insurance policies? Explain fully.
2. Mrs Sweetooth worked for Choccy Chips (Pty) Ltd, a company that produces chocolate chip cookies. Following the termination of her employment with Choccy Chips (Pty) Ltd, she signed a restraint of trade agreement in her personal capacity not to compete with Choccy Chips (Pty) Ltd. Mrs Sweetooth subsequently formed a company, Candyland (Pty) Ltd, of which she was the sole shareholder and director. Candyland (Pty) Ltd commences producing chocolate chip cookies in competition with Choccy Chips (Pty) Ltd. Advise Choccy Chips (Pty) Ltd of any legal remedies that it may have.
3. Kingsley entered into a contract with Charlotte in terms of which Kingsley sold his beach house to Charlotte. Before the beach house had been transferred to Charlotte, Kingsley changed his mind and decided that he no longer wanted to sell his beach house to Charlotte. He asked Charlotte to release him from the contract, but she refused, and informed him that if he refused to transfer the beach house to her she would approach the court for an order of specific performance to compel Kingsley to sell his beach house to her in terms of the contract.

   Kingsley subsequently formed a new company, of which he and his brother were the sole shareholders and directors. Kingsley then transferred the beach house to the company. Charlotte was informed by Kingsley's attorney that the beach house had been transferred to a company and that registration of the beach house had already taken place. She was informed further that the only remedy open to her was one for the damages she had suffered and that she would not have a remedy of specific performance against Kingsley as he could not transfer the beach house to her since he was no longer the owner of the beach house. Advise Charlotte.

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[1] Section 19(1).

[2] Section 14(4).

[3] Section 19(1).

[4] See the definition of a 'company' in s 1 of the Companies Act.

[5] A foreign company is an entity which is incorporated outside South Africa and carries on business or non-profit activities within South Africa.

[6] [1897] AC 22 (HL).

[7] These concepts are discussed below.

[8] A debenture is a written acknowledgment of indebtedness and may be a secured or unsecured debenture.

[9] 30.

[10] 50-1.

[11] Ibid.

[12] Section 19(2).

[13] 1920 AD 530. See also *Macaura v Northern Assurance Co Ltd* [1925] AC 619 (HL(Ir)).

[14] 550-1.

[15] *S v De Jager* 1965 (2) SA 616 (A).

[16] *Salomon v Salomon & Co Ltd* [1897] AC 22 (HL).

[17] *Salomon v Salomon & Co Ltd* (n 16). These exceptional circumstances relate to a court piercing the corporate veil. This is discussed further in 4.3.

[18] Section 19(2).

[19] See *Lee v Lee's Air Farming Ltd* 1961 AC 12.

[20] *Cape Pacific Ltd v Lubner Controlling Investments (Pty) Ltd* 1995 (4) SA 790 (A) 802.

[21] 1998 (2) SA 608 (C).

[22] 613.

[23] 613-14.

[24] 614.

[25] [1962] 1 All ER 442.

[26] Supra (n 20).

[27] 803.

[28] Ibid.

[29] *Cape Pacific Ltd v Lubner Controlling Investments (Pty) Ltd* (n 20) 802.

[30] 803-4.

[31] 804.

[32] *Hülse-Reutter v Gödde* 2001 (4) SA 1336 (SCA) para 23.

[33] *Amlin (SA) Pty Ltd v Van Kooij* 2008 (2) SA 558 (C) para 23.

[34] 2001 (4) SA 1336 (SCA).

[35] Para 20.

[36] Ibid.

[37] See *Hulett v Hulett* 1992 (4) SA 291 (A) 307; *Bellairs v Hodnett* 1978 (1) SA 1109 (A).

[38] See *Consolidated News Agencies (Pty) Ltd (in liquidation) v Mobile Telephone Networks (Pty) Ltd* [2010] 2 All SA 9 (SCA).

[39] See *Adams v Cape Industries plc* [1991] 1 All ER 929 (CA) 1016.

[40] See *Wambach v Maizecor Industries (Edms) Bpk* 1993 (2) SA 669 (A) and *Macadamia Finance Bpk v De Wet* 1993 (2) SA 743 (A).

[41] 1996 (4) SA 1063 (C).

[42] 2008 (2) SA 303 (C).

[43] Para 52.

[44] Section 77(3).
[45] Section 77(3).
[46] Ibid.
[47] Section 218(2).

Chapter 5
Types of Companies

Maleka Femida Cassim

5.1 Introduction

There are many functions and uses of companies. Companies are not limited to the association of a large body of persons for the conduct of business with the object of financial gain or profit-making. On the contrary, the company structure is equally available both to large groups of members and the investing public in general, as well as to small groups of members or even a single individual who wishes to conduct business under the protection of separate legal personality and limited liability.

Furthermore, the purpose of the company as an entity is not limited to profit-making - the company structure may be used for conducting public benefit activities or communal, social, charitable or other non-profit activities. The company structure may also serve many other functions, including the holding of the legal title to assets, the holding of family assets, or serving as the corporate vehicle for a joint venture where several parties are involved in a particular project.

In recognition of the many and varied functions of companies, the Companies Act 71 of 2008 ('the Act') creates scope for a number of different types or categories of companies, which are examined in this chapter.

The recognition of various types of companies under the Act is aligned with the purposes of the Act. In this regard, the Act purports to create both 'flexibility' and 'simplicity' in the formation and maintenance of companies, to promote the development of the South African economy. The availability of a diversity of corporate structures, together with the flexibility in the design and organisation of companies under the Act, is in line with one of the main themes of the Act.

These features may also serve the purposes of the Act to 'promote innovation and investment in the South African markets' and to 'continue to provide for the creation and use of companies, in a manner that enhances the economic welfare of South Africa as a partner within the global economy'. [1] The underpinning purposes of the Act must be borne in mind when contemplating the detailed sections that relate to the types of companies that may be formed.

The Act thus serves as a single statute governing many different types of companies, ranging from the very simple and basic single-shareholder company to the most complex listed public company, and the non-profit company.

5.2 Profit and non-profit companies

There are two broad categories of companies that may be formed and incorporated under the Act, namely-

(i) profit companies (of which there are four types); and

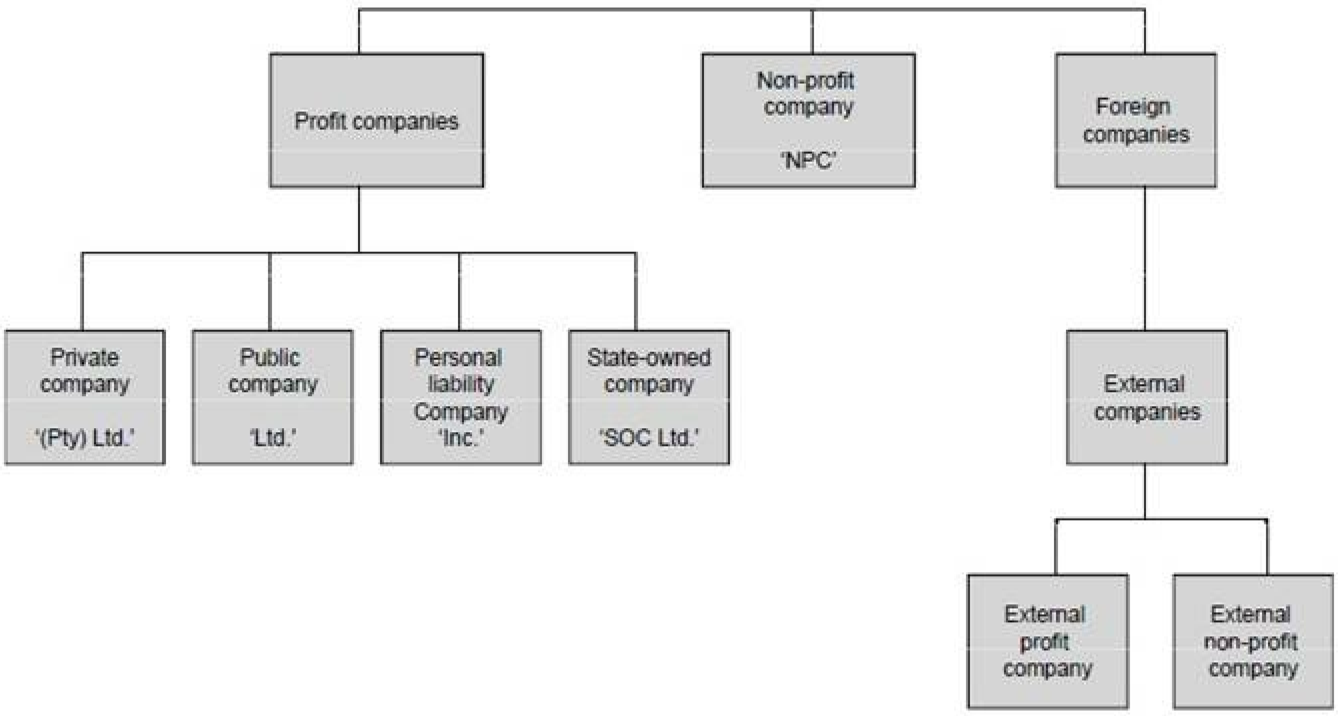
(ii) non-profit companies.

A non-profit company is formed for a public benefit object, or an object relating to a cultural or social activity or communal or group interest. It is part of the essence of a non-profit company that its income and property cannot be distributed to its members or directors. Non-profit companies are subject to a modified application of the Act and to a distinct set of essential rules that govern matters unique to non-profit companies. The non-profit company is examined in detail in 5.8.

A profit company, on the other hand, is formed for the purpose of financial gain for its shareholders. Profit companies are companies with shares, in contrast with non-profit companies which are companies without a share capital. Profit companies are subdivided into four categories: the private company, the public company, the personal liability company and the state-owned company.

See Diagram 5.1 for the types of companies.

Diagram 5.1* : Types of companies



*Note: This diagram does not take account of domesticated companies, which are discussed in para 5.12

5.3 Types of profit companies

5.3.1 Introduction

In terms of the Act, profit companies are categorised as follows: [2]

(i) the private company;

(ii) the public company;

(iii) the personal liability company; and

(iv) the state-owned company.

Each type of profit company is discussed under a separate heading below.

5.3.2 General characteristics of profit companies

There are a number of important characteristics common to all types of profit companies. First and most importantly, the purpose of the incorporation of a profit company is financial gain for its shareholders, in contrast with a non-profit company. Second, all types of profit companies may have any number of shareholders. The Act does not prescribe a mandatory minimum number of shareholders, nor does it place any limitations or restrictions on the maximum number of shareholders of any type of profit company. [3] Private companies may consequently have an unlimited number of shareholders and, by the same token, single-shareholder public companies are permissible. Third, all types of profit companies are formed by one or more persons as incorporators (or by an organ of state). [4] This may be distinguished from a non-profit company, which requires a minimum of three incorporators acting in common (or an organ of state or a juristic person). The incorporators are simply the founders of a company, who form or incorporate the company.

Certain requirements of the Act are universally applicable to all types of companies, whereas other additional requirements apply to selected companies only. In this regard, companies that bear a greater responsibility to a wider public are subjected to a more demanding disclosure, accountability and transparency regime. This pertains mainly to public companies and state-owned companies. It applies also to certain private companies and personal liability companies that have a significant social or economic impact (as discussed further in 5.4.2). The extended accountability and transparency requirements include, among other things-

(i) the auditing of financial statements;
(ii) the obligatory appointment of company secretaries;
(iii) the appointment of auditors;
(iv) the appointment of audit committees; and
(v) the appointment of social and ethics committees, which monitor the extent to which the company takes stakeholder interests into account.

5.3.3 Exceptions and special provisions

As an added measure to create flexibility in the Act, exceptions are created for certain companies. These provisions enhance flexibility in the regulation of small,

owner-managed companies and single-shareholder or single-director companies, which need not be regulated to the same extent as other companies.

In this regard, in owner-managed companies - in which all the shareholders are also directors - there are diminished formalities and a diminished need to seek shareholder approval for certain board actions. This is because ownership and control are not split in such companies. [5]

Exceptions are also created for companies in which all the shares are owned by 'related persons', [6] which results in a diminished need to protect minority shareholders.

Further special provisions apply to single-shareholder and single-director companies. In a single-shareholder profit company (other than a state-owned company), the single shareholder may exercise any voting rights on any matter at any time, without notice or compliance with any other internal formalities. By the same token, in a single-director profit company (other than a state-owned company) the sole director may at any time, without notice or compliance with any other internal formalities, exercise any power or perform any function of the board. (Although it is not expressly stated in the Act, the latter provision cannot apply to public companies, because public companies in any case are obliged to have at least three directors.)

5.4 The private company

5.4.1 Definition

By definition, a private company is one which-

(i) is not a state-owned company; and

(ii) by its Memorandum of Incorporation *both*:

(a) prohibits the offer of any of its securities to the public; *and*

(b) restricts the transferability of its securities. [7]

There are thus two core characteristics of a private company. First, its securities may not be offered to the public and, second, the transferability of its securities must be restricted. The term 'securities' has a much wider meaning than 'shares', and includes any shares, debentures or other instruments, irrespective of their form or title, issued or authorised to be issued by a profit company. These two features may consequently be considered to be the quintessence of a private company. It is noteworthy that these two essential features apply also to a personal liability company, which may be regarded as a subcategory of a private company.

Indeed, the essential distinctions between a private company and a public company are that-

(i) a private company is prohibited by its Memorandum of Incorporation from making any offer to the public of any of its securities, while a public company is permitted to do so. This enables public companies – but not private companies – to raise share capital from members of the public; and

(ii) the Memorandum of Incorporation of a private company must restrict the transferability of its securities, whereas that of a public company may but need not do so. (See further 5.4.1.1)

It is noteworthy that the former restriction of shareholders in a private company to a maximum number of 50 (in terms of the Companies Act 61 of 1973 ('the 1973 Act')) has now been abolished.

5.4.1.1 Restriction on transferability of securities of private companies

In order for a company to qualify as a private company, it is essential that its Memorandum of Incorporation restrict the transferability of its securities.

The 'transfer' of a company's securities applies to the situation where a person acquires shares in the company from an *existing shareholder* who wishes to dispose of them (usually by way of a purchase), and the shares are then 'transferred' into the name of the acquirer. This must be distinguished from the situation where new shares are acquired *directly from the company* (that is, a subscription for shares) and the company in this case 'issues' the shares to the subscriber.

Any restriction on the free right to transfer a private company's securities would suffice. The restriction of the free transferability of the securities of a private company may be attained in any of a number of different ways. For instance, it may be stated in the company's constitution (or Memorandum of Incorporation) that shares may be transferred to a non-shareholder only with the approval of the company's board of directors. Alternatively, the transfer of shares could be subject to the approval of the other shareholders. The restriction on the right to transfer shares is frequently achieved by means of rights of pre-emption under the company's constitution. Such rights of pre-emption effectively prohibit an existing shareholder from selling his or her shares to a non-shareholder, unless the other shareholders of the company have first had an opportunity to purchase the shares. This could be, for instance, at a price agreed on by the shareholders or, failing agreement, at a price determined by the auditors.

5.4.1.2 Distinction between pre-emptive rights restricting the transferability of securities and s 39 pre-emptive rights

The rights of pre-emption that may be imposed to restrict the transferability of the securities of a private company must not be confused with the rights of pre-emption that shareholders in a private company generally enjoy in terms of s 39 of the Act.

Section 39 confers on each shareholder of a private company a pre-emptive right to be offered a proportionate percentage (that is equal to the shareholder's general voting power immediately before the offer is made) of any *new* shares that the company proposes to issue, before those shares may be offered to a non-shareholder.

The pre-emptive rights under s 39 protect the existing shareholders of a private company by enabling them to preserve their voting power and prevent dilution of their voting power. [8]

The distinction between the s 39 pre-emptive rights and a pre-emptive right restricting the transferability of shares is that the former is concerned with the *issue* of shares *by the company*, while the latter is related to the *transfer* of shares *by an existing shareholder*. These are two different and distinct methods by which a person may acquire the shares of a company. To elaborate, the pre-emptive right in terms of s 39 is concerned with the acquisition of new shares *directly from the company* (that is, a subscription for shares) and the company in this case 'issues' the shares to the acquirer (the subscriber). On the other hand, the pre-emptive right restricting the transferability of shares applies to the situation where one acquires shares in the company *from an existing shareholder* who wishes to dispose of them (usually by way of a purchase) and the shares are then 'transferred' into the name of the acquirer.

A private company must both restrict the transferability of its shares and comply with the section 39 pre-emptive rights of existing shareholders to subscribe for new shares - although the latter may be excluded under the company's Memorandum of Incorporation, [9] whereas the former may not be excluded.

5.4.2 Other characteristics of private companies

The name of a private company must end with the expression 'Proprietary Limited' or its abbreviation '(Pty) Ltd.'. [10]

A private company is formed by one or more persons as incorporators or by an organ of state. A private company need only have one director at a minimum. However, this is subject to the company's Memorandum of Incorporation, which may specify a higher minimum number of directors. [11] More than one director would be necessary where a private company is required to appoint an audit committee or a social and ethics committee (whether in terms of the Act or in terms of its Memorandum of Incorporation). [12]

Regarding the extended accountability and transparency requirements, it is not obligatory for a private company to appoint a company secretary, or an audit committee. This is required only if the private company voluntarily elects to do so in terms of its Memorandum of Incorporation.

Private companies are not required to appoint social and ethics committees either - unless their public interest scores exceed the threshold prescribed by the Regulations. [13] The intention is that a social and ethics committee is required when private companies have a significant social or economic impact, such that the appointment of the committee is desirable in the public interest, having regard to the company's annual turnover, the size of its workforce or the nature and extent of its activities. The function of the social and ethics committee, as stated above, is to monitor the extent to which the company takes stakeholder interests into account.

As a general principle, it is not obligatory for a private company to appoint an auditor, save where its Memorandum of Incorporation provides otherwise, or it is a significant private company that is required by the Act or the Regulations to have its financial statements audited every year. [14]

Turning to financial statements, the default position is that the annual financial statements of (some) private companies need to be independently reviewed, but need not be audited. The requirements for the independent review of annual financial statements, including the manner, form and procedures, are prescribed by the Regulations. An audit is necessary only if the private company has voluntarily opted to have its financial statements audited, [15] or if it is required to do so by regulations in terms of the Act. The Regulations require an audit by those private companies that have a significant social or economic impact and consequently have a greater responsibility to a wider public, as indicated by factors such as their annual turnover, the size of their workforces or the nature and extent of their activities (for instance, companies with a public interest score in excess of the threshold prescribed by the Regulations, or companies that in the ordinary course of their activities hold assets in a fiduciary capacity for persons who are not related to the company where the aggregate value of those assets at any time exceeds R5 million). [16]

Moreover, in order to create further flexibility under the Act, an exemption is generally granted from both the independent review as well as the audit of the annual financial statements of an owner-managed private company (ie a private company in which every person who is a holder of or has a beneficial interest in any securities of the company is also a director of the company). [17]

5.5 The public company

5.5.1 Definition

A public company is, to all intents and purposes, undefined in the Act. The Act simply states that a public company is a profit company that is not a state-owned

company, nor a private company, nor a personal liability company. [18] In other words, a public company is defined by exclusion or by default in the sense that a public company is one that is not a private company or any other type of profit company.

Unlike a private company, the securities of a public company may be freely offered to the public. This facilitates the raising of capital from the general public.

Additionally, the shareholders in a public company (but not a private company) may freely transfer their securities unless, of course, the company elects to impose restrictions on the transferability of securities in terms of its Memorandum of Incorporation.

5.5.2 Other characteristics of public companies

The name of a public company must end with the word 'Limited' or its abbreviation 'Ltd.'.

Due to their public nature, public companies have a greater responsibility to a wider public. They raise their share capital from members of the public. In recognition of this, it is a matter of policy that there ought to be more safeguards imposed on this type of company and, in particular, a more demanding disclosure and transparency regime.

Accordingly, the enhanced accountability and transparency requirements (of Chapter 3 of the Act) apply to public companies. It is consequently mandatory for a public company to appoint a company secretary, an audit committee and an independent auditor, and to have its annual financial statements audited. [19] The annual financial statements must generally be drawn up in accordance with International Financial Reporting Standards (or in some cases, International Financial Reporting Standards for Small and Medium Enterprises). An important requirement is that the annual financial statements must include particulars showing the remuneration and benefits received by each director or prescribed officer. The annual return that every company files with the Companies and Intellectual Property Commission ('the Companies Commission') must, in the case of a public company, include a copy of its annual financial statements. A social and ethics committee must be appointed by listed public companies and by public companies with public interest scores that exceed the threshold prescribed by the regulations. [20] Chapter 4 of the Act regulates public offerings of company securities.

In terms of the Act the board of directors of a public company must consist of a minimum of three directors. More precisely, more than three directors are really required, bearing in mind that the mandatory audit committee of a public company must consist of at least three independent non-executive directors and that the social and ethics committee must have least three directors or prescribed officers, at least one of whom is a non-executive director. The minimum number of three directors for a public company is therefore in addition to the number of directors that the company must have to satisfy any requirement to appoint an audit committee or a social and ethics committee. [21]

A public company (like all other types of profit companies) is incorporated by one or more incorporators or by an organ of state. There is no longer a mandatory minimum number of shareholders for a public company (in contrast with the 1973 Act, which required a minimum of at least seven members for public companies).

5.5.3 Listing the securities of public companies

The offer by a public company of shares to the public must be distinguished from the listing of a public company's shares on a securities exchange, such as the JSE Limited. The shares (securities) of a public company may or may not be listed. The advantage of a listing is that listed securities are traded in an organised and accessible public securities market. The effect of a trading market is that members of the public are more willing to trade in the securities of the company. This facilitates access to finance for the listed public company.

Listing also makes it easier for shareholders to later sell their securities should they wish to do so. Listed companies are, however, subject to additional exchange rules such as the JSE Rules and JSE Listings Requirements, which prescribe stricter and more demanding requirements, and often more extensive duties of disclosure of certain information than are required by the Act. This provides additional safeguards for members of the public and for those who trade in securities on the exchange.

5.5.4 Differences between public and private companies

The Act thus preserves the traditional distinction in our law between public and private companies. The differences between these two types of profit companies include the following characteristics and requirements:

(i) The name of a public company must end with the term 'Ltd.' or 'Limited', while that of a private company must end with the expression '(Pty) Ltd.' or 'Proprietary Limited'.

(ii) The essence of a private company is that its Memorandum of Incorporation must both–
   (a) restrict the transferability of its securities; and
   (b) prohibit it from offering its securities to the public.

   On the other hand, public companies may offer their securities to the public, thus enabling them to raise capital from the public. Public companies may, but need not, restrict the transferability of their securities.

(iii) The existing shareholders in a private company, as a default rule, enjoy pre-emptive rights in respect of new shares to be issued by the company (in terms of s 39), unless the company opts out of this provision in its Memorandum of Incorporation. These pre-emptive rights do not, however, apply to public companies as the default position; they only apply if the public company opts in to s 39 in terms of its Memorandum of Incorporation. Such pre-emptive rights protect the existing shareholders of a private company by enabling them to preserve their voting power and prevent dilution of their voting power.

(iv) The minimum number of directors on the board of directors of a public company is three directors, but taking into account the membership of the audit committee and the social and ethics committee, more than three directors would generally be required. In contrast, the default position for a private company is a minimum of one director on the board.

(v) In view of the public nature of public companies, the Act imposes more onerous legal duties of disclosure, accountability and transparency on public companies. The more stringent disclosure and transparency regime (set out in Chapter 3 of the Act) requires a public company, although not a private company (subject to certain exceptions, as discussed above), to appoint–
   (a) a company secretary;
   (b) an auditor; and
   (c) an audit committee.

(vi) Public companies are generally required to have their annual financial statements audited, and must also include copies of their annual financial statements in their annual returns. By contrast, the annual financial statements of a private company must be independently reviewed but not audited – unless the company voluntarily audits its financial statements or an audit is required by regulations in terms of the Act (which depends, inter alia, on the company's public interest score). Moreover, an exemption is generally granted from both an audit and an independent review for certain private companies (namely owner-managed private companies where, in broad terms, every holder of securities is also a director, as explained above).

(vii) A public company must convene an annual general meeting of its shareholders. This provision no longer applies to private companies.

5.6 The personal liability company

5.6.1 Definition

A profit company is a personal liability company if-

(i) it satisfies the criteria for a *private* company; and

(ii) its Memorandum of Incorporation states that it is a personal liability company. [22]

Since a personal liability company must fulfil the criteria for a private company, it may be regarded as a special type of private company. As such, its Memorandum of Incorporation must both prohibit it from offering any of its securities to the public, and restrict the transferability of its securities.

The distinguishing characteristic of the personal liability company is that its Memorandum of Incorporation must specifically state that it is a personal liability company. This has the effect that its directors, including its past directors, are jointly and severally liable, together with the company, for any debts and liabilities of the company that are or were contracted during their respective periods of office. It seems that the Memorandum of Incorporation need not include a statement to this effect; it need merely state that the company is a personal liability company.

5.6.2 Other characteristics of personal liability companies

A personal liability company must have the word 'Incorporated' or its abbreviation 'Inc.' suffixed as the last word of its name.

The personal liability company is the successor to the incorporated or professional company formed under s 53*(b)* of the 1973 Act. The personal liability company is expected to be used primarily by associations of professional persons, such as attorneys, stockbrokers, public accountants, auditors and quantity surveyors, who wish to have the convenience and advantages of separate legal personality, especially perpetual succession, while still complying with their professional rules, which require personal liability. It may also be used by persons who are not members of professions yet wish for the directors of the company to bear personal liability for the debts and liabilities contracted by the company.

Like the private company, the personal liability company need only have a minimum of one director on the board of directors (subject to the Memorandum of Incorporation, which may specify a higher minimum number in substitution). As with all other profit companies, a personal liability company is formed by one or more persons as incorporators (or by an organ of state).

A personal liability company is subject to accountability and transparency requirements similar to those of a private company. In this regard, it need not appoint a company secretary or an audit committee, unless its Memorandum of Incorporation provides otherwise. The appointment of an auditor is only necessary if its Memorandum of Incorporation so requires, or if the company is required to have its financial statements audited every year in terms of the Act or the regulations.

5.6.3 The liability of the directors in a personal liability company

The effect of personal liability on the directors of a personal liability company is elucidated in s 19(3) of the Act. This states that the directors and past directors of a personal liability company are jointly and severally liable, together with the company, for any debts and liabilities of the company that are or were 'contracted' during their respective periods of office.

The Act states further that a person must be regarded as having received notice and knowledge of the effect of s 19(3) on a personal liability company. This, in effect, constitutes an exception to the abolition of the doctrine of constructive notice under the Act. [23] However the rationale for this is open to question.

The effect of s 19(3) on a personal liability company is that it renders the directors and past directors co-debtors with the company. The directors and the company are liable singuli et in solidum (or jointly and severally) for the contractual debts and liabilities of the company. [24]

The liability of a director or a past director is limited to the debts and liabilities of the company that were contracted *during his or her period of office as a director*.

It is further limited to the *contractual* debts and liabilities of the company, as opposed to debts and liabilities of some other nature. The case of *Fundstrust (Pty) Ltd (In Liquidation) v Van Deventer* [25] laid down that the extent of the directors' liability is limited to the company's contractual debts and liabilities that were contracted during their periods of office, and that the directors' joint and several liability does not include any liability for delictual claims or unjustified enrichment claims against the company, because these liabilities are not 'contracted'. Nor does the directors' liability extend to liability for tax and other statutory charges (including statutory liability in respect of voidable and undue preferences under the Insolvency Act 24 of 1936, which was in fact the issue in this matter), as none of these liabilities are of a *contractual* nature. The court in *Fundstrust* found that the intention of the legislature was to relate directors' liability to nothing other than the company's ordinary financial or commercial commitments.

Sonnenberg McLoughlin Inc v Spiro [26] proclaimed that the intention of the legislature was not simply to impose on the directors a liability equivalent to the common-law liability of partners. It was rather to impose on the directors an entirely new statutory liability, and to give creditors an entirely new remedy that would enable them to hold the directors liable *singuli et in solidum* for the company's debts and liabilities before its liquidation. There is accordingly a twofold effect:

- (i) First, creditors are entitled to hold the directors jointly and severally liable for the company's contractual liabilities contracted during their periods of office.
- (ii) Second, if a director pays any such debt of the company, he or she would have a right of recourse against his or her fellow directors for their proportionate shares of the debt.

It should be noted, however, that the company itself does not have a right of recourse against its directors, where the company has paid any of its debts.

5.7 The state-owned company

5.7.1 Definition

State-owned companies are now recognised as a separate type of company under the Act. A state-owned company is defined [27] as an enterprise that is registered as a company in terms of the Act and either-

- (i) is listed as a public entity in Schedules 2 or 3 of the Public Finance Management Act 1 of 1999; or
- (ii) is owned by a municipality [28] and is otherwise similar to such an

enterprise.

Public entities are enterprises that are directly or indirectly controlled by the state. The Public Finance Management Act draws a distinction between national and provincial public entities, which include national and provincial government business enterprises respectively.

5.7.2 Other characteristics of state-owned companies

The name of a state-owned company ends with the expression 'SOC Ltd.'.

Since state-owned companies are now recognised as a distinct category of company, they receive separate legislative treatment with regard to certain matters so as to avoid conflict or overlap with other legislation that applies specifically to state-owned companies but not to other companies in general, such as the Public Finance Management Act. All provisions of the Act that apply to *public* companies generally also apply to state-owned companies (subject to some exceptions). But the Minister [29] has the power to grant exemptions to state-owned companies, exempting them from having to comply with certain provisions of the Act. The Minister may grant exemptions from provisions of the Act if those provisions overlap with or duplicate an alternative regulatory scheme that is established by other national legislation applicable to the state-owned company, which achieves the purposes of the Act. [30]

Like the public company, the state-owned company is subject to the extended accountability and transparency requirements in terms of Chapter 3 of the Act. A state-owned company must consequently appoint a company secretary, an audit committee and an auditor (subject to any exemptions granted). A state-owned company must also appoint a social and ethics committee (subject to certain exceptions).

5.8 Non-profit companies

5.8.1 Definition

As explained above, there are two broad categories of companies that may be formed under the Act: first, profit companies (which may be private companies, public companies, personal liability companies or state-owned companies) and second, non-profit companies (NPCs).

According to the definition of a 'non-profit' company-

(i) it is a company that is incorporated for a public benefit object, or an object relating to one or more cultural or social activities, or communal or group interests; *and*

(ii) it is of the essence that the income and property of a non-profit company must not be distributable to its members or directors or to its incorporators, officers, or any 'related' persons (subject to certain exceptions permitted by the Act). [31]

It must be emphasised that both of these essential requirements must be satisfied for a company to constitute a NPC.

5.8.1.1 Objects of non-profit companies

A NPC must set out at least one object in its Memorandum of Incorporation. Each object of a non-profit must be either-

(i) a public benefit object; or

(ii) an object relating to one or more cultural or social activities, or communal or group interests.

A 'public benefit object' is an object for the benefit of the general public, for instance, the general promotion of education or charity. On the other hand, an object that advances a 'communal or group interest' is one that is not necessarily for the wider benefit of the general public but is in the interests of a community or a group, for instance, a local sports organisation.

The expression 'communal or group interests' is not a stand-alone object. Instead, it relates to *cultural or social* activities that advance a communal interest or a group interest. It excludes purely commercial activities.

In this regard, it was held by the Supreme Court of Appeal in *Cuninghame v First Ready Development 249 (association incorporated under section 21)* [32] that the phrase 'communal or group interests' relates to cultural or social activities, and excludes objects of a purely commercial nature. On the facts of *Cuninghame*, the main object of a company had changed from managing a rental pool on a non-profit basis to the management of the hotel business as a whole. The court ruled that, since purely commercial enterprises were excluded from the ambit of NPCs, the result was that the company's commercial hotel business was not a permissible object for a NPC (or its equivalent under the 1973 Act, the section 21 company).

It is notable that a NPC does have the scope to carry on a business, trade or undertaking. [33] But this must be consistent with or 'ancillary' to its stated objects. This implies that it cannot be an activity that is unrelated to the stated objects of the company. Any profits derived from such activity may not of course be distributed to its members or directors (or officers or related persons), but must instead be applied to advance the stated objects of the NPC.

Thus the term 'non-profit' company does not mean that the company may not make any profit at all. As stated in a recent article: [34]

> Despite the label 'non-profit' company, it must be underscored at the outset that as a general principle, a non-profit company is not wholly precluded from making profits. A non-profit company may validly make profits, as long as it complies with the basic prohibition on distributions to its members and controllers, and provided that all its assets and income, however derived, are applied to advance its stated objects.
>
> The gist of the matter thus is that profit-making activity may not be the main or primary purpose or object of a non-profit company - it may at best be only a secondary activity that is consistent with or ancillary to the company's non-commercial objects and that is used as a means of promoting and advancing the company's non-commercial objects.

5.8.1.2 Financial benefit or gain

It is crucial that a NPC does not pay or distribute any portion of its income or transfer any of its assets, whether directly or indirectly, to a member, director, incorporator or any person appointing a director of the company.

This is subject to a number of reasonable exceptions, namely-

(i) reasonable remuneration for goods delivered to the company or for services rendered to (or at the direction of) the company;
(ii) reasonable payment or reimbursement for expenses incurred in advancing the company's objects;
(iii) payment of an amount due and payable by the company in terms of a *bona fide* agreement (between the company and that person or another);
(iv) payment in respect of any rights of that person, to the extent that those rights are administered by the company in order to advance one of its objects; or
(v) payment in respect of any legal obligation that is binding on the company.

By the same token, upon the winding-up of a NPC, the prohibition on distributions to members and directors applies equally. Upon the winding-up or dissolution of a NPC, no past or present member, director or person appointing a director of the company is entitled to receive any part of the net value of the company.

5.8.2 Other characteristics of non-profit companies

The company name of a non-profit company ends with the expression 'NPC'.

The NPC is the successor to the section 21 company under the 1973 Act, which was also known as the incorporated association not for gain.

A special set of fundamental rules for NPCs is set out in the Act (in Schedule 1). This is in line with the purpose of the Act to 'provide for the formation, operation and accountability of non-profit companies in a manner designed to promote, support and enhance the capacity of such companies to perform their functions'. [35] The Act also applies with modified effect to NPC. It contains a useful list of specific provisions that have no direct relevance to NPCs and do not apply to them, namely-

(i) capitalisation of profit companies (Part D of Chapter 2 of the Act);
(ii) securities registration and transfer (Part E of Chapter 2);
(iii) remuneration and election of directors (s 66(8) and (9) and s 68);
(iv) company secretaries and audit committees, except to the extent that an obligation arises to appoint a company secretary, auditor or audit committee in terms of a requirement in the company's Memorandum of Incorporation or regulations (Parts B and D of Chapter 3);
(v) public offerings of company securities (Chapter 4);
(vi) takeovers, offers and fundamental transactions (subject to some exceptions) (Chapter 5);
(vii) rights of shareholders to approve a business rescue plan (except to

the extent that the NPC is itself a shareholder of a profit company engaged in business rescue proceedings) (ss 146*(d)* and 152(3)*(c)*);

(viii) dissenting shareholders' appraisal rights (except to the extent that the NPC is itself a shareholder of a profit company) (s 164);

(ix) sections 58 to 65, dealing with shareholders and governance of companies, which do not apply to a NPC unless it has voting members.

A NPC is not generally subject to the extended disclosure, transparency and audit requirements of the Act. It accordingly need not appoint an auditor, a company secretary or an audit committee, except if its Memorandum of Incorporation calls for it to do so. An auditor must also be appointed in the event that a non-profit company is obliged to have its financial statements audited every year in terms of the Act or regulations.

As a general principle, the annual financial statements of a NPC require only an independent review. An audit is unnecessary, unless the company voluntarily opts for an audit or if regulations in terms of the Act call for an audit. [36] The regulations require a NPC to have its annual financial statements audited if, for instance, in the ordinary course of its activities it holds assets in a fiduciary capacity for persons who are not related to the company and the aggregate value of those assets at any time exceeds R5 million, or if its public interest score for the particular financial year exceeds the threshold prescribed by the regulations.

5.8.3 Objects and policies of non-profit companies

See also the discussion at 5.8.1.1 on the objects of NPCs, and 5.8.1.2 on financial benefit or gain.

5.8.3.1 Assets and income

It is of fundamental importance that all the assets and income of a NPC, however derived, are applied to advance its stated objects.

Subject to this prerequisite, it is permissible for a NPC to-

(i) acquire and hold securities (or shares) issued by a profit company; or

(ii) carry on any business, trade or undertaking, whether it does so directly or indirectly and whether it does so alone or with any other person, provided that this is consistent with or 'ancillary' to its stated objects (see further 5.8.1.1).

5.8.3.2 Winding-up or dissolution

Upon the winding-up or dissolution of a NPC, no past or present member, director or person appointing a director of the company is entitled to any part of the net value of the company after its obligations and liabilities have been met. The entire net value of the company must instead be distributed to one or more NPCs (or registered external NPCs, voluntary associations or non-profit trusts) that have objects similar to its main object, as determined by the company's Memorandum of Incorporation, or by its members (if any) or its directors. Failing either of these, the issue is determined by the court.

5.8.3.3 Tax

A NPC that complies with the Act does not necessarily or automatically qualify for any tax advantages. To obtain any tax exemption or tax advantage, it must satisfy the requirements of the Income Tax Act. It would not automatically qualify as a public benefit organisation.

5.8.4 Incorporators of non-profit companies

A NPC is incorporated by three or more persons acting in common (as opposed to a profit company, which may be incorporated by even one person). An organ of state or a juristic person may also incorporate a NPC. [37] The incorporators of a NPC are its first directors and its first members (if any).

5.8.5 Members of non-profit companies and voting rights

A NPC may be incorporated with or without members. A NPC is not required to have members unless its Memorandum of Incorporation so provides. The term 'member', when used in relation to a NPC, means a person who holds membership in, and specified rights in respect of, that NPC.

A NPC with members may have voting members or non-voting members. No more than two classes of members may be provided for in the Memorandum of Incorporation, ie voting and non-voting members.

Where there are voting members, each voting member has at least one vote. Generally, the votes of voting members carry equal value or weight on any matter, but the company's Memorandum of Incorporation may provide otherwise. In other words, the voting rights in a NPC may be loaded disproportionately.

A NPC with members must maintain a membership register. The Memorandum of Incorporation must also set out the qualifications for membership, as well as the grounds for suspension or loss of membership. It may allow for membership to be held by juristic persons, including profit companies. The Memorandum of Incorporation must not restrict or regulate membership in any manner that amounts to unfair discrimination in terms of s 9 of the Constitution. [38] Nor may it presume the membership of any person, regard a person to be a member, or provide for the automatic or *ex officio* membership of any person, on any basis other than life-time membership awarded to a person for service to the company or to its stated public benefit objects, and with that person's consent. The Memorandum of Incorporation may provide for a membership cost. The membership cost may be initial and/or periodic and may apply to any class of membership. The Memorandum of Incorporation must also deal with the process for applying for membership, as well as any rights and obligations of membership in any class.

5.8.6 Directors of non-profit companies

A NPC must have at least three directors. [39]

In a NPC without members, the directors are appointed by the board or by other persons on the basis set out in the Memorandum of Incorporation. On the other

hand, in a NPC with members, the directors are chosen by the members on the basis set out in the Memorandum of Incorporation. If the voting members are to elect any directors, then the Memorandum of Incorporation must provide for the election of at least a third of those elected directors each year.

A NPC is prohibited from giving loans to its directors, securing the debts or obligations of directors, or otherwise giving direct or indirect financial assistance to directors. This prohibition extends also to the directors of related or interrelated companies and/or to persons related to any such directors. But there are certain exceptions to the general prohibition, in that it does not prevent transactions that-

- (i) are in the ordinary course of the company's business and for fair value;
- (ii) constitute an accountable advance to meet legal expenses in relation to a matter concerning the company;
- (iii) constitute an accountable advance to meet anticipated expenses to be incurred by the person on behalf of the company;
- (iv) are to defray the person's expenses for removal at the company's request; or
- (v) are in terms of an employee benefit scheme generally available to all employees or a specific class of employees.

5.8.7 Fundamental transactions of non-profit companies

An important provision is that a NPC may not *convert* to a profit company.

Moreover, a NPC may not amalgamate or merge with a profit company; nor may it dispose of any part of its assets, undertaking or business to a *profit* company, other than for fair value, except to the extent that such disposals of assets occur in the ordinary course of the activities of the NPC.

Where a non-profit company with voting members proposes to dispose of all or the greater part of its assets or undertaking to another *non-profit* company, or proposes to amalgamate or merge with another NPC, such proposal must be submitted to the voting members for approval in a manner comparable to that required of profit companies. [40]

5.9 Conversion of companies

A company of a certain type or category may for various reasons wish to convert into another type of company.

The Act specifically precludes the conversion of a non-profit company to a profit company, as discussed above. This is a crucial provision.

As for profit companies, the conversion of one type of profit company to another type of company is effected by amending the company's Memorandum of Incorporation, generally by way of a special resolution, to effect the necessary changes to the criteria for the relevant category of company. With regard to name change, it is vital for the company at the time also to amend its name by altering the ending expression, as appropriate, to reflect the category of profit company into which it thereafter falls.

With regard to personal liability companies, if an amendment to the Memorandum of Incorporation of a personal liability company has the effect of transforming it into any other category of company, the company must give at least ten business days advance notice, before filing the notice of amendment, to any relevant professional or industry regulatory authority. Notice must also be given to any persons who, in their dealings with the company, may reasonably be considered to have acted in reliance upon the joint and several liability of any of the directors for the company's debts and liabilities, and to any persons who may be adversely affected if the joint and several liability of any of the directors for the company's debts and liabilities is terminated. Persons who receive, or are entitled to receive, such a notice may apply to court for an order sufficient to protect their interests. [41]

5.10 The impact of the Act on pre-existing companies

Pre-existing companies are companies that were already in existence before the date of commencement of the Act, 1 May 2011. The Act applies equally to pre-existing companies that were registered under the 1973 Act (save for external companies). In this regard, the Transitional Arrangements (contained in Schedule 5 to the Act) explicitly state that pre-existing companies continue to exist as companies as if they had been incorporated and registered (ie formed) in terms of the Act.

Pre-existing companies also generally continue to bear the same name and registration number previously assigned to them. They are given two years as from May 2011 in which to amend their names, without charge or fee, to satisfy the new requirements under the Act. In addition, pre-existing companies are generally deemed (or assumed) to have changed the concluding words or concluding expressions of their names (as appropriate for the relevant type of company, eg Inc., NPC) as required in order to comply with the Act. [42]

5.11 External companies

5.11.1 Definition

It is essential to distinguish a 'foreign company' from an 'external company'. A 'foreign company' simply means an entity incorporated (or registered) in some other jurisdiction outside the Republic of South Africa. (This is irrespective of whether it is a profit or non-profit entity, and irrespective of whether it carries on business or non-profit activities within South Africa.) But where a 'foreign company' carries on business or non-profit activities (as the case may be) within the Republic of South Africa, it qualifies as an 'external company' that must be registered as such under the Act. An external company is thus a subcategory of a foreign company.

The importance of the distinction is that it is only external companies (and not all foreign companies) that are specifically required to register under the Act, and to observe certain provisions of the Act that apply to external companies.

The question arises: when is a foreign company 'conducting business, or non-profit activities, as the case may be, within the Republic [of South Africa]'? This

crucial criterion qualifies a foreign company for registration as an 'external company' under the Act. A foreign company is regarded as conducting business or non-profit activities in South Africa in two circumstances. [43] First, if the foreign company is a party to one or more employment contracts within South Africa, it must be registered as an external company in South Africa. This provides some protection to persons who are employed by such companies and who carry out their employment duties within South Africa.

The second circumstance arises when a foreign company is engaging in a course of conduct, or has engaged in a course or pattern of activities within South Africa over a period of at least six months, such as would lead a person to reasonably conclude that the company intended to continually engage in business or non-profit activities within South Africa. For these purposes, a foreign company is *not* required to register as an external company *solely* on the ground that it is currently engaged in or has engaged in any one or more of the following activities in South Africa:

(i) the holding of a shareholders' meeting or a board meeting, or otherwise conducting any of its internal affairs in South Africa;
(ii) the establishment or maintenance of any bank accounts or other financial accounts;
(iii) the establishment or maintenance of offices or agencies for the transfer, exchange or registration of the foreign company's own securities;
(iv) the creation or acquisition of any debts in South Africa, or mortgages or security interests in any property within South Africa;
(v) the securing or collection of any debt, or the enforcement of any mortgage or security interest;
(vi) the acquisition of any interest in any property.

The protection of third parties who deal with external companies, particularly employees, is catered for by the definition of an external company and the requirement for registration. The consequence of the registration of external companies is that they must disclose specified information to the Companies Commission both upon registration and continuously as part of their annual returns. As discussed in detail in Chapter 6: Formation of companies and the company constitution, an external company must continuously maintain at least one office in South Africa and must register its office in South Africa with the Companies Commission. It must also provide the names of its directors at the time, the address of its principal office outside South Africa and, very importantly, the name and address of the person in South Africa who has undertaken to accept service of documents on its behalf. [44] Such information will to a certain extent protect employees of external companies and third parties who deal with external companies. The statutory requirements on the use of the name and registration number of an external company will also ensure the provision and disclosure of vital information to third parties who deal with such a company.

5.11.2 Types of external companies

An external company that registers with the Companies Commission in terms of the Act must register either as an '*external profit company*' or as an '*external non-profit company*'. This depends on whether, within the jurisdiction in which it was incorporated, the external company meets legislative or definitional requirements that are comparable with those of a non-profit company that is incorporated under the Act. If it does, it must register as an external non-profit company. [45] If not, it must register as an external profit company. (In the specific context of non-profit companies, the question whether the legislative and definitional requirements of other jurisdictions are comparable with those for a non-profit company under the South African Act, may be particularly problematic.) [46]

Once an external company has registered its office and has been assigned a registration number, it is by definition a '*registered external company*'. The registration of external companies and company names for external companies are discussed in Chapter 6: Formation of companies and the company constitution.

If a foreign company fails to register as an external company when it is required to do so, it may be subject to a compliance notice issued by the Companies Commission, requiring the company to register within 20 business days, or to otherwise cease carrying on business or activities in South Africa. The compliance notice may be issued when an external company fails to register within three months after commencing its activities in South Africa.

5.11.3 Application of the Act to external companies

Since foreign companies are incorporated in another jurisdiction outside South Africa, the Act does not apply to foreign companies in general. The Act applies only to those foreign companies that qualify as external companies, and even then only to a limited extent.

There is one important exception: Chapter 4 of the Act, which deals with public offerings of company securities, does apply when the securities of foreign companies are offered to the public in South Africa, irrespective of whether the foreign company carries on business in South Africa and irrespective of whether it qualifies as an external company.

As for external companies, only certain specific sections of the Act extend to these companies. The legislative policy evidently is to diminish or reduce the extent of the regulation of external companies in South African law. It may be expected to promote investment in the South African markets, in line with the purposes of the Act, while concurrently providing some degree of protection for employees and third parties who deal with external companies. The sections of the Act that apply to external companies include-

(i) the provisions discussed in 5.11.1;
(ii) various sections protecting the names of registered external companies (see Chapter 6);
(iii) certain provisions relating to fundamental transactions (and, in particular, the requirement of a special resolution by external holding companies);
(iv) protection for whistle-blowers who disclose information about external companies.

Among the advantages of registration for an external company are various provisions that protect the names of registered external companies. Also, upon the dissolution or winding-up of South African non-profit companies having similar main objects to those of a registered external non-profit company, the external company qualifies to receive the net value and assets of the South African company.

5.12 Domesticated companies

A domesticated company is a foreign company whose registration has been transferred to the Republic of South Africa. In this regard, a foreign company may have its registration transferred to South Africa from the foreign jurisdiction in which it is registered. Once its registration has been transferred, the company exists as a company in terms of the Act as if it had originally been so incorporated and registered.

A foreign company may transfer its registration to South Africa if *all* the following requirements are satisfied: [47]

(i) the law of the jurisdiction (or country) in which it is initially registered permits a transfer of registration, and the company has complied with the requirements of that law in relation to the transfer;

(ii) the transfer has been approved by the company's shareholders in the specified manner;
(iii) the whole or greater part of the company's assets and undertaking are within South Africa (other than the assets and undertaking of any foreign subsidiary);
(iv) the majority of the company's shareholders are resident in South Africa;
(v) the majority of the company's directors are or will be South African citizens;
(vi) immediately following the transfer of registration, the company will satisfy the solvency and liquidity test; and
(vii) immediately following the transfer of registration, the company will no longer be registered in another jurisdiction.

However, a foreign company (despite satisfying the above requirements) is prohibited from transferring its registration to South Africa if -
(i) it is permitted to issue bearer shares, in terms of any law or its Articles or Memorandum of Incorporation, or if it has any bearer shares that remain issued;
(ii) it is in liquidation;
(iii) a receiver or manager has been appointed (by a court or otherwise) in relation to its property;
(iv) it is engaged in business rescue or in comparable proceedings; or is subject to

an approved plan or court order, comparable to an approved business rescue plan under the Act; or has entered into a compromise or arrangement with a creditor that is in force; or
(v) an application, which has not been fully disposed of, has been made to a court in any jurisdiction either to put the foreign company into liquidation, wind it up or have it declared insolvent; or for the approval of a compromise or arrangement between it and a creditor; or for the appointment of a receiver or administrator in relation to any of its property.

The application for the transfer of registration must be made in the prescribed form, and must be accompanied by the prescribed application fee and requisite documents, including a copy of the company's most recent annual financial statements and a copy of its Memorandum of Incorporation to be registered in South Africa. [48] Where the foreign company complies with the requirements for domestication and registration, the Commissioner issues a registration certificate to the effect that registration has taken place and that the company is deemed to have been incorporated under the Act.

It is important to note that the registration of a domesticated company does not establish a new juristic person. Both its identity and its continuity as a juristic person are unaffected, and are not prejudiced. Its property, rights, liabilities and obligations are not affected or prejudiced, nor are the rights of any other person in relation to it. Any legal proceedings, by or against that company, remain effective. [49]

The registration of a foreign company as a domesticated company must be distinguished from the converse process, namely the deregistration of a South African company upon the transfer of its registration to a foreign jurisdiction. A company may apply to be deregistered upon the transfer of its registration to a foreign jurisdiction. The requirements for this are first, the adoption of a special resolution by the shareholders approving of the application and transfer of registration and, second, compliance by the company with the prescribed requirements.

5.13 The impact of the Act on close corporations

5.13.1 General

The Act adopts a momentous stance on close corporations and the Close Corporations Act 69 of 1984. *Existing* close corporations are free to retain their status as close corporations indefinitely, until or unless their members decide that it is in their interest to convert the close corporation to a company. But no *new* close corporations may be formed. In tandem with this, no companies may now convert to close corporations.

The driving policy behind this is that the Act is intended to provide the scope and simplicity to structure and maintain small companies in such a way that they resemble the characteristics of close corporations. It is consequently anticipated that the formation of new close corporations would be rendered unnecessary [50] because small owner-managed companies would assimilate most of the features of close corporations. This policy is, however, debatable, particularly in view of the resounding success of the close corporation as a form of business structure, the large numbers of active close corporations in South Africa and the relative simplicity, clarity and brevity of the legislation governing close corporations as contrasted with the Companies Act.

Since existing close corporations are permitted to continue to exist under the new regime, the Act provides for the coexistence of the Close Corporations Act alongside the Companies Act. In an attempt to harmonise the law on companies and close corporations as far as is practicable, various amendments are made to the Close Corporations Act (in terms of Schedule 3 to the Companies Act). See further Chapter 24: Close Corporations.

5.13.2 Conversion of a close corporation to a company

An existing close corporation may convert to a company at any time under the new Act. It does so by filing a notice of conversion in the prescribed manner and form, accompanied by the following: [51]

(i) first, a written statement of consent approving the conversion of the close corporation, signed by members of the close corporation holding in aggregate at least 75 per cent of the members' interests in the corporation;

(ii) second, a Memorandum of Incorporation that is consistent with the Act; the close corporation would thus have either to adopt a standard-form Memorandum of Incorporation or draft one;

(iii) third, the prescribed filing fee; the fee is waived in respect of conversions within three years of the effective date, ie until 1 May 2014.

The Companies Commission then registers the converted close corporation. Upon the conversion of a close corporation to a company, the Companies Commission cancels its registration under the Close Corporations Act, gives notice in the *Government Gazette* of the conversion and enables the Registrar of Deeds to effect the necessary changes resulting from both conversions and name changes.

The effects of a conversion of a close corporation to a company may be summarised as follows:

(i) Every member of the converted close corporation is entitled to become a shareholder of the resulting company, although the shares to be held in the company by each shareholder need not necessarily be proportionate to his or her member's interest in the close corporation.

(ii) The juristic person that existed as a close corporation prior to the conversion continues to exist as a juristic person in the form of a company.

(iii) All the assets, liabilities, rights and obligations of the close corporation vest in the company.

(iv) Any legal proceedings instituted by or against the close corporation, before the

registration, may be continued by or against the company (and any other thing done by or in respect of the close corporation, is deemed to have been done by or in respect of the company).

(v) Any enforcement measures that could have been commenced in respect of the close corporation under the Close Corporations Act, for conduct occurring before the date of registration, may be brought against the company on the same basis.

(vi) Any liability of a member of a corporation for the debts of the corporation under the Close Corporations Act survives the conversion and continues as a liability of that person as if the conversion had not occurred.

5.14 The impact of the Act on partnerships

Partnerships are not addressed in the Act, and continue to be governed largely by common law.

In contrast with the 1973 Act, which imposed a maximum limit of 20 partners, [52] the new Act no longer places any restriction on the number of partners. Significantly, a partnership may now have an unlimited number of partners.

Questions

1. Bently and Benze wish to form a company to conduct a panel-beating business. Bently and Benze will be the sole shareholders and directors of the company. They do not wish to offer the shares of the company to the general public. It is important to them that it be stated in the company's Memorandum of Incorporation that if either of them wishes to sell his shares, the shares may be sold and transferred to any purchaser he chooses.
   (a) Advise Bently and Benze of the type of company that would be most suitable to meet their particular requirements.
   (b) Advise Bently and Benze of the additional legal requirements that they would have to comply with if the company is structured as a public company rather than a private company. Explain the impact that this would have on the costs and the regulatory burden.
2. Mr Snap and Ms Crackle are directors of Checks & Balances Inc, an auditing firm that is structured as a personal liability company. A third director, Professor Pop, retired and resigned as a director just over three months ago. Hammerheads Inc, a law firm, institutes legal action against Mr Snap, demanding full payment of the R300 000 debt owed by Checks & Balances Inc to Hammerheads Inc. Mr Snap makes payment in full to Hammerheads Inc. Advise Mr Snap as follows:
   (a) Was Hammerheads Inc entitled in the first place to claim payment from Mr Snap of the debt of Checks & Balances Inc?
   (b) May Mr Snap recover the R300 000 or any part of it from Ms Crackle, Professor Pop and/or Checks & Balances Inc?

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[1] Section 7 of the Companies Act.

[2] Section 8.

[3] Private companies are no longer limited to a maximum of 50 shareholders. Public companies no longer require a minimum of seven shareholders.

[4] Sections 1 and 13.

[5] See further Chapter 11: Governance and shareholders.

[6] The concept of related persons is discussed in Chapter 8: Groups of companies and related persons. A 'related person' includes a holding and subsidiary company relationship, as well as the direct or indirect 'control' of another company or its business (or the direct or indirect control of each of them or the business of each of them by a third person). Related persons also include persons married to each other, those living together in a relationship similar to a marriage, and those separated by no more than two degrees of natural or adopted consanguinity or affinity.

[7] Section 1 read with s 8.

[8] Section 39(2).

[9] The s 39 pre-emptive right applies to private companies and personal liability companies, but may be excluded in terms of a company's Memorandum of Incorporation. It does not apply to public companies or state-owned companies unless the company's Memorandum of Incorporation provides otherwise.

[10] Section 11.

[11] Section 66.

[12] An audit committee must comprise at least three members, who must be directors and who must not be involved in the day-to-day management of the company's business (s 94); while a social and ethics committee (in terms of reg 43 of the Companies Regulations GNR 351 *GG* 34239 of 26 April 2011 ('the Regulations') must have at least one non-executive director.

[13] Section 72 read with regs 43 and 26. The calculation of the public interest score takes account of the average number of employees of the company, the number of shareholders or securities holders, the company's turnover and third party liability.

[14] Sections 84 and 34.

[15] In terms of its Memorandum of Incorporation, or a shareholders' resolution, or if the board has so determined (s 30).

[16] See further regs 28 and 29 read with s 30, and Chapter 15: The auditor, financial records and reporting.

[17] But this exemption does not apply if the company falls into a class of companies that are required to have their annual financial statements audited by regulations in terms of s 30(7). It also does not relieve the company of any requirement to have its financial statements audited or reviewed in terms of any other law, or in terms of any agreement to which the company is a party.

[18] Sections 1 and 8.

[19] Sections 84 and 30.

[20] Subject to certain exceptions and exemptions - see s 72(4) and regs 43 and 26.

[21] Sections 66 and 94, and reg 43. Where a particular director is appointed to more than one committee, that director is counted only once for the purposes of calculating the minimum number of directors required for the company.

[22] Section 1 read with s 8.

[23] Section 19(5). See further Chapter 6: Formation of companies and the company constitution.

[24] *Maritz v Maritz & Pieterse Inc* 2006 (3) SA 481 (SCA); *Fundstrust (Pty) Ltd (In Liquidation) v Van Deventer* 1997 (1) SA 710 (A) 715. The reasoning underlying these decisions would presumably continue to apply to personal liability companies under the Act.

[25] *Fundstrust (Pty) Ltd (In Liquidation) v Van Deventer* supra (n 24).

[26] 2004 (1) SA 90 (C).

[27] Section 1 read with s 8.

[28] In terms of the Local Government: Municipal Systems Act 32 of 2000.

[29] Being the member of Cabinet responsible for companies (s 1).

[30] Section 9.

[31] Section 1 read with Schedule 1 to the Act.

[32] 2010 (5) SA 325 (SCA), in the context of s 21 of the 1973 Act.

[33] Item 1 of Schedule 1.

[34] Maleka Femida Cassim 'The contours of profit-making activities of non-profit companies: An analysis of the new South African Companies Act' (2012) 56(2) *Journal of African Law* 243.

[35] Section 7.

[36] See s 30, regs 28 and 29 and Chapter 15: The auditor, financial records and reporting.

[37] Section 13.

[38] Constitution of the Republic of South Africa, 1996.

[39] Section 66. This is subject to the minimum number of directors that the company must have to satisfy any requirement to appoint an audit committee or a social and ethics committee.

[40] See further Chapter 17: Fundamental transactions, takeovers and offers.

[41] Section 16.

[42] Schedule 5 item 4 read with s 11. See further Chapter 6: Formation of companies and the company constitution and Chapter 23: Transitional arrangements.

[43] Section 23.

[44] Regulation 20.

[45] Section 23.

[46] See further Maleka Femida Cassim 'The contours of profit-making activities of non-profit companies: An analysis of the new South African Companies Act' (2012) 56 (2) *Journal of African Law* 243-67.

[47] Section 13.

[48] Section 13; see also reg 17 and Form CoR 17.1.

[49] Section 13(11).

[50] *Memorandum on the Objects of the Companies Bill, 2008*, Companies Bill [B 61D-2008] paras 1 and 2.

[51] Schedule 2; see also reg 18 and Form CoR 18.1.

[52] This was done to avoid the practical difficulties that arose in dealing with large unincorporated associations.

Chapter 6
Formation of Companies and the Company Constitution

Maleka Femida Cassim

6.1 Incorporation and registration of companies

Under the Companies Act 71 of 2008 ('the Act') the formation of a company is regarded as a right, as opposed to a privilege bestowed by the state. One of the underpinning objects of the Act is 'to promote the development of the South African economy by creating flexibility and simplicity in the formation and maintenance of companies'. [1] Arising from these underlying themes of 'simplicity' and 'flexibility' is a simplified procedure for the incorporation (or formation) of companies. The procedure for the incorporation of companies has a minimum of formal requirements. There is also considerable flexibility in the structure and organisation of companies. Together with this enhanced simplicity and flexibility, the regulatory oversight of the formation and registration of companies has been reduced. The simplified procedure for the incorporation and registration of companies is discussed below.

6.1.1 Incorporation of the company

6.1.1.1 The incorporators

The 'incorporators' are the founders of the company, who are responsible for the formation or incorporation of the company.

A profit company - regardless of whether it is a public or a private company - may be incorporated by one or more persons acting as incorporators. A profit company may also be incorporated by an organ of state. In contrast, the incorporation of a non-profit company requires a minimum of three persons acting in concert. A non-profit company may also be incorporated by a juristic person or an organ of state. [2]

The responsibilities of an incorporator include the duty to sign the company's Memorandum of Incorporation, whether in person or by proxy. Each incorporator is automatically a first director of the company, who serves as a director until such time as sufficient directors have been appointed or elected. Incorporators are under no statutory duty to subscribe for any shares in the company.

6.1.1.2 The procedure for incorporation

In order to incorporate a company, the incorporators must first complete and sign a Memorandum of Incorporation (whether in person or by proxy). The Memorandum of Incorporation is the sole founding (or governing) document of the company, setting out the rights, duties and responsibilities of shareholders, directors and others within and in relation to the company, together with various other matters.

The next step is for the incorporators to file with the Companies and Intellectual Property Commission ('the Companies Commission') the following: [3]

(i) A Notice of Incorporation, the purpose of which is to inform the

Companies Commission of the incorporation of the company for the purpose of having it registered. The prescribed form of the Notice of Incorporation is dealt with by the regulations. [4] The information to be stated in the Notice of Incorporation includes the name of the company, its initial directors, its registered office, the date of its financial year-end and a notice of the appointment of the first auditor (where appointed).

(ii) A copy of the Memorandum of Incorporation. The Memorandum of Incorporation of a company may be either in the prescribed form (as set out in the regulations) [5] or in a form that is unique to the company.

(iii) Payment of the prescribed fee. [6]

If the Memorandum of Incorporation contains-

(i) any restrictive conditions; or
(ii) any prohibitions on the amendment of provisions of the Memorandum of Incorporation,

the Notice of Incorporation must contain a prominent statement drawing attention to each such provision, together with its location in the Memorandum of Incorporation. Furthermore the name of the company must be immediately followed by the expression '(RF)', which means 'ring-fenced'. (See further 6.2.1 and 6.3.2.4.)

Notably, it is no longer necessary to reserve a name for a company before the company is incorporated. This makes the formation of a company a much easier procedure to follow.

6.1.2 Registration of the company by the Companies Commission

After the Companies Commission has accepted the Notice of Incorporation that was filed by the incorporators, it must register the company as soon as practicable. To do so, the Companies Commission must -

(i) assign a unique registration number to the company;
(ii) enter certain information concerning the company, including the company name, in the companies register that is established by the Companies Commission;
(iii) endorse the Notice of Incorporation and the copy of the Memorandum of Incorporation; and
(iv) issue and deliver a registration certificate to the company. [7]

The registration certificate issued by the Companies Commission is evidence of the incorporation and registration of the company. The registration certificate serves as conclusive evidence that all the requirements for incorporation have been complied with.

Once the registration certificate has been issued, the company is incorporated and comes into existence as a separate legal person or juristic person, with effect from the date and time (if any) stated on the registration certificate. In this regard, the Companies Commission dates the registration certificate either as at the date and time it issued the certificate, or as at the specific date (if any) requested by the incorporators, whichever of these two dates happens to be the later one.

There is no requirement for a certificate to commence business, nor is there a minimum share capital requirement. A company may generally commence business once it is registered.

6.1.2.1 Rejection of the Notice of Incorporation by the Companies Commission

In certain circumstances, the Companies Commission has the power to reject the Notice of Incorporation filed by the incorporators and to refuse to register the company. [8] There are two grounds for a mandatory rejection and one for a discretionary rejection.

First, where the number of initial directors of the company is less than the prescribed statutory minimum, the Companies Commission must reject the Notice of Incorporation. In the case of either a private company or a personal liability company at least one director is required, whereas for a public company, a state-owned company or a non-profit company at least three directors are required (subject to the minimum number of directors that the company must have to satisfy any requirement to appoint an audit committee or a social and ethics committee). The second ground for a mandatory rejection of the Notice of Incorporation is where the Companies Commission reasonably believes that any of the initial directors are disqualified from being appointed as directors of the company, [9] with the result that the *remaining* initial directors are fewer than the prescribed statutory minimum. [10]

Turning to the discretionary rejection of the Notice of Incorporation, the Companies Commission 'may' reject the Notice of Incorporation where it (or anything required to be filed with it) is either incomplete or improperly completed. The discretion of the Companies Commission is subject to the substantial compliance provision of the Act, that is, the Notice of Incorporation will suffice if it is completed in a form that satisfies all the substantive requirements of the prescribed form, [11] and a deviation from the prescribed design or content will not invalidate it unless the deviation negatively and materially affects the substance of the notice, or is such that it would reasonably mislead a person reading the notice. [12]

It is noteworthy that where the proposed name of the company turns out to be unsuitable in terms of the Act, this of itself does not constitute grounds for the rejection of the Notice of Incorporation. This is a welcome change in policy. It ensures that the process of incorporating the company will not be unduly delayed

pending the registration of a suitable company name, because this would stifle the use of commercial opportunities by the company.

6.1.2.2 Registration of external companies

An external company (ie a foreign company that carries on business or non-profit activities in South Africa) must register with the Companies Commission within 20 business days of commencing with the conduct of business or non-profit activities (as the case may be) within the Republic of South Africa. [13] The meaning and definition of an 'external company' as well as the circumstances in which a foreign company is regarded as 'conducting business' within South Africa are discussed in Chapter 5: Types of companies. An external company must register either as an external non-profit company or as an external profit company.

On registration, the Companies Commission assigns a unique registration number and issues a registration certificate to the external company. The Companies Commission must maintain a register of external companies containing certain prescribed information. An external company must continuously maintain at least one office in South Africa. It registers the address of its registered office by providing the required information when filing its registration. In terms of the regulations an external company, when registering as such, must provide a certified copy of its Memorandum of Incorporation and certificate of incorporation (or equivalent documents) in its jurisdiction of incorporation. It is also required to provide the name and address of any person within South Africa who has undertaken to accept service of documents on its behalf, the names and details of its directors at the time, and the address of its principal office outside South Africa.

Once an external company has been assigned a registration number by the Companies Commission and has registered its office, it satisfies the definition of a 'registered external company'. [14]

External companies must file annual returns in the prescribed form, accompanied by the prescribed filing fee. This requires the external company to report on whether any of its information on the companies register has changed, including its registered office and directors, the foreign jurisdiction of its primary registration and the person who has consented to accept service of documents on its behalf.

For a discussion of the extent to which the Act applies to external companies and the consequences of a failure to register as an external company, see Chapter 5: Types of companies.

6.1.3 The registered office

Since a company lacks a physical existence, the registered office serves a vital purpose. Service on a company of process of court is made at the company's registered office, or at its principal place of business within the court's jurisdiction. [15] In addition, a company's accounting records must be kept at or must be accessible from its registered office. Other records of the company (whether in written or electronic form) may also be kept at the registered office (or, alternatively, they may be kept at another South African location, in which case a Notice of Location of records must be filed). [16]

Each company and every external company must continuously maintain at least one office in South Africa and register the address of its office. Where the company has more than one office, the address of the principal office is registered. [17] As explained above, a company incorporated in South Africa registers its office by providing the requisite information on its Notice of Incorporation.

A company that wishes to amend its registered office may do so by filing a notice of change of registered office. A change of registered office takes effect five business days after the filing of the notice or, if a later date is stated in the notice, it takes effect on such later date.

6.2 Company names

The first practical step in forming a company often is to choose a suitable company name. In selecting a name for the company, the incorporators must bear in mind the criteria for company names laid down by the Act. The main legal objectives are to protect the goodwill associated with names, and to prevent public deception by the use of names that are misleading and imply a non-existent association. It also is a crucial objective to prevent hateful, offensive or unconstitutional names. The Act stipulates numerous requirements and restrictions on company names. In doing so, the Act seeks to give maximum effect (within limits) to the constitutional right to freedom of expression.

6.2.1 Criteria for company names [18]

A company name may consist of words in any language. This is irrespective of whether the words are commonly used or are contrived for the purpose. Together with these words, the name of the company may include any letters, numbers or punctuation marks, and/or round brackets if used in pairs to isolate any part of the name.

Symbols are also permitted in company names. This, however, only comes into operation three years after the date of commencement of the Act, ie after 1 May 2014. The permissible symbols are the symbols +, &, #, @, �“, % and = and any others that may be permitted in terms of regulations. The ‘-’ symbol is permitted by the regulations. The more intricate details, such as which alphabet is permissible, or whether Arabic or Roman numerals may be used, or the circumstances when translations of names are required, are dealt with by the regulations.

In the case of a profit company (but not a non-profit company,) the company’s registration number may now be used as its name, provided that it is immediately followed by the expression ‘(South Africa)’. This development is to be welcomed. It will prevent delays in incorporation and registration of companies where incorporators experience difficulty in finding a suitable name. Moreover some companies, due

to the nature of their business, may not have any real need for a name and the simple use of their registration numbers would suffice.

The concluding words or concluding expression in the name of the company depends on the category or type of company it is. The appropriate expression for each category of company is as follows: [19]

(i) In the case of a private company, the company name must end with the expression 'Proprietary Limited' or its abbreviation '(Pty) Ltd.';
(ii) The name of a personal liability company must end with the word 'Incorporated' or the abbreviation 'Inc.';
(iii) The word 'Limited' or its abbreviation 'Ltd.' must appear at the end of the name of a public company;
(iv) In the case of a state-owned company the expression 'SOC Ltd.' is required;
(v) In the case of a non-profit company the expression 'NPC' is required.

The expression '(RF)', which means 'ring-fenced', must immediately follow the name of the company if its Memorandum of Incorporation stipulates any restrictive conditions or prohibits the amendment of any provisions. The purpose of inserting the expression '(RF)' is to alert third parties to the presence of the restrictive conditions or prohibitions on the amendment of certain provisions of the Memorandum of Incorporation, so that third parties may exercise appropriate caution. [20]

Turning to the restrictions on company names, since the Act seeks to give effect to the constitutional right to freedom of expression, company names are restricted as far as necessary to achieve the following three objectives:

(i) First, to protect the owners of names and other forms of intellectual property from those passing themselves off or 'coat-tailing' on their reputations and goodwill. In this regard, the Act states that the name of a company must not be the same as – or confusingly similar to – the name of another company or domesticated company, registered external company, close corporation or co-operative. An exception is made for company groups where each company bearing a similar name is a member of the same group of companies. Additionally, the name of the company may not be the same as or confusingly similar to a registered trademark, [21] or a defensive name or a name registered as a business name under the Business Names Act. [22]
(ii) Second, to protect the public from misleading names which falsely imply a non-existent association. In this regard, a proposed company name must not falsely imply or suggest that the company (i) is part of or associated with another person or entity; or (ii) is owned, managed or conducted by a person with a particular educational designation or by a regulated person or entity; or (iii) is an organ of state or a court, or is operated, sponsored, supported or endorsed by the state or any organ of state or court; or (iv) is owned, operated, sponsored, supported or endorsed by, or enjoys the patronage of, any international organisation, foreign state or

government (or head of state, head of government, government or administration or any department thereof).

(iii) Third, to prohibit hateful or offensive names or unconstitutional names which violate the right to freedom of expression. Accordingly company names may not include any word, expression or symbol that may reasonably be considered to constitute (i) propaganda for war; or (ii) incitement of imminent violence; or (iii) advocacy of hatred based on race, ethnicity, gender or religion or incitement to cause harm. [23]

In addition to the statutory criteria on company names, the common-law rules must also be borne in mind, particularly the delict of 'passing off'. The delict of passing off is linked to the first group of restrictions (above) on company names. 'Passing off' occurs where the use of a company name could result in a reasonable likelihood of members of the public being misled or confused into believing that the business of the company is, or is connected with, that of another (eg a competitor). There are two important requirements of passing off: first, that confusion or deception is reasonably likely to ensue, and second, that if confusion or deception does ensue, it will probably cause damage to the competitor. [24]

6.2.2 Registration of company names

It must be emphasised at the outset that a proposed company name that is unsuitable, inappropriate or incomplete does not prevent or delay the process of incorporation and registration of the company. This is a welcome approach that would ensure that the commencement of business by the company is not unnecessarily delayed.

When the name of a company (as entered on the Notice of Incorporation) lacks the appropriate expression indicative of the type of company (eg Ltd., Inc., (Pty) Ltd.), the Companies Commission itself may insert or substitute the correct expression when attending to the registration of the company. The same principle applies when the company name does not have the expression '(RF)' or '(South Africa)' when this is required.

In the event that the proposed name of the company is the *same* as that of another company (or another domesticated company, registered external company, close corporation or co-operative), the Companies Commission will nonetheless register the company by using an interim name (instead of the proposed company name)

both in the companies register and on the registration certificate. The interim name consists merely of the company's registration number followed by the appropriate expression indicating the type of company it is. An interim name is also used where a proposed company name is the same as a registered defensive name, business name or trademark, or has been reserved for another. Once the company has been registered in the interim name, the Companies Commission invites the company to file an amended Notice of Incorporation using another, satisfactory name.

When the company does so, the Companies Commission enters the amended company name in the companies register, and issues an amended registration certificate reflecting the amended company name. [25]

When the Companies Commission has reasonable grounds for considering that the name of a company may fall within the first group of restricted names discussed above (ie proposed names that infringe existing legal rights in the name or intellectual property), on the basis that the proposed name is '*confusingly similar*' to another relevant name or trade mark, [26] the Companies Commission may order the applicant to serve a copy of the application on any particular person or class of persons on the grounds that they may have an interest in the applicant's use of the name. This applies also where the proposed name of the company falls within the second group of restricted names discussed above (ie misleading names that falsely imply a non-existent association). A person to whom a notice is delivered, or any other person with an interest in the name, may then apply to the Companies Tribunal for a determination and an order on whether the name satisfies the requirements of the Act.

If, on the other hand, the Companies Commission on reasonable grounds considers that the name of the company is inconsistent with the third group of restricted names discussed above (ie names that are offensive or unconstitutional forms of expression), it may refer the application to the South African Human Rights Commission, which could then apply to the Companies Tribunal. Disputes concerning company names are dealt with by the Companies Tribunal. [27]

6.2.3 Changing the company name

A change of the name of a company is generally effected in the same way as any other alteration to the Memorandum of Incorporation, ie by a special resolution. [28] After changing its name, the company must file with the Companies Commission a Notice of Amendment and a copy of the amendment (together with payment of the prescribed fee). The Companies Commission then issues an amended registration certificate and alters the company's name on the companies register. The amendment of the company name takes effect on the date set out in the amended registration certificate. [29]

A change in the name of a company will have no effect on any legal proceedings by or against the company. Legal proceedings may be commenced or continued by or against the company under its new name.

6.2.4 Reserved names and defensive names

Company names may be reserved for use at a later stage. Name reservation is available on an optional or voluntary basis. This may serve a useful purpose in certain circumstances, for instance, where the incorporators have an interest in ensuring that a particular name is reserved for the company before proceeding with the formalities for incorporating and registering the company.

A name may be reserved for later use either for a newly incorporated company or for an amendment to the name of an existing company. A name reservation continues for a period of six months from the date of the application. On good cause shown, the Companies Commission may extend the six-month reservation period for a period of 60 business days at a time.

The Act permits the transfer of reserved names. A person may transfer a name reservation to another simply by filing a signed notice of transfer with the Companies Commission, together with payment of the prescribed fee. No reason or cause for the transfer is ordinarily required.

However, no person may attempt to abuse the name reservation system for the purpose of selling access to names or trading in or marketing names (or for ‘name squatting’). The Companies Commission has various powers to guard against the abuse or attempted abuse of the name reservation system. [30] The Companies Commission may issue a notice to a person suspected of attempting to abuse the name reservation system, requiring that person to show cause why the name should be transferred to or reserved for it, or the Companies Commission may simply refuse to grant the transfer or extension of the name reservation, or may even cancel the name reservation. Furthermore, where, as a result of a pattern of conduct, the Companies Commission has reasonable grounds to believe that a person has abused the name reservation system - whether by selling access to names or trading in or marketing reserved names, or by repeatedly attempting to reserve names for these purposes - it may apply for a court order prohibiting that person from reserving any names for a just and reasonable period.

Turning to defensive names, the purpose of registering a defensive name is essentially to protect the name from use by another company. A person may register any name as a defensive name if he or she has a direct and material interest in respect of the name. The registration of a defensive name lasts for a period of two years, and is renewable for a further two-year period. The registration of a defensive name may be transferred to another person.

6.2.5 Use of company name and registration number

All companies (and all external companies) are required to provide their full registered names and registration numbers to any person on demand. Companies are, moreover, prohibited from misstating their names or registration numbers in a manner that would be likely to mislead or deceive. [31] A company must have its name and registration number stated in legible characters in all notices and other official publications of the company, including those in electronic format, and in all letters, negotiable instruments, orders for money or goods, and business documents (such as delivery notes, invoices, receipts, and letters of credit of the company). Failure to comply with these provisions constitutes an offence. [32]

The practice under which a company using its trading name must use it in conjunction with its registered name will now be affected by the Consumer Protection Act 68 of 2008. The Consumer Protection Act [33] prohibits a juristic person from carrying on business under any name except its registered name (as registered under the Companies Act) or a 'business name' that has been registered to it under the Consumer Protection Act (or another public regulation). The term 'business name' refers to a name, other than its registered name, under which a juristic person carries on business. A company may consequently trade only under its registered company name or under any business name that has been registered for the use of that company under the Consumer Protection Act or another public regulation. [34]

6.3 The Memorandum of Incorporation

6.3.1 Introduction

The Memorandum of Incorporation (or Memorandum) is the founding document of the company. It sets out the rights, duties and responsibilities of shareholders, directors and others within and in relation to the company, together with various other matters. Importantly, the Memorandum of Incorporation is the sole governing document of the company. [35]

The Memorandum of Incorporation, broadly and generally, deals with matters such as the powers of the company; the amendment of the Memorandum of Incorporation; the ability to create rules of the company; securities of the company and debt instruments; shareholders, shareholders' meetings and procedures; the composition of the board of directors; the authority and powers of directors; board meetings and committees of the board; compensation and indemnification of directors and, in the case of non-profit companies, the disposal of the company's assets upon dissolution of the company. These will, of course, vary depending on each company, the type of company it is and the envisaged needs and structure of the company.

The Memorandum of Incorporation of a company may be either in a form unique to the company or in the prescribed form. The regulations set out five prescribed (or

standard or model) forms for different types of companies, some of which are short standard forms while others are long standard forms. [36] The prescribed form constitutes the simplest possible form of company, as the incorporators simply adopt the mandatory provisions of the Act and accept the default provisions with or without alterations.

The underpinning approach to the company constitution [37] and the division of powers between the organs of the company (specifically, the shareholders and the board of directors) is that management powers are vested in the board of directors in terms of the Act. The board of directors has both the power and the responsibility to manage the business of the company, except to the extent that the Act or the company's Memorandum of Incorporation provides otherwise. [38]

6.3.2 Contents of the Memorandum of Incorporation

The content of the Memorandum of Incorporation is quite flexible, in line with the purpose of the Act to create flexibility and simplicity in the formation and maintenance of companies. This creates some leeway for companies to regulate their affairs, especially their internal affairs. As a result, a diversity of company structures is possible under the Act, ranging from simple and one-member companies to more complex companies.

The Act introduces a new and fundamentally important approach to the contents of the Memorandum of Incorporation by providing for 'unalterable provisions' and 'alterable provisions', which are discussed below.

6.3.2.1 Unalterable provisions

As its basic foundation or nucleus, the Memorandum of Incorporation of every company must contain certain mandatory or core provisions. These are the 'unalterable provisions' of the Act. The unalterable provisions of the Act are generally designed to protect the interests of shareholders as well as creditors and others dealing with the company.

By definition, an 'unalterable provision' means a provision of the Act that does not *expressly* contemplate that its effect on any particular company may be altered, whether by a company's Memorandum of Incorporation or its rules. An alteration in this context has a wide meaning and includes a negation, restriction, limitation, qualification, extension or alteration in any other manner, whether in substance or in effect. [39] The unalterable provisions of the Act are thus mandatory, and may not be altered (whether in substance or in effect) in any company's Memorandum of Incorporation.

This, however, is subject to the important qualification that an unalterable provision of the Act may be made more onerous (though not less onerous) under a

company's Memorandum of Incorporation. In this regard, the Memorandum of Incorporation may impose on the company a higher standard, greater restriction, longer period of time, or any similarly more onerous requirement, than would otherwise apply to the company in terms of an *unalterable* provision of the Act. But it may in certain circumstances be difficult to determine whether a particular provision of the Memorandum of Incorporation is in fact more onerous or less onerous to the company.

A company is prevented from ‘contracting out’ of the mandatory or unalterable provisions of the Act. In this regard, the Act states that each provision of a company’s Memorandum of Incorporation must be consistent with the Act. When a provision in a company’s Memorandum of Incorporation is inconsistent with or contravenes the Act, it is *void* to the extent of its inconsistency or contravention of the Act. [40]

This is bolstered further by the anti-avoidance provision of the Act. This empowers a court to declare any provision of a company’s Memorandum of Incorporation or rules (or any agreement, transaction, arrangement or resolution) to be primarily or substantially intended to defeat or reduce the effect of a prohibition or requirement established by an unalterable provision, and to declare it void to that extent. [41]

6.3.2.2 Alterable provisions

Apart from the mandatory core of unalterable provisions which must form part of the company’s Memorandum of Incorporation, there are certain default rules of the Act that a company may choose either to accept or to alter in its Memorandum of Incorporation. These default provisions are termed ‘alterable provisions’.

The ‘alterable provisions’ of the Act may be regarded as default rules that would apply to a company unless it specifically opts out of these in its Memorandum of Incorporation. The alterable provisions of the Act allow for flexibility and enable a company to tailor the contents of its constitution (or Memorandum of Incorporation) to fit its needs.

An ‘alterable provision’ is defined as a provision of the Act in which it is *expressly* contemplated that its effect on a particular company may be altered by that company’s Memorandum of Incorporation, whether by negation, restriction, limitation, qualification, extension or other alteration in substance or effect. [42] If a company wishes to alter the effect of an ‘alterable provision’ of the Act, this must be done in terms of the company’s Memorandum of Incorporation (as opposed to, for instance, the company rules or a shareholder agreement) - failing which the alteration will be ineffective.

6.3.2.3 Provisions on matters that the Act does not address

Apart from the unalterable and alterable provisions of the Act, another type of provision that a company may include in its Memorandum of Incorporation is any

other provision dealing with a matter that the Act has left silent or unaddressed. This further enhances the flexibility and latitude in respect of the contents of the Memorandum of Incorporation.

6.3.2.4 Restrictive conditions and prohibitions on the amendment of the Memorandum of Incorporation

The Memorandum of Incorporation may generally be amended by a special resolution (in terms of s 16). However, it is permissible for a company to insert restrictive conditions into its Memorandum of Incorporation coupled with additional requirements for their amendment (in addition to the requirements set out in s 16). The Memorandum of Incorporation may even prohibit the amendment of any of its particular provisions.

This makes it possible to couple any restrictive condition [43] in the company's constitution with a particular restrictive method of amendment. It even makes it possible to entrench any key provision in a company's constitution by an absolute prohibition on its amendment.

Where a company's Memorandum of Incorporation includes any of these types of provisions, the company's Notice of Incorporation must include a prominent statement drawing attention to each such provision and its location in the Memorandum of Incorporation. Additionally, the name of the company must immediately be followed by the expression '(RF)', which means 'ring-fenced'. [44] The purpose of these two features is to draw the attention of third parties to the presence of the restrictive conditions or prohibitions on amendment.

This provides the basis for the limited application of the doctrine of constructive notice. In this regard, the Act states [45] that third parties are 'regarded as having received notice and knowledge' of any restrictive condition or prohibition on amendment, provided that the company's Notice of Incorporation has drawn attention to it, and the expression '(RF)' is suffixed to the company's name.

The creation of deemed (or assumed) notice and knowledge is remarkable. This is because the doctrine of constructive notice [46] has by and large been abolished by the Act. But the general abolition of the doctrine of constructive notice is subject to three notable exceptions. The first exception is that persons are 'regarded as having received notice and knowledge' of any restrictive condition applicable to the company, and any requirements for its amendment (in addition to the requirements of s 16). [47] The second exception is that persons are 'regarded as having received notice and knowledge' of prohibitions on the amendment of any particular provision of the Memorandum of Incorporation. [48] Third, the doctrine of constructive notice applies to the effect of the personal liability of directors and former directors of a personal liability company. [49]

A third party's constructive notice of restrictive conditions and prohibitions on the amendment of a company's constitution may have important implications. If, for instance, a restrictive condition limits the authority of the directors, then any third party who deals with the company would be deemed to have notice and knowledge of the directors' lack of authority (depending on the nature of the limitation). As such, this could destroy the third party's prospects of relying on the ostensible authority of the directors. For example, if the Memorandum of Incorporation of a company contains an entrenched provision (that may not be amended) stating that no contract of loan in excess of R1 million shall be valid unless approved in writing by two directors, and a third party purports to enter into such a contract with the company that is signed by only one director, the effect could be that the third party cannot hold the company bound to the contract. This is because the director clearly did not have actual authority to enter into the contract, nor did the director have ostensible authority. Ostensible authority is destroyed by the third party's constructive (or deemed) knowledge of the director's lack of authority to contract on his or her own in terms of the entrenched provision in the company's constitution. [50]

6.3.3 Amending the Memorandum of Incorporation

The general principle is that the Memorandum of Incorporation of a company may be amended at any time, by means of a special resolution (in terms of s 16).

An amendment may be proposed either by the board of directors or by shareholders holding at least 10 per cent of the exercisable voting rights. This is subject to the company's Memorandum of Incorporation, which may stipulate different requirements for proposals for an amendment.

The special resolution to amend the Memorandum of Incorporation may be adopted at a formal meeting of the shareholders or, alternatively, it may be in the form of a written resolution. A 'round robin' or written resolution [51] is a useful mechanism as it avoids the cost and inconvenience associated with convening a meeting of shareholders. Furthermore, it encourages voting by apathetic or passive shareholders who do not usually attend meetings.

The special resolution to amend the Memorandum of Incorporation must be supported by at least 75 per cent of the exercised voting rights, but this threshold requirement may be validly increased or decreased in a company's Memorandum of Incorporation (provided that there is a minimum margin of at least 10 per cent between the highest established requirement for approval of an ordinary resolution on any matter and the lowest established requirement for approval of a special resolution on any matter). [52] It must also be borne in mind that some provisions of the Memorandum of Incorporation may be restrictive conditions that are subject to additional requirements for (or restrictions on) amendment over and above the requirements of s 16, while other provisions of a company's Memorandum of Incorporation may be entirely prohibited from amendment. [53]

It is notable that when a profit company amends its Memorandum of Incorporation in such a manner that it no longer meets the criteria for the relevant type of profit company, the concluding expression in the name of the company must simultaneously be amended to reflect the new type of profit company it is. For instance, if the Memorandum of Incorporation of a private company is amended to permit the offer of its securities to the public, the company would become a public company and the concluding expression in its name would have to be changed from '(Pty) Ltd.' to 'Ltd.'. Additional requirements apply if a personal liability company is transformed into any other type of company. [54]

An amendment to a company's Memorandum of Incorporation may take the form of a new Memorandum of Incorporation that will replace the existing one, or an alteration may be made to the existing Memorandum of Incorporation. The company must file a Notice of Amendment with the Companies Commission, together with payment of the prescribed fee. [55] This must be accompanied by a copy of the new, substituted Memorandum of Incorporation (if any) or by a copy of the amendment (where the amendment has altered the existing Memorandum of Incorporation). An amendment to the company's Memorandum of Incorporation takes effect from the date on and time at which the Notice of Amendment is filed, or the later date (if any) set out in the Notice of Amendment. In the case of an amendment of the name of a company, the amendment takes effect on the date set out in the amended registration certification.

Apart from the alteration of a company's Memorandum of Incorporation by special resolution as described above, there are two other methods of amendment: first, the Memorandum of Incorporation may be amended in compliance with a court order. In this case, a special resolution of the shareholders is not needed and the amendment is effected simply by a resolution of the board of directors. Second, the board of directors may amend the Memorandum of Incorporation in the manner contemplated in s 36(3) and (4), relating to authorisation and classification of shares, in which case no special resolution of shareholders is required either.

6.3.3.1 Correction of patent errors in the Memorandum of Incorporation or rules

The Act provides for an innovative means to correct patent errors, such as grammatical or typographical errors, in the Memorandum of Incorporation.

When there is a patent error in spelling, punctuation, reference, grammar or a similar defect on the face of the document, the board of directors of a company (or an individual authorised by the board) may alter the company's Memorandum of Incorporation or rules in any manner necessary to correct the error. This is done simply by publishing a Notice of Alteration (in the manner set out in the Memorandum of Incorporation or the rules) and filing the Notice of Alteration with the Companies Commission. [56]

This procedure promotes greater efficiency and avoids the need to seek shareholder approval by special resolution or to comply with all the other formalities for an amendment of the Memorandum of Incorporation.

6.3.3.2 Translation of the Memorandum of Incorporation

A company may, at any time, file one or more translations of its Memorandum of Incorporation in any of the official languages of South Africa. A translation must be accompanied by a sworn statement by the person who made the translation, stating that it is a true, accurate and complete translation of the Memorandum of Incorporation. If there is a conflict between the Memorandum of Incorporation of a company and a filed translation, the Memorandum of Incorporation will prevail.

6.3.3.3 Consolidation of the Memorandum of Incorporation

After a company has filed its Memorandum of Incorporation and has subsequently filed one or more alterations or amendments to it, the company may at any time file a consolidated revision of its Memorandum of Incorporation, as so altered or amended. The Companies Commission may also require the company to file a consolidated revision of its Memorandum of Incorporation. A consolidated revision must be accompanied by a sworn statement by a director of the company or a statement by an attorney or notary public to the effect that it is a true, accurate and complete representation of the Memorandum of Incorporation, as altered and amended up to the date of the statement.

6.3.3.4 Authenticity of versions of the Memorandum of Incorporation

(i) In the event of a conflict between the Memorandum of Incorporation of a company and a filed translation, the Memorandum of Incorporation (as altered or amended) will prevail.

(ii) Similarly, the Memorandum of Incorporation, as altered or amended, will prevail if there is a conflict between the company's Memorandum of Incorporation and a filed consolidated revision, unless the consolidated revision has subsequently been ratified by a special resolution at a general shareholders' meeting of the company.

(iii) The latest version of a company's Memorandum of Incorporation that has been endorsed by the Companies Commission prevails in the event of any conflict between that version and any other purported version of the company's Memorandum of Incorporation. [57]

6.3.4 The Memorandum of Incorporation of a pre-existing company

A pre-existing company (ie a company that was already in existence before the date of commencement of the Act on 1 May 2011) may file, without charge, an

amendment to its Memorandum of Incorporation [58] to bring it in harmony with the Act. This may be done at any time within two years of 1 May 2011.

During this two-year transitional period, if there is a conflict between a provision of the Act and a provision of a pre-existing company's Memorandum of Incorporation, the latter provision will prevail (except to the extent that Schedule 5 to the Act provides otherwise). However, once the company has amended its Memorandum of Incorporation to harmonise it with the Act, or after the two-year transitional period has elapsed (whichever occurs earlier), a compliance notice may be issued to the company [59] requiring it to comply with the Act.

6.4 Rules of the company

Rules relate to the governance of a company. Rules may apply to intra-corporate matters or govern the internal affairs of a company. The rules may deal only with matters that are not addressed in the Act or in the company's Memorandum of Incorporation. For instance, rules may deal with the maximum number of directors, the venue of directors' meetings or the notice of directors' meetings (assuming that these issues are not addressed in the company's Memorandum of Incorporation).

The board of directors has the power to make rules, unless this is prohibited by the company's Memorandum of Incorporation. The board of directors may make any necessary or incidental rules by publishing a copy of the rules (in the manner specified in the company's Memorandum of Incorporation or in the rules themselves). A copy of the rules must be filed with the Companies Commission within ten business days of publication. The rules take effect ten business days after filing, or on a later date if so stated in the rules. Rules may be amended or repealed in a similar manner. [60]

Although a rule is binding from its effective date, it is initially binding on an interim basis only. The interim effect of the rule continues until it is put to a vote at the next general shareholders' meeting. If the rule is ratified by an ordinary resolution at the shareholders' meeting, the rule then becomes binding on a permanent basis. If, on the other hand, the rule is not ratified, it is no longer binding on the company and it simply lapses. But the lapse of the rule does not affect the validity of anything done in terms of that rule during the period that it had an interim effect. This is the sensible outcome, as much confusion would otherwise result. Within five business days after the ratification vote by the shareholders, the company must file with the Companies Commission a notice of ratification or non-ratification (as the case may be).

When a rule is not subsequently ratified by the shareholders, the board of directors may not make a substantially similar rule within the ensuing 12 months unless the new rule has been approved in advance by an ordinary resolution. This deters the board from taking inappropriate advantage of the interim enforceability of unratified rules.

It is obvious from the above analysis that company rules are generally amended more easily than the Memorandum of Incorporation. While an amendment of the Memorandum of Incorporation usually requires a special resolution, company rules are made, amended or repealed by the board of directors subject to confirmation by an ordinary resolution of shareholders.

It is important to note that the Memorandum of Incorporation of a company takes precedence over its rules. Company rules must be consistent with both the Act as well as the company's Memorandum of Incorporation, and any inconsistent rules are void to the extent of their inconsistency. Rules are also subject to the anti-avoidance provision of the Act.

6.5 Shareholder agreements

6.5.1 General

The shareholders of a company may enter into any shareholder agreement with one another concerning any matters relating to the company.

Shareholder agreements have a number of advantages. First, a shareholder agreement is a private document. Unlike the Memorandum of Incorporation, it is not filed with the Companies Commission and is not available for inspection by the general public. Second, the binding force of shareholder agreements derives from the normal principles of the law of contract, as opposed to s 15 of the Act (see 6.6).

On the other hand, the disadvantage of a shareholder agreement is that it binds only those shareholders who are parties to it. It does not bind any new shareholders of the company unless they consent to be bound. Furthermore, unless the agreement provides otherwise, the consent of each party to the shareholder agreement will be required to amend it (unlike amendments to the Memorandum of Incorporation which may be effected by a special resolution of the shareholders).

Although shareholder agreements have traditionally proved to be very useful in practice, the Act now makes significant inroads into the practical benefits and the utility of shareholder agreements. A shareholder agreement must now be consistent not only with the Act, but also with the company's Memorandum of Incorporation. Any inconsistent provision is void to the extent of its inconsistency. [61] Consequently shareholder agreements may no longer be used to supplant or supersede provisions of a company's constitution. This may be expected to reduce the practical value of shareholder agreements. [62]

The anti-avoidance provision of the Act may also have an impact on shareholder agreements. The anti-avoidance provision is widely drafted and empowers a court to declare any agreement (or transaction, arrangement, resolution or provision of a company's Memorandum of Incorporation or rules) to be primarily or substantially intended to *defeat* or *reduce* the effect of a prohibition or requirement established by an unalterable provision of the Act, and to declare the agreement void to that extent. [63]

6.5.2 Shareholder agreements of pre-existing companies

The force and effect of shareholder agreements of pre-existing companies is dealt with by the Transitional Arrangements to the Act. [64] This is to the effect that a pre-existing shareholder agreement continues to have the same force and effect for a period of two years after 1 May 2011, or until amended by the shareholders who are parties to the agreement.

After the two-year transitional period, the pre-existing shareholder agreement will have force and effect only to the extent of its consistency with the Act and the constitution of the company.

During the transitional period, the shareholder agreement will prevail in the event of a conflict with the Act or with the company's constitution. [65] Furthermore, during the two-year period after 1 May 2011, a compliance notice may not be issued to the company in respect of conduct that is inconsistent with the Act but consistent with the shareholder agreement, until such time as the company has filed an amendment to its Memorandum of Incorporation to bring it in harmony with the Act. It is noteworthy that practical problems may arise in the event that a company's shareholder agreement is not altered at the same time that its Memorandum of Incorporation is amended to harmonise it with the Act.

6.6 The legal status of the Memorandum of Incorporation and rules

6.6.1 Introduction

A company's Memorandum of Incorporation and company rules are binding-

(i) between the company and each shareholder;
(ii) between or among the shareholders of the company *inter se*;
(iii) between the company and each director or prescribed officer, in the exercise of his or her functions within the company; and
(iv) between the company and any other person serving the company as a member of a committee of the board, in the exercise of his or her functions within the company. [66]

A number of legal relationships are thus created by the company's Memorandum of Incorporation and rules.

It must be emphasised at the outset that the Memorandum of Incorporation and rules are not binding as between the company and outsiders, and are therefore unenforceable by outsiders or third parties.

Based on the common-law position under the 1973 Act, it is submitted that the principles discussed in 6.6.2-6.6.4 would continue to apply to the legal status of the Memorandum of Incorporation under the Act.

6.6.2 Contractual relationship

The company's Memorandum of Incorporation and rules have the legal status of a contract created by statute, in other words, a contract that derives its binding force from the terms of the Act.

6.6.3 Relationship between company and shareholder

It is clear that the company is bound to each shareholder and, conversely, that each shareholder is bound to the company. However, the company's Memorandum of Incorporation and rules are binding on a shareholder only to the extent that the rights and obligations are conferred or imposed on the shareholder *in his or her capacity as a shareholder*. By this is meant that the rights or duties imposed on a shareholder must in some way be connected with the holding of shares.

This has vital practical ramifications. For instance, if a clause in the company's constitution (ie Memorandum of Incorporation) appoints a shareholder as attorney of the company for life and the company later ceases to employ the shareholder as attorney, the shareholder will be unable to enforce the clause against the company. The reasoning is that the constitution is binding only to extent that it confers rights on a shareholder *in his or her capacity as a shareholder*, whereas the clause in issue conferred a right on the relevant shareholder *in his or her capacity as attorney*. As such, it is unenforceable against the company (see *Eley v Positive Government Security Life Assurance Co*). [67]

However, there may be scope for relying on another (unsettled) common-law principle to circumvent this: A shareholder acting *in his or her capacity as a shareholder* may restrain the company from contravening its constitution, in view of the binding nature of the constitution. In so doing, shareholders may *indirectly* enforce a right that is granted to them in the constitution *other than* in their capacity as shareholders. For instance, in the example above, the shareholder may restrain the company from breaching its constitution and thereby *indirectly* enforce his or her appointment as attorney of the company, which right is clearly granted to such a shareholder in his or her capacity as attorney. The limits of this principle are still subject to debate.

Regarding the issue of enforcement by shareholders against the company, the rights granted to a shareholder in terms of the Memorandum of Incorporation and rules are enforceable against the company by a shareholder in his or her capacity as a shareholder. The usual shareholder remedy for a breach of the constitution is an interdict or a declaratory order, as opposed to damages against the company.

6.6.4 Relationship between or among shareholders *inter se*

The Memorandum of Incorporation and rules are binding between the shareholders *inter se*. In other words, each shareholder is bound to every other shareholder, in so far as they are affected specifically *in their capacity as shareholders*. The relationship

between the shareholders *inter se* is at issue when, for example, a shareholder wishes to sell his or her shares without complying with a right of first refusal or right of pre-emption under the Memorandum of Incorporation (in terms of which shareholders wishing to dispose of their shares must offer them to the other shareholders and not to outsiders, unless the other shareholders first refuse them).

Of particular importance is the question whether shareholders may enforce the Memorandum of Incorporation against one another *directly*, without the intervention of the company itself. In *Rayfield v Hands* [68] the plaintiff, a shareholder, was permitted a *direct action* against the defendants, who were the sole directors and also shareholders of the company, in order to compel them to take over the plaintiff's shares as provided in the company's constitution. But it is arguable that if a clause in the company's constitution (or rules) does not affect a shareholder personally, a direct action by the shareholder would not be permitted and the shareholder would instead be required to bring an action through the company.

6.6.5 Relationship between company and director, prescribed officer or member of a board committee

It is clear that the Memorandum of Incorporation and rules of a company are binding between the company and each of its directors, in the exercise of their functions within the company. A director may now enforce relevant provisions of the Memorandum of Incorporation directly against the company and vice versa (to the extent that the Act does not expressly provide otherwise). Prescribed officers and board committee members may do likewise.

It must be emphasised that directors are only bound and entitled *in the exercise of their functions as directors*. This boils down to a question of fact in each case. Should the Memorandum of Incorporation or rules confer rights or impose obligations on a director in another capacity, for instance as attorney of the company, the director may not enforce this against the company.

In a similar vein, the Memorandum of Incorporation and rules are binding between the company and prescribed officers, and between the company and members of board committees, only in relation to the exercise of their respective functions within the company.

6.7 Pre-incorporation contracts [69]

6.7.1 Introduction

6.7.1.1 Significance of pre-incorporation contracts

Companies are frequently formed for a specific purpose, in order to acquire certain assets, business opportunities or other benefits. Before incurring the costs of forming

(ie incorporating and registering) a company, the promoters [70] of the company naturally desire the assurance that the company would indeed be able to acquire those assets or business opportunities upon its incorporation. Investors are also more assured when investing in a venture in which the promoter has already made the necessary legal arrangements to acquire the assets or benefits for which the company is formed. In practice, promoters tend to regard the incorporation of a company as one of the last formalities in the promotion of a company. There is thus a need for binding legal arrangements *prior* to the formation of the company.

6.7.1.2 The common-law obstacles

There are, however, certain common-law obstacles to overcome. At common law a company cannot be a party to a contract *before* its incorporation, since the company comes into existence as a legal person only upon its incorporation.

Moreover, no reliance may be placed at common law on agency principles. This is because it is logically impossible for a person (the promoter) to act as an agent for a non-existent principal (ie the non-existent company that is yet to be formed).

Furthermore, if an 'agent' purports to enter into a 'contract' on a company's behalf before the company is incorporated, the company will be unable to *ratify* the contract after it is incorporated. The reason is that ratification operates retrospectively to the time that the agent had entered into the contract, and thus to a time at which the company was not yet in existence. [71] At common law the contract will be a nullity as between the third party and the company. In addition, the 'agent' may be held personally liable on the contract.

6.7.1.3 The main methods of contracting on behalf of a company to be formed

Section 21 of the Act provides a legislative solution to overcome the hurdle of the 'non-ratification rule' at common law. [72] The purpose of s 21 is to put persons (or promoters), acting as agents, in a position to contract on behalf of the company, even though the company does not yet exist. It does so by permitting the company, once formed, to *ratify* a pre-incorporation contract entered into by an agent. Section 21 thus permits a form of statutory agency.

Besides s 21 of the Act, the other important method of contracting on behalf of a company to be formed is the common-law *stipulatio alteri* (contract for the benefit of a third party). Here the promoter contracts in his or her own name, as a principal (and not as an agent), for the benefit of the company to be formed. In contrast, a promoter who relies on a s

21 pre-incorporation contract evidently acts in the capacity of an *agent* on behalf of the company to be formed. The two methods, although superficially quite similar, are nevertheless separate and distinct.

A useful practical alternative is for promoters simply to acquire a company off the shelf from an agency providing this service, and to thereafter contract in the company's name, without the need for a pre-incorporation contract. The use of a shelf company is particularly convenient where the promoters wish to expedite the process of setting up a business. After purchasing a shelf company, the promoters would file with the Companies Commission the necessary notices to change the registered office of the company, its name, the directors, provisions of the Memorandum of Incorporation and so on. It is nevertheless expected that, despite this possibility, pre-incorporation contracts will continue to play an important role in the corporate world.

Besides s 21 of the Act and the *stipulatio alteri*, there are certain other methods on which a promoter may rely. These include an offer made to the promoter 'or his (or her) nominee', or the cession of an option by the promoter to the company once it comes into existence. A further common-law method is the cession of the rights and delegation of the obligations, under a contract concluded between the promoter and the third party, to the company once it is formed.

6.7.2 Section 21 pre-incorporation contracts

6.7.2.1 General

A pre-incorporation contract is a written agreement entered into before the incorporation of a company by a person who purports to act in the name of, or on behalf of, the proposed company, with the intention or understanding that the proposed company will be incorporated, and will thereafter be bound by the agreement.

Section 21 of the Act enables persons, acting as agents, to contract on behalf of non-existent companies that are yet to be formed, and furthermore enables companies on their formation to *ratify* such pre-incorporation contracts. A number of key points must be highlighted: First, a s 21 pre-incorporation contract must be a *written* agreement. Second, the agreement is entered into *before* the company comes into existence. Third, it is entered into by a third party and a person (promoter), in his or her capacity as an *agent*, who purports to act in the name of or on behalf of the company. Section 21 does not apply where the promoter contracts in his or her own name, as *principal*, for the benefit of the company to be formed - in this event, the common-law *stipulatio alteri* would apply. Fourth, once the company is incorporated and comes into existence, it may *ratify* the pre-incorporation contract entered into by the promoter. Fifth, once ratified, the pre-incorporation contract becomes enforceable against the company.

An important issue is the formalities for pre-incorporation contracts.

The sole formality for a s 21 pre-incorporation contract is that it must be in writing. This is a laudable formality. Written pre-incorporation agreements provide certainty. They also ensure that the board of directors of the company receives full and proper disclosure of the terms of the pre-incorporation agreement before ratifying it and that there are no disputes over the terms of the agreement.

The other burdensome formalities for statutory pre-incorporation contracts have fortunately been abolished. Most significantly, pre-incorporation contracts need no longer be lodged or filed at the Companies Commission. This removes a major disadvantage that was formerly associated with the publicity and public scrutiny of statutory pre-incorporation contracts (under the 1973 Act). Under the Act, notice of pre-incorporation contracts may be given to a company but this is merely on a voluntary basis. In terms of the regulations, a person may (not must) give notice to a company of a pre-incorporation contract, by filing and delivering a notice in the prescribed form, including particulars of the contract, which forms part of the public record of the company concerned. [73] However, the downside is that it creates the risk that the board of directors of the company (once it is formed) may be completely unaware of the existence of the pre-incorporation contract if the optional notice is not given. [74] This risk is exacerbated by the consideration that pre-incorporation contracts need no longer be mentioned in the company's constitution as objects of the company.

Notably, s 21 deals not only with pre-incorporation agreements, but also extends to any other 'action' purported to have been 'made or done' in the name of or on behalf of a company that is yet to be incorporated.

6.7.2.2 Ratification of a section 21 contract

A pre-incorporation contract becomes enforceable against the company once it is ratified by the company.

The power to ratify pre-incorporation contracts lies with the board of directors of the company. The board may either ratify or reject a pre-incorporation contract, and may do so completely, partially or even conditionally. [75]

Should the board fail either to ratify or to reject a pre-incorporation contract within three months after the company's incorporation, then the company is 'regarded to have ratified' it. In other words, there is a *deemed ratification* in the event that the company fails to act within the three-month period.

The concept of a deemed ratification may have its benefits, particularly from the point of view of the third party. But it may result in harsh and inflexible effects for the company, to the extent that it stipulates a cut-off time of three months without requiring that the board should have had any knowledge of the pre-incorporation contract. The concept of a deemed ratification of pre-incorporation contracts - coupled with the abolition of the mandatory filing of pre-incorporation contracts at the Companies Commission, and the abolition of the mandatory reference to pre-incorporation contracts in the company's constitution - could create a definite stumbling block for the company. [76] It gives rise to the risk that companies whose boards do not have full knowledge (or even any knowledge) of pre-incorporation contracts could find themselves nonetheless bound to such contracts.

A pre-incorporation contract that has been ratified, or that is deemed to have been ratified, is enforceable against the company. Furthermore, the liability of the agent in respect of the agreement is discharged upon ratification (see further below).

The ratification of pre-incorporation contracts has retrospective effect. Unfortunately the wording of s 21 [77] is ambiguous and problematic, in that it is debatable whether the retrospectivity extends to the date that the company was *incorporated* or, conversely, the date that the contract was *entered into* by the agent and the third party. This is a significant issue in practice. It determines the point at which the company obtains rights and incurs obligations under the agreement. For instance, it determines the time when the profits of a business that is being sold under a pre-incorporation contract accrue to the company or, in the case of immovable property, when liability for the payment of property rates would arise. Ideally, pre-incorporation contracts ought to be retrospective, with the retrospectivity extending to the date that the contract was *entered into* by the agent and the third party, as opposed to the (later) time that the company was *incorporated*. As it happens, this issue remains unsettled under the Act.

6.7.2.3 Liability of the promoter for a section 21 contract

The promoter is jointly and severally liable for liabilities created in terms of the pre-incorporation contract in two circumstances:

(i) if the company is not subsequently incorporated; or
(ii) if the company, once incorporated, rejects any part of the pre-incorporation contract.

By providing for the liability of the promoter, the Act creates a fundamental balance between the conflicting rights and liabilities of the company, the promoter and the third party. If, for instance, the company is never incorporated, or if the company decides against ratifying the pre-incorporation contract, the third party (that is, the party with whom the promoter purported to contract on behalf of the unformed company) is not left without any remedy. Rather, the promoter is liable to the third party in the event of non-incorporation of the company or non-ratification of the contract. In other words, the promoter bears the risk of non-incorporation and/or non-ratification. This is a modern and comprehensive solution, which ensures that the third party is suitably protected.

To the extent that a pre-incorporation contract is ratified - whether this be an actual or a deemed ratification - the liability of the promoter is discharged, and the agreement is instead enforceable against the company.

An exception is made to the promoter's liability where the company, once incorporated, enters into an agreement on the same terms as the pre-incorporation contract or in substitution for it. In other words, if the pre-incorporation contract is not ratified, but is instead novated or substituted by a new contract between the third party and the company, then the promoter is released from liability despite the company's failure to ratify the pre-incorporation contract. This is both logical and reasonable.

The question arises: with whom is the promoter 'jointly and severally liable' in terms of s 21? The wording of the Act is vague in this context. It is submitted that the intention is to cater for the situation where there is more than one promoter of a company that is yet to be formed, in which case the co-promoters will be jointly and severally liable. In practice there is often more than one promoter or even a group of promoters. In some cases it is not even the promoter him- or herself who signs the pre-incorporation contract, but an agent, employee, accountant or even a family member of the promoter. It is in the interests of fairness and equity that liability should not be confined merely to the signatory of the pre-incorporation contract in these instances. Instead, liability under the (as yet unratified) pre-incorporation contract ought properly to be imposed also on all the other co-promoters jointly and severally. [78]

Section 21 regrettably leaves open the potential for abuse by a 'fly-by-night company'. This is where the promoter, in the subsequent realisation that a pre-incorporation contract is no longer beneficial or profitable (for instance, due to changes in market conditions or due to the subsequent availability of a more favourable transaction), procures a shell company or an insolvent company to ratify the contract. In other words, there is a sham incorporation or an opportunistic adoption, with the result that the third party is left with a fruitless or meaningless right of action for breach of contract against a company without any assets. In this way, the promoter effectively escapes personal liability for the pre-incorporation contract, by taking advantage of this loophole in the Act. [79]

6.7.2.4 Entitlement of the promoter

The Act provides that a promoter who is liable for a rejected pre-incorporation contract' may assert a claim against the company for any benefit it has received (or is entitled to receive) in terms of the agreement. It is noteworthy that the promoter's claim in terms of this provision lies against the company, and not against the third party to the contract. This may prevent the unjustified enrichment of the company at the expense of the promoter. For instance, where the company received property under a rejected (or unratified) pre-incorporation contract for which the promoter is liable, the promoter may claim the property from the company.

The Act thus addresses the promoter's entitlement to the benefits of an unratified agreement vis-à-vis the company. But s 21 as a whole is silent on the promoter's entitlement to the benefits of the contract vis-à-vis the third party.

In this regard, it is not an automatic legal consequence that a promoter, who is personally liable for *liabilities* under a pre-incorporation contract, is also able to take the initiative of *enforcing* the agreement against the third party. In other words, personal liability for the liabilities does not invariably mean that the promoter is entitled also to the *benefits* of the contract or to exact performance of the contract. Section 21 of the Act is silent on whether the personally liable promoter may demand the benefits of the contract from the third party. [80]

6.7.2.5 Other important issues

The Act is similarly silent on the rights of the parties during the interim period between the execution of the pre-incorporation contract and the company's ratification of it. Of particular practical significance is the question whether the third party may unilaterally withdraw from a pre-incorporation contract prior to its ratification and, if not, how and by whom this is to be enforced. These issues are simply and disappointingly left unresolved in s 21 of the Act.

A further interesting issue is whether a promoter is able to contract out of his or her liability under s 21. It appears that the drafters of the Act did not intend the promoter to have the power to contract out of his or her liability. It would, of course, ultimately be for the court to decide this vital issue. The anti-avoidance provision of the Act may be quite significant in this regard.

6.7.3 The *stipulatio alteri* or contract for the benefit of a third party

The *stipulatio alteri* is a common-law device by which two parties contract with each other for the benefit of a third party. It is likely that the *stipulatio alteri* may continue to be used as an alternative method for pre-incorporation contracts, whereby a promoter stipulates in favour of an unformed company that he or she is engaged in bringing into existence.

In a *stipulatio alteri* the promoter (known also as the stipulator or promisee in this context) enters into a contract with the other party (termed the promisor) for the benefit of the company yet to be formed (the third party in the context of the *stipulatio alteri*).

It is essential that the promoter (or trustee) must act as a *principal* and not as an agent. In other words, the promoter contracts in his or her own name and not in the name of the company. It is this factor that distinguishes the *stipulatio alteri* from pre-incorporation contracts made in terms of s 21 of the Act. Accordingly, in a *stipulatio alteri* the promoter enters into the pre-incorporation contract as a principal, whereas in a s 21 pre-incorporation contract the promoter apparently acts as an agent on behalf of the company to be formed.

Under the *stipulatio alteri* the company, once it is incorporated, has an election (or choice) to accept or adopt the benefit of the contract. Consequently, the company is not bound by the contract unless and until it elects to adopt the benefit of the contract. Upon acceptance by the company, it becomes a party to the contract with the promisor. If the company accepts the benefit, it must also accept all the consequent obligations and other terms of the contract. [81]

Until the company makes its election, the parties to the contract are the promoter and the promisor (ie the other party to the contract). During that time, the promisor cannot unilaterally withdraw from or cancel the contract. Should the promisor attempt to do so, the promoter may obtain an interdict against him or her. Failing an interdict, and if the promisor repudiates the contract, the promoter may claim damages for breach of contract. However, specific performance (in respect of an obligation ultimately to be due to the company) will not as a general principle be granted in favour of the promoter, unless the terms of the contract so provide.

From the perspective of the company, the disadvantage of the *stipulatio alteri* is that, prior to acceptance by the company, the promoter and the promisor may mutually cancel the contract. This is because the promoter acts as a principal. The mutual cancellation of the contract clearly has the effect of depriving the company of the benefit of the contract.

A significant issue is whether the promoter is personally liable in the event that the company is not incorporated or if the company chooses not to adopt the benefit of the contract. Unless the contract so provides, the promoter does *not* become personally liable on the contract, and the contract simply lapses. Accordingly, the promisor is well advised to ensure that the particular *stipulatio alteri* agreement indeed provides for the personal liability of the promoter.

Furthermore, if the company fails to adopt the benefit of the contract, the promoter is not automatically entitled to step into the shoes of the company and insist on accepting the benefit of the contract for him- or herself or to personally exact performance of the contract, save where the contract so provides.

There are no formalities for the *stipulatio alteri* other than those imposed by the general law of contract for the relevant transaction.

It is likely that s 21 of the Act does not curtail the use of the *stipulatio alteri* as a device for entering into pre-incorporation contracts, as discussed above. The retention of the common-law *stipulatio alteri* as a method for contracting for the benefit of a company yet to be formed is commendable. However, it does mean that problems may continue to be encountered in determining which type of contract was entered into, ie whether the parties entered into a s 21 pre-incorporation contract or a *stipulatio alteri*. This issue may cause substantial difficulty where the wording of the contract is ambiguous.

The question whether the parties have entered into a *stipulatio alteri* (in which the promoter acts as a principal) or whether they have entered into a s 21 pre-incorporation contract (in which the promoter acts as an agent for the company) has important practical implications. Different consequences may flow from each of the two types of contract, as discussed above. For instance, while the promoter under a s 21 pre-incorporation contract is personally liable for the liabilities under the contract, the promoter in a *stipulatio alteri* is only personally liable if the contract so provides; and whereas s 21 pre-incorporation contracts are apparently retrospective, the issue of the retrospectivity of the *stipulatio alteri* is less clear.

Under the previous company law regime, the difficulty in determining which type of contract was involved was largely caused by uncertainty concerning the guiding criteria. The courts held that the deciding factor was the intention of the parties to the particular contract, which depended on the facts of the case, and was determined from the terms of the contract and the surrounding circumstances.

Questions

1. Section 65(7) of the Companies Act 71 of 2008 states as follows: 'For an ordinary resolution to be approved by shareholders, it must be supported by more than 50% of the voting rights exercised on the resolution.' Section 65(8) of the Act states that a company's Memorandum of Incorporation may require a higher percentage of voting rights to approve an ordinary resolution.
   (a) Is this an alterable provision or an unalterable provision?
   (b) The Memorandum of Incorporation of N Co Ltd states that for an ordinary resolution of the company to be approved, it must be supported by at least 40 per cent of the exercised voting rights. Is this a valid provision? Explain.
   (c) P and Q are shareholders of Baffled & Bewildered (Pty) Ltd. P and Q were the only shareholders who had voted in favour of an ordinary resolution to elect X as a director of Baffled & Bewildered (Pty) Ltd. P and Q together held 51 per cent of the voting rights that were exercised on the ordinary resolution. P and Q are parties to a shareholder agreement of Baffled & Bewildered (Pty) Ltd, which states that for an ordinary resolution to be approved by shareholders, it must be supported by more than 60 per cent of the voting rights exercised on the resolution. However, the Memorandum of Incorporation of Baffled & Bewildered (Pty) Ltd states that the

approval of an ordinary resolution requires the support of more than 50 per cent of the voting rights exercised on the resolution. Advise P and Q what percentage of voting rights is required in law for the approval of the ordinary resolution of Baffled & Bewildered (Pty) Ltd.

(d) For the purposes of *(c)*, assume that the Memorandum of Incorporation of Baffled & Bewildered (Pty) Ltd is silent on the percentage of voting rights required for the approval of an ordinary resolution. The shareholder agreement, however, states that an ordinary resolution requires the approval of more than 60 per cent of the exercised voting rights. Advise P and Q what percentage of voting rights is required for the approval of the ordinary resolution of Baffled & Bewildered (Pty) Ltd.

2. A group of incorporators wishes to have a public company incorporated and registered under the name Red Flag Ltd. The incorporators have completed and signed the Memorandum of Incorporation, which states that clauses 2.2 and 3.4 are entrenched and are entirely prohibited from amendment.

(a) Advise the incorporators of any additional requirements for the name of the company and the Notice of Incorporation of the company.

(b) Explain the doctrine of constructive notice and whether it will apply in this situation.

3. Knight and Daye wish to open a sunglasses boutique. They decide to form a company for that purpose. They are very eager to commence business, having just returned from an international sunglasses exhibition where they discovered the latest trends and styles. Knight and Daye wish to ensure that they are able to obtain stock of these sunglasses from the supplier, Trendi. They accordingly enter into a written agreement with Trendi, in which they purport to act as agents on behalf of the company that is still to be formed (ie incorporated and registered). Before the company comes into existence, Trendi delivers the first consignment of sunglasses, valued at R300 000, to Knight and Daye in terms of the pre-incorporation contract.

(a) Discuss the liability, if any, that Knight and Daye may incur on the pre-incorporation contract under the Companies Act 71 of 2008.

(b) Once the company is formed and has come into existence, will the agreement with Trendi become enforceable against the company? If not, explain how a pre-incorporation contract would become enforceable against the company.

(c) If the company ratifies the pre-incorporation contract with Trendi, will the company become liable for payment of the amount of R300 000 owed to Trendi for the delivery of the sunglasses before it had come into existence?

(d) Assume that Knight and Daye had not acted as agents on behalf of the company to be formed, but had instead contracted with Trendi in their own names, for the benefit of the company to be formed. What method would Knight and Daye be using for this pre-incorporation contract? How would this affect Knight and Daye's liability under the pre-incorporation contract, in contrast with their liability in *(a)*?

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[1] Section 7.

[2] Sections 1 and 13.

[3] Section 13.

[4] See Form CoR 14.1 and reg 14 of the Companies Regulations GNR 351 *GG* 34239 of 26 April 2011 ('the Regulations'). Annexure A to Form CoR 14.1 deals with the initial directors of the company; Annexure B deals with the alternative names for the company; Annexure C is the notice of ring-fencing provisions; and Annexure D is the notice of company appointments.

[5] See reg 15 and Forms CoR 15.1A, 15.1B, 15.1C, 15.1D and 15.1E.

[6] The fee is set out in Table CR 2B of the Regulations and varies depending on the form of the company's Memorandum of Incorporation. The basic fee is R175 or R475.

[7] Section 14.

[8] Section 13.

[9] On any of the grounds of disqualification set out in s 69; see further Chapter 12: Governance and the board of directors.

[10] Evidently the Companies Commission may accept a Notice of Incorporation regardless of the disqualification of any initial directors, if the remaining initial directors still make up the requisite minimum number.

[11] That is, Form CoR 14.1, as discussed above.

[12] Section 6(8).

[13] Section 23.

[14] Section 1.

[15] Rule 4(1)*(a)*(v) of the Supreme Court Rules and Rule 9(3)*(e)* of the Magistrates' Courts Rules.

[16] These records are referred to in s 24. See further Chapter 11: Governance and shareholders.

[17] Section 23.

[18] Section 11.

[19] Pre-existing companies (ie companies formed before 1 May 2011) are deemed to have changed their names in so far as required to comply with these provisions - see Chapter 23: Transitional arrangements.

[20] See further 6.3.2.4.

[21] Or to a trade mark that has been filed for registration or a well-known trade mark in terms of the Trade Marks Act 194 of 1993, unless the registered owner of that mark has consented in writing to its use.

[22] Act 27 of 1960, unless the registered owner has transferred the registration to the company.

[23] A pre-existing company (ie a company formed under the Companies Act of 1973) may file, without charge, within two years of 1 May 2011, a notice of name change together a copy of the relevant special resolution to alter its name in order to meet the requirements of the Act. See further Chapter 23: Transitional arrangements.

[24] *Peregrine Group (Pty) Ltd v Peregrine Holdings Ltd* 2000 (1) SA 187 (W) 198 and the appeal case 2001 (3) SA 1268 (SCA); *Polaris Capital (Pty) Ltd v Registrar of Companies* 2010 (2) SA 274 (SCA); *Azisa (Pty) Ltd v Azisa Media CC* 2002 (4) SA 377 (C). In *Azisa* the court stated that there is no hard-and-fast rule, and that much depends on the degree of similarity of the names, the likelihood of confusion and the business activities of the respective parties.

[25] Section 14.

[26] If, on the other hand, the relevant name is the '*same*' as one of these, the Companies

Commission will instead register the company in an interim name (as discussed above).

[27] In terms of s 160 of the Act.

[28] In terms of s 16 of the Act. See further 6.3.3 on amending the Memorandum of Incorporation.

[29] The criteria for company names, the registration of company names and disputes concerning company names, as discussed in 6.2.1 and 6.2.2, apply equally to an amended company name.

[30] Section 12.

[31] If the company has been issued with an interim name (as reflected on its registration certificate), the company must use its interim name until its amended name has been registered.

[32] Section 32.

[33] Section 79.

[34] The provisions of the Consumer Protection Act regarding business names are not yet in force. These business name provisions will not be enforceable against any person who has been actively conducting business under a business name for at least one year before the relevant provisions have come into force (Schedule 5, item 2 of the Consumer Protection Act).

[35] Under the Companies Act 61 of 1973 ('the 1973 Act'), the constitution of a company consisted of two documents, namely the Memorandum of Association and the Articles of Association. The need for a two-document constitution has now fallen away.

[36] See reg 15 and Forms CoR 15.1A, 15.1B, 15.1C, 15.1D and 15.1E, which set out, respectively, the short standard form Memorandum of Incorporation for private companies; the long standard form for profit companies; the short standard form for non-profit companies without members; the long standard form for non-profit companies without members; and the long standard form for non-profit companies with members.

[37] That is, the Memorandum of Incorporation.

[38] Section 66.

[39] Sections 1 and 15.

[40] Section 15.

[41] Section 6. For a full discussion of the Memorandum of Incorporation, see further Maleka Femida Cassim 'Chapter 4: Formation of companies and the company constitution' in Farouk HI Cassim et al *Contemporary Company Law* 2 ed (2012) para 4.3.

[42] Sections 1 and 15.

[43] Regrettably, however, the Act does not define the phrase 'restrictive conditions applicable to the company'.

[44] Sections 11 and 13.

[45] Section 19.

[46] Under the 1973 Act, the effect of the doctrine of constructive notice was that third parties dealing with a company were regarded as having received notice or deemed to have knowledge of the contents of the company's constitution or other company documents merely because they were public documents. This no longer applies under the Act in general, but there are three exceptions. See further Chapter 7: Corporate capacity, agency and the turquand rule.

[47] To which the Notice of Incorporation has drawn attention, and provided that the company's name includes the element '(RF)'.

[48] Ibid.

[49] As discussed in Chapter 5: Types of companies.

[50] However, the third party, as well as the company, may have a remedy against the director.

[51] In terms of s 60, shareholders must exercise their votes in writing within 20 business days after receiving the written resolution, and the written resolution will be adopted if it is supported by the requisite number of voting rights for a special resolution. See further Chapter 11: Governance and shareholders.

[52] Section 65. See further Chapter 11: Governance and shareholders.

[53] See 6.3.2.4 on restrictive conditions and prohibitions on the amendment of the Memorandum of Incorporation.

[54] See further Chapter 5: Types of companies.

[55] See reg 15 and Form CoR 15.2, and the prescribed fee in Table CR 2B.

[56] Section 17.

[57] Section 18.

[58] The reference to the Memorandum of Incorporation of a pre-existing company is taken to mean its Memorandum of Association and Articles of Association. See further Chapter 23: Transitional arrangements.

[59] With respect to conduct that is consistent with the company's Memorandum of Incorporation but inconsistent with the Act.

[60] Section 15(3)-(5A).

[61] Section 15(7).

[62] Farouk HI Cassim 'The Companies Act 2008: An overview of a few of its core provisions' (2010) 22 *SA Merc LJ* 157 at 167-8. For further discussion of shareholder agreements, see Maleka Femida Cassim 'Chapter 4: Formation of companies and the company constitution' in Farouk HI Cassim et al *Contemporary Company Law* 2 ed (2012) para 4.5.

[63] Section 6(1).

[64] Schedule 5, item 4. See further Chapter 23: Transitional arrangements.

[65] Except to the extent that the agreement or the company's constitution provides otherwise.

[66] Section 15(6).

[67] (1876) 1 ExD 88.

[68] [1960] 1 Ch 1; [1958] 2 All ER 194.

[69] This section on pre-incorporation contracts is derived from Maleka Femida Cassim 'Pre-incorporation contracts: The reform of section 35 of the Companies Act' (2007) 124(2) *SALJ* 364, and Maleka Femida Cassim 'Some difficult aspects of pre-incorporation contracts in South African law and other jurisdictions' (2012) 13(1) *Business Law International* 5.

[70] There is no fixed definition of a promoter. A promoter, in broad terms, may be regarded as someone who undertakes to form a company with reference to a specific project, and to set it going.

[71] *Kelner v Baxter* [1866] LR 2 CP 174; *McCullogh v Fernwood Estate Ltd* 1920 AD 204.

[72] That is, that a company at common law cannot ratify a pre-incorporation contract made before the company's formation by an agent on behalf of the company.

[73] Regulation 35 and Form CoR 35.1.

[74] Maleka Femida Cassim 'Some difficult aspects of pre-incorporation contracts in South African law and other jurisdictions' (2012) 13(1) *Business Law International* 5.

[75] If a person has given notice to a company of a pre-incorporation contract, the company must, within five business days of its decision to reject or ratify the pre-incorporation contract, file a notice of its decision (in form CoR 35.2) and deliver a copy of the notice to each party to the contract or each person who is materially affected by the action.

[76] Maleka Femida Cassim (n 74).

[77] Section 21 states that, once ratified, 'the agreement is as enforceable against the company as if the company had been a party to the agreement when it was made'.

[78] Maleka Femida Cassim 'Pre-incorporation contracts: The reform of section 35 of the Companies Act' (2007) 124(2) *SALJ* 364 at 376-7.

[79] The court could perhaps pierce the corporate veil in these circumstances in order to impose the liability on the promoter for the company's breach of contract.

[80] See further Maleka Femida Cassim (n 74).

[81] Whether the adoption of the benefit of the *stipulatio alteri* operates retrospectively is an unsettled area of law. In practice, the ideal situation would be to include a term in the contract that either provides for or prohibits retrospectivity.

Chapter 7
Corporate Capacity, Agency and the Turquand Rule

Farouk HI Cassim

7.1 Legal capacity of the company

7.1.1 Introduction

7.1.1.1 Historical development

In order to understand the modern approach to corporate capacity, it is necessary to examine, albeit briefly, the *ultra vires* [1] doctrine and to have regard to its historical development.

For a contract to be legally binding and enforceable against a company, apart from having to comply with the formalities for a valid contract, it was always necessary for two additional company law requirements to be fulfilled. First, the company was required to have the legal capacity to enter into the contract; and second, the director or officer representing the company had to have authority to enter into the contract on behalf of the company. Both capacity and authority were essential prerequisites for a binding contract. Capacity and authority, although linked, are very different legal concepts. Capacity in this context meant, and still does mean, the legal competency and the powers of the company, while authority referred, and still refers, to the power of a company's director or officer or other individual to act on behalf of the company.

The legal capacity of a company under the previous company law regime was determined by the main object of the company as set out in the objects clause of its memorandum of association. The clause would specify the purposes for which the company had been formed. The objects clause was taken to define the existence of the company as a legal person. According to the *ultra vires* doctrine, a company existed in law only for the purposes of the objects stated in the objects clause of its memorandum of association. These included any objects that were reasonably incidental or ancillary to the company's main object. Beyond these limits, a company had no legal existence.

Consequently, if a company, in performing some act or in entering into some contract or transaction, had exceeded its legal capacity as determined by its objects clause, the company ceased to exist as a legal person for the purposes of that contract. It followed that such a contract was absolutely null and void and could not be ratified even by the unanimous assent of all the shareholders. In this statement lies the kernel of the *ultra vires* doctrine as expounded in *Ashbury Railway Carriage and Iron Co v Riche*. [2]

From this brief discussion so far, an *ultra vires* act may be defined as some act or transaction entered into by a company which, although not unlawful or contrary to public policy, is beyond the legitimate powers of the company. [3]

7.1.1.2 The object of the ultra vires doctrine

Historically, the object of the *ultra vires* doctrine was twofold: first, to protect investors and shareholders of the company so that they would know the purposes for which their money could be used; and second, to protect creditors of the company.

Shareholders and creditors were, in theory, able to assess the risk of buying shares in the company or dealing with the company simply from the main object of the company. [4] The protection of shareholders and creditors was at the time, and still is, regarded as being of great importance to company law. In modern company law, perhaps more effective means of protecting shareholders, creditors and investors may have been developed, but the objectives remain the same.

7.1.1.3 The legal consequences of an ultra vires contract

The legal consequences of an *ultra vires* contract went further than merely rendering the contract null and void. This was merely the external consequence [5] of an *ultra vires* contract, namely that the contract was absolutely null and void. The contract could not be enforced by either the company or the other party to the contract. But apart from the external consequences, there were also two important internal consequences to every *ultra vires* contract that remain relevant to modern company law and to the Companies Act 71 of 2008 ('the Act'). By 'internal' consequences is meant the consequences that arise between the company, its directors and its shareholders.

The first internal consequence is that in every *ultra vires* contract entered into by the directors or other company representatives acting on behalf of the company, the directors could not possibly have had authority to enter into the contract, since a director or an agent could never have had authority that exceeded the legal capacity of the company (or principal). The errant director or agent concerned would necessarily have been in breach of a fiduciary duty not to exceed his or her authority. To put it differently: if the company did not have legal capacity (ie the power to enter into the contract), its directors or other agents could not possibly have had authority to enter into the contract on behalf of the company. The directors' authority must obviously be limited by the company's capacity. It follows that the directors would inevitably have exceeded their authority and would as a result be liable to the company for damages for breach of their fiduciary duty not to exceed their authority. [6] Every director is under a fiduciary duty not to act beyond the limits of his or her authority. The liability of the directors arises irrespective of any fault on the part of the directors.

The second internal consequence of an *ultra vires* contract was that, since the company in entering into an *ultra vires* contract would inevitably have failed to comply with the requirements of its constitution, every shareholder of the company would have been entitled at common law to institute legal proceedings to restrain the company from entering into or performing an *ultra vires* contract due to the contractual nature of the company's constitution. The constitution of the company formed, and still forms, the basis of a statutory contractual relationship between the company and its shareholders. [7] Apart from statute law, the company's memorandum and articles of association have long been held at common law to constitute a contract between the company and its shareholders. [8]

7.1.1.4 The failure of the ultra vires doctrine

Companies were easily able to circumvent the *ultra vires* doctrine by specifying in detail and as widely as possible in their objects clauses all the business activities the company might conceivably wish to pursue, together with a comprehensive and detailed catalogue of ancillary powers. [9] Each clause was typically designated an independent objects clause, [10] with the result that a company could have legal capacity to carry on every conceivable type of business activity.

Drafting techniques thus enabled companies to evade the *ultra vires* doctrine. In consequence of the width of objects clauses, the *ultra vires* doctrine developed into an illusory protection for the shareholders and a pitfall for unwary third parties dealing with the company.

The acceptance by the House of Lords in *Cotman v Brougham* [11] of the validity of the independent objects clause was taken even further in *Bell Houses Ltd v City Wall Properties Ltd*, [12] where the court accepted the validity of a subjective objects clause. A subjective objects clause typically empowered the board of directors to carry on any trade or business whatsoever which, in the opinion of the board, could advantageously be carried on by the company in connection with any business of the company. A subjective objects clause permitted the company to pursue any activity that the directors subjectively considered to be related or ancillary to the company's main object. In accepting the validity of this type of objects clause, the court deprived the *ultra vires* doctrine of all its remaining vitality.

7.1.1.5 The reform of the ultra vires doctrine

After the decision of the court in *Bell Houses Ltd v City Wall Properties Ltd*, [13] almost all common-law jurisdictions that had adopted the *ultra vires* doctrine from English law either abandoned or reformed the doctrine by statutory amendment. In South African law this was done by s 36 of the Companies Act 61 of 1973 ('the 1973 Act'). Section 36 did not abolish the *ultra vires* doctrine entirely. Instead, it abolished only the external consequences of an *ultra vires* contract while preserving its internal consequences. It remained mandatory for a company to state its object(s) in the main objects clause of its memorandum of association. Section 36 is briefly discussed here, as the approach it adopts is relevant to the Companies Act of 2008.

In terms of s 36 of the 1973 Act, an *ultra vires* contract was no longer void by reason only of a lack of capacity or a lack of authority on the part of the directors to enter into an *ultra vires* contract on behalf of the company. The directors' lack of authority did not affect the validity of the contract, provided that such a lack of authority arose only from a lack of capacity. Externally, the *ultra vires* contract was valid and binding between the company and the other party to the contract (ie the third party); either party to the contract could enforce it and neither party could escape from it on the grounds of *ultra vires*.

This was reinforced by a statutory estoppel that precluded both the company and the third party from asserting or relying, in any legal proceedings, on such a lack of capacity, power or authority. The basic theme of s 36, which as we shall see later is also adopted by the Companies Act of 2008, is that if a company, in legal proceedings against the third party, cannot assert or rely on its lack of capacity, then its lack of capacity cannot be proved. The dispute must then be resolved as if the lack of capacity did not exist. [14]

Under s 36 of the 1973 Act, unlike s 20(5) of the Companies Act of 2008, the knowledge, whether actual or constructive, of the third party that the contract was beyond the capacity of the company was deemed to be irrelevant. It was also not a requirement that the third party should act in good faith.

While the external consequences of an *ultra vires* contract were abolished, the internal consequences of an *ultra vires* contract were preserved by s 36 of the 1973 Act. As between the company, its directors or shareholders, the directors would still be liable to the company for breach of fiduciary duty not to exceed their authority, and shareholders of the company were entitled to restrain the company or its directors from entering into an *ultra vires* contract. But an important change was that once the contract was concluded, shareholders lost their right to restrain performance of the contract. The basis was that the contract, in terms of s 36, was no longer void. Furthermore, the statutory estoppel in s 36 precluded reliance on or assertion of a lack of capacity in any legal proceedings. In this event (ie once the contract was concluded), the liability of the directors for breach of fiduciary duty would still apply to render the miscreant directors liable in damages to the company for any loss suffered as a result of the unauthorised contract.

7.1.2 Legal capacity under the Act

The modern approach to the legal capacity of a company is that it is archaic and outdated to restrict a company to a specific business activity. In line with this approach, the Act states that, unless a company's Memorandum of Incorporation provides otherwise, a company has the legal capacity and the powers of an individual. [15] This is intended to allow a company to conduct any lawful activity it chooses. It does not necessarily mean that a company may do everything that a natural person may do, as there are certain acts that by their very nature a metaphysical entity, such as a company, cannot do. The usual examples are to enter into a contract of marriage, to obtain a driver's licence, to exercise a right to vote, or to have a right of audience in a superior court. There are also statutory restrictions on the business activities that a company may pursue. (For instance, a company may not simply conduct business as a bank or an insurance company unless it also complies with the specific statutory requirements for a bank or an insurance company.)

The Act, in providing that a company has all the legal powers and capacity of an individual, follows the approach adopted in other common-law jurisdictions and also in the Close Corporations Act 69 of 1984.

Section 19(1)*(b)* of the Act provides that a company has all of the legal powers and capacity of an individual, except to the extent that (i) a juristic person is incapable of exercising any such power, or having any such capacity; or (ii) the company's Memorandum of Incorporation provides otherwise.

Equally importantly, it is no longer mandatory in terms of the Act for a company to have an objects clause in its Memorandum of Incorporation. [16] This alone removes much of the legal complexity surrounding the determination of the main object of the company.

7.1.3 Restricting the company's capacity under the Act: Overview

Section 20(1) states that if a company's Memorandum of Incorporation limits, restricts or qualifies the purposes, powers or activities of that company-

(a) no action of the company is void by reason only that-
  - (i) the action was prohibited by that limitation, restriction or qualification; or
  - (ii) as a consequence of that limitation, restriction or qualification, the directors had no authority to authorise the action by the company.

Although companies now generally have unrestricted legal capacity under the Act, a company's Memorandum of Incorporation may, on an optional basis, impose restrictions, limitations, or qualifications to its purposes, powers or activities. When a company restricts its objects it is restricting the purposes for which its powers may be exercised. It follows that its powers may not be exercised for a purpose that conflicts with such restrictions. This would not only be *ultra vires*, it would of necessity be beyond the authority of its directors. In terms of s 20(1)*(a)* (as set out above), such restrictions, however, have no effect on the validity of the contract between the company and the other party to the contract (that is to say, externally). The contract remains valid and binding on both the company and the other party. The company's lack of legal capacity will not necessarily invalidate the contract but the directors or other corporate representatives may incur liability for failing to comply with the restrictions in the company's constitution. What the restriction does is to deprive the directors of authority to enter into a contract that is inconsistent with the restriction, and, in addition, the shareholders may be entitled to restrain the contract (this is discussed below).

Moreover (as with s 36 of the 1973 Act), the directors' lack of authority resulting from a lack of capacity does not inevitably affect the validity of the contract. This is explicitly provided in the Act (s 20(1)*(a)*(ii), as set out above), which states that no action of a company is void by reason *only* that, as a consequence of a limitation, restriction or qualification to the purposes, powers or activities of the company as specified in its Memorandum of Incorporation, the directors had no authority to authorise the action by the company. The underlying basis of this provision is the same as under s 36 of the 1973 Act (as discussed above), namely in order for the contract to be valid the directors' lack of authority must arise only from a lack of capacity. There must be no other reason for such a lack of authority. [17] Where this requirement is met, the contract or action will remain valid.

As under s 36 of the 1973 Act, the new Act contains a statutory estoppel that precludes either the company or the other party to the contract from relying on the limitation, restriction or qualification on the company's purposes, powers or activities, in order to assert that the contract is void. [18] Consequently, the issue of non-compliance with the restrictions on the capacity of the company cannot be raised between the company and the other party to the contract (ie externally), although it may be raised internally as between the company, its directors, prescribed officers and shareholders.

The *ultra vires* doctrine is preserved internally as a form of shareholder protection and protection for the company. This is not very different from s 36 of the 1973 Act: the directors may still incur liability to compensate the company on the grounds of their breach of a fiduciary duty; and the shareholders (and others, as discussed below) may still be entitled in certain circumstances to restrain the directors from entering into the contract.

It is clear from this discussion that the Companies Act of 2008 abolishes the *ultra vires* doctrine externally, but has preserved it internally to the extent that a lack of capacity may be raised only as between the company, its directors, prescribed officers and its shareholders. The internal consequences of an *ultra vires* contract enable shareholders of a company to exercise some control over the activities of its directors and to restrain them from entering into *ultra vires* contracts in contravention of the provisions of the company's Memorandum of Incorporation. The previous legal principles relating to the consequences of an *ultra vires* contract have retained both their relevance and their importance.

The question arises whether an illegal or unlawful contract falls within the ambit of s 20(1) (as set out above), with the effect that the contract is validated. In this regard, the word 'only' in s 20(1)*(a)*(i) serves the useful purpose of excluding from the ambit of the section any contract that is illegal or unlawful. This wording puts it beyond doubt that the section applies to an action or contract of the company that is void by reason *only* that it was prohibited by a limitation, restriction or qualification on the company's purposes, powers or activities in its Memorandum of Incorporation. If the action or contract in question is void because it is illegal or unlawful, or if there is any other ground for the nullity of the contract, the section will not apply to validate such a contract. Such a contract would fall outside the scope of the section. (This was also the position under s 36 of the 1973 Act.) In brief, the statutory provisions relating to lack of capacity have no application to illegal contracts.

7.1.4 The internal consequences of an *ultra vires* act

As stated above, the Act preserves the internal consequences of an *ultra vires* contract. It permits the issue of capacity to be raised in proceedings *(a)* between the company and its shareholders, directors or prescribed officers; or *(b)* between the shareholders and directors or prescribed officers of the company. [19]

Two comments may be made with regard to this provision. First, it is now extended to include prescribed officers. [20] This extension is new in our law. Second, it may be noted that, apart from this extension, the wording of the relevant provision of the Act (viz s 20(1)*(b)*(i) and (ii)) is virtually identical to the wording of the exception in s 36 of the 1973 Act. [21] This provision preserves the internal consequences of an *ultra vires* action. The internal remedies are discussed in more detail below.

7.1.5 Ratification

Section 20(2) of the Act provides that, if a company's Memorandum of Incorporation limits, restricts or qualifies the purposes, powers or activities of the company, or limits the authority of the directors to perform an act on behalf of the company, the shareholders may, by special resolution, ratify any action of the company or the directors that is inconsistent with any such limit, restriction or qualification. But no action of the company may be ratified if it is in contravention of the Act (s 20(3)). The effect of ratification of the *ultra vires* contract is that the internal consequences of an *ultra vires* contract fall away.

It is noteworthy that the section refers to the directors of the company without any reference to the prescribed officers of the company. Consequently, the unauthorised act of a prescribed officer may not be ratified by special resolution. The relevant act must be an act of the company or its directors. Our Companies Act thus overrules *Ashbury Railway Carriage and Iron Co v Riche* (discussed above), which laid down the principle that, since an *ultra vires* contract is an absolute nullity, it could not be ratified even by the unanimous assent of all the shareholders of the company.

7.1.6 The shareholders' claim for damages

Section 20(6) of the Act provides that each shareholder of a company has a claim for damages against *any person* who intentionally, fraudulently or due to gross negligence causes the company to do anything inconsistent with *(a)* the Act, or *(b)* a limitation, restriction or qualification contemplated in s 20, unless it has been ratified by a special resolution of the shareholders in terms of s 20(2). As discussed above, the Act excludes ratification of an act of a prescribed officer. The act must be that of the company or its directors. Ratification will exclude the shareholder's claim for damages. The effect of s 20(6) is that even an intentional or fraudulent act that is inconsistent with a constitutional limitation, restriction or qualification to the purposes, powers or activities of the company is now ratifiable by special resolution, but sensibly not an act that is inconsistent with the Act.

7.1.7 The shareholders' right to restrain acts beyond the company's capacity

As discussed above, the *ultra vires* doctrine has not been abandoned in its entirety: the internal consequences of an *ultra vires* act have been preserved, even though these consequences may now have developed into issues of the directors' fiduciary duties and shareholder rights.

One of the internal consequences is that the directors will be in breach of their fiduciary duty in entering into a contract that is inconsistent with a limitation, restriction or qualification on the company's powers, purposes or activities as specified in its Memorandum of Incorporation. It is notable that the right of the company to seek damages against the directors for breach of fiduciary duty does not form part of s 20 itself. For this, one would have to rely on the principles relating to the liability of directors (particularly s 77(3)*(a)* and s 77(2)*(a)*). [22] If the act of the director has not been ratified by a special resolution of the shareholders, the errant director could also, in an appropriate case, be declared a delinquent director.

The second internal consequence that is relevant here is that the shareholders have a right to institute legal proceedings to prevent the company or its directors from contravening the relevant provisions of its Memorandum of Incorporation. In other words, shareholders (and others) have a right to restrain *ultra vires* contracts or actions. This shareholder action is preserved.

In this regard, the Act provides that one or more shareholders, directors or prescribed officers of a company may apply to the High Court to restrain the company or the directors from doing anything inconsistent with a limitation, restriction or qualification on the purposes, powers or activities of the company as specified in its Memorandum of Incorporation. [23] This is subject to the rights of the *bona fide* third party, which is discussed in 7.1.8. [24]

7.1.8 The protection of the *bona fide* third party

The right to restrain an *ultra vires* act is, however, subject to the right to damages of a third party who *(a)* obtained the rights in good faith, and *(b)* did not have actual knowledge of the particular limit, restriction or qualification. [25]

According to this section, if the third party (ie the other party to the contract) is in good faith *and* without knowledge of a constitutional limitation, restriction or qualification on the purposes, powers or activities of the company, he or she will be entitled to damages in the event of a restraining action (under s 20(5)). Such a restraining action will not prejudice any rights that the third party may have to

damages. But, of course, the third party will not have a right to specific performance of the contract in the event of a restraining action.

If, on the other hand, the third party is not in good faith *or* has actual knowledge of the limitation, restriction or qualification on the company's capacity (as further discussed below), so that he or she knows and appreciates the fact that the company has failed to comply with a constitutional restriction on its capacity, the third party loses his or her rights to damages where the contract (or 'action') is restrained. In this event, the third party would not be able to enforce the transaction against the company, nor will he or she be able to claim damages from the company. From this it follows that a *mala fide* third party will be entitled to his or her rights in respect of the contract only if there is no intervening legal action to restrain the contract.

7.1.9 The requirements of good faith and actual knowledge

The new approach, as stated above, is that for a third party to preserve his or her rights to damages against the company in the event of a restraining action (by a shareholder, director or prescribed officer to prevent the company or its directors from doing anything inconsistent with its Memorandum of Incorporation), the third party must satisfy two requirements: *(a)* he or she must have obtained his or her rights in good faith, and *(b)* he or she must not have had actual knowledge of the limitation, restriction or qualification on the company's purposes, powers or activities in its Memorandum of Incorporation.

In short, if the third party is in bad faith *or* if he or she knows of the restriction in the company's constitution, he or she will not be protected should there be a restraining action by a shareholder, director or prescribed officer. The third party must be in good faith at the time that he or she obtained the relevant rights.

For third parties to be deprived of the protection of s 20(5) on the basis of actual knowledge, they must know of the limitation. It is not clear whether they must also understand and appreciate the significance of the limitation. If the third party has inspected the company's Memorandum of Incorporation and is consequently aware of the limitation or restriction but fails to understand it or to interpret it properly, he or she may nevertheless still be deprived of the protection of s 20(5) (ie he or she will lose the right to claim damages from the company, on the basis of actual knowledge of the limitation). On the other hand, the fact that the third party has no actual knowledge of the limitation does not necessarily mean that he or she is in good faith. This, for instance, will apply to someone who is wilfully blind or displays a wilful diligence in ignorance. Such persons will be deprived of their rights to damages under s 20(5) on the basis of a lack of good faith.

7.1.10 Conclusion

A company that prefers to avoid the complex provisions of s 20 could simply decide not to impose any restrictions on its capacity in its Memorandum of Incorporation. In this event, neither the external nor the internal operation of the *ultra vires* doctrine will apply to the company, which will have the capacity of an individual. It will have the capacity to enter into any legal contract in so far as juristic persons are capable of doing so.

7.2 The doctrine of constructive notice

According to the common-law doctrine of constructive notice, persons dealing with a company were deemed (or presumed) to be aware of the contents of the constitution and other public documents of the company that were lodged with the Registrar of Companies and were open to public inspection, whether they had read these documents or not. [26]

Following modern company law trends in other common-law jurisdictions, the doctrine of constructive notice was finally abolished by the Act. [27] The Act states that a person may not be regarded as having received notice or knowledge of the contents of any document relating to a company merely because the document has been filed or is accessible for inspection at an office of the company.

Having abandoned the doctrine of constructive notice, the Act reintroduces a muted version of the doctrine that applies only in two specific circumstances. [28] First, the Act provides that a person must be regarded as having notice and knowledge of any 'ring-fencing' provisions in the company's Memorandum of Incorporation, provided that attention has been drawn to it in the company's notice of incorporation and to its location in the company's Memorandum of Incorporation, and the expression 'RF' (meaning ring-fenced) has been suffixed to the name of the company. [29] By ring-fencing provisions is meant any prohibition on the amendment of any provision of the Memorandum of Incorporation, or any restrictive condition and a restrictive procedure for its amendment. The expression 'RF' is designed to alert third parties to any restrictive conditions or prohibitions on amendment that apply to the ring-fenced company. If third parties ignore this warning they will have only themselves to blame as they are deemed to be aware of the restrictive conditions that apply to the company.

The second instance where the doctrine of constructive notice applies is in the case of a personal liability company. Persons dealing with such a company are deemed to be aware of the effect of the directors' and former directors' joint and several liability for debts and liabilities of the company 'contracted' [30] during their periods of office. The rationale of this particular provision remains obscure.

7.3 The Turquand rule (the presumption of

compliance with formal and procedural requirements)

7.3.1 The common law

The Turquand rule was historically formulated as an exception to the doctrine of constructive notice. It was originally designed to mitigate or relieve the severe effects of the doctrine of constructive notice. In the course of its development, the Turquand rule came to serve functions other than merely to mitigate the effect of the doctrine of constructive notice. Had it not been so, the Turquand rule would have been abolished together with the abandonment of the doctrine of constructive notice. The Turquand rule is also called the 'indoor management rule', ie those dealing with a company are not affected by the company's indoor management rules or by the company's internal irregularities. It is derived from the seminal case of *Royal British Bank v Turquand*, [31] which was concerned with restrictions placed by the constitution of a company on the authority of the directors of the company to contract on its behalf. The Turquand rule was adopted and applied in South African law. [32]

The Turquand rule protects *bona fide* third parties who are not aware of any internal irregularities that affect the validity of their contracts with the company. Provided that they are in good faith, third parties are protected by the rule, which entitles them to assume that all the company's internal formalities required for a valid contract have been complied with. A third party acting in good faith is under no duty to enquire whether the company has complied with its internal formalities and procedural requirements. The basis of the Turquand rule is that *bona fide* third parties should not be prejudiced by a company's failure to comply with its own internal procedures and formal requirements. The Turquand rule is justified on the basis of business convenience. Business dealings with a company would be very difficult, if not hazardous, if third parties were required to enquire into the internal affairs of a company.

Typical internal formalities are the company's compliance or non-compliance with such matters as the quorum requirements for shareholders' meetings or board meetings, the period of notice for such meetings, the voting procedure at meetings or the constitutional limitations on the authority of persons representing the company. A third party dealing with the company may simply assume that the company has complied with these internal formalities unless he or she knows or suspects that they have not been complied with.

The practical effect of the Turquand rule is that it prevents a company from escaping liability under an otherwise valid contract solely on the grounds that some internal formality or procedure was not complied with. Proof by the company that it has failed to fulfil its own internal formalities is not a sufficient basis for escaping liability under the contract.

The facts of *Royal British Bank v Turquand* [33] best illustrate the rule itself. In this case, the articles of association (or the constitution) of the company authorised its board of directors to borrow money, provided that the board obtained the prior approval by ordinary resolution of the shareholders of the company. The board borrowed money from the Royal British Bank without obtaining the approval of the shareholders of the company. The Royal British Bank had no knowledge of this fact. The court ruled that, even though the board had failed to comply with the company's articles of association, the company was nevertheless bound by the loan taken from the Royal British Bank. The approval of the shareholders as stipulated in the company's articles of association was an internal formality. The bank, which was in good faith, was entitled to assume that this internal formality had been duly complied with.

The Turquand rule is concerned not only with limitations on the authority of the directors of the company. The rule applies to all internal irregularities that take place in the management of the company. But the rule does not protect a third party who knows [34] that an internal formality has not been complied with, or a third party who *suspects* that the internal formality has not been complied with but deliberately shuts his or her eyes or turns a blind eye. There must be an absence of circumstances that put the third party on inquiry. [35] The rule cannot be invoked by a third party who is put on inquiry and fails to make inquiry. If a third party is put on inquiry, he or she must make inquiry. The third party may be put on inquiry by the very nature of the transaction. The more unusual the transaction, the greater is the need to make inquiry. [36] Significantly, the Turquand rule does not protect a third party who relies on a forged document. [37]

The Turquand rule is intended for the protection of outsiders who have no means of knowing whether the internal formalities and procedures required under the company's constitution have been complied with. On this basis, directors and other insiders may not rely on the rule. [38] The directors of a company are taken to know that the company's internal formalities have not been complied with. [39] It is the duty of directors to manage the affairs of the company and to ensure that its transactions are regular. Directors are not entitled to assume that internal formalities have been complied with when, due to their very own neglect, these internal formalities have not in fact been complied with. [40]

In *Hely-Hutchinson v Brayhead Ltd* [41] the court distinguished between a director acting in his or her capacity as a director and a director who is acting, not as a director, but as an outsider contracting with the company. The court suggested that in the latter instance the director may rely on the Turquand rule. This attempt to narrow down the rule that insiders may not rely on the Turquand rule draws a distinction between inside and outside transactions.

7.3.2 The Turquand rule and the Act

Section 20(7) of the Act states that a person dealing [42] with a company in good faith, other than a director, prescribed officer or shareholder of the company, 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, its Memorandum of Incorporation and any rules of the company unless, in the circumstances, the person knew or 'reasonably ought to have known' of any failure by the company to comply with any such requirement. This is a statutory formulation of what in essence is the common-law Turquand rule, as discussed above but with some important modifications (as discussed below). The section applies to internal procedures and formalities even if they are prescribed by the Act. The fact that the internal formality is contained in a statute should make no difference to the application of the section. The section is very wide. It also applies to all of the company's formal and procedural requirements in terms of the company's Memorandum of Incorporation or rules.

The statutory provision also encapsulates the common-law rule that, if the third party is a director, prescribed officer or shareholder of the company, he or she will not be protected. The basis of this exception, as explained above, is that a director or prescribed officer and even a shareholder ought reasonably to have known of non-compliance with the company's internal procedures and formalities. They have access to the company's records and minutes of meetings. Even a shareholder has more effective means of information than an outsider, in the form of notices of meetings and proposed resolutions to be submitted for approval at shareholders' meetings. It is noteworthy that the section refers to 'shareholders' and not to the holders of the company's securities, such as the holders of the company's debt instruments, who are not necessarily 'insiders'.

The Act also preserves the Turquand rule as developed at common law. [43] It provides that s 20(7) must be construed concurrently with, and not in substitution for, the common-law principle relating to the presumed validity of the actions of the company in the exercise of its powers. This is of course a reference to the common-law Turquand rule. There is now in our law both a common-law and a statutory indoor management rule. From this, it follows that the statutory rule (ie s 20(7)) would, like the common-law Turquand rule, probably not apply to forgeries (discussed above).

The difficulty, however, is that s 20(7) is not properly aligned with the common-law formulation of the Turquand rule. The overlap between the two could prove to be a source of difficulties in practice. The statutory rule is likely to operate both more widely in some respects than the common-law rule and, in other respects, more narrowly. The common-law Turquand rule, as stated above, will not protect a third party who knew or *suspected* that an internal formality or procedure had not been complied with. In striking contrast, the statutory rule goes much further than this, in excluding a third party who '*reasonably ought*' [emphasis added] to have known of non-compliance with a formality. The test is objective. It displaces the presumption if the third party 'reasonably ought to have known'. This weakens the assumption that third parties may make regarding compliance with internal formalities and procedures. To this extent it is narrower than the common-law rule. One possible advantage of the approach adopted in the Act is that if, for whatever reason, the requirements of the statutory rule in s 20(7) are not satisfied, a *bona fide* third party may still be entitled to rely on the common-law Turquand rule.

It is significant that unlike the statutory rule, the common-law Turquand rule is not applied to companies only. The courts have extended the rule to technikons [44] and trade unions. [45] The rule is growing in importance but perhaps, with the abolition of the doctrine of constructive notice, there may be less of a need for an 'indoor management rule'. This is not to suggest in any way that the Turquand rule is no longer of any importance. There is also nothing odd in preserving the indoor management rule while abolishing the doctrine of constructive notice. English law adopted this approach years ago.

One important consequence of the abolition of the doctrine of constructive notice that must be emphasised here is that the common-law Turquand rule and the statutory rule (ie s 20(7)) will now, unlike in the past, apply even where a special resolution is required as an internal formality to some matter. This is because there is no longer any constructive notice of special resolutions filed by the company with the Companies and Intellectual Properties Commission.

7.3.3 The Turquand rule and the delegation of authority

An important issue is whether the statutory rule in s 20(7) applies to the power of delegation. The common-law Turquand rule does not apply to the authority of the board of directors to delegate its powers to any ordinary director or agent. In other words, the Turquand rule may entitle a third party to assume that someone has been appointed as an authorised agent, but he or she cannot, by relying on the Turquand rule, assume that a specific person or persons has or have been appointed. To apply the Turquand rule in this situation would be to place companies at the mercy of any agent who purports to contract on their behalf. This common-law principle may well continue to apply to s 20(7) of the Act. This remains to be seen.

7.4 Representation and the authority of the directors

A company is an artificial person that cannot act on its own. It acts only through the medium of its directors and officers. Consequently, the principles of agency law are of particular importance to corporate law. In this respect, s 66(1) of the Act provides

that the business and affairs of a company *must* be managed by or under the direction of its board, which has the authority to exercise all the powers and perform any of the functions of the company, except to the extent that the Act or the company's Memorandum of Incorporation provides otherwise. This provision imposes, subject to the company's Memorandum of Incorporation and the Act, a mandatory duty on the board of directors to manage the business of the company. It also confers on the board the authority to exercise all the powers of the company subject to the company's Memorandum of Incorporation.

The board of directors is likely in practice to delegate its powers to manage the business of the company to individual directors and officers of the company, and particularly to the managing director of the company. If such persons enter into contracts on behalf of the company, whether or not the company will be bound by such contracts must depend on the principles of agency law, which require such individuals to have authority to contract on behalf of the company. Authority is a concept of agency law. It is also the nub of the law of agency.

According to agency law, if an agent contracts with a third party on behalf of the company, the contract will bind the third party and the principal (the company) as if concluded personally between them. The agent is a mere intermediary or conduit. He or she acquires no rights and incurs no liability under the contract unless the contrary is agreed upon by the parties. Once the contract with the third party is concluded, the agent falls out of the picture. An agent who contracts with a third party without any authority will not only fail to bind the principal to the contract, but will also incur liability to compensate a third party who suffers loss in consequence thereof for breach of warranty of authority, or in appropriate circumstances, for misrepresentation.

The same principles apply to a director who contracts on behalf of the company. For the director or any other agent, for that matter, to do so, he or she must have authority to act on behalf of the company. Such authority may be actual authority, usual authority or ostensible authority, or it may be authority given *ex post facto* in the form of ratification by the company of an unauthorised contract entered into by the director.

7.4.1 Actual authority

Actual authority consists of express authority and implied authority. Express authority is authority given in so many words, either orally or in writing. As we have seen above, where express authority is subject to compliance with some internal formality, the common-law Turquand rule and now s 20(7) of the Act entitle a *bona fide* party to assume that this formality has been duly complied with, unless he or she knew or ought reasonably to have known that it has not.

Implied authority is authority given not in so many words, but which arises as a reasonable inference from the conduct of the principal. It may also be authority that is necessary or reasonably incidental to the performance of the agent's express authority.

A third way in which implied authority may arise is discussed in 7.4.3.

7.4.2 Ostensible authority

Ostensible authority (also known as apparent authority or agency by estoppel) [46] is no authority at all; it is an oxymoron or contradiction in terms. It arises where a person has by his or her words or conduct created the impression that someone is his or her duly authorised agent thereby inducing an innocent third party to deal with the agent in that capacity. The agent's apparent or ostensible authority is the result of the principal's statements or conduct (but not necessarily the consent of the principal). It is thus based on an estoppel, which is an equitable concept preventing a person (the principal) from benefiting from his or her own misrepresentation.

Ostensible authority is the authority of an agent as it appears to others. It may exceed or extend actual authority [47] (see below). This may apply where, for instance, the company or its board of directors 'hold out' a particular director as having authority in certain circumstances to contract on behalf of the company when in fact the director does not actually have authority. [48]

Actual authority and ostensible authority are quite independent of one another. Ostensible authority arises where the principal has made a representation, whether by words or conduct, to the third party that the agent has the requisite authority to act on his or her behalf, and if the third party has reasonably relied on this representation, the principal will be estopped (prevented) from denying the authority of the agent.

The representation must be made by the principal and not only by the agent, otherwise anyone would be bound by the acts of a self-appointed agent or director.

7.4.2.1 Requirements for ostensible authority

In *Freeman and Lockyer v Buckhurst Park Properties (Mangal) Ltd*, [49] Diplock LJ stated:

> An 'apparent' or 'ostensible' authority, on the other hand, is a legal relationship between the principal and the contractor, created by a representation, made by the principal to the contractor, intended to be, and in fact acted on by the contractor that the agent has authority to enter on behalf of the principal into a contract of a kind within the scope of the 'apparent' authority, so as to render the principal liable to perform any obligation imposed on him by such contract.

Three requirements, according to *Freeman*, must be fulfilled for ostensible authority:

(i) First, a representation must have been made to the third party that the agent has authority to enter into a contract of the kind sought to be enforced.

(ii) Second, such representation must have been made by a person or persons who have actual authority to manage the company's business either generally or in respect of the matters to which the contract relates. A third party cannot rely on the agent's own representation that he or she has authority. The agent would also represent that he or she has authority but it is not the agent's representation that gives rise to ostensible authority.

(iii) Third, the third party must have been induced by the representation to enter into the contract, ie he or she must in fact have relied on it. The representation must have been the proximate cause of the third party entering into the contract. [50]

In *Freeman*, the court also stressed the importance of the doctrine of constructive notice and the requirement that the company should have had capacity to enter into the contract. Since the doctrine of constructive notice has been abolished, this point is no longer relevant. As discussed in 7.2, the doctrine of constructive notice still applies in relation to ring-fenced companies, with the result that in the context of the limited application of the doctrine, ostensible authority may be destroyed. In these instances, the legal principle still applies that there can be no ostensible authority if the third party knows or is deemed to know (by virtue of the doctrine of constructive notice) that the particular agent, or director or other company representative, had no actual authority to enter into the contract.

The three requirements for ostensible authority, as laid down in *Freeman*, amount to saying that such ostensible authority arises where the board of directors has made a representation, whether by words or conduct, that a particular director or company officer has authority to bind the company to certain kinds of contracts (that fall within the scope of his or her ostensible or apparent authority) even though such contracts fall outside the scope of his or her actual authority. In this way, ostensible authority may extend actual authority.

If the person dealing with an agent knows that the agent does not have actual authority to conclude the particular contract or transaction in question, that person cannot rely on ostensible authority. If the third party knows or has reason to know that the contract is contrary to the commercial interests of the principal, it will be difficult for the third party to assert with any credibility that he or she believed that the agent did have authority.

In *NBS Bank Ltd v Cape Produce Co (Pty) Ltd* [51] the court, in approving of *Freeman*, laid down six requirements for ostensible authority as opposed to the three requirements set out in *Freeman*, namely-

(i) a representation, whether by words or by conduct;
(ii) made by the principal (ie someone with actual authority);
(iii) in a form such that the principal should reasonably have expected that outsiders would act on the strength of the representation;
(iv) that was relied on by the third party;
(v) such reliance being reasonable; [52] and

(vi) resulting in prejudice to the third party.

The onus of establishing these requirements lies on the third party.

7.4.2.2 Ostensible authority and breach of fiduciary duty

From the point of view of the third party, it makes no difference whether the agent has actual or ostensible authority, because the principal will in any event be bound to the third party. It makes an important difference, however, between the principal and the agent. As ostensible authority is no authority at all, the agent will be liable to the principal for breach of the fiduciary duty not to exceed his or her authority. In contrast, implied authority is actual authority; thus no action for breach of fiduciary duty would lie against the agent in this case.

If, however, the principal is not bound to the third party at all, on the basis of a lack of authority (including a lack of ostensible authority), the third party may have a delictual action against the director or agent based on misrepresentation or an action for breach of warranty of authority. In the latter event, the director or agent is not liable on the contract. The measure of damages is that the agent must put the third party in the same position as if the principal had been bound by the contract.

7.4.3 Usual authority

It must be emphasised at the outset that usual authority may form part of implied authority, in which event it is referred to as implied usual authority; or it may be restricted usual authority, in which event it may form the basis for ostensible authority. In this latter instance, the principal appoints an agent to an office or a position that carries with it authority to contract on behalf of the principal but the principal has restricted this usual authority. If, for instance, a bank appoints a person as a branch manager, it thereby makes a representation that its branch manager has the powers usually associated with the branch manager of a bank. It is a form of holding-out. [53]

The importance of usual authority in company law arises from the fact that the position or office occupied by a company officer who is an employee of the company may determine the extent of his or her authority. To put it differently, the authority of the agent may flow from the office held by the particular company officer in question.

The appointment of a person as the managing director or company secretary may carry with it implied usual authority to do whatever falls within the usual scope of that office. The courts have on many occasions recognised and acknowledged the wide usual authority of a managing director. [54] In *Hopkins v T L Dallas Group Ltd*, [55] the court similarly stated that where the board of directors appoints one of their members to an executive position they implicitly authorise him or her to do all such things as fall within the usual scope of that office. A managing director or chief executive director has very wide implied usual authority to contract on behalf of the company. In *SA Securities Ltd v Nicholas* [56] the court stated that the mere fact of appointing a person as managing director gives him certain implied powers. Anyone dealing *bona fide* with the managing director is entitled to assume that the managing director has all the powers which his or her position ostensibly would give him or her. On the other hand, the chairperson of the board of directors or an ordinary individual director does not have wide usual authority to contract on the company's behalf. [57] (In their case, either the director has actual authority or is held out to be a person with authority to act on behalf of the company.)

In *Panorama Developments (Guildford) Ltd v Fidelis Furnishing Fabrics Ltd*, [58] Lord Denning held that a company secretary is an officer of the company with extensive duties and responsibilities. He is no longer a mere clerk, but the chief administrative officer of the company. He is entitled to sign contracts connected with the administrative side of a company's affairs, such as employing staff and hiring chauffeur-driven cars required for the purposes of the company's business. All these things may be regarded as part of the usual authority of a company secretary. Since it is mandatory for public companies to appoint a secretary in terms of the Act, *Panorama Developments* is an important case to bear in mind.

Where company officers act within the scope of their usual authority, the company may in certain circumstances still be bound by their acts even though the company may have restricted the scope of their usual authority. Such restricted usual authority does not form part of implied authority. Instead, the basis of liability in such cases would be ostensible authority, provided that the prerequisites for such authority (as discussed above) are satisfied.

7.4.4 Ratification

Ratification, as discussed above, is a retrospective authorisation or conferral of authority by the principal or the company. In effect, the company or principal forgives the agent and adopts the unauthorised contract, usually with retrospective effect. If ratified, the contract becomes fully binding, with retrospective effect, on the company.

Questions

1. The Memorandum of Incorporation of Infinity Ltd provides that the management and control of the company are vested in the board of directors, which has the power to delegate its authority to any director of the company. This power of delegation is never exercised by the board but Eager, a director of Infinity Ltd, enters into a contract on behalf of the company with Janet.
   (a) Under what circumstances, if any, will Infinity Ltd be bound by the contract?
   (b) Explain the extent to which the legal capacity of Infinity Ltd would be relevant to your answer in *(a)*.

2. Is the *ultra vires* doctrine dead and buried? Explain fully.

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[1] By *ultra vires* is meant literally 'beyond or outside the powers of the company'.

[2] (1875) LR 7 HL 653.

[3] See Farouk HI Cassim 'The rise, fall and reform of the *ultra vires* doctrine' (1998) 10 *SA Merc LJ* 293.

[4] *Cotman v Brougham* [1918] AC 514 (HL) 520.

[5] By the 'external' consequence is meant the legal position between the company and the other party to the contract.

[6] See further Chapter 14: The duties and the liability of directors, and s 77(3)*(a)*.

[7] See s 65(2) of the 1973 Companies Act and s 15(6) of the Companies Act 71 of 2008. See further Chapter 6: Formation of companies and the company constitution, where this is discussed in detail.

[8] *Hickman v Kent or Romney Marsh Sheep Breeders' Association* [1915] 1 Ch 881.

[9] See Farouk HI Cassim (n 3) 295.

[10] That is, a clause to the effect that all objects stated in the company's objects clause must be interpreted as new main objects and that no object should be treated as ancillary to another object.

[11] Supra (n 4).

[12] [1966] 2 All ER 674 (CA).

[13] Supra (n 12).

[14] Farouk HI Cassim (n 3) 307.

[15] Section 19(1)*(b)*.

[16] This does not apply to a non-profit company, which would have to set out at least one object in its Memorandum of Incorporation. See further Chapter 5: Types of companies.

[17] If the directors do not have authority for a reason other than or a reason additional to a lack of capacity on the part of the company, then the contract is not binding on the company, even against a *bona fide* third party. As a result of s 20(1)*(a)*(ii), a contract for which the directors had no authority as a result only of a lack of capacity on the part of the company may become binding on the company without the need for any ratification.

[18] Section 20(1)*(b)*.

[19] Section 20(1)*(b)*.

[20] A 'prescribed officer' is a person who, although not a director of the company, exercises general executive control over and management of the company's business and its activities or a person who regularly participates to a material degree in the exercise of general executive control over and management of the business or the activities of the company or a significant portion of it (reg 38, Companies Regulations GNR 351 *GG* 34239 of 26 April 2011).

[21] Viz 'except as between the company and its members or directors, or as between its members and directors'.

[22] See further Chapter 14: The duties and the liability of directors.

[23] Section 20(5).

[24] Section 20(4), on the other hand, provides that one or more shareholders, directors or prescribed officers of a company, or a trade union representing employees of the company, may apply to the High Court to restrain the company from doing anything inconsistent with the Act.

[25] Section 20(5).

[26] The Dickerson Report ('Proposals for a New Business Corporations Law for Canada' (1971) vol 1 para 8.4 at 28), in considering the abolition of this judge-made rule, stated: 'It may be that prudent people do inspect public documents in their own interests. That, however, is a far cry from imposing upon them as a matter of course a legal duty to do so and that is the effect of the doctrine of constructive notice.'

[27] Section 19(4).

[28] Section 19(5).

[29] For a detailed discussion of this provision, see Chapter 6: Formation of companies and the company constitution.

[30] See *Fundstrust (Pty) Ltd (In Liquidation) v Van Deventer* 1997 (1) SA 710 (A), which held that the joint and several liability of the directors of such a company is limited to debts and

liabilities ‘contracted’ during their periods of office. It does not include tax liability, delictual liability or liability under the Insolvency Act 24 of 1936, since these liabilities are not ‘contracted’. See further Chapter 5: Types of companies.

[31] (1856) 6 E&B 327.

[32] See *Mine Workers’ Union v Prinsloo* 1948 (3) SA 831 (A) where the Turquand rule was applied to a trade union. The Turquand rule was held to form part of South African common law in *Legg & Co v Premier Tobacco Co* 1926 AD 132.

[33] Supra (n 31). Turquand was the liquidator of a mining and railway company. This was an action for the return of money borrowed from the plaintiff, the Royal British Bank.

[34] *Howard v Patent Ivory Manufacturing Co* (1888) 38 ChD 156; *Burnstein v Yale* 1958 (1) SA 768 (W).

[35] See *Underwood Ltd v Bank of Liverpool and Martins* [1924] 1 KB 775 (CA), where a director of a company endorsed cheques payable to the company and deposited these cheques into his personal account.

[36] *Underwood Ltd v Bank of Liverpool and Martins* (n 35).

[37] *Ruben v Great Fingall Consolidated* [1906] AC 439 (HL).

[38] *Morris v Kanssen* [1946] AC 459; *Smith v Hennicker-Major & Co* [2002] 2 BCLC 655.

[39] *Howard v Patent Ivory Manufacturing Co* (n 34).

[40] *Morris v Kanssen* (n 38).

[41] [1967] 3 All ER 98 (CA).

[42] ‘Dealing’ is not defined. Presumably it means being a party to a transaction or other act to which the company is a party. It may alternatively be narrowly construed to be confined only to contracts and not other acts.

[43] Section 20(8).

[44] *F P W Engineering Solution (Pty) Ltd v Technikon Pretoria and Others* [2004] 1 All SA 204 (T).

[45] *Mine Workers’ Union v Prinsloo* 1948 (3) SA 831 (A). In *Potchefstroom se Stadsraad v Kotze* 1960 (3) SA 616 (A) the Turquand rule was applied to a municipality.

[46] See *NBS Bank Ltd v Cape Produce Co (Pty) Ltd* 2002 (1) SA 396 (SCA) para [25].

[47] *Hely-Hutchinson v Brayhead Ltd* [1967] 2 All ER 14 (CA).

[48] *Freeman and Lockyer v Buckhurst Park Properties (Mangal) Ltd* [1964] 1 All ER 630 (CA).

[49] Supra (n 48) 644F.

[50] In *NBS Bank Ltd v Cape Produce Co (Pty) Ltd* (n 46) the court required the third party’s reliance on the representation to be reasonable.

[51] Supra (n 46) para [26].

[52] See *Connock’s (SA) Motor Co Ltd v Sentraal Westelike Ko-operatiewe Maatskappy Bpk* 1964 (2) SA 47 (T).

[53] *NBS Bank Ltd v Cape Produce Co (Pty) Ltd* (n 46).

[54] See, for instance, *Wolpert v Uitzigt Properties (Pty) Ltd* 1961 (2) SA 257 (W); *SA Securities Ltd v Nicholas* 1911 TPD 450.

[55] [2005] BCLC 543 (Ch).

[56] 1911 TPD 450.

[57] *Wolpert v Uitzigt Properties (Pty) Ltd* (n 54). See also *NBS Bank Ltd v Cape Produce Co (Pty) Ltd* (n 46).

[58] [1971] 3 All ER 16 (CA).

Chapter 8
Groups of Companies and Related Persons

Richard Jooste

8.1 General

Generally speaking, when one company controls one or more other companies, the companies together are referred to as a 'group' of companies. The controlling company is referred to as the holding company of the other companies, who are referred to as the subsidiaries of the holding company. What is meant exactly by the holding/subsidiary relationship is dealt with below.

In understanding why a group of companies arises the following is useful:

> [A group's] basic characteristic is that the management of the different and independent holding and subsidiary companies comprising the group is co-ordinated in such a way that they are managed on a central and unified basis in the interests of the group as a whole. This management on a unified basis is possible because of the control, implicit in the holding/subsidiary company relationship, which the holding company exercises over the subsidiary or subsidiaries. This control makes it possible that the group is managed as an economic unit, in the sense that the different holding and subsidiary companies no longer carry out their commercial activities on a footing of complete economic independence. [1]

The control involved in a group situation can, however, be abused and the interrelationship can be used to mask what is really happening. This has necessitated legislative intervention. The following are examples of how the legislature has intervened:

(i) Group and consolidated financial statements are required in respect of a group of companies. [2]

(ii) The auditor of a holding company has the right to access all current and former financial statements of any subsidiary of that holding company and is

entitled to require from the directors or officers of the holding company or subsidiary any information and explanations in connection with any such statements and in connection with the accounting records, books and documents of the subsidiary as may be necessary for the performance of the auditor's duties. [3]

(iii) Where shares are issued by a company to certain persons, shareholder approval is generally required. [4] Such persons include the holding companies and subsidiary companies of the company issuing the shares. [5]

(iv) A company may not directly or indirectly pay any fine that may be imposed on a director of the company, or of its holding or subsidiary company, who has been convicted of an offence in terms of any national legislation. [6]

(v) In certain circumstances, where a company offers, to holders of the company's shares, securities in the company or any other company within the same group of companies, a prospectus is required. [7]

The fact that the legislature has had to intervene does not, of course, mean that there is anything inherently wrong with the group structure. In fact, on the contrary, as seen in the quote above, group structures usually provide commercial, financial and organisational advantages for the group as a whole.

The legislative intervention does not interfere with the foundational principle of the separate legal personality of each company in a group. Each company in the group remains a separate legal person. From a legal point of view a group is not itself a separate legal person.

8.2 The holding/subsidiary relationship

The definitions of 'holding company' and 'subsidiary' [8] are of vital importance because, as seen above, the holding/subsidiary relationship brings with it the existence of a group of companies and accordingly the possible application of numerous provisions of the Act.

The holding/subsidiary relationship is based on control of the subsidiary company by the holding company either at board meeting or general meeting level. [9]

The relationship exists if the holding company itself controls the subsidiary, or does so through other subsidiaries or in combination with other subsidiaries. [10] The following possibilities present themselves to make Company S a subsidiary of Company H:

(i) Company H itself controls Company S;

(ii) Company H together with one or more of its subsidiaries controls Company S;

(iii) One or more of Company H's subsidiaries control Company S. (It will be recognised that, if a subsidiary of Company H controls Company S, then Company S will have two holding companies.)

The above possibilities also exist if the control is exercised through the nominees of Company H and/or its subsidiaries (that is, by persons who hold shares not for their own benefit but on behalf of Company H, ie agents). [11]

'Control' at board meeting level means having the right to appoint or elect, or control the appointment or election of, directors of that company who control a majority of the votes at a meeting of the board. [12]

'Control' at general meeting level means having the ability directly or indirectly to exercise, or control the exercise of, a majority of the general voting rights at general meetings of that company, whether pursuant to a shareholder agreement or otherwise. [13] (A shareholder agreement usually involves shareholders agreeing to vote in a certain way.)

A 'majority' is more than 50 per cent.

A company is a 'wholly-owned subsidiary' of another juristic person if all of the general voting rights of the company are held or controlled, alone or in any combination, by that juristic person, one or more other subsidiaries of that juristic person, or one or more nominees of that juristic person or any of its subsidiaries. [14]

The following examples illustrate the above (in all cases the percentages are percentages of votes at board *or* general meeting level):

1. *Facts:* Company H
↓ 51%
Company S

Solution:
Company S is a subsidiary of Company H

2. *Facts:* Company H
↓
S1 S2 S3 ↓ 30%
1% ↓ 20% ↓ ↓
→ → Company X
(S1, S2 and S3 in the example are subsidiaries of Company H)
Solution:
Company X is a subsidiary of Company H

3. *Facts:* Company H → → →
↓
S1 S2 S3 ↓%
1% 30% 6% ↓
↓ ↓ ↓ ↓
Company X ← ← ← ←
(S1, S2 and S3 in the example are subsidiaries of Company H)
Solution:
Company X is a subsidiary of Company H

Other important aspects of the holding/subsidiary relationship

(i) It must be borne in mind that attempts to avoid the holding/subsidiary relationship may be thwarted by the application of s 6(1) of the Act, which is a general anti-avoidance provision. So an attempt to avoid recognition as the holding company of another company could be struck down.

(ii) Voting rights held by a person as nominee (ie agent) for another person are to be treated as held by that other person. [15]

(iii) Voting rights held by a person in a fiduciary capacity are to be treated as held by the beneficiary of those voting rights. A trustee of a trust is an obvious example of a person acting in a fiduciary capacity. Accordingly, where the trustee holds voting rights associated with issued securities of a company, those voting rights are to be treated as held by the beneficiary of those voting rights. A company can be a beneficiary of a trust.

(iv) Voting rights that are exercisable only in certain circumstances are to be taken into account only when those circumstances have arisen, and for so long as they continue; or when those circumstances are under the control of the person holding the voting rights.

(v) Voting rights that are exercisable only on the instructions or with the consent or concurrence of another person are to be treated as being held by a nominee for that other person. [16] This has the following effect, among other things. Assume Company A and Company B, with the concurrence of each other, can exercise the majority of the voting rights in Company S. This means that in respect of the voting rights in Company S, Company B holds the voting rights as nominee for Company A and vice versa, ie Company A holds the voting rights as nominee for Company B. This means that Company S is a subsidiary of both Company A and Company B.

(vi) Not only voting rights attaching to shares in a company come into the reckoning in determining the holding/subsidiary relationship. This is clear from the reference to 'securities' and not 'shares' in the Act. [17] Accordingly, voting rights attaching to 'debt instruments' [18] must also be taken into account. It is thus possible, for example, for a company to be the holding company of another company through the holding of the majority of the voting rights in that other company, which voting rights are attached to debentures [19] in that other company.

(vii) Voting rights held through a shareholder's agreement are expressly stated to be taken into account in the determination of the holding/subsidiary relationship. [20] So if a shareholder of a company undertakes, in terms of a shareholder's agreement, to vote in a certain way, those who benefit from such agreement will be regarded as holding that shareholder's voting rights.

(viii) Whereas it is possible for a juristic person other than a company to be a 'holding company', the same is not true of a 'subsidiary', which must be a company. [21] So a trust could be a 'holding company'. A trust cannot be a subsidiary. It can only be a holding company. The same goes for a close corporation: it cannot be a subsidiary, but it can be a holding company.

8.3 Directors' fiduciary duties and the holding/subsidiary relationship

As a group of companies is not a separate legal person, the directors of the companies in the group owe no duties to the group. They only owe duties to their own respective companies. So a company cannot compel a director of its subsidiary to look to the group when exercising his or her discretion. If acting in the interests of the group would be acting in the company's interests, that would be in order, particularly if it is in the interests of minority shareholders. [22]

However, as Blackman says: [23]

> [w]hat is required [of directors of a company] is that the transaction be judged according to the interests of their company, and, in particular, with regard to the interests of the minority shareholders in their company. The concept of the financial stability of the group as a whole does not necessarily show that a particular company within the group has received value in return for a transaction which it entered into for such an end; always vital are the particular circumstances and the fact that each company within a group of companies retains its own legal personality.

It follows from the above that a director of a company owes no fiduciary duties to its holding company. 'Nominee directors' are accordingly, as the courts have said, in a precarious position. Thus it has been said:

> Although there is authority for the proposition that where the company's [constitution] provide[s] for the appointment of directors to represent the interests of shareholders with particular interests [ie 'nominee directors'], such directors may act to further those interests (on the theory that it is in the interests of the company
>
> that they do so), this principle, even if correct, clearly has no application in the case of the directors of a subsidiary whose board is appointed by its holding company. [24]

The position of directors of a company in relation to the company's subsidiary depends on whether the subsidiary has an independent board. If it is independent, neither the holding company nor its directors owe the subsidiary fiduciary duties. However, where a holding company places its nominees on the board of the subsidiary, the holding company, and hence its directors, must behave with scrupulous fairness to the minority shareholders of the subsidiary and avoid imposing on their nominees the alternative of disregarding their instructions or betraying the interests of the minority. [25] In other words, while neither the directors of a holding company nor the holding company itself stand in a fiduciary relationship to their subsidiary, they do owe it a duty not to interfere or otherwise undermine the independence of its directors. [26]

Where the board of the subsidiary is not independent, the general principle is that a person who procures the election of a board of directors under circumstances which make it impossible for them to exercise an independent judgment must observe the utmost good faith in his or her dealings with the company. Such a person has knowingly deprived the company of independent advice and this duty arises from the circumstances which he or she has chosen to bring about.

Where the holding company in fact conducts the business of the subsidiary, it must act fairly in regard to the interests of the subsidiary.

8.4 The 'related' and 'interrelated' concepts

Apart from the holding/subsidiary relationship, the Act also recognises what are termed 'related' and 'interrelated' relationships between persons, and makes certain provisions applicable if such relationships exist. It is therefore important to know whether such a relationship exists.

The rationale for recognition of such relationship appears to be that, if a company transacts with another person and they are related or interrelated, they might not act at arm's length (ie without bias), and might accordingly act to the detriment of the company and its creditors and/or members. For example, if a company makes a loan to a director of the company, certain requirements of the Act must be met. The same applies if the loan is to a person 'related' to the director.

It is of course possible that the parties to the transaction who are related or interrelated may be acting quite independently and at arm's length, and accordingly the Act (s 2(3)) makes it possible for a person to be exempted from the application of a provision of the Act that would apply to that person because of the relationship.

As will be seen, the definitions of 'related' and 'interrelated' persons are wide and it may not always be factually or legally simple to determine whether companies are related or interrelated, especially in complex group structures. Section 2(3), referred to above, may have an ameliorating role to play in this regard.

8.4.1 The 'related' relationship

Section 1 of the Act provides that 'related', when used in respect of two persons, means persons who are connected to one another in any manner contemplated in section 2(1).

Section 2(1) distinguishes the 'related' relationships between-

(i) two individuals;
(ii) an individual and a juristic person; and
(iii) two juristic persons.

8.4.1.1 Two individuals

An individual is related to another individual if they are-

(i) 'married or live together in a relationship similar to a marriage'; or
(ii) 'separated by no more than two degrees of natural or adopted consanguinity or affinity'.

To determine the degree of consanguinity between two relatives, one must count up from the one relative to the nearest common ancestor and then continue counting down to the other relative. Relatives of a person separated by no more than two degrees of consanguinity are thus the person's parents and children (first degree) and brothers, sisters, grandchildren and grandparents (second degree). Such persons are included whether the relationship arises naturally, through adoption or through marriage (affinity). For example, brothers, sisters, parents and grandparents through adoption are included, as are grandparents-in-law, parents-in-law, brothers-in-law and sisters-in-law.

8.4.1.2 An individual and a juristic person

An individual is related to a juristic person 'if the individual directly or indirectly controls the juristic person'. The 'control' envisaged [27] is the same as the control envisaged where one juristic person controls another juristic person, which is dealt with below.

8.4.1.3 Two juristic persons

A juristic person is related to another juristic person if-

(i) either of them directly or indirectly controls the other, or the business of the other;
(ii) either is a subsidiary of the other; or
(iii) a person directly or indirectly controls each of them, or the business of each of them.

8.4.1.4 Control

As can be seen from the above, the element of 'control' is very important and its meaning is therefore vital.

Control of a company

A person controls a company if-

(i) that person is a subsidiary of that company;
(ii) that person, together with any related or inter-related person–
  - is directly or indirectly able to exercise or control the exercise of a majority of the voting rights associated with securities of that company, whether pursuant to a shareholder agreement or otherwise, or
  - has the right to appoint or elect, or control the appointment or election of, directors of that company who control a majority of the votes at a meeting of the board;
(iii) that person has the ability to materially influence the policy of the company in a manner comparable to a person who, in ordinary commercial practice, would be able to exercise an element of control referred to in *(a)* and *(b)*.

It will be recognised that the point in paragraph *(b)* above is virtually identical to the voting control required for the holding/subsidiary relationship to exist (see earlier).

Control of a close corporation

A person controls a close corporation if that person owns the majority of members' interests in the close corporation, or controls directly, or has the right to control, the majority of members' votes in the close corporation. Control also exists if that person has the ability to materially influence the policy of the close corporation in a manner comparable to that of a person who, in ordinary commercial practice, would be able to exercise an element of control referred to in the last paragraph.

Control of a trust

A person controls a trust if that person has the ability to control the majority of the votes of the trustees or to appoint the majority of the trustees, or to appoint or change the majority of the beneficiaries of the trust. Control also exists if that person has the ability to materially influence the policy of the trust in a manner comparable to that of a person who, in ordinary commercial practice, would be able to exercise an element of control referred to in the last paragraph.

8.4.2 The 'interrelated' relationship

Section 1 of the Act defines 'inter-related' as follows:

> 'inter-related', when used in respect of three or more persons, means persons who are related to one another in a linked series of relationships, such that two of the persons are related in a manner contemplated in section 2(1), and one of them is related to the third in any such manner, and so forth in an unbroken series.

So, for example, if Company X is related to Company Y and Company Y is related to Mr A and Mr A is related to Mr B and Mr B is related to Trust C and Trust C is related to Close Corporation D, then Company X, Company Y, Mr A, Mr B, Trust C and Close Corporation D are interrelated persons.

Questions

1. In terms of the rules of X Co, A Co and B Co each have the right to appoint 50 per cent of the directors of X Co. However, the directors appointed by A Co each carry two votes at board meetings as opposed to one each by those appointed by B Co. The shares in X Co, which are all ordinary shares, are all held by C Co.
    - All the shares in C Co are held by Mr Bullet.
    - A Co holds 50 ordinary shares and 51 participating preference shares in Y Co. Y Co has a total authorised and issued share capital of 100 ordinary shares and 100 participating preference shares. Both classes of shares carry one vote per share. In terms of an agreement between A Co and B Co, A Co is legally obliged to vote in accordance with B's instructions at general meetings of Y Co's members.
    - A Co holds all the 101 ordinary 'A' shares in Z Co. B Co holds all the 100 ordinary 'B' shares in Z Co. The ordinary 'A' shares carry one vote each and the 'B' shares two votes each.
    - A Co holds 50 per cent of the shares (of which there is only one class) in P Co. A Co also holds 51 per cent of the debentures in P Co. The shares and debentures each carry one vote at meetings of P Co.
    - A Co and B Co each hold 50 per cent of the shares (of which there is only one class) in Q Co. A Co has the right to appoint four directors out of the six and B Co has the right to appoint

the other two. However, B's directors have three votes each at board meetings of Q Co whereas A's directors only have one vote each.

- Mr Brown holds all the shares in R Co as a nominee for A Co.
- A Co and B Co each have the right to appoint one director of W Co. The articles of W Co provide for a maximum of two directors and for the chairman of the board to rotate from year to year. The chairman has a casting vote. A and B have an equal shareholding in W Co.
- A Co has an option to purchase shares in T Co giving voting control at meetings of members of T Co. The shares in T Co are owned by C Co (95 per cent) and A Co (5 per cent).
- A Co is a trustee of the S Trust, a trading trust, and exercises the majority of the voting power on the board of trustees of S.

(a) Explain, giving reasons, whether A Co is the holding company of X Co, Y Co, Z Co, P Co, Q Co, R Co, W Co, T Co and the S Trust.

(b) State the implications in terms of the Companies Act of the holding/subsidiary relationship.

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[1] DH Botha 'Recognition of the group concept in company law' (1982) 15 *De Jure* 107 at 108.

[2] Section 30 read with the definition of 'financial statement' in s 1 of the Act.

[3] Section 93(1)*(b)*.

[4] Section 41.

[5] Ibid.

[6] Section 78(3) read with the definition of related company in s 2(1)*(c)*.

[7] Section 95.

[8] Section 1.

[9] Sections 1 and 3.

[10] Section 3(1)*(a)*.

[11] Ibid.

[12] Section 3(1)*(a)*(ii).

[13] Section 3(1)*(a)*(i).

[14] Section 3(1)*(b)*.

[15] Section 3(2)*(c)*(i).

[16] Section 3(2)*(b)*.

[17] Section 3.

[18] See Chapter 9: Shares, securities and transfer.

[19] See Chapter 9: Shares, securities and transfer. A debenture is an example of a 'debt instrument'.

[20] Section s 3(1)*(a)*(i).

[21] See the definition of 'holding company' and 'subsidiary' in ss 1 and 3(1). Section 3(1) begins with the words: '(1) A company is'.

[22] An illustration of this is *Charterbridge Corporation Ltd v Lloyds Bank Ltd* [1970] Ch 62; [1969] 2 All ER 1185, where it was accepted that the giving of a guarantee by a company to secure the overdraft of another company within the same group was in the interests of the company giving the guarantee.

[23] Blackman et al *Commentary on the Companies Act* (2002) 8-54.

[24] Blackman (n 23) 8-56.

[25] *Per* Viscount Simonds in *Scottish Co-operative Wholesale Society Ltd v Meyer* [1959] AC

324 at 341; [1958] 3 All ER 66 71 (HL).

[26] Ibid.

[27] Section 2(2).

Chapter 9
Shares, Securities and Transfer

Richard Jooste and Jacqueline Yeats [*]

9.1 General

The activities of a company are financed through the issue by the company of securities in the company (usually shares) or by borrowings by the company. In this way funds are made available to the company through investments made in securities in the company or by loans made to the company.

Financial accounts drawn up in compliance with the Companies Act 61 of 1973 were required to reflect the amount of 'share capital', 'stated capital' and 'share premium'. This is no longer the case under the Companies Act 71 of 2008 ('the Act') and these terms are not used in the Act.

The monies raised by a company through the issue of shares can be referred to as the 'share capital' of the company, although, as has just been stated, this is not a term used in the Act.

A distinction is drawn in the Act between 'authorised' and 'issued' shares of a company. The 'authorised' shares are the shares which the company is entitled by its Memorandum of Incorporation to issue. The 'issued' shares are shares that are authorised and issued.

9.2 Nature of a share

The proprietary interest that a person holds in a company is a 'share'. The company as a separate legal person is capable of owning assets. Accordingly, ownership of the assets resides in the company and the holding of a share in the company does not entitle the shareholder to ownership or part or joint ownership of its assets. A share is accordingly defined in the Act [1] as 'one of the units into which the proprietary interest in a profit company is divided'.

Fidelis Oditah explains the legal nature of a share as follows: [2]

> Shares are a bundle of intangible property rights shareholders receive from the company in return for their contribution of cash or non-cash assets to the company. Shares define and allocate *(a)* income rights ie rights of participation in the company's cashflow, usually in the form of dividend; *(b)* the incidence of the risk of loss, usually in the form of priority rights in relation to capital; and *(c)* power of control, principally through voting rights. Shares are classified according to income, capital and control rights. The definition and allocation of these rights is an integral part of shares. By reason of ownership of a share, a shareholder becomes the owner of an intangible property right in a company made up of income, capital and voting rights, all determined by the terms of the issue of the share, the company's [constitution], the general law and applicable statutes of the place (ie country) of incorporation of the company. Shares are the units into which shareholders' rights of participation in the company's cash flow, management and on a return of capital, are divided.

In considering the nature of a share, the following must be noted:

(i) A share issued by a company is regarded as movable property. [3] It is transferable in any manner provided by or recognised by the Act or other legislation. [4]

(ii) A share does not have a label or indicator of value. Under the previous Companies Act it was possible to have shares with no label of value, known as 'no par value' shares and also shares with a label of value, known as 'par' or 'nominal' value shares, for example, a 'R10 share'. The danger of this was that the par value could be misleading if the actual value was different from the par value and hence the concept of par value was dropped in drafting the current Act. There was no fundamental difference between a par value and a 'no par' value share.

Regarding par value shares in existence at the time the Act came into force

('the effective date'), the Act requires the Minister, in consultation with the members of the Cabinet responsible for national financial matters, to make regulations, to take effect as of the general effective date, providing for the optional conversion and transitional status of any nominal or par value shares, and capital accounts of a pre-existing company. [5] Any such regulations must, however, preserve the rights of shareholders associated with such shares, as at the effective date, to the extent that doing so is compatible with the purposes of the Act. [6] In accordance with this requirement the Minister has made Companies Regulation 31, which provides for the conversion of the par value shares and related matters, including the protection of the rights of the holders of the par value shares.

(iii) The term 'security' is wider than 'share'. In terms of s 1 of the Act, 'securities' means any shares, debentures or other instruments, irrespective of their form or title, issued by a profit company. 'Other instruments' no doubt includes, for example, derivative instruments, bonds, options and instruments based on an index. Debentures are dealt with later in this chapter.

9.3 Classes of shares

The basic presumption is that all shares enjoy equal rights. However, it is possible for a company to have shares with different rights, preferences, limitations and terms, in which case the company has 'classes' of shares.

Generally, the division of shares into various classes is based on the nature of the rights they give with regard to dividends and participation in a distribution on liquidation, and voting rights. But this is not always so. For example, where all the company's shares carry the same rights with regard to dividends and return of capital, some of them may have conversion rights, eg the right to convert the shares into shares of another class.

A company has almost unlimited freedom to create the capital structure it desires, and in so doing to structure the rights of each of its various classes of shares in an almost infinite variety of ways.

All the shares of any particular class authorised by a company have preferences, rights, limitations and other terms that are identical to those of other shares of the same class. [7]

Shares may be divided, according to the rights attached to them, into four main types or classes of shares: *(a)* preference shares, *(b)* shares, *(c)* ordinary shares, and *(d)* deferred shares.

9.3.1 Preference shares

Where the rights of classes of shares differ on the basis of rights to priority with regard to dividends and/or return of capital, the class or classes that enjoy preference rights are referred to as 'preference' shares. The shares that enjoy no preferred rights are referred to as 'ordinary' shares.

It is only possible therefore for preference shares to exist by way of juxtaposition with other shares. They have some preference or priority over ordinary shares.

It is usual for preference shares to carry a preferential right to dividend. Unless, which is rarely the case, they are entitled to their preference dividend on the making of a profit by the company, the holders of preference shares are entitled to claim their preference dividend only if both sufficient assets are available for such distribution and the dividend has been declared in the manner provided by the memorandum or rules.

Preference shareholders do not have any right to participate in surplus profits unless the right to do so is conferred, in which case the preference shares are known as 'participating preference shares'. Therefore, unless there is provision to the contrary, the participation of preference shares in the distribution of profits is restricted to the fixed percentage dividend to which they are entitled. The preference in dividend rights thus operates both as a priority over other shares and as a limitation on dividend participation. Participating preference shares, then, entitle their holders to the fixed percentage preference dividend and to a share in the residual distributable profits.

'Cumulative preference shares' give the holder a prior right to both arrear and current preference dividends. This means that, if the monies applicable to dividends in one year are not sufficient to pay the preference dividend, the deficiency, including arrears, must be made good at a subsequent dividend distribution before anything is paid as dividend to the holders of other shares ranking after such preference shares.

The general presumption is that, if the conditions of issue are silent in this regard, preference shares are cumulative.

When a preference dividend has been declared, the preference shareholder's claim to it is that of a creditor. This is also so where the company's Memorandum of Incorporation or rules provide that the preference shareholders have a right to their preference dividend and to arrear dividends if the company makes a profit. The dividends become a debt due by the company on the making of a sufficient profit and do not become a debt due by the company only when declared. ('Declaration' of a dividend simply means 'deciding to pay' a dividend.)

In the absence of an express stipulation that shares enjoying a preference with regard to dividends also enjoy a preference with regard to repayment of capital on liquidation, the preference and ordinary shareholders share in the capital on a pro rata basis.

On liquidation, if there is a surplus after capital has been repaid, preference and ordinary shareholders will share equally in the surplus in proportion to their respective shareholdings. This is the case whether the surplus represents capital or profits. Preference shareholders' rights may, however, be restricted.

It is possible that the value of preference shares with a preference to return of capital on winding-up may be undermined by the effect of s 46 of the Act. Section 46 empowers a company to make distributions to its shareholders by virtue of their shareholding, subject to a liquidity and solvency test. This test merely prohibits payments if, after the distribution, the fairly valued assets of the company would be less than the liabilities of the company. In addition, s 48 empowers a company to repurchase its shares, provided that the same liquidity and solvency tests are satisfied. In both instances the rights of preference shareholders are not considered. [8]

9.3.2 Redeemable shares

Section 37(5) of the Act provides that a company's Memorandum of Incorporation may establish, for any class of shares, terms that provide for shares of that class to be redeemable subject to the requirements of ss 46 and 48 (the latter provisions are dealt with later)-

(i) at the option of the company, the shareholder, or another person at any time, or upon the occurrence of any specified contingency;
(ii) for cash, indebtedness, securities or other property;
(iii) at prices and in amounts specified, or determined in accordance with a formula; or
(iv) subject to any other terms set out in the company's Memorandum of Incorporation.

A redemption of shares is a repurchase of the shares made in terms of a right to purchase or to sell conferred on the company or the holder of the shares as a term of the issue.

Redeemable shares are not restricted to redeemable *preference* shares as was the case under the 1973 Act, and accordingly any class of share may be redeemable.

Despite the similarities between a redeemable share and a debt, such a share is not a debt. In the event of the redemption of a preference share the company pays its shareholders the sum concerned and in this sense there is, throughout the duration of the shareholdership, a *vinculum juris* (a legal link) between shareholder and company which may ripen into an enforceable debt, but this fact cannot render a shareholder, including a shareholder of preference shares, a prospective or contingent creditor within the meaning of the Act.

The company's right to redeem is solely for the benefit of the company. The interests of the creditors cannot be affected by a waiver by the company of its right to redeem; on the contrary, their interests are best served if there is no redemption. The company may redeem none or all or any of the redeemable preference shares, as it pleases and as determined by the board of directors. No member, or any one else, has grounds for complaint if the company decides not to redeem any shares. Nor can the rights of any person other than the company be affected if the company enters into an agreement by which it renounces its right to redeem any particular shares. There is nothing in the section, or in the common law, which obliges the company to redeem or which prohibits an agreement not to exercise the right of redemption, unless, possibly, where the effect of the agreement is to deprive the shares concerned of their character of redeemable preference shares, eg by providing that they are under no circumstances to be redeemed.

9.3.3 Ordinary shares

The term 'ordinary shares' describes shares that are fully participating as to dividends, capital and surplus assets on winding-up. Where there are preference

shares, ordinary shares confer on their holders the residue of the rights with regard to dividend and/or repayment of capital not attaching to the preference shares.

9.3.4 Deferred shares

A deferred share is rarely found. It is a share bearing the restriction that no dividend can be paid to the shareholder in a particular year unless the ordinary shareholders are first paid a certain amount for that year. Deferred shares have in the past usually been issued as remuneration for promoters for services rendered in the formation of the company (founders' shares) or to persons who have sold assets, including a business as a going concern, to the company (vendors' shares).

9.4 Authorisation for shares

The Act provides [9] that a company's Memorandum of Incorporation:

(i) must set out the classes of shares, and the number of shares of each class, that the company is authorised to issue;

(ii) must set out, with respect to each class of shares–
- a distinguishing designation for that class, and
- the preferences, rights, limitations and other terms associated with that class,

but may set out a class of shares without specifying the associated preferences, rights, limitations or other terms of that class for which the board of the company must determine the associated preferences, rights, limitations or other terms; and

(iii) may authorise a stated number of unclassified shares, which are subject to classification by the board of the company and which must not be issued until the board of the company has determined the associated preferences, rights, limitations or other terms.

The authorisation and classification of shares, the numbers of authorised shares of each class, and the preferences, rights, limitations and other terms associated with each class of shares, as set out in a company's Memorandum of Incorporation, may be changed only by: [10]

(i) an amendment of the Memorandum of Incorporation by special resolution of the shareholders; or

(ii) the board of the company, except to the extent that the Memorandum of Incorporation provides otherwise.

Except to the extent that a company's Memorandum of Incorporation provides otherwise, the company's board may- [11]

(i) increase or decrease the number of authorised shares of any class of shares;
(ii) reclassify any classified shares that have been authorised but not issued;
(iii) classify any unclassified shares that have been authorised but are not issued; or
(iv) determine the preferences, rights, limitations or other terms of shares in a class subject to determination by the board.

If the board of a company acts in any one of these ways, the company must file a Notice of Amendment of its Memorandum of Incorporation, setting out the changes effected by the board.

9.5 Authority to issue shares

The board of directors of a company is given the authority by s 38, generally, to issue shares.

If a company issues shares that have not been authorised or in excess of the number of authorised shares of any particular class, the issue of those shares may be retroactively authorised within 60 business days after the date on which the shares were issued.

Although the general position under the Act is that the board has the authority to issue shares and does not need to seek shareholder approval, there are instances, set out in s 41, where shareholder approval by special resolution is required for the issue of shares and securities convertible into shares and the grant of options to take up securities. Such approval is required where the issue of the shares, securities or options is to-

(i) a director, future director, prescribed officer, or future prescribed officer of the company or his or her nominee; or
(ii) a person related or interrelated to the company, or to a director or prescribed officer of the company or his or her nominee.

Requiring shareholder approval is clearly desirable because of the board's potential conflict of interest. There are, however, situations where conflict of interest is not a concern and, accordingly, no shareholder approval is required in certain instances set out in s 41, for example, where the issue is in proportion to existing holdings, and on the same terms and conditions as have been offered to all the shareholders of the company or to all the shareholders of the class or classes of shares being issued; or pursuant to an offer of shares to the public.

Where an issue by a company of shares, securities convertible [12] into shares, or rights exercisable for shares involves a significant number of shares, it is desirable that the approval of shareholders be obtained because of the possible resultant change in control of the company. This appears to be the rationale behind s 41(3): shareholder approval is required where the issue is in a transaction, or a series of integrated transactions, if the voting power of the class of shares that are issued or issuable as a result of the transaction or series of integrated transactions will be equal to or exceed 30 per cent of the voting power of all the shares of that class held by shareholders immediately before the transaction or series of transactions.

A director who was present at the board meeting at which an issue by the company referred to in s 41 was approved without complying with s 41 may incur personal

liability for any loss, damages or costs incurred as a result. The director will incur liability if he or she failed to vote against the issue despite knowing that the issue was inconsistent with s 41 (s 41(5)).

A company may not issue shares to itself. [13]

9.6 Consideration for shares

If the board of directors of a company could issue shares for any consideration, existing shareholders could potentially be prejudiced through a watering down in the value of their shares if the shares are issued for an inadequate consideration. Accordingly, s 40 of the Act provides that the board may issue shares only-

(i) for adequate consideration to the company, as determined by the board;
(ii) in terms of conversion rights associated with previously issued securities of the company; or
(iii) as capitalisation shares (see below for the meaning).

However, in the past the courts have been reluctant to inquire closely into the value of such consideration unless it was obviously inadequate or there was evidence of fraud or of an absence of any *bona fide* valuation of the consideration.

This approach by the courts has been incorporated into the Act by s 40(3), which provides that 'the adequacy of consideration for any shares may not be challenged on any basis other than in terms of section 76, read with section 77(2)'. Section 76 places various duties on directors, including the duty to avoid a conflict of interests; to act in good faith, for a proper purpose and in the best interests of the company; and to act with due care, skill and diligence. It follows from the reference to s 76 read with s 77(2) that the board's determination of the adequacy of the consideration for shares may only be challenged on the basis that the determination of the adequacy of the consideration constitutes a breach of one or more of these duties.

'Consideration' has a very wide meaning [14] and does not only include money but also, for example, anything of value and services.

Despite the unlimited power that the board has regarding the type of consideration, s 40 does provide certain safeguards where the company does not receive the consideration immediately on the issue of the shares. The idea is to permit the company to issue the shares, but to require the shares to be held in trust for the subscribing party until receipt takes place.

The general scheme of s 40 is to permit the subscriber to enjoy the benefits attached to the shares only to the extent that the consideration for the shares has actually been received by the company, unless the trust agreement provides otherwise.

9.7 Capitalisation shares

Instead of distributing profits to its shareholders by way of a cash dividend, the board of a company may, except to the extent that the company's Memorandum of Incorporation provides otherwise, capitalise the profits and issue authorised shares

to the shareholders as capitalisation shares on a pro rata basis. [15] Issuing the capitalisation shares on a pro rata basis means no shareholders can be prejudiced by the issue.

It is not a requirement that capitalisation shares issued to a shareholder should be of the same class as the shares already held by the shareholder. They may be of a different class.

When resolving to award a capitalisation share, the board may at the same time resolve to permit any shareholder who is entitled to receive such an award to elect instead to receive a cash payment, at a value determined by the board. [16] However, the board of a company may not resolve to offer a cash payment in lieu of awarding a capitalisation share unless the board has considered the solvency and liquidity test, as required by s 46, on the assumption that every such shareholder would elect to receive cash; and is satisfied that the company would satisfy the solvency and liquidity test immediately upon the completion of the distribution. [17] The latter requirement is aimed at the protection of creditors.

In *Commissioner for Inland Revenue v Collins* [18] Innes CJ explained the effect of a capitalisation issue as follows:

> The company has parted with no assets - no money or moneys worth - and the shareholders have received none. The profits dealt with remain in the business as they were before. The only difference is that as they have become portion of the capital they are represented by shares; but these shares do not increase the holder's interest in the company; that also remains exactly what it was before. The distribution being pro rata his interest in the old capital plus the undivided profits under the old holding was exactly the same as his interest in the increased capital under the new holding. The total assets of the company have not changed, and his original share represented the same proportion of the then issue as his increased shares do of the increased issue. The intrinsic value of each new share is therefore lower than the intrinsic value of each share before the increase of capital ... the new certificates simply increase the number of shares with consequent dilution of the value of each share.

As a general rule only that which can be distributed as dividends out of profits can be capitalised. Where capitalisation shares are issued in the mistaken belief that there are profits available for dividend, the issue is void and any dividend paid in respect of those shares can be reclaimed by the company.

9.8 Debt instruments

Companies are not only financed through the issue of shares; they may also issue 'debt instruments'. 'Debt instruments' are governed by s 43 of the Act and with a few exceptions include any 'securities' other than shares. 'Securities' include the various hybrid securities that have sprung up in recent years. There are exclusions, for example, money market instruments.

'Debt instruments' have the characteristics of both a share and a debt, as well as the feature of making the holder thereof a creditor of the company. There are of course significant differences between a shareholder and a creditor of a company with regard to rights against the company, the ranking of claims on insolvency of the company and taxation of the return on the security.

'Debt instruments' include 'debentures'. The Act does not define what a 'debenture' is. The courts have consistently said that there is in fact no precise definition of a 'debenture'. A debenture, the courts have said, is essentially a written acknowledgement of indebtedness, irrespective of its form.

Not every document creating or acknowledging a debt of a company is, however, necessarily a debenture. The term would not include a negotiable instrument (for example, a cheque) and many other documents in which the company agrees to pay a sum of money, for example, a specific mortgage of land to secure a future obligation to purchase property.

A debenture holder is a particular kind of creditor. The holder is a creditor of the company for the amount of the loan and interest, whose rights are defined by the terms of the issue of the debenture read with the provisions of the Act.

The terms of issue of debentures usually provide that they are redeemable (repayable) at a fixed future date, or between specified dates, at their nominal value, unless the terms of the issue stipulate that a premium is payable on redemption in addition to the nominal value.

Instead of issuing debentures that each represent a separate debt, a single debt can be created and debenture stock certificates issued to the subscribers in such amounts as each wants, subject usually to a prescribed minimum amount. Holders of debenture stock certificates are, then, participants with others in the whole stock, and they can (subject to any restrictions imposed by the stock conditions) sell and transfer any fraction of the amount issued to them.

Where there are a great number of debenture holders and the company contracts with each debenture holder to repay the principal sum and interest until repayment, and gives each debenture holder security over its assets for that amount to rank proportionately as between the individual debenture holders, difficulties could arise. If the company wishes to modify the security, dispose of any of the mortgaged assets, or depart in any way from the terms of its undertaking with the individual debenture holders, it can do so only with the consent of all the debenture holders concerned. This problem can be solved by the introduction of a trust deed by which trustees are appointed to represent the interests of all the debenture holders. The trust deed creates mortgages over the company's assets in favour of the trustees, empowers the trustees to consent on the debenture holders' behalf to minor departures by the company from the terms of the loan, and authorises the trustees to call meetings of the lenders to decide whether to authorise the trustees to enforce the security when a case arises for doing so, or to agree to a modification of their rights or their securities when the company is unable to meet its obligations in full. Because the company contracts with each individual debenture holder to pay the principal of the loan and interest, the debenture holder is a creditor of the company, and consequently he or she can exercise all the legal remedies available to a creditor to recover what is individually owed to him or her. However, only the trustees can enforce the security.

A further step can be taken. The company may contract with the trustees to repay the loan and to pay interest on it until repayment. These payments are to be made either to the trustees on behalf of the debenture holders, or directly to the debenture holders themselves in proportion to their individual subscriptions. The subscribers are, in turn, provided with debenture stock certificates issued by the company, which evidence their respective rights to a proportionate share of the total amount of the loan equal to the amount they have individually subscribed. But there is no contract by the company with these debenture stockholders to repay the amounts that they have individually advanced. The debenture stockholders are not creditors of the company, even where the company has contracted with trustees in the trust deed to pay the principal of the loan and the interest directly to the debenture stockholders. The trustees are the creditors of the company for the whole amount of the loan plus interest and the debenture stockholders are equal beneficiaries under the trust. Consequently, the debenture stockholders' remedies are primarily against the trustees; but by suing them to compel them to enforce their contractual rights against the company and to realise the security vested in them, a debenture stockholder can indirectly enforce the same remedies against the company as a debenture holder can otherwise enforce directly.

The board of a company may authorise the company to issue a secured or unsecured debt instrument, except to the extent provided otherwise by the company's Memorandum of Incorporation, [19] and must determine whether each such debt instrument is secured or unsecured. [20] Every security document [21] must in fact clearly indicate, on its first page, 173 whether the relevant debt instrument is secured or unsecured. [22] There is no restriction on the manner in which a debt instrument is secured.

Except to the extent that a company's Memorandum of Incorporation provides otherwise, a debt instrument issued by the company may grant special privileges regarding, for example, voting at general meetings and the appointment of directors. [23]

9.9 Options for subscription of securities

A company may contract with a person that it will issue securities to a person who desires to take them up in the future. [24] This contract confers a contractual right on the holder to require, at the appropriate time, the company to allot and issue to him or her the agreed number of securities. This right is an 'option'. The option will specify the time or times when, and the exercise price at which, the option may be exercised.

An option holder has been considered to be a contingent creditor.

The authority to issue the options appears to rest with the board.

There is no restriction in the Act on the authority of the board of directors to grant

options to themselves or other persons related to them. This is highly questionable because of the potential for abuse. There is, however, a restriction on the issue of the securities which are the subject matter of the option. [25]

9.10 Shareholders' pre-emption rights

If a private company wishes to issue shares to outsiders it is understandable that existing shareholders may be concerned at the fact that new (strange) shareholders are being brought into the company. Section 39 of the Act recognises this concern and provides that, with certain exceptions, if a private company proposes to issue any shares, each shareholder of that company has a right, before any other person who is not a shareholder of that company, to be offered and, within a reasonable time, to subscribe for, a percentage of the shares to be issued equal to the voting power of that shareholder's general voting rights immediately before the offer was made. [26]

This right is restricted. It does not apply in respect of a public company or state-owned company, except to the extent that the company's Memorandum of Incorporation provides otherwise.

The right also does not apply in respect of a private company or personal liability company with respect to any issue of its shares in terms of options or conversion rights; or as contemplated in s 40(5) to (7); [27]

or as capitalisation shares. [28]

A private or personal liability company's Memorandum of Incorporation may limit, negate, restrict or place conditions upon the right with respect to any or all classes of shares of that company. [29]

Except to the extent that a private or personal liability company's Memorandum of Incorporation provides otherwise, in exercising the right a shareholder may subscribe for fewer shares than the shareholder would be entitled to subscribe for; and shares not subscribed for by a shareholder within the reasonable time given may be offered to other persons to the extent permitted by the Memorandum of Incorporation. [30]

The pre-emptive right referred to in s 39 must not be confused with the right of pre-emption that may be imposed to satisfy the requirement that the securities of a private company must be restricted from being freely transferable. [31]

9.11 Registration and transfer of securities

9.11.1 Certificated and uncertificated securities

Shares may be 'certificated' (evidenced by a certificate [32]) or 'uncertificated'. [33] 'Uncertificated' securities are defined in s 1 of the Act as meaning 'any securities

defined as such in section 29 of the Securities Services Act 2004'. Section 29 of the Securities Services Act defines uncertificated securities as securities that are not evidenced by a certificate or written instrument and that are transferable by entry without a written instrument. In terms of s 29 of that Act, 'entry' includes electronic recordings.

9.11.2 Equal status of securities

Unless the Act expressly provides otherwise-

(i) the rights and obligations of security holders are not different solely on the basis of their respective securities being certificated or uncertificated; and

(ii) any provision of this Act applies with respect to any uncertificated securities in the same manner as it applies to certificated securities. [34]

9.11.3 'Certificated' securities

9.11.3.1 Register of certificated securities

Every profit company must maintain a securities register or its equivalent in the prescribed form, as required by s 50. [35]

A securities register maintained in accordance with the Act is sufficient proof of the facts recorded in it, in the absence of evidence to the contrary. [36]

Any person who holds or has a beneficial interest [37] in any securities issued by a profit company, or who is a member of a non-profit company, has a right to inspect and copy, without any charge for any such inspection or upon payment of no more than the prescribed maximum charge for any such copy, the information contained in the securities register of a profit company, or the members register of a non-profit company that has members. [38] Any other person has a right to inspect or copy the securities register of a profit company, or the members register of a non-profit company that has members, upon payment of an amount not exceeding the prescribed maximum fee for any such inspection. [39]

9.11.3.2 Security certificates

A certificate evidencing any certificated securities of a company must state the following: [40]

(i) the name of the issuing company;
(ii) the name of the person to whom the securities were issued;
(iii) the number and class of shares and the designation of the series, if any, evidenced by that certificate; and
(iv) any restriction on the transfer [41] of the securities evidenced by that certificate.

A security certificate must be signed by two persons authorised by the company's board. This acts as proof that the named security holder owns the securities, in the absence of evidence to the contrary. [42]

A signature may be affixed to or placed on the certificate by autographic, mechanical or electronic means. [43]

9.11.3.3 Transfer of certificated securities

Securities in a company can be acquired directly from the company by way of issue and allotment to the acquirer. They may also be acquired by transfer from the holder thereof.

9.11.3.4 Issue and allotment

A contract to acquire securities in a company from the company is not a contract of purchase, but a contract referred to as a contract of 'subscription' or 'allocation'.

An issue and allotment of securities pursuant to an offer to the public is governed by the Act. [44] Otherwise the common-law rules of contract apply, which means that no particular form of agreement is required, and the contract may be effected in any manner in which a contract may be concluded. It may be either written or oral and either express or implied.

In accordance with the general principles of contract, the subscriber applies to the company for securities. This is the offer. The company then allots the securities to the subscriber. The allotment is the acceptance of the offer and the contract is concluded when the acceptance comes to the notice of the subscriber, or when the acceptance is posted.

9.11.3.5 Transfer

The Act says very little about the transfer of certificated securities. Section 35(1) of the Act says that '[a] share issued by a company is movable property, transferable in any manner provided for or recognised by this Act or other legislation'. Section 51 of the Act, which is headed 'Registration and transfer of certificated securities', simply provides regarding transfer that 'a company must enter in its securities register every transfer of any certificated securities' [45] but must do so only if the transfer '*(a)* is evidenced by a proper instrument of transfer that has been delivered to the company; or *(b)* was effected by operation of law'. [46] Section 51(1)*(a)*(iv) also implies that restrictions can be placed on the transfer of the securities.

It therefore appears that, if a purchaser of securities delivers to the company a valid agreement for the purchase thereof (not in any particular form), the purchaser can, subject to any restrictions on the transferability of the securities, demand that the company register the transfer of the securities in his or her name.

It is not expressly provided that the company must issue new securities certificates to the purchaser, but this seems to be implied. It is also not expressly provided that the securities certificates held by the seller must be delivered with the instrument of

transfer, although the requirement that a proper instrument of transfer be delivered implies that this is required. It would of course make sense if this were to be the case.

When a purchaser enters into an agreement with the seller of securities in a company, the seller 'cedes' the rights attached to the securities to the purchaser. The rights are therefore transferred by cession. A cession is a transfer of a right. Mere agreement is sufficient for a valid cession of the rights attached to a security. Delivery of the security certificate is not a requirement for the validity of the cession of rights arising out of securities. Delivery is simply evidence that the cession has taken place. It is, however, the intention of the parties 'that determines when the rights are ceded; and no doubt in most cases that intention is present when, and only when, the share [security] certificates together with a signed blank transfer form are delivered by the seller to the purchaser'. [47]

In the case of shares, although cession has taken place, it does not, it appears, make the purchaser a shareholder in the company. This view is based on the definition of 'shareholder' in s 1 of the Act, which provides:

> 'shareholder', subject to section 57(1), means the holder of a share issued by a company and who is entered as such in the certificated or uncertificated securities register, as the case may be.

It appears that it is only once the purchaser is registered as the shareholder in the company's securities register that he or she can exercise the rights attaching to the shares. Until registration it seems that-

> the transferor holds the shares and the rights deriving from the shares for the exclusive

> benefit of the transferee. The transferor will have to act in accordance with the instructions of the transferee as the beneficial holder and owner of the shares. [48]

As seen above, the purchaser has the right to registration. [49]

As can be seen from the definition of 'shareholder' in s 1, the definition is subject to s 57(1). Section 57(1) provides:

> In this Part, 'shareholder' has the meaning set out in section 1, but also includes a person who is entitled to exercise any voting rights in relation to a company, irrespective of the form, title or nature of the securities to which those voting rights are attached.

The effect of this qualification appears to be that for the purposes of Part F of Chapter 2 of the Act (Governance of companies) a person who is entitled to exercise voting rights attaching to any securities (not only shares but, for example, debentures) qualifies as a shareholder even though that person is not registered in the securities register. Such a person is not a shareholder, however, for any other purpose. For example, such a person would not be able to claim a dividend from the company in question.

9.11.3.6 Transferability of shares

The general rule is that shareholders have the right to deal freely with their securities. However, the Memorandum of Incorporation or the rules of a company may restrict transferability of its securities. [50] In the case of private companies such restriction is of course obligatory. [51]

The courts are, however, reluctant to restrict transferability and accordingly the rule is that provisions limiting transferability must be restrictively interpreted.

As far as the reasons for restricting transferability are concerned, the view is that in the case of the statutory requirement that the transferability of shares in a private company be restricted, the object would seem to be that of protecting the public and restricting speculation. As far as the company (whether private or public) is concerned, restrictions are usually imposed to allow existing shareholders a measure of control over the identity of the company's shareholders, to maintain an existing pattern of control, or to prevent one or more shareholders from obtaining control by purchase from other shareholders.

A common restriction on transferability is making the right of transfer subject to a *right of pre-emption*. Usually this involves a provision that a member who wishes to dispose of his or her shares must first offer them to the other shareholders pro rata to their existing shareholdings at a price to be determined in a prescribed way.

If the Memorandum of Incorporation empowers the directors to allocate the shares among such shareholders of the company as the directors decide, the directors do not have to allocate the shares to the bidding shareholders in proportion to their shareholding. In fact, a bidding shareholder need not be allocated any shares. [52]

A shareholder is not bound to sell his or her shares to the members unless one or more of them agree to take up all the shares offered.

9.11.3.7 Security by cession in securitatem debiti

Shares can be used to secure a debt. This is done by cession *in securitatem debiti* (cession as security for a debt), which may be done in two ways:

(i) The shareholder can pledge his or her rights to the cessionary (ie the transferee); or

(ii) The shareholder can cede them out-and-out to the cessionary subject to the condition that they will be ceded back to him or her on repayment of the debt.

Whether the cession is a pledge or an out-and-out cession depends on the intention of the parties.

The default position is the pledge construction.

9.11.4 Nominee holdings and beneficial interests in certificated securities [53]

9.11.4.1 'Nominee' holdings

To the extent that the Memorandum of Incorporation does not provide otherwise, it is possible for a person to hold securities in his or her name on behalf of someone else. [54] This person is referred to in common parlance as the 'nominee' of the latter.

The relationship between the nominee and the owner is one of principal and agent. Nominees are agents with limited authority; they hold shares in name only, on behalf of their principals, from whom they take their instructions.

9.11.4.2 Holding of a beneficial interest

Where securities are held as a nominee, the nominee's principal holds a beneficial interest in those securities. However, there are circumstances not involving a nominee holding where someone other than the registered holder of securities holds a beneficial interest in the securities. This is apparent from the definition of 'beneficial interest' in the Act. In terms of the definition a ' beneficial interest' in a security means entitlement through, for example, agreement to-

(i) receive or participate in any distribution in respect of the company's securities;

(ii) exercise or cause to be exercised, in the ordinary course, any or all of the rights attaching to the company's securities; or

(iii) dispose or direct the disposition of the company's securities, or any part of a distribution in respect of the securities. [55]

It follows from the definition that, for example, if X does not hold shares in a company but nevertheless has the right, through an agreement with a shareholder of the company, to the dividends from the shares held by that shareholder, X has a beneficial interest in those shares. Another example would be where X has the right to determine how the shareholder exercises the voting rights attaching to the shares.

In addition to the definition of 'beneficial interest' the Act provides that a person is regarded as having a beneficial interest in a security of a public company if the security is held in an official capacity, for example, as a trustee, by another person on that first person's behalf, or if that first person-

(i) is married in community of property to a person who has a beneficial interest in that security;
(ii) is the parent of a minor child who has a beneficial interest in that security;
(iii) acts in terms of an agreement with another person who has a beneficial interest in that security, and the agreement is in respect of the co-operation between them for the acquisition, disposal or any other matter relating to a beneficial interest in that security;
(iv) is the holding company of a company that has a beneficial interest in that security;
(v) is entitled to exercise or control the exercise of the majority of the voting rights at general meetings of a juristic person that has a beneficial interest in that security; or
(vi) gives directions or instructions to a juristic person that has a beneficial interest in that security, and its directors or the trustees are accustomed to act in accordance with that person's directions or instructions. [56]

It follows from the above that if, for example, Company X holds shares in Company Y and the directors of Company X are accustomed to act in accordance with Z's instructions, then Z has a beneficial interest in Company Y.

9.11.4.3 Disclosure of beneficial interests

There could be various reasons why persons may wish to use a nominee to hold their securities. It could be, for example, to keep their holding confidential. The reason for doing so could be legitimate, but the lack of transparency it creates could lead to undesirable cover-ups of, for example, insider trading and unlawful competition. It is also undesirable that a company should be 'unable to communicate with its real shareholders or should be kept ignorant of a build-up of shareholding towards a take-over of control'. [57] It is because of such potential mischief that the Act requires disclosure by nominees of those for whom they are holding their shares and also disclosure by the holder of shares of those persons who may have a beneficial interest in those shares. [58]

A company must keep a register of such disclosures. If a person holds in excess of 5 per cent of the beneficial interests, this must be disclosed in the annual financial statements. [59]

The concept of beneficial interest becomes relevant in other parts of the Act. There is uncertainty, however, as to whether the deeming provision in s 56(2) applies only in the context of disclosure in terms of s 56(3) or throughout the Act.

9.11.5 Uncertificated securities

9.11.5.1 Introduction

As was stated earlier, [60] securities issued by a company may be either certificated or uncertificated. [61] Certificated securities are evidenced by a physical paper certificate whereas uncertificated securities are not; they 'exist' only in the form of electronic records. Generally the rights and obligations of security holders and the provisions of the Act are the same and apply equally whether one is dealing with certificated or uncertificated securities. Thus everything which has been stated in relation to certificated securities thus far applies to uncertificated securities as well. However, there are certain specific provisions in the Act which apply only to uncertificated securities and these are discussed below.

In order to understand the provisions which apply to uncertificated securities, it is necessary to have some general understanding of the electronic settlement system used in the listed trading environment and the way in which it functions. In 1997 the JSE Limited launched an electronic settlement system known as STRATE (an acronym for 'Share Transactions Totally Electronic') ('Strate') to replace the existing system, which was based on the manual settlement of listed share transactions. The main components of the Strate system are the Central Securities Depository (or 'CSD') and Central Securities Depository Participants ('CSDPs' or 'participants'). The function of the CSD is to oversee, control and manage the dematerialisation [62] of securities, Strate and the participants. The CSDPs or participants are entities (mainly banking institutions) which have met certain qualifications and requirements laid down by Strate. They keep and manage electronic share accounts for investors or brokers. Only participants (not brokers or investors) may liaise directly with the CSD.

9.11.5.2 Registration of uncertificated securities

If a company has issued uncertificated securities or if its issued certificated securities have become uncertificated because they have been dematerialised, [63] the Act provides that prescribed details of the securities (including ownership details) must be kept in the company's uncertificated securities register. The uncertificated securities register forms part of the securities register of a company and any information contained therein is presumed to be correct unless the contrary is proved. [64]

9.11.5.3 Transfer of uncertificated securities

Uncertificated securities are transferred from one person to another without any physical scrip or paper changing hands. The Strate system works as follows: when a trade has been completed (ie the seller of listed uncertificated securities has agreed to sell them and a purchaser has agreed to buy those securities at a particular price) brokers signal - via Strate - the participant for the seller, and the bank, as the CSDP. The seller's CSDP checks that it is in possession of the securities and, if so, these are electronically flagged to indicate that they are to be sold. The bank acting on behalf of the purchaser examines the purchaser's account balance to confirm that the funds are available to settle the trade. If so, the seller's securities account balance is temporarily frozen. The banks are then electronically signalled for payment. While the buyer's bank account balance is debited the seller's account will be credited for payment of the transaction. The relevant participants debit the seller's securities account and credit the purchaser's securities account. In this way the trade is settled finally and irrevocably five working days after it has taken place. It is important to

note that a transfer which takes place in this way [65] occurs despite any fraud, illegality or insolvency that may affect the uncertificated securities or transaction. Only if a transferee was party to, or had knowledge of, the fraud, illegality or insolvency is he or she prohibited from relying on this 'validity' provision. In all other circumstances the transfer of ownership is valid and cannot be challenged or reversed. This protection of the good faith transferee is one of the cornerstones of the Strate system.

9.11.5.4 Security by cession in securitatem debiti

As was explained previously, shares can be used to secure a debt. However, when one is dealing with uncertificated securities there is no physical certificate that can be delivered to effect the cession. Although not vital to secure the cession, delivery of a certificate may be very important evidence that cession has in fact taken place. To address this issue the legislation provides that a pledge or cession to secure a debt must be reflected by an entry in the (electronic) account of the pledgor or cedent indicating that the securities have been pledged or ceded. The interest in those securities may then not be transferred except with the written consent of the pledgee or cessionary. [66]

9.11.5.5 Substitution

It is possible, at any time, for an investor to withdraw all or some of the uncertificated securities he or she holds in an uncertificated securities register and obtain a certificate in respect of the withdrawn securities. This amounts to a 'materialisation' of the securities. The relevant participant and the company must amend their records to reflect the change and the company is obliged to deliver a share certificate in respect of those securities to the investor within ten business days. [67]

9.11.5.6 Liability relating to uncertificated securities

The Act lists certain unlawful actions with respect to securities registers which may result in incurring liability to anyone who suffers loss or damage as a result of those actions. The actions include altering, entering in or removing from the register the name of any person, and changing details of the number or description of uncertificated securities in the register. Furthermore, anyone who gives an instruction to transfer uncertificated securities must warrant that the instruction is legal and correct and may be held liable for loss or damage if it later turns out that this was not the case. [68]

9.11.5.7 Beneficial interest in uncertificated securities

The issue of determining and reporting who has a beneficial interest in uncertificated securities may prove to be more challenging than when the same provisions are applied to certificated securities. This is largely due to the South African Strate system in general and the many different forms that registration may take. To counter this, the Act states that any registered holder who is not also the beneficial holder of uncertificated securities must disclose details of the person on whose

behalf he or she holds the securities as well as the number and class of securities held for each person. This must be done in writing to the company within five business days after the end of every month or otherwise provided on payment of a fee. [69] Furthermore, the company must maintain a register of disclosures and must publish a list of persons who hold beneficial interests in more than five percent of the company's securities. [70] To the extent that they are not discussed here the other provisions of the Act dealing with a beneficial interest in securities, which are examined in relation to certificated securities, apply equally to uncertificated securities. [71]

Questions

1. You are approached by a client who wishes to start a business using a company. The client asks your advice on how the company can obtain funds from other persons to help run the business.

   Advise the client, distinguishing between the various possibilities and the rights that the persons providing the funds will have against the company.
2. A company has legally distributable profits. Describe the various alternative ways in which the company could apply the profits.
3. *(a)* How does the law safeguard a company where the company issues shares on credit (ie it is not to receive the consideration for the shares immediately on their issue)?

   (b) What forms may the consideration for shares take?
4. How does the law safeguard existing shareholders of a company when the company issues shares to directors of the company?
5. Granny Good has inherited some shares in a listed public company from her sister. She calls the broker to tell him that she wants a share certificate which she can hide under her mattress to keep it safe.

   (a) Can the broker fulfil her request? Give a reason for your

answer.

(b) Advise Granny Good whether you think that her plan is a good idea. Give a reason for your answer.

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[*] Richard Jooste wrote paras 9.1 to 9.11.4, and Jacqueline Yeats wrote para 9.11.5.

[1] Section 1.

[2] 'Takeovers, share exchanges and the meaning of loss' (1996) 112 *Law Quarterly Review* 424 at 426-7.

[3] See s 35(1).

[4] Ibid.

[5] Item 6(3) of Schedule 5 to the Companies Act.

[6] Ibid.

[7] Section 37(1).

[8] Section 4(2)*(c)*.

[9] Section 36.

[10] Section 36(2).

[11] Section 36(3).

[12] 'Convertible', when used in relation to any securities of a company, means securities that may, by their terms, be converted into other securities of the company, including *(a)* any non-voting securities issued by the company and which will become voting securities (i) on the happening of a designated event; or (ii) if the holder of those securities so elects at some time after acquiring them; and *(b)* options to acquire securities to be issued by the company, irrespective of whether those securities may be voting securities, or non-voting securities contemplated in paragraph *(a)*.

[13] Section 35(3).

[14] See the definition of 'consideration' in s 1.

[15] Section 47(1)*(a)*.

[16] Section 47(1)*(e)*.

[17] Section 47(2).

[18] 1923 AD 347 at 363-4.

[19] Section 43(2)*(a)*.

[20] Section 43(2)*(b)*.

[21] '(S)ecurity document' includes any document by which a debt instrument is offered or proposed to be offered, embodying the terms and conditions of the debt instrument, including, but not limited to, a trust deed or certificate.

[22] Section 43(2)*(b)*.

[23] Section 43(3).

[24] Section 42.

[25] Section 41. See 9.5.

[26] Section 39(2).

[27] That is, where the consideration is delayed.

[28] Section 39(1)*(b)*.

[29] Section 39(5).

[30] Section 39(4).

[31] See, in this regard, 5.4.

[32] Section 49(1).

[33] Ibid.

[34] Section 49(3).

[35] See ss 24(4)*(a)*, 50(1), 56(7) and Companies Regulation 36.

[36] Section 50(4).

[37] See below.

[38] Section 26(1)*(d)*.

[39] Section 26(2).

[40] Section 51(1).
[41] See 9.11.3.3 and 9.11.3.5.
[42] Section 51(1)*(b)*.
[43] Section 51(2).
[44] See Chapter 4 of the Act.
[45] Section 51(5).
[46] Section 51(6).
[47] MS Blackman *LAWSA* vol 4 part 1 para 229.
[48] HS Cilliers & ML Benade *Corporate Law* 3 ed (2000) para 18.16.
[49] Section 51(5).
[50] This is implied in s 51(1)*(a)*(iv).
[51] Section 8(2)*(b)*(ii)*(bb)*.
[52] Blackman et al *Commentary on the Companies Act* (2002) 5-187.
[53] Regarding voting by beneficial interest holders, see 11.2.3.
[54] Section 56(1).
[55] Section 1. It does not include any interest held by a person in a unit trust or collective investment scheme in terms of the Collective Investment Schemes Act 45 of 2002.
[56] Section 56(2).
[57] Cilliers & Benade (n 48) para 15.14.
[58] The wording regarding the latter (s 56(3)) is, however, problematic, although the intention to require disclosure of such beneficial interest holders is clear. Legislative amendment is called for to provide clarity.
[59] Section 56(7).
[60] See 9.11.1.
[61] Currently the securities of listed public companies.
[62] Dematerialisation is a technical term for the replacement of paper share certificates with electronic records to enable the Strate system to operate. Once securities have been dematerialised they are uncertificated securities.
[63] This is possible in accordance with s 49(5) and the rules of Strate.
[64] Section 50(4).
[65] In terms of s 53.
[66] Section 43 of the Securities Services Act, 2004.
[67] Section 49(5) and (6).
[68] Section 55.
[69] Section 56(3).
[70] Section 117(1) read with s 118(1)*(a)*.
[71] See 9.11.4.

Chapter 10
Corporate Finance

Richard Jooste

10.1 Introduction

'Corporate finance' is not a legal or technical term. So what is this chapter concerned with? It is concerned mainly with the law governing the return by a company of its funds to its shareholders. Such a return can obviously, in certain circumstances, be detrimental to the interests of creditors and minority shareholders of the company. As a result of such return, creditors of the company may not be paid and minority shareholders may be treated unfairly. The law needs to step in and ensure that such prejudice does not occur.

It will be recognised that there are also other instances where there may be abuse of a company's funds, for example, where a company assists in the acquisition of shares in the company or a company financially assists its directors in some way. The law in this regard is also dealt with in this chapter.

As will be seen, the main way in which the law seeks to provide the protection that is needed is by permitting the above transactions only if they do not result in the insolvency or illiquidity of the company.

This chapter therefore deals with situations where a company parts with its funds other than in the course of carrying on its business. How a company raises funds in order to finance its business is dealt with in Chapter 9: Shares, securities and transfer, and Chapter 16: Public offerings of company securities.

10.2 Distributions

10.2.1 General

As stated above, the distribution by a company of its assets to its shareholders, whether the distribution be in the form of cash or otherwise, ought to be carefully regulated by any legal system intent on protecting the interests of creditors and minority shareholders of the company. Until 1999 such protection was largely provided by the maintenance of capital principle, which manifested itself in various ways:

(i) Dividends could not be paid out of capital.
(ii) A company could not acquire its own shares (often referred to as a 'repurchase' or 'buy-back') or shares in its holding company.

(iii) Par value shares could not be issued at a discount except under stringent conditions.
(iv) A company could not, generally, provide financial assistance for the acquisition of its own shares or shares in its holding company.

Creditors have no recourse to the company's shareholders when the company cannot pay its debts, forcing them to rely exclusively on the company's assets. This is the effect of limited liability. Until 1999 the capital maintenance rule entitled creditors to rely on the fact that no part of the company's capital could be paid out except in the legitimate course of business or under a reduction of share capital authorised by the Companies Act. Creditors accepted the risk that the company could lose part or all of its paid up capital in carrying on its business, but they had a right to rely on the capital remaining undiminished by the return of any part of it to the shareholders. The capital could be spent or lost in carrying on the business of the company, but it could not be reduced except in the manner and with the safeguards provided by the law.

In 1999 the law changed with far-reaching amendments to the Companies Act 61 of 1973. The maintenance of capital principle was effectively abolished, companies were permitted to acquire their own shares and shares in their holding companies, and the distinction between a company's profits and other funds was removed. The distribution of funds by a company to its shareholders was allowed provided, inter alia, that the company's solvency and liquidity were not placed in jeopardy and, in the case of a buy-back or a purchase by a company of shares in its holding company, in addition, a special resolution was required.

The Companies Act 71 of 2008 ('the Act') follows a similar approach, but the provisions are significantly different from those of the 1973 Act.

The new Act does not deal entirely separately with the different types of distributions. Section 48 deals specifically with the acquisition by a company of its own shares and shares in its holding company, while distributions, generally, are dealt with in s 46 of the Act. The definition of 'distribution' in s 1 of the Act includes a transfer of the consideration for the acquisition by a company of its own shares, or shares in any company in its 'group'. Accordingly, acquisitions by a company of its own shares or shares in its group are governed by both s 46 and s 48. Sections 46 and 48 are not, however, the only relevant provisions governing distributions. For example, the liability of directors in this context is dealt with in s 77. The Act also provides that all holders of a particular class of shares must be treated equally, unless the Memorandum of Incorporation provides otherwise. It provides, furthermore, that the Memorandum of Incorporation may entitle the shareholders to 'distributions' calculated in specific ways [1] and may provide for preferences as to distributions or liquidation rights in respect of different classes of shares. [2]

10.2.2 The definition of 'distribution'

All distributions governed by the Act are encapsulated in the definition of 'distribution' contained in the Act. [3] The definition is very wide. The following should be noted:

(i) The definition expressly excludes liquidation distributions.

(ii) Included as a distribution is a direct or indirect transfer, by a company, of money or other company property, other than its own shares, to or for the benefit of one or more of its shareholders or the shareholders of another company within the same group of companies. A number of specific inclusions is provided. These inclusions are:

- dividends;
- payments in lieu of capitalisation shares (the board may, when issuing capitalisation shares, if permitted by its Memorandum of Incorporation, offer shareholders a cash payment as an alternative to the capitalisation shares. Such a cash alternative will also qualify as a distribution);
- payments of the consideration for the acquisition by a company of its own shares;
- payments of the consideration for the acquisition by any company in a group of shares of another company in the group; and
- transfers by a company in respect of any of the shares of that company or of another company within the same group. [4]

(iii) There is no definition of 'dividend' in the Act. Ordinarily, when one uses the term 'dividend', one is referring to a distribution by a company of profits of the company. There is nothing, however, in the provisions governing distributions which turns on the distinction between profits and other funds.

(iv) Companies may, in terms of the Act, issue redeemable shares [5] and the redemption is a distribution.

(v) The payment by a company to a shareholder in terms of the appraisal remedy provision [6] does not constitute a 'distribution'. [7] Why this distinction is drawn is unclear. The distinction is difficult to justify.

(vi) A distribution is made by the company by incurring a debt or obligation in favour of its own shareholder, or a shareholder of another company in the group. For example, if a company guarantees repayment of a shareholder's debt owing to another person, the company makes a distribution to the shareholder.

(vii) If a company waives a debt owing to it by one of its shareholders, the waiver is a distribution. So by releasing the shareholder from the obligation to pay the debt the company makes a distribution.

(viii) The definition of 'distribution' in the Act covers distributions by a company not only to its own shareholders but also to holders of shares in any company within the same group of companies. All the implications of this extension of the definition to the group context are unclear, as is the rationale. The strange result of this extension is that the payment made by a company when purchasing further shares in its subsidiary would be a ‘distribution’ as defined. Why such a payment should be regulated as a distribution is unclear.

10.2.3 Authorisation of a distribution

A distribution by a company must generally be authorised by the company’s board of directors. [8]

No shareholder approval of any kind is required for a distribution. It is not clear from the Act whether the Memorandum of Incorporation can validly impose any prohibitions, conditions or requirements relating to distributions, for example, a condition that distributions can only be made out of profits or that shareholder approval is required. There seems little doubt that such provisions in the Memorandum should be valid.

It appears that class rights [9] must be respected at all times and the directors do not have the power to discriminate among shareholders of the same class when it comes to the distribution of dividends.

10.2.4 The solvency and liquidity requirement

In an effort to safeguard creditors and minority shareholders of a company, the company’s board of directors must not make any proposed distribution unless-

(i) it has applied the solvency and liquidity test; [10] and
(ii) it has acknowledged, by resolution, that it has reasonably concluded that the company will satisfy the test immediately after completion of the proposed distribution. [11]

When more than 120 business days have passed since the board’s acknowledgement that it has applied the solvency and liquidity test and it has reasonably concluded that the company will satisfy the test, and the company has not yet completed the distribution, the board is required to reconsider the solvency and liquidity test with respect to the remaining distribution to be made. [12] The company may not proceed with or continue a distribution unless the board adopts a further resolution acknowledging that it has applied the solvency and liquidity test and has reasonably concluded that the company will satisfy it. [13]

The solvency and liquidity test is set out in s 4 of the Act.

A company satisfies the solvency and liquidity test at a particular time if, considering all reasonably foreseeable financial circumstances of the company at that time-

(i) the assets of the company, as fairly valued, equal or exceed the liabilities of the company, as fairly valued (the solvency aspect); and
(ii) 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 (the liquidity aspect). [14]

The solvency and liquidity aspects have different theoretical justifications. The solvency aspect recognises the priority that creditors enjoy over shareholders upon dissolution of the company by preventing the company from favouring its shareholders through a partial liquidation. The justification for the liquidity aspect is that it recognises the fundamental expectation of creditors to be paid on time. [15]

Significant points relating to the solvency and liquidity test are:

(i) In applying the test one must consider a fair valuation of the company's assets and liabilities, including any reasonably foreseeable contingent assets and liabilities, irrespective of whether or not arising as a result of the proposed distribution, or otherwise. A contingent liability is one that will only become due and payable on the happening of an event which may or may not occur. A contingent asset is a claim to an asset the vesting of which is conditional on the happening of an event that may or may not occur. The question that is important is the likelihood of the contingent event occurring and, if it is likely to occur, the time when it is likely to occur.

(ii) Unless the Memorandum of Incorporation of the company provides otherwise, preference shareholders are not to be treated as creditors of the company. So unless the Memorandum provides otherwise, these preference shareholders are left out in the cold. Their preferential rights will be meaningless because all the company's net assets may be returned to its ordinary shareholders. This is clearly unsatisfactory.

(iii) It appears that the solvency and liquidity of the company is a purely objective test, ie whether a hypothetical reasonable board would have been satisfied with the solvency and liquidity of the company. The test is not a subjective test which takes into account the knowledge, skill and experience of the particular board in question.

(iv) In dealing with the solvency aspect of the test, claims in respect of previously authorised distributions that have not yet been fully completed must clearly be taken into account as liabilities.

(v) Where a company making a distribution is part of a group of companies, the solvency and liquidity test involves looking only at that company's assets and liabilities, and not the assets or liabilities of any other company in the group or the assets and liabilities of the group as a whole.

10.2.5 Liability of directors

A director of a company is liable for any loss, damages or costs sustained by the company as a direct or indirect consequence of an unlawful distribution. [16]

Liability of a director arises only if the director participates in the relevant resolution 'knowing' that the distribution was unlawful. [17] In this regard s 1 of the Act provides for an extended meaning of 'knowing'. It provides that-

'knowing', 'knowingly' or 'knows', when used with respect to a person, and in relation to a particular matter, means that the person either-

(a) had actual knowledge of the matter; [or]

(b) was in a position in which the person reasonably ought to have-

(i) had actual knowledge;

(ii) investigated the matter to an extent that would have provided the person with actual knowledge; or

(iii) taken other measures which, if taken, would reasonably be expected to have provided the person with actual knowledge of the matter.

If the board of a company has made a decision contrary to the Act, the company, or any director who has been or may be held liable, may apply to a court for an order setting aside the decision. [18]

Regarding liability flowing from an unlawful distribution, sight must not be lost of the general liability provision in s 20(6). Section 20(6) provides that each shareholder of a company has a claim for damages against any person who intentionally, fraudulently or due to gross negligence causes the company to do anything inconsistent with the Act.

10.2.5.1 Relief from liability

A director may be relieved from liability if there has been no wilful misconduct or wilful breach of trust. A court may provide this relief if the director has acted honestly and reasonably; or, having regard to all the circumstances of the case, it would be fair to excuse the director. [19]

10.2.5.2 Prescription

The proceedings to recover any loss, damages or costs from a director may not be commenced more than three years after the act or omission that gave rise to the liability. [20]

10.2.5.3 Limit on amount of damages, loss and costs

The Act [21] provides for a limit on the amount for which a director can be liable. It provides that the amount cannot exceed, in aggregate, the difference between-

(i) the amount by which the value of the distribution exceeded the amount that could have been distributed without causing the company to fail to satisfy the solvency and liquidity test; and

(ii) the amount, if any, recovered by the company from persons to whom the distribution was made.

It appears that this means that, if the distribution is R100, the lawful amount is R80 and the amount recovered by the company is R7, then the amount a director could be liable for is R13.

10.2.6 Recovery of unlawful distributions from shareholders

The Act does not expressly provide that a shareholder to whom an unlawful distribution has been made is liable to return such distribution.

However, being unlawful, the distribution would be invalid and recovery would be possible in terms of the common law irrespective of the *bona fides* of the shareholder. [22]

10.2.7 Prevention of unlawful distribution

A company may be restrained by the court from making a distribution contrary to the Act or the company's Memorandum. [23]

10.2.8 Dividends out of profits

The Act draws no distinction between the distribution of profits and any other distributions (these other distributions are usually referred to as distributions of 'capital'). However, the Memorandum of Incorporation may require dividends to be paid only out of profits. In such a case, unless the Memorandum of Incorporation defines the term 'profits', it appears that the case law remains relevant.

In this regard the following 'rules' have been devised by the courts:

(i) Profits earned before a company is incorporated (pre-incorporation profits) constitute capital.

(ii) Dividends received by a holding company from a subsidiary which have been paid out of profits earned by the subsidiary prior to the holding company acquiring the subsidiary (pre-acquisition profits) are not income earned, they are part of the purchase price that the holding company paid for the shares in the subsidiary.

(iii) The profits of a subsidiary are not profits which the subsidiary's holding company may treat as its own profits. This flows from the basic principle that a company is a separate legal entity.

(iv) A company may retain revenue profits from past periods as undistributed profits, subject to any losses in the next or later periods.

(v) Even where the company's accounts profits have been transferred to reserves for specific purposes, such as the replacement of fixed assets or future tax payments or the depreciation of goodwill, if the purposes for which those reserves are intended fail, or the profits are not required for those purposes, they may be re-transferred in order to pay dividends. If, however, the Memorandum requires a reserve fund of a certain amount to be set aside for a particular purpose before any dividend is declared, no part of the fund can be distributed as dividend unless the Memorandum is altered.

(vi) Furthermore, profits carried to reserve will not be available for dividend where the company has, in effect, capitalised them by applying them so as to replace capital previously lost or to replace the loss in value of a capital asset arising from depreciation.

(vii) If a company elects to apply profits in paying up unissued shares as capitalisation shares, those profits will, of course, be capitalised and so cease to be available for dividend.

(viii) Capital profits (for example, on the sale of fixed assets), realised or unrealised, are not distributable without reference to the result of the whole accounts fairly taken for the year. Consideration must therefore be given to the financial position of the company as a whole. Accordingly, while dividends may in proper cases be paid out of revenue profits despite there having been a depreciation of capital, any loss that may possibly have been incurred on other fixed assets, as well as any net loss on the company's trading activities during the financial year in question, must be brought into account against the realised capital profit in question. It has been held that the only losses that need to be set off are those suffered during the trading period when the profit is made, but there is also authority suggesting that all past losses must be set off.

(ix) The courts have held that it is permissible to pay as a dividend an unrealised increase in the value of the company's fixed assets. It would appear, however, that the Memorandum of Incorporation would have to authorise such distribution; the appreciation must be of a permanent nature in the sense that it is not liable to short-term fluctuations; and the valuation resulting in the surplus must have been made in good faith by competent valuers.

(x) Dividends may be, and usually are, based upon the company's revenue or trading profits. The profits are net of revenue expenses and depreciation in the value of circulating assets. Unless the Memorandum of Incorporation provides otherwise, all losses suffered in earlier periods may be disregarded. A dividend may thus be paid out of the company's revenue or trading profits of a period without having to write off past trading losses and a deficiency in the company's capital need not be recouped out of such profits.

(xi) In determining what revenue profits are, a distinction is drawn between 'fixed assets' and 'circulating or current assets'. As has been held:

> '[C]apital' is fixed in the sense of being invested in assets intended to be retained by the company more or less permanently and used for producing income ... ['Circulating capital'] is a portion of the subscribed capital of the company intended to be used by being temporarily parted with and circulated in business, in the form of money, goods or other assets, and which, or the proceeds of which, are intended to return to the company with an increment, and are intended to be used again, and again and to always return with some accretion. [24]

(xii) Realised and unrealised profits on current assets may be taken into account. Losses in previous periods in respect of fixed or capital assets, and losses to such assets during the current period, need not be taken into account. Providing out of profits for the depreciation of fixed assets is not required, eg the company's plant and machinery, or for a drop in value of its property or goodwill or for irrecoverable investments or long-term loans. A wasting fixed asset, such as a licence, does not need to be provided for as capital replacement before paying a dividend.

(xiii) Earnings after commencement of winding-up are capital and not income. [25]

(xiv) The following must also be borne in mind when addressing the question of what is revenue profit:

> The mode and manner in which a business is carried on, and what is usual or the reverse, may have a considerable influence in determining the question what may be treated as profits and what as capital. Even the distinction between fixed and floating capital, which may be appropriate enough in an abstract treatise like Adam Smith's 'Wealth of Nations', may with reference to a concrete case, be quite inappropriate. [26]

(xv) The Memorandum of Incorporation may place restrictions on what constitutes profits 'available for dividend', eg the Memorandum may restrict the distribution of certain types of profit.

(xvi) Unless the Memorandum of Incorporation provides otherwise, a company is not obliged to distribute its profits by way of dividend. It may instead retain all or part of them as undistributed profits, or use them to write off past losses, or place all or part of them to reserve, or apply them in paying up unissued shares to be issued to its members as capitalisation shares; or enter into a contract which has the effect of rendering net profits unavailable for dividend. These are entirely questions of internal management.

(xvii) In exercising a discretion whether or not to distribute a dividend the directors have a fiduciary duty to consider the interests and legitimate expectations of the shareholders when deciding on how much should be distributed to them, and must bear in mind that one of the major benefits to members is the payment of dividends. The directors may be acting for an improper purpose if, ignoring the interests of the members, they retain for the greater growth and glory of the company profits which could, with entire propriety and commercial ease, be paid out to members in dividends.

(xviii) Directors of a closely held or 'domestic' company expose themselves to legal action where the shareholders are accustomed, subject to the company's needs, to a dividend out of trading profits, and a dividend is not paid.

10.2.9 Distributions of gifts

The definition of distribution and the provisions of the Act governing distributions apply only to distributions to shareholders in their capacity as shareholders. They do not apply to distributions to shareholders in any other capacity or to anyone else. In particular they do not apply to gifts made by a company to such persons. This means that the solvency and liquidity requirement does not have to be met. It is doubtful that this is what the legislature intended.

As has been pointed out, [27] gifts made by companies 'are of two kinds: *(a)* gifts that further, realise or are incidental or conducive to a business object ('business gifts') and *(b)* gifts that are not made in the furtherance of such an object but as gratuitous distributions of the company's assets ('pure gifts' or 'truly gratuitous dispositions'). To determine whether a gift is the one or the other the true intention of the donor

must be ascertained. What is important is the intention of the donor and not the labels which the parties attach to the transaction, ie what the parties choose to call it. The issue is the gift's substance rather than its outward appearance. Thus payment of interest which is out of proportion to the size of a debt; remuneration of a director out of proportion to any possible value attributable to the director's holding of office; and a sale at an undervalue have all been held to be nothing but 'dressed-up gifts'.

A company has the capacity to make gifts [28] subject to any restrictions in its Memorandum of Incorporation. [29]

A business gift is a normal business transaction, in principle no different from any other business transaction entered into by a company, and, consequently, it is subject to the same rules that apply to any other such transaction. [30]

A pure gift is not a business transaction and in terms of the common law, in the absence of a provision in the company's constitution empowering the directors or the majority of the members in general meeting to make pure gifts, such gifts may only be made with the consent of all the members.

10.3 Repurchases (buy-backs)

10.3.1 General

Before an amendment to the 1973 Act in 1999 a company could not acquire its own shares even if permitted to do so by its constitution. This was established in *Trevor v Whitworth* [31] and until 1999 was a fundamental part of our law. As stated in *Trevor v Whitworth*, the prohibition had two purposes: *(a)* to protect creditors, and *(b)* to protect the company's shareholders by preventing a company from trafficking in its own shares. An additional reason given for the prohibition was that it would be disastrous to allow managing directors to buy out inquisitive or troublesome critics.

To prevent avoidance of this prohibition through a subsidiary of a company purchasing shares in the company, such purchases were also prohibited by the 1973 Act. The prohibition was, however, rejected in most states in the USA and this approach was later followed in Canada, the UK, Australia, New Zealand and, finally, South Africa.

Some of the justifications for a share repurchase that have been suggested [32] are:

(i) Share repurchases can be usefully utilised to buy out dissident shareholders.
(ii) Share repurchases enable a company to return surplus funds to shareholders who can then make other more profitable investments.
(iii) Share repurchases can be used to maintain or achieve what is perceived to be a desirable debt–equity ratio.
(iv) Where a company has a number of shareholders with small shareholdings, the administrative overheads that this causes can be

reduced by the company buying out these 'odd-lots' without incurring any material cost.

(v) A share repurchase assists companies engaging in takeovers and mergers by enabling them to take shares off the market to be reissued as consideration in takeovers and mergers without dramatically increasing the company's issued shares. (The purpose of this exercise is to prevent dilution of the equity of the non-selling shareholders, usually a matter of concern only for the controlling shareholders.)

(vi) A share repurchase provides a means to avert a hostile takeover. In such a situation the repurchase may have a number of strategic purposes: it may increase the percentage of the target's shares owned by management or its supporters; it may raise the price of the target's shares above the offer price, forcing the bidder to increase its offer or abandon its bid; and by means of repurchase, the target company may rid itself of the liquid assets which make it an attractive target in the first place, or make itself an unattractive target by increasing its debt–equity ratio.

(vii) Repurchases assist management in a buy-out of control of their company by reducing (at company expense) the number of shares that have to be acquired to gain control of the company. They will usually also reduce liquidity of the outstanding shares, thus depressing the price of those shares and placing the remaining shareholders under coercion to sell.

10.3.2 Redemptions and repurchases

A distinction is drawn in company legislation and practice between 'redemptions' and 'repurchases' of shares. Both involve the return to a company of shares the company has issued to shareholders. In return, the company will pay money or transfer assets to the shareholder(s) concerned. With a redemption, the company acquires shares in accordance with its Memorandum of Incorporation or in the terms of the issue of the shares. A 'repurchase', on the other hand, is a transaction entered into between a company and one or more of its shareholders in terms of which it is agreed that the company will acquire their shares.

The provisions of the Act regulating 'repurchases' [33] do not apply to 'redemptions'. [34]

10.3.3 Regulation of repurchases by the Act

10.3.3.1 'Acquire'

The Act [35] refers to the 'acquisition' by a company of its own shares. The term 'acquisition' is, however, a misnomer because it indicates that the acquiring company holds the shares. This is not possible, because a company cannot acquire rights against itself. [36] In any event, s 35(5) of the Act makes it clear that the shares acquired by the company no longer, on acquisition, retain the status of issued shares, but have the same status as shares that have been authorised but not issued. It follows

that the direct acquisition by a company of 'treasury' shares [37] is not possible, although a limited acquisition thereof is possible through the company's subsidiaries. [38] A treasury share is simply a share which a company acquires in itself, which it holds as a shareholder and which does not revert to an unissued share.

10.3.3.2 Conflict with Memorandum of Incorporation

It appears that provisions in the Memorandum of Incorporation that prohibit acquisitions partially or altogether, or permit them only if certain conditions are met, are effective.

10.3.3.3 Requirements for a repurchase

Repurchases necessitate compliance with the following requirements:

(i) There must be compliance with the requirements for 'distributions', which include compliance with the solvency and liquidity test (so a repurchase involves a 'distribution').

(ii) The board of directors of a company needs no authorisation from the shareholders of the company to make a distribution pursuant to a repurchase. A board resolution suffices.

An exception to the exclusion of shareholders from the decision to make a buy-back is to be found in s 48(8), which provides that, if a company is to repurchase shares from a director or prescribed officer of the company, or a person related to a director or prescribed officer of the company, a board resolution does not suffice. The decision by the board must be approved by special resolution.

Not only does the Act generally exclude shareholders from deciding on a buy-back, it also contains no provisions aimed at informing shareholders as to the merits or demerits of an offer to acquire their shares.

(iii) The repurchase by a company of its own shares must not result in the only shareholders being one or more of its subsidiaries. [39] This is understandable, because it would clash with the limit on the number of shares that the subsidiaries of a company may hold in the company. [40] This requirement is of course unnecessary, because the limit would prevent this from happening anyway.

(iv) An acquisition by a company of its own shares must not result in the company whose shares are acquired being left with only 'convertible or redeemable' shares. [41]

10.3.4 Enforceability of agreement to acquire shares

An agreement with a company providing for the acquisition by the company of shares issued by it is enforceable against the company. [42] Such enforceability is subject to the qualification that the agreement is not enforceable if the company would fall foul of the solvency and liquidity requirement.

10.3.5 Reversal of acquisition

If a company acquires shares contrary to the Act, the company must, [43] not more than two years after the acquisition, apply to a court for an order reversing the acquisition, and the court may order-

(i) the person from whom the shares were acquired to return the amount paid by the company; and

(ii) the company to issue to that person an equivalent number of shares of the same class as those acquired.

10.3.6 Directors' liability

A director of a company is liable for any loss, damages or costs sustained by the company as a direct or indirect consequence of the director being party to the acquisition by the company of its own shares despite knowing that the acquisition was contrary to the Act. The liability arises if the director was present at the meeting when the board approved the acquisition and failed to vote against the acquisition, knowing that the acquisition was contrary to the Act. [44]

As mentioned above, an acquisition by a company of its own shares involves a distribution and accordingly the acquisition may also give rise to liability on the part of a director for an unlawful distribution.

The liability provisions relating to a distribution have been dealt with earlier and so will not be repeated here.

10.3.7 Treasury shares

Treasury shares are shares acquired by a company which, instead of being cancelled on their reacquisition, are held by the company.

Although the Act does not permit the direct holding by a company of treasury shares, as pointed out earlier, the company may, to a limited extent, do so through a subsidiary or subsidiaries.

Regarding the use of treasury shares in other jurisdictions, the position in Australia, New Zealand and Canada is similar to the position in South Africa. The American Model Business Corporation Act of 1979 has rendered treasury shares redundant by requiring re-acquired shares to be restored to the status of authorised but unissued shares or, in certain circumstances, to be cancelled and eliminated from authorised shares. Treasury shares are currently permitted in Singapore, Malaysia, the United Kingdom and the European Union.

The view is taken by some that treasury shares provide distinct advantages: they

afford companies flexibility in managing their capital structure and in adjusting their debt-equity ratio, reduce or avoid the cost of raising new capital, and are also useful for employee share schemes.

10.4 Acquisition by a company of shares in its holding company (indirect repurchases)

Until the 1973 Act was amended in 1999, the Act prohibited a company from being a member of its holding company. This prohibition was aimed at preventing an indirect return of capital to shareholders and the indirect trafficking in its shares by a holding company.

The amendment to the 1973 Act in 1999 made it possible for subsidiaries of a holding company to acquire shares in the holding company subject to certain requirements. [45]

Subject to what is said below, the current Act also permits such acquisitions.

10.4.1 'Limit'

The Act [46] provides that any subsidiary of a company may acquire shares in that company, but subject to a limit. The limit is that-

> any subsidiary of a company may acquire shares of that company, but-
>
> (i) not more than 10%, in aggregate, of the number of issued shares of any class of shares of a company may be held by, or for the benefit of, all of the subsidiaries of that company, taken together.

There is uncertainty regarding this limit. Is the limit 10 per cent of each class, or 10 per cent of the total shares, irrespective of class of share? For example: Company X has three classes of shares, A shares, B shares and C shares. One hundred of each have been issued. Is the maximum limit on the number of shares that subsidiaries of company X can acquire in Company X (i) ten A shares, ten B shares and ten C shares, or (ii) 30 shares, irrespective of their class?

It is clear from the Act [47] that, in determining the number of shares held by subsidiaries in their holding company, shares acquired by the subsidiaries before they became subsidiaries of the holding company must be taken into account.

It appears that shares acquired by a subsidiary as a trustee or in a representative capacity must be taken into account in determining the percentage holding. This is anomalous.

It also appears that shares acquired by subsidiaries in their holding company by way of a capitalisation issue must be taken into account in determining whether the 10 per cent limit has been exceeded.

10.4.2 Requirement of s 48(3)

Section 48(3) provides that, despite any provision of any law, agreement, order or the Memorandum of Incorporation of a company, the company may not acquire its own

shares, and a subsidiary of a company may not acquire shares of that company if, as a result of that acquisition, there would no longer be any shares of the company in issue other than-

(i) shares held by one or more subsidiaries of the company; or
(ii) convertible or redeemable shares.

The requirement in (ii) above makes no sense in relation to a company acquiring shares in its holding company. If a subsidiary acquires shares in the holding company from another shareholder, the company's shares remain the same. If the shares are issued by the holding company to the subsidiary, that simply increases the company's shares. So it is difficult to see how the acquisition can have the result envisaged in (ii) above.

10.4.3 Provisions governing 'distributions' applicable

The definition of 'distribution' in s 1 of the Act includes a transfer of money or other property by a company as consideration for the acquisition of shares in a company in the same group of companies as the transferring company. Accordingly, the provisions governing 'distributions' [48] apply to the distribution made by a company pursuant to an acquisition by the company of shares in its holding company.

10.4.4 Reversal of acquisition

If a company acquires any shares contrary to the Act, the company must, not more than two years after the acquisition, apply to a court for an order reversing the acquisition, and the court may order the person from whom the shares were acquired to return the amount paid by the company; and the company to issue to that person an equivalent number of shares of the same class as those acquired. [49]

10.4.5 Directors' liability

Where a company acquires shares in its holding company unlawfully or makes a distribution pursuant to such an acquisition unlawfully, directors of the acquiring company incur liability. The liability is for any loss, damages or costs sustained by the company as a direct or indirect consequence of the director being party to the distribution or acquisition despite knowing that the acquisition or distribution was unlawful. The liability arises if the director was a party to the resolution approving the acquisition or distribution and failed to vote against it, knowing that the acquisition or distribution was unlawful.

The liability is limited to the difference between 'the amount by which the value of the distribution exceeded the amount that could have been distributed without causing the company to fail the solvency and liquidity test' and 'the amount, if any, recovered by the company from persons to whom the distribution was made'. [50]

10.4.6 Voting rights not exercisable

The voting rights attaching to the shares held by subsidiaries in their holding company present a problem. [51] The Act neutralises the votes of shares held by a subsidiary in a holding company in respect of those shares acquired by the subsidiary when it was a subsidiary. It does not, however, cover any shares the subsidiary may have acquired in the holding company before it became the holding company of that subsidiary. It is unlikely that this discrepancy was intended.

10.5 Financial assistance for the acquisition of securities

10.5.1 Background

The Act [52] regulates the situation where a company provides financial assistance for the acquisition of the company's securities.

The mischief at which such regulation is aimed is the abuse that becomes possible when persons with insufficient funds or credit facilities of their own purchase the shares of a company, gaining control of the company, and use the funds of the company to pay for the shares acquired by them. The object of such regulation is simply to ensure that corporate funds are used for proper corporate purposes. A person who purchases shares in a company must do so out of his or her own funds and not by misusing the funds of the company.

Originally the regulation took a hard-line approach but the current approach is a more liberal one.

10.5.2 Overview of regulation

The regulation is to be found in s 44 of the Act, which provides that-

(i) the board may authorise the company to provide financial assistance by way of a loan, guarantee, the provision of security or otherwise to any person for the purpose of, or in connection with, the subscription of any option, or any securities, issued or to be issued by the company or a related or inter-related company, or for the purchase of any securities of the company or a related or inter-related company;

(ii) the Memorandum of Incorporation of a company may, however, provide otherwise;

(iii) despite any provision of a company's Memorandum of Incorporation to the contrary, the board may not authorise any such financial assistance unless certain requirements are satisfied (see below);

(iv) the board must ensure that any conditions or restrictions respecting the granting of financial assistance set out in the company's Memorandum of Incorporation have been satisfied.

(v) a decision by the board of a company to provide financial assistance, or an agreement with respect to the provision of any such assistance, is void to the extent that the provision of that assistance would be inconsistent with the Act or the Memorandum of Incorporation;

(vi) the provision of unlawful financial assistance may result in liability on the part of any director who was party to the transaction.

10.5.3 The meaning of 'financial assistance'

The only aid provided by the Act in determining the meaning of 'financial assistance' is that-

(i) financial assistance does not include lending money in the ordinary course of business by a company whose primary business is the lending of money; [53]

(ii) financial assistance includes a loan, guarantee, the provision of security or otherwise. [54]

'Financial assistance' is not a term capable of precise legal definition and the courts have held that it is clearly unwise for the legislature to lay down a precise definition of this term. The absence of a clear definition means, however, that the section can give rise to uncertainties and ambiguities and has the potential to bring innocuous transactions into play.

Section 38 of the 1973 Act also regulated 'financial assistance' and the case law that arose in relation to the meaning of financial assistance in s 38 is obviously still of vital importance in interpreting the new legislation in this regard.

It will be recognised that 'assistance' involves something in the nature of aid or help. It cannot exist in a vacuum: it must be given to someone.

For the assistance to qualify, the assistance must be 'financial'. Therefore, providing documents or information relating to the transaction in question, responding to requests for information relating thereto, providing access for the purpose of inspection of records, restructuring of the board of directors and concluding *bona fide* service contracts all involve co-operation by the company with the parties to the transaction, but do not constitute 'financial assistance'. By facilitating a transaction (for example, by serving as a vehicle or conduit for the transmission of money to a party to the transaction), a company does not give 'financial assistance'. There is no financial assistance provided when the direct object of the transaction is simply to give to another person what he or she is in any event entitled to, even where the transaction involves a net transfer of value from the company. So, for example, the proper distribution of a dividend by a company to a shareholder is not financial assistance even if the dividend is to enable the shareholder to acquire further shares in the company.

Nor does the payment of a debt that is due and payable constitute financial assistance, even if such payment is a condition of the share sale.

Financial assistance is also not given where the seller of the shares is given security by the company for the repayment of a loan made by him or her to the company, the object being the continuation of the loan.

Where a company passes a bond over its property with the direct object of securing, or raising money to pay off or reduce, the seller's loan account, this will not amount to the giving of financial assistance even if the ultimate goal of the

transaction was to facilitate the purchaser's acquisition of the shares by rendering it unnecessary for him or her to purchase the loan account along with the shares.

A distinction is drawn between the 'ultimate goal' of a transaction and its 'direct object', and it is only the direct object that is relevant. If the direct object is not the provision of financial assistance by the company for the purposes of or in connection with a purchase of its shares, then it is irrelevant that the ultimate goal of the transaction was to enable a person to purchase such shares.

A test that has been used to determine whether a company has given financial assistance for the acquisition of its shares is the so-called 'impoverishment test'. This involves asking whether the transaction in question has made the company poorer. If so, there has been financial assistance.

The impoverishment test has come in for a great deal of criticism and has been much debated. In *Lipschitz NO v UDC Bank Ltd* [55] the Appellate Division referred to the criticism and held that it was not convinced of the generality of the acceptance of the impoverishment test. Such an interpretation, the court said, unduly narrowed and restricted the terms of the Act which 'expressly and unequivocally includes within the meaning of 'financial assistance' acts not necessarily nor even probably involving impoverishment of the company'.

It has been held that the issue is whether 'in a practical business sense' financial assistance was given for the purpose of or in connection with the acquisition of the shares.

Where an agreement is not genuine but is disguised in order to hide the true agreement (which is to provide financial assistance), the court will give effect to the true position, for example, where a company creates a fictitious debt to the seller or enters into a fictitious service contract with the seller.

Financial assistance will also have been given where the company purchased an asset at an inflated price or where the asset was not required for the purposes of its business, [56] even if a fair price was paid. [57] Where, however, the asset is bought by the company in the ordinary course of business in the genuine belief that the purchase is a good commercial proposition and the seller subsequently uses the proceeds to purchase shares in the company, there would be no financial assistance.

Where it is a condition of a share sale that the company whose shares are being sold will pay an excessive rental to the seller in respect of a lease agreement between the company and the seller, financial assistance will have been given.

10.5.4 The meaning of 'for the purpose of or in connection with'

Section 44 of the Act, like its predecessor s 38 of the 1973 Act, regulates the provision of financial assistance 'for the purpose of' or 'in connection with' the acquisition of the securities referred to. The two elements are linked to form a single prohibition, but although so linked they are vitally different in concept.

The impoverishment test, although not the sole test to determine what is meant by 'financial assistance', may be relevant and helpful in deciding whether such

assistance was given 'for the purpose of or in connection with' the purchase of the company's shares. Knowing the financial position of the company and of others involved may also be useful in this regard.

A distinction must be drawn between the 'purpose' and the 'motive' or 'reason' why a purpose is formed. Motive is not the same as purpose. [58] Thus in *Brady v Brady* [59] the UK's House of Lords said:

> If one postulates the case of a bidder for control of a public company financing his bid from the company's own funds, the obvious mischief at which the section is aimed, the immediate purpose which it is sought to achieve is that of completing the purchase and vesting control of the company in the bidder. The reasons why that course is considered desirable may be many and varied. The company may have fallen on hard times so that a change of management is considered necessary to avert disaster. It may merely be thought, and no doubt would be thought by the purchaser and the directors whom he nominates once he has control, that the business of the company will be more profitable under his management than it was heretofore ... but ... the purpose and the only purpose of the financial assistance is and remains that of enabling the shares to be acquired and the financial or commercial advantages flowing from the acquisition, are a by-product of it rather than independent purpose of which the assistance can properly be considered to be an incident.

The meaning of the words 'in connection with' was dealt with by the Appellate Division in *Lipschitz NO v UDC Bank Ltd*. [60] The court said the meaning of the words was profoundly affected by the concept 'for the purpose of' to which it was an alternative. The words appeared to have been inserted to cover a situation where, although the actual purpose of the company in giving financial assistance might not have been established, the conduct of the company nevertheless stood in such close relationship to the purchase of its shares that substantially, if not precisely, its conduct was similar to that of a company that was giving the forbidden assistance with the purpose described in the section. The words had been inserted merely to close possible loopholes and not to create a different type of offence, or a lesser offence, or to prohibit conduct that was not substantially similar to the conduct prohibited by the main provision characterised by the words 'for the purpose of'. The exact extent of the enlargement of the scope of the prohibition could obviously not be defined, everything depending upon the facts peculiar to each individual case. However, it could be said that, where the purpose of the company was something other than the purchase of its shares, there would in general be little room for a finding that the act had nevertheless been performed 'in connection with' the purchase of shares.

The court gave the following example. Company A, for its own purposes, guarantees B's overdraft at a bank so as to enable B to carry on his business of manufacturing certain equipment which Company A necessarily requires for its business and which equipment it purchases from B. Company A knows at the time of giving the guarantee that B, who has confidence in the stability and management of his company, intends to invest in shares in Company A the surplus profits he will make as a result of being able to continue his manufacturing business by reason of the overdraft facilities made available to him by virtue of A's guarantee. The guarantee given by A clearly amounts to the giving of financial assistance to B, but not at all for the purpose of the purchase of the company's shares; its purpose, clearly established, was to enable B to continue producing the equipment required by A. In such a case there would be no room for finding that, because A knew of B's ultimate intention regarding the purchase of shares in the company, the financial assistance given by A, although not given for the purpose of purchasing shares but for a different purpose, was nevertheless 'in connection' with the purchase of shares and was therefore in contravention of the section.

Where a seller's credit loan account was being sold as well as his or her shares, it was held in relation to s 38 of the 1973 Act that financial assistance by the company to purchase the loan account would not infringe s 38, even though it facilitated the purchase of the shares. [61] In such circumstances the financial assistance could not be construed as being 'in connection with' the purchase of the shares. [62] Nor was s 38 contravened where, through a reciprocal arrangement, Company A gave financial assistance for the purchase of shares in Company B and Company B gave financial assistance for the purchase of shares in Company A. [63]

10.5.5 Purchase of or subscription for securities

Section 44 regulates financial assistance for the 'purchase' of or 'subscription' for 'securities' and not only 'shares'.

Section 1 of the Act provides that 'securities' means any shares, debentures or other instruments, irrespective of their form or title. The definition is wide and would include, for example, notes, derivative instruments, bonds, and debentures.

The reference to 'purchase' and 'subscription' makes it clear that s 44 applies where a company-

(i) assists a person in purchasing a security in the company from the holder of the security; and
(ii) assists a person in acquiring a security in the company from the company itself (in other words, where the person subscribes to the company for the security).

Section 44 is concerned only with a purchase or a subscription. If the financial assistance relates to any other transaction, the section is not operative. Accordingly, where the financial assistance relates to the cancellation of a share sale [64] the section is not applicable.

Section 44 also applies to financial assistance provided for the subscription of any 'option'.

10.5.6 Authority for provision of financial assistance

The opening words of s 44(2) are: 'Except to the extent that the Memorandum of Incorporation of a company provides otherwise, the board may authorise' the provision of financial assistance as envisaged by s 44.

Section 44(2) gives the authority to provide financial assistance to the board of directors. However, the opening words of s 44(2) indicate the legislature's intention that the Memorandum of Incorporation may remove or substitute the board's authority (for example by the authority of the members in general meeting) or qualify or restrict it in some way. This is borne out by s 44(4), which provides that the board must ensure that 'any conditions or restrictions respecting the granting of financial assistance set out in the company's Memorandum of Incorporation have been satisfied'.

10.5.7 Requirements of s 44(3) and (4)

Irrespective of what the Memorandum of Incorporation may say, financial assistance is prohibited unless the requirements set out in s 44(3) and (4) are met. The requirements, all of which must be complied with, are:

(i) The particular provision of financial assistance must be pursuant to an employee share scheme that satisfies the requirements of s 97, [65] or pursuant to a special resolution of the shareholders, adopted within the previous two years, which approved such assistance either for the specific recipient, or generally for a category of potential recipients, and the specific recipient falls within that category. [66]

(ii) The board must be satisfied that immediately after providing the financial assistance, the company would satisfy the solvency and liquidity test.

(iii) The board must be satisfied that the terms under which the financial assistance is proposed to be given are fair and reasonable to the company. [67]

10.5.8 Extension to a 'related or inter-related' company

Section 44 of the Act applies to financial assistance by a company for the acquisition, not only of securities in itself, but also of securities in 'a related or inter-related company'. [68] This goes much further than s 38 of the 1973 Act, which only covered financial assistance by a company for the acquisition of shares in itself or its holding company. An obvious example of the new extended ambit of s 44 is that, whereas in the 1973 Act there was no bar to a company providing financial assistance for the purchase of shares in its subsidiary or a fellow subsidiary, these transactions now fall squarely within the ambit of s 44.

10.5.9 Consequences of contravention of section 44

10.5.9.1 Voidness

Section 44(5) of the Act provides that a board decision or agreement to provide financial assistance is void to the extent that the provision of that assistance would be inconsistent either with s 44 or with any conditions or restrictions in respect of the granting of financial assistance set out in the Memorandum of Incorporation of the company.

10.5.9.2 Criminal consequences

Section 44 of the Act contains no criminal liability provision. A punitive sanction that appears possible is a fine of an administrative nature flowing from a failure to comply with a compliance notice issued by the Companies and Intellectual Property Commission established in terms of s 185 of the Act. [69]

10.5.9.3 Liability of directors

A director who participates in an unlawful provision of financial assistance may be liable for any loss, damages or costs sustained by the company as a direct or indirect consequence thereof. [70]

10.5.9.4 Shareholders' remedies

Section 44 of the Act, which deals with financial assistance, does not provide shareholders with any remedy. However, there are two general remedies which shareholders could use when faced with an unlawful provision of financial assistance by their company:

(i) Each shareholder of a company has a claim for damages against any person who causes the company to do anything inconsistent with the Act, or with a limitation, restriction or qualification in the Memorandum of Incorporation, unless that action has been ratified by the shareholders. [71]

(ii) Any person who contravenes any provision of the Act is liable to any other person for any loss or damage suffered by that person as a result of that contravention. [72]

It is unfortunate that liability is not extended to the directors of the holding company of the company contravening s 44. After all, they are usually the main culprits.

10.6 Financial assistance to directors and others

10.6.1 Introduction

Those in control of a company's finances are in a position of power, a position that has the potential for abuse, particularly where the company provides the controllers with loans or security. Recognising this potential for abuse, the Act regulates certain transactions by allowing them only if certain requirements are satisfied and requiring disclosure in a company's financial statements of the particulars of some of these transactions. [73]

The provisions cast their tentacles wide, drawing in an extensive range of transactions, as well as parties to such transactions, to which the provisions apply. The extent of this range is such that a vigilant, law-abiding company is faced with an onerous task in ensuring that it has complied with the law. The transactions that are regulated are transactions providing 'financial assistance' to the 'controllers' of the company and, as will be seen below, the Act casts its net wider than just directors. [74]

10.6.2 Financial assistance

'Financial assistance', in this context, is defined in the Act. [75] It includes-

(i) lending money;
(ii) guaranteeing a loan or other obligation; and
(iii) securing any debt or obligation.

The definition, however, excludes-

(i) lending money in the ordinary course of business by a company whose primary business is the lending of money;
(ii) an accountable advance to meet–
  - legal expenses in relation to a matter concerning the company; or
  - anticipated expenses to be incurred by the person on behalf of the company;
(iii) an amount to defray the person's expenses for removal at the company's request.

The definition is not exhaustive of the forms that financial assistance may take. Transactions such as donations, sales at discounted prices and leases at favourable rentals appear to be 'financial assistance', as well as the giving of abnormal credit.

The precise ambit of 'financial assistance' is not clear. A similar problem arose in relation to s 38 of the 1973 Act, which made it unlawful for a company to assist financially in the acquisition of its own shares or shares in its holding company 'by means of a loan, guarantee, the provision of security or otherwise'. [76] A fair amount of case law built up with regard to what fell within the ambit of the words 'or otherwise' in s 38, which may have a role to play in determining the scope of financial assistance in s 45. It must of course be borne in mind that financial assistance in the context of s 38 was more limited than it is in the current s 45 because, to fall foul of s 38, it had to be for the purpose of, or in connection with, the acquisition of shares. For s 45 to operate the objective of the assistance is, of course, irrelevant.

10.6.3 Who must be financially assisted?

The persons who may not be provided with financial assistance, unless the requirements of s 45 are satisfied, are described as follows, using Company X as the company providing the assistance:

- (i) a director or prescribed officer of Company X;
- (ii) a director or prescribed officer [77] of a company related or inter-related to Company X;
- (iii) a company or corporation that is related to or inter-related to Company X;
- (iv) a member of a corporation that is related to or inter-related to Company X;
- (v) a person related to Company X or related to any of the persons in (i) to (iv).

The 'related' and 'inter-related' relationships referred to in (ii) to (v) above are defined in s 2 of the Act and are dealt with in Chapter 8: Groups of companies and related persons.

It will be recognised immediately that s 45 is aimed at financial assistance provided not only to individuals but also to certain companies and corporations.

As can be seen from the wide definition of 'related' and 'inter-related' persons, [78] s 45 of the Act casts its net very wide. The extent of its operation is tempered to some extent by s 2(3), which enables a court, the Companies Tribunal or the Panel to exempt any person from the operation of s 45 if there is sufficient evidence that the 'related' or 'inter-related' relationship is such that the person acts independently of the related or inter-related person. It follows that if, for example, a company makes a loan to its subsidiary, or to a director thereof (his or her sole directorship), because the company acts independently of the subsidiary (and the director), it is possible that the company may be exempted from the operation of s 45 by invoking s 2(3). However, it may not always prove to be factually or legally simple to determine whether companies are related or inter-related, especially in complex group structures. Although s 2(3) provides relief, the onus remains on the company to prove it is acting independently and, even if such an application is not made or proves unnecessary, the directors will need to apply their minds to determine whether a particular transaction falls within the ambit of s 45 or not. This may prove to be difficult, time-consuming and expensive for the company, and may make the practical application of s 45 challenging, without necessarily providing significant additional protection for creditors and shareholders.

10.6.4 The requirements of s 45

As mentioned above, a number of requirements or conditions must be satisfied to avoid a contravention of s 45, despite anything to the contrary contained in the Memorandum of Incorporation. [79] The requirements or conditions are those prescribed by s 45 and the Memorandum of Incorporation. [80] The Memorandum of Incorporation may also prohibit or restrict the provision of financial assistance generally or particular transactions that constitute financial assistance. [81] In summary, the requirements of s 45 that must be met in order to avoid a contravention of the section are:

(i) the financial assistance must be pursuant to an employee share scheme [82] or pursuant to a special resolution; [83]

(ii) the solvency and liquidity test must be satisfied; [84] and

(iii) written notice to shareholders and any trade union representing its employees must be given by the board if it adopts a resolution to provide financial assistance. [85]

10.6.5 The consequences of contravening s 45

A contravention of s 45 has no criminal consequences, in keeping with the Act's clearly evident policy of decriminalising company law.

A resolution by the board to provide financial assistance or an agreement with respect to the provision of any such assistance is void to the extent that the provision of that assistance would be inconsistent with the Act or a prohibition, condition or requirement regarding financial assistance in the company's Memorandum of Incorporation. [86]

The Act imposes liability on any director who was present at the meeting when the board approved the resolution or agreement, or, where no formal board meeting was held, participated in the making of such a decision by way of a 'round robin' resolution. [87] The liability arises if the director failed to vote against the resolution, despite *knowing* that the provision of financial assistance was inconsistent with s 45 or the company's Memorandum of Incorporation. [88] Liability accordingly hinges on a subjective enquiry into the director's knowledge at the relevant time.

The liability of directors is liability for any loss, damages or costs sustained by the company as a direct or indirect consequence of the voidness of the resolution or agreement. [89]

If the board of a company has made a decision contrary to s 45 the company, or any director who has been or may be held liable, may apply to a court for an order setting aside the decision. [90]

The proceedings to recover any loss, damages or costs may not commence more than three years after the act or omission that gave rise to the liability took place. [91]

10.6.6 Disclosure in the annual financial statements

The Act contains disclosure provisions. A company which is required to be audited is required in terms of s 30(4) to include in its annual financial statements particulars showing the remuneration received by each director, or individual holding any prescribed office in the company. [92] The definition of 'remuneration', which is in s 30(6), includes, inter alia, financial assistance to a director, past director or future director, or person related to any of them, for the subscription of shares, as contemplated in s 44.

Questions

1. Karoo (Pty) Ltd, whose sole business is the leasing of building equipment, has an authorised share capital of 100 000 shares, of which 80 000 have been issued at a price of 90 cents each.
    - Karoo is a subsidiary of Mail Ltd.
    - The directors of Karoo are Tom and Dick.
    - The directors of Mail Ltd are Tom and Harry.
    - The rules of Karoo provide that the board shall have unlimited power to make loans and issue shares.

    State, giving reasons, whether the following transactions, which are unrelated, can be legally entered into, and, if so, what legal requirements need to be complied with for each transaction.

    (a) Karoo purchases 5 000 shares in Mail at a price of 80 cents each. The shares are held by Karoo for its own benefit.

    (b) Karoo issues 100 shares to one of its directors at a price of 70 cents each.

    (c) Mail wishes to raise a large sum of money for a new factory through an issue of shares but wishes to avoid the expense and delay of an offer to the public. An investment company, Rope (Pty) Ltd, is willing to subscribe for the bulk of the shares on condition that Karoo provides it with office premises at half rates. Karoo obliges.

    (d) Karoo borrows R60 000 from a bank and Mail guarantees repayment of the loan.

    (e) Karoo decides that it has capital in excess of its needs and accordingly purchases 10 000 of its own shares from Mail at R1 each, the terms of payment being R1 000 per month.

    (f) A loan is made by Karoo to Tom's son for housing purposes.

    (g) Instead of Karoo paying a dividend to Mail, Karoo releases Mail from a debt owing by Mail to Karoo.

    (h) Calto CC is a close corporation controlled by Harry. Karoo makes a loan to Calto.

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[1] Section 37(5)*(c)*.

[2] Section 37(5)*(d)*.

[3] See s 1, where 'distribution' is defined.

[4] Section 1 under 'distribution' para *(a)*(iv) read with s 164(19).

[5] See Chapter 9: Shares, securities and transfer.

[6] See Chapter 16: Public offerings of company securities.

[7] See s 164(19) of the Act read with para *(a)*(iv) of the definition of 'distribution'.

[8] See s 46(1)*(a)*(ii).

[9] See Chapter 9: Shares, securities and transfer.

[10] See s 4.

[11] Section 46(1)*(b)* and *(c)*.

[12] Section 46(3)*(a)*.

[13] Section 46(3)*(b)*.

[14] Section 4.

[15] K van der Linde 'The solvency and liquidity approach in the Companies Act 2008' 2009 *TSAR* 224 at 240.

[16] Section 77(3)*(e)*(vi).

[17] Sections 46(6)*(b)* and 77(3)*(e)*(vii).

[18] Section 77(5)*(a)*.

[19] Section 77(9).

[20] Section 77(7).

[21] Section 77(4)*(b)*.

[22] K van der Linde 'The regulation of distributions to shareholders in the Companies Act 2008' 2009 *TSAR* 484 at 499, 500.

[23] Section 20(4) and (5) of the Act.

[24] Swinfen Eady J in *Ammonia Soda Co Ltd v Chamberlain* [1918] 1 Ch 266; [1916-17] All ER Rep 708 (CA) 713.

[25] *Bishop v Smyrna & Cassaba Railway Co (No 2)* [1895] 2 Ch 596 at 596.

[26] *Dovey v Cory* [1901] AC 477 at 486-7 per Lord Halsbury LC.

[27] MS Blackman et al *Commentary on the Companies Act* (2002) 5-158.

[28] Section 19(1)*(b)*.

[29] Sections 15(2)*(b)* and 20.

[30] Blackman et al (n 27) 5-159.

[31] (1887) 12 App Cas 409 (HL).

[32] See Blackman et al (n 27) 5-49 to 5-61 for a comprehensive analysis and criticism of the reasons used to justify the purposes of repurchases.

[33] Namely ss 46 and 48.

[34] Section 48(1)*(a)*.

[35] Section 48.

[36] Blackman et al (n 27) 5-43.

[37] See 10.3.7 on treasury shares.

[38] See further below.

[39] Section 48(3)*(a)*.

[40] See below.

[41] Section 48(3)*(b)*.

[42] Section 48(4).

[43] Section 48(6).

[44] Section 48(7).

[45] Section 89 of the 1973 Act.

[46] Section 48(2)*(b)*.

[47] Section 48(2)*(b)*(i).

[48] Section 46.

[49] Section 48(6).

[50] Section 77(4).

[51] Section 48(2)*(b)*(ii).

[52] Section 44.

[53] Section 44(1).

[54] Section 44(2).

[55] 1979 (1) SA 789 (A).

[56] *Gradwell (Pty) Ltd v Rostra Printers Ltd* 1959 (4) SA 419 (A) 425.

[57] *S v Hepker* 1973 (1) SA 472 (W) 479.

[58] *Independent Steels (Pty) Ltd v Ryan* (1989) 15 ACLR 518 SC (Vic) 524.

[59] [1988] 2 All ER 617 (HL) 633.

[60] 1979 (1) SA 789 (A) 804-5.

[61] *Lipschitz NO v UDC Bank Ltd* 1979 (1) SA 789 (A) 806.

[62] Ibid.

[63] Ibid.

[64] *Pires v American Fruit Market (Pty) Ltd* 1952 (2) SA 337 (T).

[65] Section 44(3)*(a)*(i).

[66] Section 44(3)*(a)*(ii).

[67] Section 44(3)*(b)*.

[68] See s 2 of the Act as to what constitutes a 'related or inter-related person'. In this regard, see Chapter 8: Groups of companies and related persons.

[69] Section 171 of the Act. An administrative fine may be imposed by the court in an amount not exceeding the greater of 10 per cent of the respondent's annual turnover during the preceding financial year and an amount to be prescribed by the Minister by way of regulation subject to a maximum fine of R1 000 000. See s 175(1) of the Act. The constitutionality of the administrative fine may be questionable.

[70] Section 44(6).

[71] Section 20(6).

[72] Section 218(2).

[73] Sections 30 and 45.

[74] Section 45.

[75] Section 45(1).

[76] Similar wording is to be found in s 44(2), the new Act's counterpart to s 38 of the 1973 Act. See 10.5.

[77] A 'prescribed officer', in terms of s 1 of the Act, 'means the holder of an office, within a company, that has been designated by the Minister in terms of section 66(11)'.

[78] See Chapter 8: Groups of companies and related persons.

[79] Section 45(3).

[80] Section 45(4).

[81] Section 45(2) and (4).

[82] Section 45(3)*(a)*(i). The scheme must satisfy the requirements of s 97.

[83] Section 45(3)*(a)*(ii).

[84] Section 45(3)*(b)*(i). See 10.2.4.

[85] Section 45(5).

[86] Section 45(6).

[87] Section 45(6).

[88] Section 45(7)*(b)*. See also s 77(3)*(e)*(iv).

[89] Section 45(7) read with s 77(3)*(e)*(v).

[90] Section 77(5)*(a)*.

[91] Section 77(7).

[92] Section 30(4)*(a)*.

Chapter 11
Governance and Shareholders

Rehana Cassim

11.1 Introduction

The shareholders of a company are one of the organs of a company. The other organ of a company is the board of directors. The shareholders are required to make certain substantive decisions regarding the management of the company. These decisions are made at a shareholders' meeting. Just as the shareholders cannot make decisions which are required to be made by the directors, the directors cannot make those decisions that are required to be made by the shareholders.

The Companies Act 71 of 2008 ('the Act') sets out procedural rules relating to the convening of shareholders' meetings, the provision of notice of meetings, attendance at meetings, the conduct of meetings, the passing of resolutions and voting at meetings. It is essential that these formalities be complied with so that the business transacted at a shareholders' meeting is not open to challenge on the grounds of non-compliance with the formalities, or because of irregularities in the proceedings - even though in some instances compliance with certain formalities is waived. These issues are discussed in this chapter.

11.2 Shareholders

11.2.1 Definition of 'shareholder'

A shareholder is a person who holds at least one share issued by the company and is entered as a shareholder in the securities register of the company.

The terms 'shareholder' and 'member' have traditionally been used interchangeably, but the Act now does away with this interchangeability of the terms. The term 'member' is no longer used when referring to a 'shareholder'. Instead, the Act uses the term 'member' only in respect of non-profit companies.

11.2.2 Securities register

Every profit company must keep a securities register, which is a register of its issued securities. 'Securities' are widely defined in s 1 of the Act to mean any shares, debentures or other instruments, irrespective of their form or title, issued or authorised to be issued by a profit company. The register must contain certain information about each class of securities that has been issued, such as the names and addresses of the persons to whom the securities were issued, the number of securities issued to each person and the date on which the securities were issued. [1] A non-profit company must keep a register of members.

The securities register may be a certificated one or an uncertificated register. A certificated register is one where the securities issued by the company are evidenced by a certificate, whereas an uncertificated register is one in which the company does not issue certificates evidencing title to those securities. [2] If a company has issued uncertificated securities or has issued securities that have ceased to be certificated, a record must be administered and maintained by a participant or central securities depository (CSD) in the prescribed form, as the company's uncertificated securities register, and this forms part of that company's securities register. [3]

11.2.3 Beneficial and registered shareholders

Except to the extent that a company's Memorandum of Incorporation provides otherwise, a company's issued securities may be held by, and be registered in the name of, one person for the beneficial interest of another person. [4] The beneficial shareholder is entitled to the rights attached to the share while the registered shareholder is the person in whose name the share happens to be registered. Such a person is also known as a nominee. Thus even if a person's name is in the securities register it does not necessarily mean that they own the shares, as that person could be the registered shareholder of the shares but not the beneficial shareholder.

There are several reasons why a person may not want the shares of a company to be registered in his or her own name. One reason may be that the person wishes to keep his or her identity unknown. Another reason may be where the directors of a

company may refuse the registration of the transfer of shares and, in order to circumvent this refusal, the seller of the shares may become the registered shareholder while the purchaser becomes the beneficial shareholder. Another example is where a financial or other institution acts as the registered shareholder on behalf of numerous investors in a number of different shares.

The company is not obliged to take notice of the fact that the registered shareholder holds the shares as nominee on behalf of another person. But problems that may arise out of shares being held by registered shareholders are that insider trading becomes very difficult to detect; minority shareholders are unable to detect a change in the controlling shareholder; the board of directors and shareholders are not in a position where they may be forewarned of a hostile takeover; competition legislation is difficult to administer; and a company itself does not know who a large percentage of its shareholders are, which makes communication with all the shareholders virtually impossible. [5] Thus there are good reasons why the identity of the beneficial owner of the shares in a public company should be accessible to those who wish to know it. Disclosure also protects the public, because it promotes market transparency and maintains a free and fair regulated securities market. [6]

Accordingly, in terms of the Act, the registered shareholder is required to disclose to the company, in writing, the identity of the beneficial shareholder and the number and class of securities held for the beneficial shareholder. [7] This information must be disclosed within five business days after the end of every month during which a change has occurred in the information relating to beneficial shareholding or more promptly or frequently to the extent so provided by the requirements of a CSD. The information must otherwise be provided on payment of a prescribed fee charged by the registered holder of securities. [8] Accordingly, if there is nothing new to disclose, disclosure need not be made. But this is subject to the rules of a CSD - disclosure will have to be made more promptly or frequently if the rules of a CSD so provide.

Any company that knows or has reasonable cause to believe that any of its securities are held by one person for the beneficial interest of another may by notice in writing require either of those persons to-

(i) confirm or deny that fact;
(ii) provide particulars of the extent of the beneficial interest held during the three years preceding the date of the notice; and
(iii) disclose the identity of each person with a beneficial interest in the securities held by that person. [9]

This information must be provided not later than ten business days after receipt of the notice.

Regulated companies must establish and maintain a register of the disclosures made regarding the beneficial interests in securities. [10]

Regulated companies are companies to which the Takeover Regulations are applicable. A regulated company must also publish in its annual financial statements (if it is required to have such statements audited) a list of the persons who hold beneficial interests equal to or in excess of 5 per cent of the total number of securities of that class issued by the company, together with the extent of those beneficial interests. [11]

11.3 Record date for determining shareholder rights

The board of directors must set a record date for the purposes of determining who is entitled to receive notice of a shareholders' meeting; to participate in and vote at a meeting; to decide matters by written consent or electronic communication; to exercise pre-emptive rights; to receive distributions; and to be allotted or exercise other rights. [12] This is particularly important when the shares of a company are constantly being traded.

The record date must not be set too far in advance of the meeting because if shares are traded between the record date and the date of the meeting, persons who are no longer shareholders at the date of the meeting would be entitled to vote and those who have become shareholders after the record date would not be entitled to vote (save by instructing the shareholder on record how to vote). The record date may not be more than ten business days before the date on which the event or action for which the record date is set is scheduled to occur. [13] Note that the record date may not be earlier than the date on which it is determined, ie it may not be retrospective.

Should the board of directors fail to determine a record date for any action or event, unless the Memorandum of Incorporation or rules provide otherwise, the record date would be, in the case of a meeting, the latest date by which the company is required to give notice to the shareholders of that meeting, or, in any other event, the date of the action or event. [14]

11.4 Instances where compliance with formalities is not required

In the three instances discussed below, in order for decisions to be made by the shareholders, the formalities of holding a meeting are not required to be followed.

11.4.1 Unanimous assent at common law

At common law, the doctrine of unanimous assent permits informal methods of giving shareholder consent. This doctrine allows shareholders to take decisions by unanimous agreement without the need for a formal meeting or without having to observe all the formalities which shareholders' meetings usually entail, such as the giving of notice. Decisions may be taken by unanimous assent provided all the shareholders are fully aware of what is being done and they have all assented to it. For instance, in *Gohlke & Schneider v Westies Minerale (Edms) Bpk* [15] the then Appellate Division held that the shareholders of a company could validly appoint a director to the board without any formal meeting being held by virtue of their unanimous assent, as evidenced by a contract signed by all of them.

The doctrine of unanimous assent is particularly useful in small companies. Note that the principle of unanimous assent may not be used to do something that the shareholders do not have the power to do in a shareholders' meeting, nor can it be relied on to obtain an illegal outcome.

11.4.2 Companies with one shareholder

Where a profit company (other than a state-owned company) has only one shareholder, that shareholder may exercise the voting rights pertaining to that company on any matter at any time, without complying with the formalities of notice or any internal formalities, except to the extent that the company's Memorandum of Incorporation provides otherwise. Furthermore, ss 59 to 65 of the Act, relating to shareholders' meetings, notices of meetings and resolutions, do not apply to the governance of that company. [16]

11.4.3 Companies in which every shareholder is also a director

If every shareholder of a company (other than a state-owned company) is also a director of that company, in terms of the Act any matter that is required to be referred by the board of directors to the shareholders for a decision may be decided by the shareholders at any time after being referred by the board, without notice or compliance with any other internal formalities, except to the extent that the Memorandum of Incorporation provides otherwise. [17] But this is subject to the following requirements being fulfilled:

(i) Every such person must have been present at the board meeting when the matter was referred to them in their capacity as shareholders.
(ii) Sufficient persons must be present in their capacity as shareholders to satisfy the quorum requirements of the Act.
(iii) A resolution adopted by such persons in their capacity as shareholders must have at least the support that would have been required for it to be adopted as an ordinary or a special resolution, as the case may be, at a properly constituted shareholders' meeting.

This provision is very useful in small companies where the shareholders and the directors are the same persons. By permitting the board meeting and the shareholders' meeting to be rolled into one, the section conveniently disposes of unnecessary and superfluous compliance with internal formalities. But a distinction is made between decisions taken in the capacity of a director and those taken in the capacity of a shareholder in that, when acting in the capacity of a shareholder, such persons are not subject to the provisions of ss 73 to 78 of the Act relating to the duties, obligations, liabilities and indemnification of directors.

Note that in terms of s 30(2A) of the Act, companies in which the shareholders and directors are the same persons, are exempt from having their annual financial statements audited or independently reviewed. [18]

11.5 Proxies

A shareholder is not obliged to personally attend a shareholders' meeting and to personally vote on resolutions. Instead, he or she may appoint a proxy to attend, participate in, speak and vote on his or her behalf at a shareholders' meeting. Proxy appointments are essential and very useful because in practice many shareholders do not or are not able to attend meetings. Note that the appointment of a proxy is not in itself a vote until it is actually acted upon, ie until the vote is actually cast.

11.5.1 Persons who may be appointed as proxies

Any individual may be appointed as a proxy, including an individual who is not a shareholder of the company. [19] Except to the extent that the Memorandum of Incorporation provides otherwise, there is no limit to the number of proxies that may be appointed and a shareholder may appoint two or more persons concurrently as proxies, and may appoint more than one proxy to exercise voting rights attached to different securities held by the shareholder. [20] Except to the extent that the Memorandum of Incorporation provides otherwise, a proxy may delegate his or her authority to act on behalf of a shareholder to another person, subject to any restrictions set out in the instrument appointing the proxy. [21]

11.5.2 Procedure to appoint a proxy

A proxy appointment must be in writing and must be dated and signed by the shareholder appointing the proxy. [22] Except to the extent that the Memorandum of Incorporation of a company provides otherwise, a copy of the instrument appointing a proxy must be delivered to the company, or to any other person on behalf of the company, before the proxy exercises any rights of the shareholder at a shareholders' meeting. [23] It seems that the proxy appointment may be delivered to the company electronically. The Act does not stipulate a time period within which the proxy appointment must be delivered to the company. Presumably, proxy appointments may be handed in at the meeting.

11.5.3 Validity of the proxy appointment

A proxy appointment remains valid for one year after the date on which it was signed, or for any longer or shorter period expressly set out in the appointment. [24] This period of appointment is subject to the proxy appointment not being revoked by the shareholder or expiring at an earlier period. [25]

11.5.4 Delivery of notices to proxy

Notices from the company to the shareholder must be delivered to the shareholder and not to the proxy or proxies. Notices are only to be delivered to the proxy or proxies if the shareholder has directed the company in writing to do so and has paid any reasonable fee charged by the company for doing so. [26]

11.5.5 Voting

A proxy may vote as he or she thinks fit, unless the Memorandum of Incorporation provides otherwise or unless the shareholder in question has indicated, on the proxy form, the manner in which the proxy should vote. [27] A proxy is entitled to vote on a show of hands or on a poll. A shareholder may instruct a proxy to vote for or against a resolution or to abstain from voting altogether.

11.5.6 Revocation of the proxy appointment

A proxy appointment may be revoked, unless the proxy appointment expressly states otherwise. [28] If the appointment is revocable, a shareholder may revoke it by cancelling the appointment in writing or by appointing a different person as the proxy, and delivering a copy of the revocation instrument to the originally appointed proxy and to the company. [29] Once the proxy appointment is revoked the proxy may no longer act on behalf of the shareholder. The guiding principle is that every proxy is subject to an implied condition that the proxy should only be used if the shareholder is unable to attend the meeting. Thus a proxy appointment may be suspended at any time and to the extent that the shareholder chooses to act directly and in person to exercise any of his or her rights as a shareholder. [30]

11.5.7 Company-sponsored invitations to appoint a proxy

A company may invite shareholders on the proxy appointment form to appoint a proxy from a list of names provided by the company. [31] Such an invitation must be sent to every shareholder who is entitled to notice of the meeting at which the proxy is intended to be exercised. The invitation or form of instrument supplied by the company for the purpose of appointing a proxy must bear a reasonably prominent summary of the rights given to the proxy holders. A shareholder is not bound to appoint one of the persons named by the company as a proxy in the prepared proxy form, and may write in the name of a proxy chosen by him or her. The proxy appointment remains valid until the end of the meeting at which it was intended to be used (unless it is revoked earlier by the shareholder). [32]

11.6 Shareholders' meetings

11.6.1 Purpose of a shareholders' meeting

Shareholders' meetings are held in order to provide shareholders with an opportunity to debate and vote on matters affecting the company. The Act gives shareholders at a shareholders' meeting some substantive constitutional and managerial powers. These powers include the power to amend the Memorandum of Incorporation; the power to vote on and approve a rule made by the board of directors relating to the governance of the company; the power to remove directors; the power to fill vacancies on the board of directors; and the power to approve the disposal of all or the greater part of the company's assets or undertaking.

11.6.2 Distinction between a shareholders' meeting and an annual general meeting

A distinction is drawn in the Act between a shareholders' meeting and an annual general meeting (AGM). Both are meetings of the shareholders, but an AGM is one which is held once a year and at which particular business is required to be conducted. A public company must convene an AGM, but the Act no longer makes it mandatory for a private company to do so. [33] The minimum business that must be transacted at an AGM comprises the following: [34]

(i) the presentation of the directors' report, [35] the audited financial statements for the immediately preceding financial year and an audit committee report;
(ii) the election of directors, to the extent required by the Act or the company's Memorandum of Incorporation;
(iii) the appointment of an auditor for the ensuing financial year and the appointment of an audit committee; and
(iv) any matters raised by the shareholders, with or without advance notice to the company.

The business transacted at an AGM may go beyond the matters listed above, provided the business is properly put before the shareholders.

A public company must convene an AGM of its shareholders no more than 18 months after the company's date of incorporation. Thereafter, it must convene an

AGM once in every calendar year, but no more than 15 months after the date of the previous AGM, or within such an extended time permitted by the Companies Tribunal on good cause being shown. [36]

The shareholders are given wide powers at the AGM in that they are able to raise any matters of their own at the meeting, without having to give advance notice to the company of these matters, and to express their views on matters relating to the company's affairs. The AGM is a key mechanism for promoting transparency and accountability in the management of the company's affairs. It gives shareholders an opportunity to question the directors on various issues relating to the company's affairs. In practice, though, many shareholders, particularly shareholders of public listed companies, do not attend the AGM as they are usually widely dispersed throughout the country and indeed the world, and it would be impractical to do so. Accordingly, most shareholders, particularly institutional investors, decide on their votes before the meeting and simply appoint proxies to vote on resolutions at meetings. Thus in practice the AGM is not always the forum for debating, information exchange and decision-making that it was intended to be.

11.7 Convening a shareholders' meeting

11.7.1 Persons who may convene a shareholders' meeting

The board of directors or any other person specified in the company's Memorandum of Incorporation or rules may at any time convene a shareholders' meeting. [37]

11.7.2 Instances when a company must hold a shareholders' meeting [38]

A company must hold a shareholders' meeting in the following instances:

11.7.2.1 When the board of directors is required by the Act or the Memorandum of Incorporation to refer a matter to the shareholders for decision

11.7.2.2 When a vacancy on the board is required to be filled

If a vacancy arises on 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 if the director who held the post had been appointed to the post by a person named in or determined in terms of the Memorandum of Incorporation, or by a new election. [39] The election must be conducted at the next AGM of the company or, if the company is not required to hold AGMs, the vacancy must be filled within six months after it arose, either at a shareholders' meeting called for the purpose of electing the director, or by a written polling of all the shareholders who are entitled to vote in the election of that director. If, as a result of a vacancy arising on the board of directors, there are no remaining directors of a company, any shareholder who is entitled to vote in the election of a director may convene a meeting for the purpose of such an election. [40]

11.7.2.3 When one or more written and signed demands for a shareholders' meeting are delivered to the company

A shareholders' meeting must be called by the board of directors or any other person specified in the company's Memorandum of Incorporation or rules if one or more written and signed demands for such a meeting are delivered to the company by the shareholders. [41] Some points to note about calling a meeting in this way are the following:

(i) The demand must be substantially for the same purposes and must be signed by holders of at least 10 per cent of the voting rights entitled to be exercised in relation to the matter proposed to be considered at the meeting. [42]

(ii) The Memorandum of Incorporation may specify a lower but not a higher threshold than 10 per cent. [43]

(iii) The demand must describe the specific purpose for which the meeting is proposed, and matters not stated in the demand may not be dealt with at the meeting.

(iv) The company or any shareholder of the company may apply to court for an order setting aside the demand for a meeting on the grounds that the demand is frivolous, or calls for a meeting for no other purpose than to reconsider a matter that has already been decided by the shareholders, or is otherwise vexatious. [44]

(v) A shareholder who called a meeting by means of a demand may withdraw that demand before the meeting commences.

(vi) Where a demand for a meeting is withdrawn the company must cancel the meeting if the voting rights of any remaining shareholders continuing to demand the meeting fall below the minimum percentage of voting rights to call a meeting. [45]

11.7.2.4 When an annual general meeting of the shareholders is required to be convened

11.7.2.5 Whenever required by the company's Memorandum of Incorporation

11.7.3 Failure to convene a meeting

If a company is unable to convene a shareholders' meeting (including an AGM) because it does not have any directors, or because all its directors are incapacitated, any person authorised by the Memorandum of Incorporation may convene the meeting. [46] If no such person is so authorised, any shareholder may request the Companies Tribunal to issue an administrative order for a shareholders' meeting to be convened on a date, and subject to any terms, that the Tribunal considers appropriate in the circumstances. [47]

Where a company fails to convene a meeting for any reason (other than that it had

no directors or that all its directors were incapacitated) at a time (i) required in accordance with its Memorandum of Incorporation; (ii) required by demand by the shareholders, or (iii) within the time period required for a public company to convene an AGM, a shareholder may apply to court for an order requiring the company to convene a meeting on a date and subject to any terms that the court considers appropriate in the circumstances. [48] However, this power is generally only exercised by the court in exceptional circumstances because the general policy of the courts has been not to interfere with the internal domestic affairs of the company in instances where the company ought to be able to regulate its own affairs by appropriate resolutions of a majority of shareholders.

The company must compensate a shareholder who applies to the Companies Tribunal or to court to convene a meeting for the costs of those proceedings. [49]

Note that a failure by a company to hold a shareholders' meeting would affect neither the existence of the company, nor the validity of any action taken by the company. [50]

11.8 Notice of meetings

A company must deliver a notice of each shareholders' meeting in the prescribed manner and form to all the shareholders of the company as at the record date. [51] A notice may be transmitted electronically directly to a shareholder.

11.8.1 Period of notice

In the case of a public company or a non-profit company that has voting members, the notice of each shareholders' meeting must be delivered at least 15 business days before the meeting is to begin. In any other case the notice must be delivered at least ten business days before the meeting is to begin. [52] A company's Memorandum of Incorporation may provide for a longer or shorter minimum notice period. A company may call a meeting with shorter notice subject to the provisos that every person who is entitled to exercise voting rights in respect of any item on the meeting agenda is present at the meeting and votes to waive the required minimum notice of the meeting. [53]

11.8.2 Content of notice

The shareholders must be given sufficient information about the meeting in order to decide whether to attend the meeting, personally, by proxy or at all, and whether to vote in favour of or against the proposed resolutions. For these reasons the notice of the meeting must be in writing and must include the following information: [54]

(a) the date, time and place for the meeting and the record date for the meeting;

(b) the general purpose of the meeting, as well as any specific purpose for which a meeting may have been demanded by the shareholders (if applicable);

(c) a copy of any proposed resolution of which the company has received notice, and which is to be considered at the meeting, and a notice of the percentage of voting rights that would be required for that resolution to be adopted;

(d) a reasonably prominent statement that–

(i) a shareholder entitled to attend and vote at the meeting is entitled to appoint a proxy to attend, participate in and vote at the meeting in the place of the shareholder, or two or more proxies if the Memorandum of Incorporation so permits;
(ii) a proxy need not be a shareholder of the company; and
(iii) section 63(1) of the Act requires that participants at the meeting provide satisfactory identification.

In the case of an AGM of a company the notice must include the financial statements to be presented or a summarised form thereof, as well as directions on how to obtain a copy of the complete annual financial statements for the preceding financial year. [55]

11.8.3 Defects in the notice

A distinction is drawn between a material defect and an immaterial defect in the notice of a shareholders' meeting. An immaterial defect in the form or manner of giving notice, or an accidental or inadvertent failure in the delivery of notice to any particular shareholders to whom it was addressed, would not invalidate any action taken at the meeting. [56]

However, if the defect in the giving of notice is material, the meeting may proceed only if every person who is entitled to exercise voting rights in respect of any item on the meeting agenda is present at the meeting (in person or proxy) and votes to approve the ratification of the defective notice. [57] If the material defect in the form or manner of giving notice relates only to one or more particular matters on the agenda for the meeting, such matter or matters may be severed from the agenda and the notice would remain valid with respect to any remaining matters on the agenda. The meeting may proceed to consider a severed matter if every person who is entitled to exercise voting rights in respect of any item on the meeting agenda is present at the meeting (in person or proxy) and votes to approve the ratification of the defective notice. [58]

11.9 Conduct of shareholders' meetings

11.9.1 Location of shareholders' meetings

Except to the extent that the Memorandum of Incorporation provides otherwise, the board of directors of the company may determine the location for any shareholders' meeting, which shareholders' meeting may be held in South Africa or even in any foreign country. [59]

11.9.2 Attending and participating in a shareholders' meeting

Before a person attends or participates in a shareholders' meeting, he or she must present reasonably satisfactory identification, and the chairperson of the meeting must be reasonably satisfied that the right of that person to participate and vote, either as a shareholder or as a proxy for a shareholder, has been reasonably verified. [60]

11.9.3 Electronic communication

A shareholders' meeting may be conducted by electronic communication, or one or more shareholders (or proxies) may participate by electronic communication in a shareholders' meeting that is being held in person. [61] This is subject to the proviso that all participants must be able to communicate concurrently with each other without an intermediary, and must be able to participate reasonably effectively in the meeting. Permitting shareholders to participate in meetings electronically and to vote electronically would encourage them to play a more active role in the company's affairs. Flexibility is maintained by permitting a company in its Memorandum of Incorporation to restrict electronic meetings if it so chooses. A shareholder (or proxy) must pay for the access to the electronic communication (unless the company determines otherwise). [62]

11.10 Voting at meetings

11.10.1 Show of hands and poll

Voting at a meeting may take place by a show of hands or by polling. [63] On a show of hands, any person present at the meeting (as a shareholder or proxy), and entitled to exercise voting rights, has one vote, irrespective of the number of shares held. [64] Voters in favour of a motion are asked to raise their hand and are counted and voters against a motion are asked to do the same. Each voter is counted once only. The chairperson then announces whether the motion is carried or lost.

In contrast, if voting is by polling, any person who is present at the meeting (as a shareholder or proxy) has the number of votes determined in accordance with the voting rights associated with the shares held by that shareholder. [65] Thus a shareholder's full voting power is used when voting on a poll. Despite any provision of a company's Memorandum of Incorporation or agreement to the contrary, a polled vote must be held on any particular matter to be voted on at a meeting if a demand for such a vote is made by (i) at least five persons having the right to vote on that matter (either as a shareholder or proxy), or (ii) a person who is, or persons who together are, entitled as a shareholder (or proxy) to exercise at least 10 per cent of the voting rights entitled to be voted on that matter. [66]

The procedure for voting on a poll is that voting papers are given to the shareholders present, who indicate whether their vote is in favour of or against the motion. Since a shareholder is entitled to exercise all the voting rights attached to his or her shares, the number of shares in respect of which he or she is voting must be indicated on the voting paper. Scrutineers are appointed to examine and count the votes and to eliminate 'spoilt' votes, ie those voting papers that have not been properly completed. When the votes have been counted, the chairperson is informed of the result and he or she declares the result of the poll to the meeting.

There are advantages and disadvantages to voting on a show of hands and on a poll. Voting on a show of hands has the advantage of being a fast and simple process of taking uncontroversial decisions quickly. But a disadvantage of this method of voting is that a shareholder's full voting power is not used when voting on a show of hands. Voting on a show of hands is also not confidential and the vote of a shareholder voting on a show of hands could easily be influenced by the manner in which other shareholders vote at the meeting. An advantage of voting on a poll is that a shareholder's full voting power is used, and the vote is concealed from the other shareholders. A disadvantage however is that there is a record of how each individual shareholder has voted.

11.10.2 Voting agreements

Shareholders may enter into agreements in terms whereof they undertake to vote in a particular way. A shareholder's right to vote may be exercised in his or her own interests and not necessarily in the company's interests. This is because a shareholder's right to vote is a proprietary right of his or her shareholding, and, unlike a director, when a shareholder votes he or she does not owe any fiduciary duty to the company. There are, however, limitations to a shareholder's right to vote in any way he or she pleases. For instance, a majority may not oppressively and fraudulently use their votes to defraud a minority.

11.11 Chairperson at meetings

The Act does not deal with the appointment of a chairperson at a shareholders' meeting. Presumably this would be dealt with in the company's Memorandum of Incorporation. Generally, the chairperson of the board of directors acts as the chairperson of the shareholders' meeting, or alternatively a shareholder may be elected at the meeting to chair the meeting. It is the chairperson's duty to preserve order at the meeting and to ensure that the proceedings are conducted in a proper manner. He or she must act objectively, honestly and fairly in the interests of all parties and in the best interests of the company. [67] It is important to note that the chairperson owes a duty to the meeting and not to the board of directors, even if he or she is a director.

11.12 Quorum

A quorum is the minimum number of qualified persons whose presence at a meeting is necessary before any business may be validly transacted at the meeting. The Act specifies two quorum requirements: one must be satisfied in order for a shareholders' meeting to commence and the other for a matter at the meeting to be considered.

A shareholders' meeting may not commence until sufficient persons are present at the meeting to exercise, in aggregate, at least 25 per cent of all the voting rights that are entitled to be exercised in respect of at least one matter to be decided at the meeting. [68] In addition, a matter to be decided at a shareholders' meeting may not begin to be considered unless sufficient persons are present at the meeting to exercise, in aggregate, at least 25 per cent of all the voting rights that are entitled to be exercised on that particular matter at the time the matter is called on the agenda. The Memorandum of Incorporation may specify a higher or a lower threshold in place of the 25 per cent required in both these respects. [69] If a company has more than two shareholders, a meeting may not begin, or a matter begin to be debated, unless at least three shareholders are present at the meeting, provided that the quorum requirements for a meeting to begin and for a matter to be debated as specified in the Act or the Memorandum of Incorporation (if different) are satisfied. [70]

Once the quorum requirements have been satisfied, should shareholders leave the meeting, resulting in the number of shareholders present being below the quorum requirements, the meeting may continue and a matter may nevertheless be considered at the meeting as long as at least one shareholder with voting rights is still present at the meeting. [71] This may have the effect that one shareholder may make a decision that would bind the company and all the other shareholders. However, flexibility is maintained in that the Memorandum of Incorporation or rules may provide that the requisite quorum must be present throughout the meeting in order for the meeting to continue or for a matter to be considered at the meeting.

11.13 Postponement and adjournment of meetings

There is a distinction between a postponement and an adjournment of a meeting. A postponement of a meeting entails deferring the date of the meeting before it is held, while an adjournment of a meeting is the suspension of the business of the meeting with the intention of continuing the meeting at a later time.

11.13.1 Postponement where quorum is not present

If a quorum for a meeting to commence is not present within one hour after the appointed time for the commencement of the meeting, the meeting is postponed

without motion, vote or further notice, for one week. [72] This is an alterable provision of the Act, which may be modified by the company's Memorandum of Incorporation or rules.

If the quorum for a matter to be considered at the meeting is not present within one hour after the appointed time for a meeting to commence, and if there is other business on the agenda of the meeting, the consideration of that matter may be postponed to a later time in the meeting without motion or vote. However, if there is no other business on the agenda of the meeting, then the meeting must be adjourned for one week, without motion or vote. [73] The Memorandum of Incorporation or rules may alter the one hour limit or the one week period. [74]

Where a meeting cannot commence due to the absence of a quorum, the chairperson of the meeting may extend the one hour limit for a reasonable period on the grounds that exceptional circumstances affecting weather, transport or electronic communication may have impeded the ability of the shareholders to be present at the meeting. Such extension of time must be reasonable. A further ground for such extension is that one or more shareholders who are delayed have communicated their intention to attend the meeting, and those shareholders, together with others in attendance, would then satisfy the quorum requirements. [75]

11.13.2 Notice of a postponed or adjourned meeting

A company is not required to give further notice of a meeting that is postponed or adjourned unless the location for the meeting is different from the location of the postponed or adjourned meeting, or is different from the location announced at the time of the adjournment, in the case of an adjourned meeting. [76]

11.13.3 Deemed quorum

If at the time appointed for a postponed meeting to begin, or for an adjourned meeting to resume, a quorum is still not present, then the shareholders of the company who are present in person or by proxy will be deemed to constitute a quorum. [77]

11.13.4 Voluntary adjournments of meetings

A shareholders' meeting, or the consideration of any matter being debated at the meeting, may be adjourned from time to time without further notice, on a motion supported by shareholders entitled to exercise, in the aggregate, a majority of the voting rights held by all of the persons who are present at the meeting at the time; and that are entitled to be exercised on at least one matter remaining on the agenda of the matter, or on the matter under debate, as the case may be. [78] The adjournment of the meeting or the consideration of the matter being debated at the meeting may

be either to a fixed time and place or 'until further notice', as agreed at the meeting. A further notice need only be given to shareholders if the meeting determined that the adjournment was 'until further notice'. [79]

11.13.5 Period of adjournment

A meeting may not be adjourned beyond the earlier of a date that is 120 business days after the record date or a date that is 60 business days after the date on which the adjournment occurred. [80] However, a company's Memorandum of Incorporation may provide for different maximum periods of adjournment of meetings or even for unlimited adjournment of meetings. [81]

11.14 Shareholder resolutions

Matters that are raised for decision at a meeting are framed as resolutions and are put to the vote by the shareholders. Shareholder resolutions are either an ordinary resolution or a special resolution. [82]

11.14.1 Proposing a resolution

The board of directors may propose a resolution to be considered by the shareholders. [83] In addition, any two shareholders of a company may propose a resolution concerning any matter in respect of which they are each entitled to exercise voting rights. [84] A resolution proposed by the shareholders must be expressed with sufficient clarity and specificity and must be accompanied by sufficient information or explanatory material to enable a shareholder who is entitled to vote on the resolution to decide whether to participate in the meeting and to seek to influence the outcome of the vote on the resolution. [85]

Before the start of the meeting at which a resolution will be considered, if a shareholder or director believes that the form of the resolution does not meet these requirements, he or she may seek leave to apply to court for an order restraining the company from putting the proposed resolution to a vote until the necessary requirements have been satisfied. The shareholder or director in question may also require the company or the shareholders who proposed the resolution, as the case may be, to take appropriate steps to amend the resolution so that it complies with the requirements, and to compensate him or her for the costs of the proceedings, if successful. [86] Once a resolution has been approved it may not be challenged or impugned by any person in any forum on the grounds that it did not meet the necessary requirements. [87]

11.14.2 Ordinary resolutions

For an ordinary resolution to be approved by the shareholders, it must be supported by more than 50 per cent of the voting rights exercised on the resolution, ie 50% + 1. [88] If the requisite support is not obtained, the resolution is not adopted. Note that, save for an ordinary resolution for the removal of a director in terms of s 71 of the Act, a company's Memorandum of Incorporation may require a higher percentage of voting rights to approve an ordinary resolution, or one or more higher percentages of voting rights to approve ordinary resolutions concerning one or more particular matters, provided that there must at all times be a margin of at least ten percentage points between the highest established requirement for approval of an ordinary resolution on any matter and the lowest established requirement for approval of a special resolution on any matter. [89]

11.14.3 Special resolutions

For a special resolution to be approved by shareholders it must be supported by at least 75 per cent of the voting rights at a shareholders' meeting or by written resolution without a meeting. [90] The Memorandum of Incorporation may permit a different percentage of voting rights to approve any special resolution, or one or more different percentages of voting rights to approve special resolutions concerning one or more particular matters, provided that there must at all times be a margin of at least ten percentage points between the highest established requirement for approval of an ordinary resolution on any matter and the lowest established requirement for approval of a special resolution on any matter. [91] For instance, subject to the above proviso, the Memorandum of Incorporation may provide that 100 per cent approval is required to approve a special resolution. This introduces flexibility in the passing of special resolutions. However, concerns have been raised about this level of flexibility as it may be used by companies to erode shareholder rights by lowering the threshold required for the approval of special resolutions.

A special resolution is required to be passed for the most important decisions relating to the company's affairs. Section 65(11) of the Act sets out the matters for which a special resolution is required:

(i) to amend the company's Memorandum of Incorporation;
(ii) to ratify a consolidated revision of the Memorandum of Incorporation;
(iii) to ratify actions by the company or directors in excess of their authority as contemplated in s 20(2) of the Act;
(iv) to approve an issue of shares or grant of rights if the shares or rights are issued to directors, prescribed officers, future directors or prescribed officers, inter-related persons or their nominees;
(v) to approve an issue of shares or securities where the voting power of the shares issued will equal or exceed 30 per cent of the voting power of shares of that class held by shareholders immediately prior to the transaction;
(vi) to authorise the board of directors to grant financial assistance to any person for the purpose of or in connection with the subscription of any option or any securities of the company or a related or inter-related company or for the purchase of the company's securities or a related or inter-related company, and to provide financial assistance to a director or prescribed officer of the company or to a related or inter-related company or corporation (see further s 45(2) of the Act);
(vii) to approve a decision of the board for the company to reacquire its own shares *(a)* where the shares are to be acquired by the company from a director or prescribed officer of the company or a

person related to a director or prescribed officer of the company; and *(b)* where the transaction alone or together with other transactions in an integrated series of transactions involves the acquisition by the company of more than 5 per cent of the issued shares of any particular class of the company's shares;

(viii) to authorise the basis for compensation to directors of a profit company;

(ix) to approve the voluntary winding-up of the company;

(x) to approve the winding-up of a solvent company by a court order;

(xi) to approve an application to transfer the registration of the company to a foreign jurisdiction;

(xii) to approve any proposed fundamental transaction to the extent required by Part A of Chapter 5, viz a disposal of all or the greater part of a company's assets or undertaking, an amalgamation, a merger and a scheme of arrangement; and

(xiii) to revoke a resolution relating to dissenting shareholders' appraisal rights.

A company's Memorandum of Incorporation may require a special resolution to approve any other matter not contemplated in s 65(11). [92]

Under the Companies Act 61 of 1973 all special resolutions had to be registered with the Registrar of Companies in order to be effective, but this is no longer a requirement. In some instances the Act requires certain special resolutions to be filed with the Companies and Intellectual Property Commission ('the Companies Commission'), [93] but this is not the same as the registration of a special resolution. Note, however, that the Companies Commission has made it a requirement that certain special resolutions are to be registered with it.

11.15 Written resolutions

Instead of holding a formal meeting, the shareholders may consent in writing to decisions that could be voted on at a shareholders' meeting. Such resolutions are also known as round robin resolutions. Such decisions have the same effect as if they had been approved by voting at a meeting. [94] This procedure circumvents the procedural formality of convening a meeting and provides companies with a quick and efficient means of passing resolutions.

11.15.1 Consent of shareholders required

The written resolution must be submitted for consideration to those shareholders who are entitled to exercise voting rights in relation to the resolution. [95] The resolution will not be adopted if it is not supported by sufficient shareholders to form a quorum for a shareholders' meeting. The written resolution must be adopted by the same percentage of support as is required to pass a resolution at a meeting. Decisions requiring an ordinary resolution as well as a special resolution may be passed by means of a written resolution.

11.15.2 Time within which the consent must be obtained

The resolution must be voted on in writing by the shareholders within 20 business days after the resolution was submitted to them. [96] Accordingly, if the necessary support for the resolution is not obtained by that date, the resolution will lapse, and should a shareholder assent to the written resolution after the expiry of 20 business days, the assent would be ineffective.

11.15.3 Restrictions

A director may not be removed by a written resolution of the shareholders without the holding of a meeting. If the resolution were to be passed in this way, it would deprive the director in question of the opportunity to present his or her case before the meeting.

Another restriction is that no business of a company that is required to be conducted at the company's AGM (in terms of the Act or the Memorandum of Incorporation) may be conducted by a written resolution of the shareholders without the holding of a meeting. [97]

11.15.4 Informing shareholders of the written resolution

The company must deliver a statement to the shareholders describing the results of the vote within ten business days after the company has adopted the written resolution. [98] This ensures that the shareholders are kept fully informed of written resolutions that are adopted.

11.16 Company records

11.16.1 Records

Every company must maintain certain documents, accounts, books, writing, records and other information for a period of seven years (or any longer period specified in any applicable public regulation). [99] If a company has existed for a shorter period

than seven years, it is required to retain its records for that shorter time. [100] The records must be kept in written form and must be accessible at the company's registered office or another location or locations within South Africa. A company is required to file a notice setting out the location or locations at which any particular records are kept or from which they are accessible if those records are not kept at or made accessible from the company's registered office or are moved from one location to another. [101]

Every company must maintain the following records: [102]

(i) a copy of its Memorandum of Incorporation, and any amendments or alterations to it and any rules of the company;
(ii) a record of its directors and past directors;

(iii) copies of all reports presented at AGMs of the company;
(iv) copies of all annual financial statements and accounting records;
(v) notices and minutes of all shareholders' meetings, including all resolutions adopted by the shareholders, and any document that was made available by the company to the shareholders in relation to each resolution;
(vi) copies of any written communications sent generally by the company to all holders of any class of the company's securities; and
(vii) minutes of all meetings and resolutions of directors or directors' committees or the audit committee (if any).

Every profit company is also required to maintain a securities register and every non-profit company that has members is required to maintain a members' register. [103] Every company must also maintain records of its company secretaries and auditors, if applicable. [104]

11.16.2 Access to records

A person who has a beneficial interest in any securities issued by a profit company, or who is a member of a non-profit company, has a right to inspect and copy the information contained in the records of the company, save for the accounting records, the minutes of directors' meetings and resolutions of directors, directors' committees and the audit committee. [105] The Memorandum of Incorporation of a company may make provision for additional information rights of any person with regard to information that pertains to the company. [106] This is subject to the proviso that no right may negate or diminish any mandatory protection of any record required by or in terms of Part 3 of the Promotion of Access to Information Act 2 of 2000 (PAIA). [107] The rights of access to company records set out in the Companies Act are in addition to, and not in substitution for, any rights a person may have to access information in terms of s 32 of the Constitution of the Republic of South Africa, 1996, [108] PAIA or any other public regulation. [109]

11.16.3 Exercising the right to access the information contained in the company's records

The right to information provided by the Act may be exercised by direct request made to the company in the prescribed manner, either in person or through an attorney or other personal representative designated in writing, or in accordance with PAIA. [110] The rights must be exercised during business hours for reasonable periods. [111] Persons who have a beneficial interest in securities issued by a profit company and members of a non-profit company have a right to inspect and copy the records without any charge for such inspection, or upon payment of no more than the prescribed maximum charge for a copy of the records. [112] All other persons have a right to inspect or copy the securities register or members' register and the register of directors of a company, upon payment of an amount not exceeding the prescribed maximum fee for any such inspection. [113]

In order to access the records of a company a written request to exercise that right must be made to the company by delivering to the company a completed Request for Access to Information Form (Form CoR 24), or to the extent applicable any further documents or other material required in terms of PAIA. [114] To the extent applicable, the person's right of access to the information must be confirmed in accordance with PAIA. [115]

A company that receives a request in terms of a Request for Access to Information Form must accede to the request within 14 business days by providing the opportunity to inspect or copy the register concerned to the person making such request. [116] It is an offence for a company to fail to accommodate any reasonable request for access, or unreasonably to refuse access, to any record that a person has a right to inspect or copy in terms of the Act, or otherwise to impede, interfere with, or attempt to frustrate, the reasonable exercise by any person of their right to access to the company records set out in the Act. [117]

Questions

1. Ringo (Pty) Ltd, a company based in Johannesburg, has 100 shareholders, who are based predominantly in London, South Africa and New York. The company's Memorandum of Incorporation states that the quorum for a shareholders' meeting is 25 shareholders present in person or by proxy. The company wishes to amend its Memorandum of Incorporation to provide that the quorum for a shareholders' meeting will now be 15 shareholders present in person or by proxy.
   (a) Advise Ringo (Pty) Ltd whether it is legally entitled to effect such an amendment to its Memorandum of Incorporation.
   (b) Assuming that Ringo (Pty) Ltd is legally entitled to effect such an amendment to its Memorandum of Incorporation, advise the company how it should go about effecting such an amendment to its Memorandum of Incorporation and set out the procedures and formalities with which the company must comply.
   (c) Assume that Ringo (Pty) Ltd convenes a meeting of its shareholders in Johannesburg to vote on this amendment to the Memorandum of Incorporation, but many of its shareholders based in London and New York are not able to attend the meeting in South Africa. Advise Ringo (Pty) Ltd of the various options open to it in order to overcome this problem. Further, advise Ringo (Pty) Ltd of the options open to it if only ten shareholders were to attend the shareholders' meeting.
   (d) Advise the shareholders on the different methods of voting on

this amendment to the Memorandum of Incorporation at a shareholders' meeting and the advantages and disadvantages of each method of voting at the meeting.

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[1] See s 50(2) of the Act and reg 32 of the Companies Regulations GNR 351 *GG* 34239 of 26 April 2011 ('the Regulations'), which set out in detail the information that must be included in the securities register.

[2] Section 49(2).

[3] Section 50(3).

[4] Section 56(1).

[5] See the Memorandum on the Objects of the Companies Bill, 2008, Companies Bill [B 17D-99] 30.

[6] Ibid.

[7] Section 56(3).

[8] Section 56(4).

[9] Section 56(5).

[10] Section 56(7) and reg 32(3).

[11] Section 56(7).

[12] Section 59(1).

[13] Section 59(2).

[14] Section 59(3).

[15] 1970 (2) SA 685 (A).

[16] Section 57(2).

[17] Section 57(4).

[18] This exemption does not apply if the company falls into a class of company that is required to have its annual financial statements audited in terms of the Regulations. It also does not relieve the company of any requirement to have its financial statements audited or reviewed in terms of another law or in terms of any agreement to which the company is a party. Despite the company's exemption from having its annual financial statements audited or independently reviewed, the company's investors may nevertheless in certain instances require such companies to have their annual financial statements audited. In this event the company may have its financial statements voluntarily audited in terms of s 30(2).

[19] Section 58(1).

[20] Section 58(3).

[21] Ibid.

[22] Section 58(2).

[23] Section 58(3).

[24] Section 58(2).

[25] Section 58(2).

[26] Ibid.

[27] Section 58(7).

[28] Section 58(4).

[29] Ibid.

[30] Ibid.

[31] Section 58(8).

[32] Section 58(8).

[33] See s 61(7).

[34] Section 61(8).

[35] The directors' report deals with the state of affairs of the company, the business and profit or loss of the company (or of the group of companies if the company is part of a group), including any matter material for the shareholders to appreciate the company's state of affairs, and any prescribed information (s 30(3) of the Act).

[36] Section 61(7).

[37] Section 61(1).

[38] Section 61(2).
[39] Section 70(3).
[40] Section 70(4).
[41] Section 61(3).
[42] Ibid.
[43] Section 61(4).
[44] Section 61(5).
[45] Section 61(6).
[46] Section 61(11).
[47] Ibid.
[48] Section 61(12).
[49] Section 61(13).
[50] Section 61(14).
[51] Section 62(1).
[52] Ibid.
[53] Section 62(2A).
[54] Section 62(3).
[55] Section 62(3).
[56] Section 62(6).
[57] Section 62(4).
[58] Section 62(5).
[59] Section 61(9).
[60] Section 63(1).
[61] Section 63(2).
[62] Section 63(3).
[63] Section 63(4).
[64] Section 63(5).
[65] Section 63(6).
[66] Section 63(7).
[67] *South African Broadcasting Corporation Ltd v Mpofu* [2009] 4 All SA 169 (GSJ).
[68] Section 64(1).
[69] Section 64(2).
[70] Section 64(3).
[71] Section 64(9).
[72] Section 64(4).
[73] Section 64(4).
[74] Section 64(6).
[75] Section 64(5).
[76] Section 64(7).
[77] Section 64(8).
[78] Section 64(10).
[79] Section 64(11).
[80] Section 64(12).
[81] Section 64(13).
[82] Section 65(1).
[83] Section 65(2).
[84] Section 65(3).
[85] Section 65(4).
[86] Section 65(5).
[87] Section 65(6).
[88] Section 65(7).
[89] Section 65(8).

[90] Section 65(9).

[91] Section 65(10).

[92] Section 65(12).

[93] For example, a special resolution providing for the voluntary winding-up of a company must be filed with the Companies Commission, together with the prescribed notice and filing fee (s 80(2)).

[94] Section 60(2).

[95] Section 60(1).

[96] Ibid.

[97] Section 60(5).

[98] Section 60(4).

[99] Section 24(1).

[100] Section 24(2).

[101] Section 25.

[102] Section 24(3).

[103] Section 24(4).

[104] Ibid.

[105] Section 26(1*)*.

[106] Section 26(3).

[107] Part 3 of PAIA deals with the access to records of private bodies, and ss 62 to 70, in particular, deal with grounds for refusal of access to records.

[108] Section 32 of the Constitution of the Republic of South Africa, 1996 provides as follows:

> (1) Everyone has the right of access to -
>
> *(a)* any information held by the State; and
>
> *(b)* any information that is held by another person and that is required for the exercise or protection of any rights.
>
> (2) National legislation must be enacted to give effect to this right, and may provide for reasonable measures to alleviate the administrative and financial burden on the State.

The national legislation contemplated in s 32(2) of the Constitution is PAIA.

[109] Section 26(7).

[110] Section 26(4).

[111] Ibid.

[112] Section 26(1).

[113] Section 26(2).

[114] Regulation 24(3).

[115] Regulation 24(2).

[116] Section 26(5) and reg 24(4).

[117] Section 26(9). A person convicted of an offence in terms of the Act is liable to a fine or to imprisonment for a period not exceeding 12 months, or to both a fine and imprisonment (s 216).

Chapter 12
Governance and the Board of Directors

Rehana Cassim

12.1 Introduction

A company is a juristic person and thus can function only through human agency. It acts through its shareholders in shareholders' meetings, and through its directors and employees. The board of directors of a company is responsible for managing the business and affairs of a company. It has the authority to exercise all the powers and perform any of the functions of the company, but its powers may be curtailed by the Companies Act 71 of 2008 ('the Act') or the company's Memorandum of Incorporation. [1]

The Act sets out rules relating to the appointment of directors, grounds of ineligibility and disqualification of persons to be directors, the removal of directors, the procedure to declare directors delinquent or under a probation order, board committees, board meetings, resolutions of directors and the remuneration of directors. These issues are discussed in this chapter.

12.2 Who is a 'director'?

Directors play a crucial role in managing the affairs of a company, and it is thus important to be able to identify the directors of a company so as to establish who is accountable in regard to managing the affairs of a company. In general, the law is concerned with rendering directors responsible because they have the power to manage the company's business and to make vital decisions relating to the running of the company. Higher standards are continually being expected of directors, as evidenced by the Act, the King Report on Governance for South Africa 2009 ('the King III Report') and the King Code of Governance for South Africa 2009 ('the Code'). In these circumstances certain individuals may wish to evade being formally classified as directors. Accordingly, it is important to be able to identify the directors of a company.

12.2.1 Definition of a 'director'

A 'director' is defined in s 1 of the Act as 'a member of the board of a company, as contemplated in section 66, or an alternate director of a company and includes any person occupying the position of a director or alternate director, by whatever name designated'. From this definition it is clear that a person who is not formally appointed as a director of a company may nevertheless be deemed to be a director if he or she occupies the position of a director, whether with or without lawful authority. Note that the title or description of a position is not relevant in determining whether a person is a director. For instance, it is possible for someone to be a director even though he or she is described as a manager. It is the substance of that person's activities that will determine whether he or she is a director.

Section 66 of the Act recognises the following types of directors:

(i) Director appointed in terms of the Memorandum of

Incorporation

A director may be appointed by any person who is named in, or determined in terms of, the Memorandum of Incorporation.

(ii) Ex officio director

An *ex officio* director is a person who is a director of a company as a consequence of holding some other office, title, designation or similar status. He or she has all the powers and functions of any other director of the company, except to the extent that these are restricted by the Memorandum of Incorporation, and is subject to all the liabilities of any other director of the company. But a person may not serve as an *ex officio* director should he or she be or become ineligible or disqualified to be a director under the Act.

(iii) Alternate director

An alternate director is elected or appointed to serve as a member of the board of a company in substitution for another director who has been elected or appointed to the board of directors. Alternate directors serve a useful purpose. For instance, they allow a director who is ill or has other commitments to ensure that his or her influence is still maintained at board level through an alternate director when he or she is unable to be present.

An alternate director may only be appointed if the Memorandum of Incorporation makes provision for a director to nominate an alternate director to act in his or her stead. An alternate director may act as a director only in the absence of his or her appointer. While an alternate director only enjoys the powers that his or her appointer enjoyed, he or she is subject to all the duties a director owes to his or her company and must exercise and discharge all the powers and functions of a director. An alternate director ceases to hold office whenever the director who appointed him or her ceases to be a director, or gives notice to the company secretary that the alternate director is no longer representing him or her.

(iv) Director elected by shareholders

Each director of a profit company (except the first directors, a director appointed in terms of the Memorandum of Incorporation and an *ex officio* director) must be elected by the shareholders, to serve as a director of the company for an indefinite term or for a term set out in the Memorandum of Incorporation. [2] In the case of a profit company (other than a state-owned company), the Memorandum of Incorporation must provide for the election by shareholders of at least 50 per cent of the directors, and 50 per cent of any alternate directors. The Memorandum of Incorporation may provide that a higher percentage of directors must be elected by the shareholders. A company may, for instance, require the election of all its directors by its shareholders. Alternatively, a company may, for example, require 50 per cent (or less) of its directors to be appointed by parties other than the shareholders, such as the board of directors, other stakeholders or outsiders.

In addition, the following types of directors are recognised in our law:

(v) De jure director

A *de jure* director simply means a person validly and formally appointed to the position of a company director who has freely consented to that appointment.

(vi) Temporary director

Unless the Memorandum of Incorporation of a profit company provides otherwise, the board of directors may appoint a person to serve as a director temporarily until such time as the vacancy has been filled by a director who has been elected by the shareholders. [3] Such temporary director must satisfy the requirements for election as a director, and has all the powers, functions and duties and is subject to all of the liabilities of any other director of the company.

(vii) Nominee director

Generally, a nominee director is appointed by a shareholder who controls sufficient voting power in the company to represent his or her interests. Nominee directors may, for example, represent a major shareholder, a class of shareholders, a significant creditor or an employee group. Nominee directors are useful in certain situations, for instance where a major shareholder agrees to subscribe for shares in a company on the condition that he or she has representation on the board of directors, or where a major shareholder lacks the time or expertise to serve as a director personally and thus wishes to appoint a nominee to act on his or her behalf.

While the practice of appointing a nominee director to represent the interests of the person who nominated him or her is legally recognised, the presence of a nominee director may well lead to a potential conflict of interests should the interests of the company not coincide with those of the nominator. It is important to note that in carrying out his or her duties and functions as a director, a nominee director is in law obliged to serve the interests of the company and not the interests of any nominator, employer or principal. [4] He or she may not fetter his or her vote as a director, and as a director may not be subject to the control of any employer or principal other than the company. [5]

(viii) Puppet director

A puppet director is a person who has been placed on the board of directors with the intention that he or she should blindly follow the instructions of his or her controller. In *S v Shaban* [6] the court stated that '[o]ur law does not know the complete puppet who pretends to take part in the management of a company whilst having no idea what it is to which he puts his signature. It is utterly foreign to the basic concepts of our law and the Courts will punish it as fraud.' [7]

A puppet director will not escape liability for breach of a fiduciary duty by laying the blame on the person who put him or her in office and pulled the strings.

Likewise, the 'puppet master' will not escape liability on the ground that he or she was not formally appointed to the office of director. [8]

(ix) De facto director

A *de facto* director is a person who claims to act and purports to act as a director, without having been so appointed either validly or at all. The words 'occupying the position of a director' in the definition of a 'director' in s 1 of the Act make it clear that a *de facto* director constitutes a director for the purposes of the Act. Accordingly, a 'director' may not escape his or her duties simply because he or she has not been formally or validly appointed as a director. A *de facto* director is subject to the fiduciary and other duties of a director.

In order to establish that a person is a *de facto* director of a company, it must be proved that he or she undertook functions in relation to the company that could properly have been discharged only by a director and that such person participated in directing the affairs of the company on an equal footing with the other directors and not in a subordinate role. A *de facto* director must be shown to have exercised a real influence in the corporate decision-making process of the company. There is no single test to determine whether a person is a *de facto* director and all relevant factors must be taken into account in determining whether a person is a *de facto* director.

(x) Shadow director

A shadow director is a person in accordance with whose directions or instructions the directors of the company are accustomed to act. As the name indicates, a shadow director 'lurks in the shadows', sheltering behind others who he or she claims are the only directors of the company to the exclusion of him- or herself. [9] The concept of a shadow director emerged to prevent the use of intermediaries acting as directors as a facade for the real exercise of power within the company. [10]

A shadow director is not held out to be a director by the company, but exercises power from the shadows. While concealment is not a prerequisite for a person to be a shadow director, in practice most shadow directors are likely to want to remain anonymous. Some reasons why shadow directors may want to remain anonymous are that they wish to avoid being subject to certain of the duties or liabilities imposed on directors (such as liability for wrongful trading if the company fails), or because they have been disqualified from being validly appointed as directors. Should only a minority of the company's directors be accustomed to act in accordance with a person's instructions or directions, this would not be sufficient to make that person a shadow director.

Even though the Act does not explicitly define the concept of a shadow director, the definition of a 'director' in s 1 of the Act is wide enough to include a shadow

director because of the phrase 'occupying the position of a director'. Shadow directors have been recognised in our common law, even if they have not been referred to as 'shadow directors'. [11]

(xi) Executive, non-executive and independent directors

The Act does not distinguish between executive, non-executive and independent directors, but an important distinction is made between these types of directors in practice, and in the King III Report and the Code. An executive director is involved in the day-to-day management of the company and is in the full-time salaried employ of the company. He or she is generally under a contract of service with the company. A non-executive director, on the other hand, is a part-time director and is not an employee of the company. He or she is not involved in the day-to-day management of the company, but plays an important role in providing objective judgment, independent of management, on issues facing the company. Non-executive directors are usually appointed to the board of directors for the purpose of bringing an external, independent perspective to the management of a company. An independent, non-executive director is one who does not have a relationship with the company outside his or her directorship. He or she is free of any relationships which could materially interfere with the independent exercise of his or her judgment.

12.3 The legal position of directors

The precise nature of the legal relationship between the company and a director is still a controversial question and several views have been expressed on this issue. Among other things, directors have been described as agents of the company, as trustees of the company, and as managing partners.

In some respects the relationship of a director to the company is analogous to that of an agent. For instance, directors, like agents, act for the benefit of some other person, that is, the company, and not for their own benefit, and when they contract on behalf of the company, they do not incur liability, unless they act outside their powers, or expressly or impliedly assume liability. [12] But under the Act the analogy between a director and an agent is not as strong as it may have been under the Companies Act of 1973 Act ('the 1973 Act'). Previously, a director did not enjoy original powers to act and, like an agent, his or her power to act arose from, and was limited by, the powers conferred on him or her. But the Act now (in terms of s 66(1)), subject to the company's Memorandum of Incorporation, confers original powers and duties on directors. Thus the position of a director has changed considerably under the Act.

The position of a director is analogous to that of a trustee in that a director, like a trustee, stands in a fiduciary relationship to the company in the performance of his or her duties, and acts for the benefit of some other person, and not for his or her own

benefit. Furthermore, as in the case of a trustee, the property that is under the control of a director must be applied for the specified purposes of the company, and for its benefit. But the description of a director as a trustee is not appropriate in South African law because in South African law trust property is vested in the trustee, whereas the property which directors are bound to administer is not vested in them but in the company itself, ie directors do not own any part of the property of the company. Also, the courts do not apply the same strict standards of care and skill to directors as are applied to trustees.

Directors have also been described as managing partners. The position of directors is analogous to managing partners in that they are empowered to manage a business. But, unlike managing partners, directors do not necessarily have a financial interest in the business, and even where they do hold shares in the company they are not, as directors, liable for the company's debts. [13]

It is evident from the above discussion that directors cannot properly be categorised as agents, trustees or managing partners, but that they occupy a unique position. [14] In other words, the legal relationship of a director is *sui generis*: it stands in a class of its own. It cannot be determined by reference to a single legal relationship, but must be determined by reference to the facts of each case. [15]

12.4 Prescribed officers

Under the Companies Regulations [16] a person is designated a 'prescribed officer' of a company if that person-

(a) exercises general executive control over and management of the whole, or a significant portion, of the business and activities of the company; or

(b) regularly participates to a material degree in the exercise of general executive control over and management of the whole, or a significant portion, of the business and activities of the company.

This definition is a broad one, and would encompass a wide group of persons, including persons who are not directors of a company. Examples of persons who may fall within the definition of a 'prescribed officer', subject to the functions which they perform in the company, would be the chief executive officer of a company, the financial director and the chief operating officer. The title given to a person by the company is irrelevant in determining whether such person is a prescribed officer. [17]

Notably, certain provisions of the Act which apply to directors also apply to the prescribed officers of the company. The object is to ensure that prescribed officers are subject to the same strict duties and accountability as directors. For instance, s 69 of the Act, which sets out the grounds of ineligibility and disqualification of directors, also applies to prescribed officers. In addition, ss 75 (director's personal financial interests), 76 (standards of director's conduct) and 77 (liability of directors and prescribed officers) of the Act apply to directors as well as to prescribed officers. Note

that the annual financial statements of a company that is required to have its annual financial statements audited must include particulars showing the remuneration and benefits received by directors as well as prescribed officers of the company. [18] It is thus important for persons who fall within the definition of a 'prescribed officer' in a company to be identified and to be made aware of the consequences of accepting an appointment to such positions.

12.5 Office-bearers of the company

12.5.1 Manager

The position of a director is not to be equated with that of a manager as there are fundamental differences between the two positions. For instance, directors are required by statute, they are essential to a company, they are generally appointed by the shareholders, and their functions and duties are defined by law. A manager, on the other hand, is an employee of the company and his or her services are engaged by the directors. He or she is not legally essential to the company and his or her position is not defined by law. A further difference between directors and managers is that directors are accountable to the shareholders for the company's performance and may be removed from office by the shareholders, while managers are usually appointed and dismissed by the directors and do not interact with the shareholders. [19]

12.5.2 Managing director

A managing director is a person who is the direct and immediate representative of the board of directors, and acts within his or her authority to bind the company in its dealings with other parties. The functions of a managing director are not fixed by law, but depend on the specific terms of his or her appointment. As the chief executive who is in charge, under the board of directors, of the daily running of the company, the managing director's task is to supervise the work of other managers and the daily conduct of the company's affairs.

12.5.3 Chairperson of the board of directors

The Memorandum of Incorporation may make provision for the directors to elect a chairperson of their meetings and to determine the period for which he or she is to hold office. Generally, in the absence of a specific mandate or authorisation by the company in the Memorandum of Incorporation or otherwise, the position of the chairperson of the board of directors differs little from that of an ordinary director, and the chairperson usually does not have any additional powers merely by virtue of being the chairperson. But the chairperson's position is an important one in that he or she is obliged at board meetings to preserve order, and to take care that the proceedings are conducted in a proper manner. The chairperson has a fiduciary

duty to act objectively. [20] He or she must be satisfied that the meeting has been properly convened and constituted, that the provisions of the Act and the Memorandum of Incorporation are complied with and that the business is properly put before the meeting. As regards voting at board meetings in terms of the Act, in the case of a tied vote, except to the extent that the Memorandum of Incorporation provides otherwise, the chairperson has a casting vote only if he or she did not have or cast a vote initially. [21]

12.5.4 Company secretary

The secretary of a company is ordinarily the chief administrative officer of the company. The Act makes it mandatory for every public company and state-owned company to appoint a company secretary (although this is subject to certain exemptions). [22] It is not mandatory for a private company, personal liability company and non-profit company to appoint a company secretary, save to the extent that the company's Memorandum of Incorporation provides otherwise. [23] It is of course open to such companies to appoint company secretaries voluntarily if they wish to do so. The disqualifications relating to the appointment of a director set out in the Act apply equally to the appointment of a company secretary. [24]

Whereas in the past the company secretary was regarded as a mere clerk or servant who was required to do what he or she was told, today the company secretary has grown in importance in the role he or she plays in the company's affairs. The company secretary has a vital role to play in assisting the board to ensure proper corporate governance. For the duties of the company secretary refer to Chapter 15: The auditor, financial records and reporting.

12.5.5 Auditor

Before a company's financial statements are submitted to the members, the statements must be audited by an auditor. The function of the auditor is to ensure that the financial information relating to the company's affairs, as prepared by the directors, fairly and accurately reflects the company's financial position. The purpose of an audit is first, to protect the company itself from the consequences of undetected errors or wrongdoing, and second, to provide shareholders with reliable information to enable them to scrutinise the conduct of the company's affairs. The auditor must be independent of the company. [25]

A public company and a state-owned company must appoint an auditor. [26] A private company, a personal liability company and a non-profit company that are required by the Act or the Regulations to have their annual financial statements audited every year, and a company that is required only in terms of its Memorandum of

Incorporation to have its annual financial statements audited must appoint an auditor. [27] See further, on the role and functions of the auditor, Chapter 15: The auditor, financial records and reporting.

12.6 Number of directors

12.6.1 Minimum number of directors

A private company and a personal liability company must appoint at least one director to the board of directors, while a public company and a non-profit company must appoint at least three directors. [28] This is in addition to the minimum number of directors that the company must have to satisfy any requirement, whether in terms of the Act or its Memorandum of Incorporation, to appoint an audit committee and/or a social and ethics committee. [29] The minimum number of directors so derived is subject to the Memorandum of Incorporation, which may require a company to have a greater minimum number of directors. [30]

The audit committee must comprise at least three directors who are not involved in the day-to-day management of the company's business or were not so involved during the previous financial year. [31] The social and ethics committee must comprise three directors or prescribed officers of the company, at least one of whom must be a director who is not involved in the day-to-day management of the company's business and was not so involved within the previous three financial years. [32] This means that those companies that are required to have an audit committee and/or a social and ethics committee will require at least three directors in addition to the minimum required number of directors. But note that, save as provided in the Act or the company's Memorandum of Incorporation, any particular director may be appointed to more than one committee of the company. Thus when calculating the minimum number of directors required for a company, a director who has been appointed to more than one committee must be counted only once. [33]

No maximum number of directors is prescribed by the Act. The King III Report makes recommendations relating to the size of the board of directors. This is discussed in Chapter 13: Corporate governance.

12.6.2 Company with one director

Where a profit company (other than a state-owned company) has only one director, that director may exercise any power or perform any function of the board at any time, without notice or compliance with any other internal formalities (except to the

extent that the Memorandum of Incorporation provides otherwise). [34] The company is also exempt from the application of various provisions of the Act. [35]

12.6.3 Failure to have the required number of directors

If the number of incorporators of a company, together with any *ex officio* directors and directors to be appointed in terms of the Memorandum of Incorporation, is fewer than the minimum number of required directors, the board of directors must call a shareholders' meeting within 40 business days after the company has been incorporated, for the purpose of electing sufficient directors to fill all the vacancies on the board. [36] However, failure by a company to have the required minimum number of directors does not limit or negate the board's authority or invalidate anything done by the board or the company. [37]

12.7 Appointment of directors

12.7.1 Initial appointment of directors

The first directors of a company are the incorporators of the company, and such persons serve as directors of the company until the minimum number of required directors (in terms of the Act or the Memorandum of Incorporation) has been appointed or elected. [38]

12.7.2 Subsequent appointments

12.7.2.1 Appointments by a person named in the Memorandum of Incorporation

As discussed previously, a director may be appointed and removed by a person named in, or determined in terms of, the Memorandum of Incorporation. [39] Where the authority to appoint a director is vested in a third party, that third party is not under any obligation to appoint as a director the most suitable person for the position.

12.7.2.2 Appointments by the shareholders

Each director of a profit company, other than the first directors, a director appointed in terms of the Memorandum of Incorporation and an *ex officio* director, must be elected by the shareholders, to serve as a director of the company for an indefinite term or for a term set out in the Memorandum of Incorporation. [40] Unless the Memorandum of Incorporation of a profit company provides otherwise, the election is to be conducted as a series of votes, and each director is to be appointed by a separate resolution. [41] The series of votes continues until all vacancies on the board at that time have been filled. Having separate voting for each candidate prevents a block of candidates being voted on together, which will compel a shareholder who wishes to vote for only one candidate of the block to vote for all the candidates even though there may be one (or more) candidates whom he or she does not want to elect as a director. But note that the Memorandum of Incorporation may make provision for two or more candidates to be elected as directors by way of a single resolution. [42] A shareholder may only exercise his or her right to vote once, and the vacancy will be filled if a majority of the voting rights exercised are in support of the candidate. [43]

The general rule is that shareholders may vote for a director in their own interests, even if their interests conflict with those of the company, and they are under no obligation to choose the person most suitable to be a director. Of course it is in a shareholder's interests to ensure that the director he or she supports is competent, but there is no duty to vote in this way.

12.7.2.3 Appointments by the board of directors or other stakeholders or outsiders

In the case of a profit company (other than a state-owned company) the Memorandum of Incorporation must provide for the election by shareholders of at least 50 per cent of the directors and 50 per cent of any alternate directors. [44] Thus at least half of the board of directors must be elected by the shareholders. This implies that a company could require 50 per cent or less of its directors to be appointed by parties other than the shareholders, such as the board of directors, or other stakeholders or outsiders. Where the power to appoint directors is vested in the board of directors it is a fiduciary power and must be exercised in good faith in the interests of the company and not for any improper or collateral purpose. [45]

12.7.2.4 Other appointments

As previously discussed, provision is made in the Act for the appointment of *ex officio* directors, alternate directors, temporary directors and nominee directors.

12.7.3 Consent to be a director

For a person to be entitled to serve as a director of a company, he or she must deliver a written consent to the company to serve as its director. [46] A person may not become a director of a company if this consent is not delivered to the company. This obviously does not apply to *de facto* and shadow directors.

An election or appointment of a person as a director will be a nullity if at the time of the election or appointment that person was ineligible or disqualified from being a director. [47]

Within ten business days after a person becomes a director of the company (or ceases to be a director of the company), the company is required to file a notice with the Companies and Intellectual Property Commission ('the Companies Commission') to this effect. [48]

12.8 Terms of appointment

A director is not as such an employee or servant of the company, but may be employed by the company as an employee in terms of a separate contract of service. A person's position as a director is independent of his or her position as an employee. A person simultaneously employed as an executive director and as a board member holds two distinct positions - that of a director and that of an employee. The terms upon which directors hold office may be contained either in the Memorandum of Incorporation or in a service contract that exists outside of, and is unconnected to, the Memorandum of Incorporation. The dismissal of a director as an employee does not of itself result in the termination of his or her office as a director. Thus, depending on the terms of his or her employment contract, should a director be dismissed as an employee he or she may still remain a director of the company until he or she is removed as a director or resigns as a director. [49] Likewise, the removal of a director from the board of directors does not result in the automatic termination of his or her employment contract.

Should the company breach the provisions of the Memorandum of Incorporation relating to a director, the director will have a contractual claim against the company based on the Memorandum of Incorporation.

Regarding the term of office of a director, each director of a company, other than the first directors, a director appointed in terms of the Memorandum of Incorporation and an *ex officio* director, must be elected by the shareholders to serve for an indefinite term or for a term as set out in the Memorandum of Incorporation. [50] It is questionable whether it is advisable for a person to remain in the position of a director for an indefinite term, because this may affect his or her independence as a director and may not accord with good corporate governance practices. Of course, even if a director is appointed for an indefinite term, he or she may nevertheless be removed as a director by ordinary resolution at any time in terms of the Act. [51]

12.9 Record of directors

Every company is required to maintain a record of its directors.

12.9.1 Information to be contained in the record of directors

The information that must be contained in the record of directors includes details such as full names and any former names of the directors; identity numbers or, failing that, dates of birth; nationality and passport numbers (for persons who are not of South African nationality); occupation; date of their most recent election or appointment as a director of the company; name and registration number of every other company or foreign company of which such a person is a director and, in the case of a foreign company, the nationality of that company, and any other prescribed information. [52] The record of directors must include details relating to the company's current directors as well as its past directors.

Regulation 23 of the Regulations further requires the company's record of directors to include, with respect to each director of the company, the address for service for that director, and in the case of a company that is required to have an audit committee, the professional qualifications and previous experience of the director.

Note that it is no longer necessary to provide details of a director's residential address and an address for service of documents for each director will suffice. Keeping a director's residential address away from the public record protects his or her personal privacy and prevents harassment and abuse of directors.

12.9.2 Retention of record of directors

The records that a company is required to keep in terms of the Act or any other public regulation must be retained for seven years, or any longer period of time specified in any other applicable public regulation. [53] If a company has existed for fewer than seven years then it is required to retain its records for that shorter time. [54] With respect to the company's past directors, the information relating to any past director must be retained for seven years after the director has retired from the company. [55]

12.9.3 Location of record of directors

The record of directors must be accessible at the company's registered office, or another location or locations within South Africa. [56] A company must file a notice setting out the location or locations where the records are kept if they are not kept at the registered office, or are moved from one location to another.

12.9.4 Inspection of record of directors

Persons who hold a beneficial interest in securities issued by a profit company and members of a non-profit company have a right to inspect and copy the register of

directors free of a charge for such inspection, or upon payment of no more than the prescribed maximum charge for a copy of the records. [57] Persons who do not hold a beneficial interest in any securities issued by a profit company or who are not members of a non-profit company have a right to inspect or copy the register of directors of a company upon payment of an amount not exceeding the prescribed maximum fee for any such inspection. [58]

Note that the Memorandum of Incorporation of a company may make provision for additional information rights of any person with regard to information that pertains to the company. [59] This is subject to the proviso that no right may negate or diminish any mandatory protection of any record under Part 3 of the Promotion of Access to Information Act 2 of 2000 ('PAIA'). [60]

The right to inspect and copy the directors' register may be exercised by direct request made to the company in the prescribed manner, either in person or through an attorney or other personal representative designated in writing, or in accordance with PAIA. [61] The right may be exercised for a reasonable period during business hours. [62] Any person claiming a right of access to any record held by a company must deliver to the company a completed Request for Access to Company Information in Form CoR 24, or to the extent applicable, any further documents or other material required in terms of PAIA. [63] A company that receives a request in terms of a Request for Access to Company Information in Form CoR 24 must accede to the request within 14 business days by providing the opportunity to inspect or copy the register concerned to the person making such request. [64] It is an offence for a company to fail to accommodate any reasonable request for access, or unreasonably to refuse access, to any record that a person has a right to inspect or copy, or otherwise to impede, interfere with, or attempt to frustrate, the reasonable exercise by any person of his or her right of access to the company's records. [65]

12.10 Company rules

Unless prohibited by the Memorandum of Incorporation, 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 that are not addressed in the Act or the Memorandum of Incorporation. [66] Such rules must be consistent with the Act and the Memorandum of Incorporation, failing which they will be void to the extent of the inconsistency. [67] See further, on company rules, Chapter 6: Formation of companies and the company constitution.

12.11 Ineligibility and disqualification of persons to be directors

12.11.1 Application

The provisions of the Act setting out the grounds of ineligibility and disqualification of directors apply not only to directors and alternate directors, but also to prescribed officers and persons who are members of the company's board committees or audit committee, irrespective of whether or not such persons are also members of the company's board of directors. [68]

12.11.2 Qualifications

The Act does not prescribe any minimum qualifications for a director, such as qualifications relating to the education and training of directors. Instead, the Act imposes criteria that disqualify a person from being a director. The Act does not impose a share qualification requirement on directors either; accordingly, being a shareholder is not a formal condition of being a director. The reason for not imposing minimum qualifications is that these are regarded as being an internal company policy issue. The Memorandum of Incorporation may, however, on an optional basis, impose minimum qualifications to be met by directors of a particular company. [69]

12.11.3 Distinguishing ineligibility from disqualification

The difference between a person who is ineligible to be a director and one who is disqualified from being a director is that a disqualification is not absolute and a court has a discretion to permit a disqualified person to accept an appointment as a director. No such flexibility is permitted with respect to an ineligible person, who is absolutely prohibited from being a director.

12.11.4 Grounds of ineligibility

The following persons are ineligible to be company directors: [70]

(i) juristic persons;
(ii) unemancipated minors or persons under a similar legal disability; [71]
(iii) any persons who do not satisfy any minimum qualification set out in the Memorandum of Incorporation; and
(iv) any persons disqualified in terms of any additional grounds of ineligibility (or disqualification) set out in the Memorandum of Incorporation.

A director of a company must be a natural person. A company or a close corporation, for example, is a juristic person and may not be appointed as a director. A trust is also regarded as being a juristic person for purposes of the Act, and accordingly may not be appointed a director either. A person is a minor until he or she attains the age of 18. The Act does not prescribe a maximum age beyond which a person may not be appointed as a director of a company.

12.11.5 Grounds of disqualification

Each of the following persons is disqualified from being a director of a company: [72]

(i) a person prohibited by a court of law from becoming a director;
(ii) a person declared to be delinquent by a court of law;
(iii) an unrehabilitated insolvent;
(iv) a person prohibited in terms of any public regulation to be a director of a company;
(v) a person removed from an office of trust on the grounds of misconduct involving dishonesty; and
(vi) a person convicted, in South Africa or elsewhere, and imprisoned without the option of a fine or fined more than the prescribed amount, [73] for theft, fraud, forgery, perjury or other offences as specified in s 69(8)*(b)*(iv) of the Act.

The offences specified in s 69(8)*(b)*(iv) are-

(i) an offence involving fraud, misrepresentation or dishonesty;
(ii) an offence in connection with the promotion, formation or management of a company; and
(iii) an offence under the Companies Act, the Insolvency Act 24 of 1936, the Close Corporations Act 69 of 1984, the Competition Act 89 of 1998, the Financial Intelligence Centre Act 38 of 2001, the Securities Services Act 36 of 2004 or Chapter 2 of the Prevention and Combating of Corrupt Activities Act 12 of 2004.

As with the grounds of ineligibility, the Memorandum of Incorporation may impose additional grounds for the disqualification of directors. [74]

These provisions are not designed to punish the individual, but to protect the public and to prevent the corporate structure from being used to the financial detriment of investors, shareholders, creditors and persons dealing with the company. The disqualification does however involve a substantial interference with the freedom of the individual and also carries with it a degree of stigma for anyone who is disqualified.

12.11.6 Consequences of ineligibility and disqualification

An ineligible or disqualified person may not be appointed or elected a director of the company, or consent to be appointed or elected a director, or act as a director of a company. [75] It follows that, should a person become ineligible or disqualified while serving as a director of a company, he or she will cease to be entitled to continue to act as a director with immediate effect. [76] A company may not knowingly permit an ineligible or disqualified person to serve or act as a director. [77]

12.11.7 Exemption from disqualification

A court has an unfettered discretion to exempt a person from the application of the grounds listed in 12.11.5(iii) to 12.11.5(vi). [78] A court of appeal will only interfere with the decision if it is satisfied that the discretion was not exercised properly. The factors to be taken into account by a court in exercising its discretion cannot be stated exhaustively, because each case depends on its own facts. The fundamental question is whether in all the circumstances the applicant has satisfied the court that the defect of character no longer exists, and that the person concerned has rehabilitated him- or herself and measures up to the high standards required of directors.

12.11.8 Duration of disqualification

A disqualification under the grounds listed in 12.11.5(v) and 12.11.5(vi) ends at the later of five years after the date of removal from office or the completion of any sentence imposed for the relevant offence, as the case may be, or at the end of any extension of the disqualification, as determined by a court of law. [79]

The Companies Commission may apply to court, at any time before the expiry of a person's disqualification, for an extension of the disqualification under the grounds listed in 12.11.5(v) and 12.11.5(vi), which the court, in its discretion, may grant for no more than five years at a time, should it find that an extension is necessary to protect the public, having regard to the conduct of that person up to the time of the application. [80]

12.11.9 Public register

The Companies Commission must establish and maintain a public register of persons who are disqualified from serving as directors, or who are subject to an order of probation as a director, in terms of a court order pursuant to the Act or any other law. [81] The Companies Commission may, for purposes of maintaining the public register of persons disqualified from serving as directors, obtain relevant information from the official records of the clerk of the magistrates' court, the Master of the High Court, the South African police services, any regulatory authority or any institution that regulates any profession in South Africa. [82]

12.12 Delinquent directors and directors on probation

Under the Act an application may be made to court to declare a director delinquent or to have him or her placed under an order of probation. This is a significant innovation in the Companies Act.

12.12.1 *Locus standi*

A wide range of persons may apply to court for orders declaring a director delinquent or placing him or her under probation. These are: a company, a shareholder, a director, a company secretary or prescribed officer of a company, a registered trade union that represents employees of a company or another employee representative, the Companies Commission and the Takeover Regulation Panel. In addition, any organ of state responsible for the administration of any legislation may bring an application to declare a director delinquent. [83] Specific grounds of delinquency or probation are available to each of these persons. The application may be brought not only against a present director of a company but also against a former director, ie a person who had been a director within the 24 months immediately preceding the application. It is important to guard against abuse by such persons because this mechanism may well be used to lodge vexatious claims, which may result in damage being caused to the reputation of directors.

12.12.2 Grounds of delinquency [84]

A court must make an order declaring a person to be a delinquent director if, inter alia, the person-

(i) consented to serve as a director, or acted in the capacity of a director or prescribed officer, while ineligible or disqualified to be a director;
(ii) while under an order of probation, acted as a director in a manner that contravened that order;
(iii) while a director, grossly abused the position of a director;
(iv) while a director, took personal advantage of information or an opportunity, or intentionally or by gross negligence inflicted harm upon the company or a subsidiary of the company;
(v) while a director, acted in a manner that amounted to gross negligence, wilful misconduct or breach of trust in relation to the performance of his or her functions within, and duties to, the company or in a manner contemplated in s 77(3)*(a)*, *(b)* or *(c)* of the Act; [85]
(vi) has repeatedly been subject to a compliance notice or similar enforcement mechanism;
(vii) has at least twice been personally convicted of an offence or subjected to an administrative fine or penalty, in terms of any legislation; or
(viii) was, within a period of five years, a director of one or more companies or a managing member of one or more close corporations, or controlled or participated in the control of a juristic person, irrespective of whether concurrently, sequentially or at unrelated times, that was convicted of an offence or subjected to an administrative fine or similar penalty in terms of any legislation. [86]

12.12.3 Grounds of probation [87]

A court may make an order placing a person under probation if the person-

(i) while a director, was present at a meeting (whether in person, by electronic communication or represented by proxy) and failed to vote against a resolution despite the inability of the company to satisfy the solvency and liquidity test, contrary to the Act;
(ii) while a director, acted in a manner materially inconsistent with the duties of a director;
(iii) while a director, acted in or supported a decision of the company to act in a manner that was oppressive or unfairly prejudicial; or
(iv) within any period of ten years after 1 May 2011 was a director of more than one company or a managing member of more than one close corporation (be it concurrently, sequentially or at unrelated times), and during that time two or more of those companies or close corporations had each failed to pay all their creditors or meet all their obligations (except under a business rescue plan resulting from a resolution of the board of directors or a compromise with creditors).

12.12.4 Terms of the order and conditions

The effect of an order of delinquency is that a person is disqualified from being a director of a company. [88] An order of delinquency may under certain circumstances be unconditional and subsist for the lifetime of the delinquent director, or it may be conditional and subsist for seven years or longer, as determined by the court. [89]

A person who has been placed under probation may not serve as a director except to the extent permitted by the order of probation. [90] The probation order may be subject to any conditions the court considers appropriate (including conditions limiting the application of the declaration to one or more particular categories of companies) and generally subsists for a period not exceeding five years. [91]

Some of the conditions that the court may impose on the order of delinquency or probation are that the director concerned is required to undertake a designated programme of remedial education relevant to the nature of his or her conduct as a director, or to carry out a designated programme of community service. A court may also order the director concerned to pay compensation to any person adversely affected by his or her conduct as a director, to the extent that such a victim does not otherwise have a legal basis for claiming compensation. A further condition the court may impose on an order of probation is that the person concerned be supervised by a mentor in any future participation as a director while the order remains in force, or be limited to serving as a director of a private company, or of a company of which that person is the sole shareholder. [92]

12.12.5 Application to suspend or set aside the order of delinquency or probation

Save for certain instances, a delinquent director may, three years after the order of delinquency was made, apply to court to suspend the order of delinquency and to substitute for it an order of probation (with or without conditions). [93] If the order of delinquency is so suspended, it may be set aside by the court after two years of suspension. [94] A person who is subject to an order of probation may apply to court to set aside the order of probation, at any time more than two years after it was made. [95] On considering these applications, a court may not grant the order applied for unless the applicant has satisfied any conditions attached to the original order. [96] A court may grant the order if, having regard to the circumstances leading to the original order, and the conduct of the applicant in the ensuing period, the court is satisfied that the applicant has demonstrated satisfactory progress towards rehabilitation, and there is a reasonable prospect that the applicant will be able to serve successfully as a director of a company in the future. [97]

12.13 Vacancies on the board of directors

12.13.1 Instances when a vacancy arises

A person ceases to be a director and a vacancy arises on the board of directors in the following circumstances: [98]

(i) when a fixed term of office as a director, as specified in the Memorandum of Incorporation, expires;
(ii) upon resignation or death;
(iii) in the case of an *ex officio* director, where he or she ceases to hold the office, title, designation or similar status that entitled him or her to be an *ex officio* director;
(iv) if the person becomes incapacitated to the extent that he or she is unable to perform the functions of a director and is unlikely to regain that capacity within a reasonable time;
(v) if the person is declared delinquent by a court or is placed on probation under conditions that are inconsistent with continuing to be a director of the company;
(vi) where the person becomes ineligible or disqualified from being a director; and
(vii) where the person is removed as a director by the shareholders, or the board of directors or a court order.

12.13.2 Filling of a vacancy

Within ten business days after a person ceases to be a director of the company, the company is required to file a notice with the Companies Commission to this effect. [99]

Once a vacancy arises on 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 if the director had been appointed by a person named in or determined in terms of the Memorandum of Incorporation, or by a new election. [100] The election must be conducted at the next annual general meeting of the company if the company is required to hold such meetings. If the company is not required to hold annual general meetings, then the vacancy must be filled within six months after it arose, either at a shareholders' meeting called for the purpose of electing the director, or by a written polling of all the shareholders who are entitled to vote in the election of that director. [101] If, as a result of a vacancy arising on the board of directors, there are no remaining directors of a company, any shareholder who is entitled to vote in the election of a director may convene a meeting for the purpose of such an election. [102]

Unless the Memorandum of Incorporation of a profit company provides otherwise, the board of directors may also appoint a person who satisfies the requirements for election as a director to fill a vacancy and serve as a director on a temporary basis until the vacancy has been filled by election. [103]

12.14 Removal of directors

Under the Act a director may be removed from office by the following persons:

(i) the shareholders – this is a powerful weapon in the hands of the shareholders. The shareholders' right to remove a director is in addition to the right to place a director under probation or to have him or her declared a delinquent director; [104]

(ii) the board of directors; [105]

(iii) the Companies Tribunal (in certain instances); [106]

(iv) a business rescue practitioner, during business rescue proceedings, by applying to court for an order removing a director from office on various specified grounds; [107]

(v) a person named in or determined in terms of the Memorandum of Incorporation, which may make provision for the direct appointment and removal of a director by such person. [108]

12.14.1 Removal by the shareholders

In terms of s 71 of the Act, a director may be removed from office by the shareholders at a shareholders' meeting. Notably, the ability of the shareholders to remove a director applies despite anything to the contrary contained in the company's Memorandum of Incorporation or rules, or an agreement between a company and a director, or even an agreement between any shareholders and a director. [109] Accordingly, s 71 overrides a provision in the company's Memorandum of Incorporation, and any rules or an agreement between the company and a director not to remove a particular director. Thus the position of a director may not be effectively entrenched in these documents. A provision in the Memorandum of Incorporation of a company in terms of which a director has the power to veto any resolution to remove him or her as a director may not take effect to prevent his or her removal by a resolution duly adopted.

12.14.2 Removal by the board of directors

The board of directors may remove a director if a company has more than two directors and:

(i) a shareholder or director alleges that a director has become ineligible or disqualified in terms of the Act to be a director;

(ii) a shareholder or director alleges that a director has become incapacitated to the extent that he or she is unable to perform his or her functions, and is unlikely to regain that capacity within a reasonable time; or

(iii) a shareholder or director alleges that a director has neglected or has been derelict in the performance of his or her functions. [110]

Where the board of directors wishes to remove a director, one of the above stated grounds must apply. In contrast, where the shareholders wish to remove a director, the Act does not state the grounds upon which a director may be removed.

In terms of s 71(3), should a director or shareholder allege that one of the above grounds is applicable, the board must determine the matter by resolution, and may remove a director whom it has determined to be ineligible, disqualified, incapacitated,

negligent or derelict, as the case may be. Section 71(3) does not provide that the allegation must be made in writing, and presumably the allegation could be made verbally, for example at a board meeting or a shareholders' meeting.

Note that when the board of directors votes to remove a director, the director concerned does not participate in the vote. Of course, a director who is a shareholder may vote on the question of his or her own removal, in his or her capacity as a shareholder.

The board of directors may remove a director only where the company has at least three directors. Where the company has fewer than three directors the board of directors may not remove the director concerned, but the matter must be referred to the Companies Tribunal by any director or shareholder of the company. This is discussed further in 12.14.7.

12.14.3 Notice

Before the resolution is put to the vote by the shareholders or the board of directors, the director in question must be given notice of the meeting and a copy of the proposed resolution to remove him or her from office. Where the resolution to remove the director is to be considered by the board of directors, the resolution must be accompanied by a statement setting out the reasons for the resolution with sufficient specificity to reasonably permit the director in question to prepare and present a response. [111] This is not a requirement when a director is removed by the shareholders.

12.14.4 Presentation

The director in question must be given a reasonable opportunity to make a presentation to the shareholders' meeting or to the board of directors (in person or through a representative), as the case may be, before the resolution is put to the vote. [112] The object of this presentation is to prevent a director from being removed on an impulsive vote and without having had a proper opportunity to state his or her case.

12.14.5 Ordinary resolution

Removal of a director must be by ordinary resolution of a company in a shareholders' meeting, or by a resolution of the board of directors.

For an ordinary resolution to be approved by the shareholders, it must be supported by more than 50 per cent of the voting rights exercised on the resolution. Section 65(8) of the Act, which provides that the Memorandum of Incorporation may specify a higher percentage of voting rights to approve an ordinary resolution, prohibits this option in respect of an ordinary resolution for the removal of a director under s 71 of the Act. If this were not the case, it would be possible for a company to frustrate or impede the shareholders' right to remove a director by specifying a higher percentage for the removal of a director.

The resolution to remove a director may not be informally passed in writing by the shareholders without holding a meeting. If the resolution were to be passed in this way, it would deprive the director in question of the opportunity to present his or her case before the meeting.

12.14.6 Application to court to review the board's determination

Where the board has voted to remove a director, the director may apply to court to review the board's decision. The application to court must be brought by the aggrieved director within 20 business days of the board's decision. [113] This application may also be brought by the person who appointed that director in terms of the Memorandum of Incorporation. [114]

Should the board decide that none of the applicable grounds for removal of the director in question apply, any director who voted otherwise on the resolution, or any shareholder who has voting rights which are exercisable in the election of that director, may apply to court to review the board's determination. [115] The court may either confirm the board's determination not to remove the director in question, or remove the director from office if the court is satisfied that there are grounds for his or her removal. Should the court confirm the board's decision not to remove the director in question, the applicant in question will be required to compensate the company and any other party for costs incurred in terms of the application. [116] Should the court reverse the board's decision not to remove the director in question, then the applicant will not be required to compensate the company or any other party for the costs incurred in terms of the application.

The removal of a director by the shareholders is not subject to review by a court.

12.14.7 Removal by the Companies Tribunal

As mentioned previously, the board of directors may not remove a director where a company has fewer than three directors. In such a case any director or shareholder may apply to the Companies Tribunal to determine the director's removal on the grounds that a director has become ineligible or disqualified to be a director, incapacitated, negligent or derelict in the performance of the functions of a director. [117] Where the Companies Tribunal removes a director, the same procedure which applies to the removal of a director by the board of directors, subject to the changes required by the context, would apply to the Companies

Tribunal. [118]

12.14.8 Application of the Labour Relations Act 66 of 1995 (‘the LRA’) to the removal of directors

Neither the LRA nor the Companies Act deprives directors of protection under the LRA. [119]

The LRA should therefore be considered when removing an executive director from office under the Companies Act. Reliance on an automatic termination

provision to automatically end an employment relationship once an individual is removed as a director is not permissible. [120] Such an automatic termination provision is no more than a facilitating provision in that, should an individual be removed as a director, this could open grounds for the termination of his or her employment as an executive director.

12.14.9 Breach of contract and damages

While directors are not entitled to prevent their own removal, they are entitled to pursue any right they may have at common law, or otherwise to apply to court for damages or other compensation for loss of office as a director or loss of any other office as a consequence of being removed as a director. [121] Thus, where the director’s removal from office constitutes a breach of contract on the part of the company, or where the company has contracted to compensate the director in the event of his or her removal from office, the director in question may claim damages or other compensation from the company. [122]

12.15 Retirement from office

The company’s constitution usually makes provision for the retirement of the directors. It typically provides that all directors shall retire from office at the first annual general meeting, and that at the annual general meeting in every subsequent year a third of the directors shall retire. Alternatively, the company’s constitution may provide that the company in general meeting may from time to time determine the terms of office and the manner of retirement. It is also usually provided in the constitution that the directors to retire in every year shall be those who have been the longest in office since their last election. The constitution may provide further that a retiring director will be eligible for re-election.

12.16 Resignation of directors

Directors may terminate their offices simply by tendering their resignation, and depending on the requirements of the Memorandum of Incorporation, they may do so by giving written or oral notice to the company or the board of directors. Resignation is taken to be a final, unilateral act, and therefore (unless the Memorandum of Incorporation or a contract between the director and the company provides otherwise) it takes effect when it is tendered. Thus the concurrence or acceptance of the resignation by the company is not required to terminate the appointment of the director. A director who has contracted to serve the company for a fixed period may resign before the termination of that period, but he or she will be liable to the company for damages for any loss the company has suffered as a result of the premature termination of his or her services.

12.17 Remuneration of directors

There are broadly two sources of directors' remuneration: one source is the fees which they may receive for their services as a director (such as fees for attending board meetings) and the other source may be a director's employment contract, if one is entered into, which would provide for the payment of a salary and other benefits. There is some doubt as to the scope of s 66(8) of the Act dealing with the remuneration of directors and particularly with the reference to the words 'service as directors'.

In public-listed companies in particular the controversy over the remuneration packages of directors and senior executives has been a core issue in the corporate governance debate. The King III Report makes some important recommendations regarding the remuneration of directors and senior executives. See further Chapter 13: Corporate governance.

12.17.1 No automatic right to remuneration

A director is not automatically entitled to be remunerated for his or her services as a director simply because he or she has been appointed as a director. Of course, if a director enters into a contract of employment with the company, he or she would be entitled to those rights that flow from the employment contract and would stand in the position of both an employee and a director in relation to the company.

12.17.2 Remuneration may be prohibited by Memorandum of Incorporation

Under the Act a company may pay remuneration to a director for his or her services as a director, unless this is prohibited by the Memorandum of Incorporation. [123] Should the Memorandum of Incorporation prohibit the payment of remuneration, a director is not entitled to remuneration for his or her services, and the board of directors may not cause the company to pay remuneration to the directors. Should the directors remunerate themselves out of the company's funds in circumstances where they are not entitled to be remunerated, they are bound to account to the company for it, and to pay damages.

12.17.3 Special resolution required

Remuneration paid to directors for their service as directors may be paid only in accordance with a special resolution approved by the shareholders within the previous two years. [124] Should the shareholders fail to approve the payment of such remuneration, the directors are not entitled to receive such remuneration. Accordingly, the decision whether or not a director is to be remunerated is placed in the hands of the shareholders, and not in the hands of the board of directors or any other party. Presumably, the rationale for the onerous requirement of a special resolution being necessary to approve the remuneration is to encourage good corporate governance and to curtail excessive remuneration. Companies must ensure that a special resolution is passed prior to any remuneration being paid to a

director and that this special resolution is updated at least every two years. Remuneration paid without such a special resolution would be invalidly paid and should therefore be recoverable by the company or the liquidator.

12.17.4 Remuneration not contingent on company earning sufficient profits

Unless express provision is made to the contrary, there is no presumption that directors' remuneration is contingent on the company earning sufficient profits. If a director is entitled to be remunerated, that remuneration is a debt owed by the company. Should the company be wound up, the director may claim the remuneration owed to him or her in competition with the company's ordinary creditors.

12.17.5 Disclosure of remuneration in annual financial statements

With regard to those companies that are required to have their annual financial statements audited in terms of the Act, the annual financial statements must include particulars showing the remuneration and benefits received by each director and prescribed officer. [125]

12.18 Board committees

12.18.1 Appointment of committees

Except to the extent that the Memorandum of Incorporation provides otherwise, the board of directors may appoint any number of committees and may delegate any of its authority to a committee. [126] But note that the board of directors remains liable for the proper performance of the duty delegated.

12.18.2 Members of committees

Unless the Memorandum of Incorporation or a resolution establishing a committee provides otherwise-

- (i) a board committee may consist of persons who are not directors of the company, provided they are not ineligible or disqualified from being directors;
- (ii) non-director members of a committee do not have any right to vote on matters to be decided by the committee;
- (iii) a committee may consult with or receive advice from any person;
- (iv) a committee has the full authority of the board in respect of a matter referred to it. [127]

The Act places the same standards of conduct and liability on non-director members of a board committee and the audit committee as if they were directors of the company. Non-director members are useful in that they may bring knowledge and expertise to board committees that is lacking among the director members of the committees.

12.18.3 Compulsory committees

12.18.3.1 Audit committee

While a company may generally determine its own number and type of committees, a public company and a state-owned company must appoint an audit committee (this is subject to certain exemptions). [128] A private company, personal liability company and a non-profit company may voluntarily decide to appoint an audit committee. [129]

The audit committee should comprise at least three non-executive directors who satisfy the prescribed minimum qualification requirements. [130] At least one-third of the members of a company's audit committee at any particular time must have academic qualifications, or experience, in economics, law, corporate governance, finance, accounting, commerce, industry, public affairs or human resource management. [131]

Section 76(1) of the Act provides that the standards of directors' conduct set out in s 76 of the Act also apply to members of the audit committee. But each member of the audit committee is required to be a director, and would in any case be subject to the duties set out in s 76 of the Act.

The duties of the audit committee are set out in some detail in s 94(7) of the Act. Note that s 94(10) of the Act provides that the appointment and duties of an audit committee will not reduce the functions and duties of the board or the directors of the company, except with respect to the appointment, fees and terms of engagement of the auditor. Thus, save for the appointment, fees and terms of engagement of the auditor, the audit committee is accountable to the board of directors. See further Chapter 15: The auditor, financial records and reporting.

12.18.3.2 Social and ethics committee

(i) Appointment of social and ethics committee

In certain circumstances companies are required to appoint a social and ethics committee where it is desirable in the public interest, having regard to (i) the annual turnover; (ii) workforce size; or (iii) the nature and extent of the activities of such companies. [132] Regulation 43(1) of the Regulations requires a state-owned company and a listed public company to appoint a social and ethics committee. In addition, any other company that has in any two of its previous five years scored above 500 points in the calculation of its public interest score is required to appoint a social and ethics committee. [133]

The committee must comprise at least three directors or prescribed officers of the

company, at least one of whom must be a director who is not involved in the day-to-day management of the company's business, and must not have been so involved within the previous three financial years. [134]

(ii) Failure to appoint social and ethics committee

If a company fails to appoint a social and ethics committee, the Companies Commission may issue a notice to that company to show cause why the Companies Commission should not convene a shareholders' meeting for the purposes of making that appointment. [135] Should the company fail to respond to such a notice, or in responding, fail to satisfy the Companies Commission that the board of directors will make the appointment, or convene a shareholders' meeting to make the appointment, within an acceptable period, the Companies Commission may give notice to the shareholders and convene a shareholders' meeting to make the appointment of the committee. [136]

The Companies Commission may also assess a pro rata share of the costs of convening the shareholders' meeting to each director of the company who knowingly permitted the company to fail to appoint a social and ethics committee. A company that has been given such a notice or a director who has been so assessed any portion of the costs of a shareholders' meeting, may apply to the Companies Tribunal to set aside the notice or the assessment, in whole or in part. [137]

(iii) Exemptions from appointing social and ethics committee

In certain circumstances a company that falls within a category of companies that is required to appoint a social and ethics committee may apply to the Companies Tribunal for an exemption from this requirement.

Such an exemption may be granted where:

(a) the Tribunal is satisfied that the company is required in terms of other legislation to have, and does have, some form of formal mechanism within its structures that substantially performs the functions that would otherwise be performed by the social and ethics committee; [138]

(b) the Tribunal is satisfied that it is not reasonably necessary in the public interest to require the company to have a social and ethics

committee, having regard to the nature and extent of the company's activities; [139] or

(c) a company is a subsidiary of another company that has a social and ethics committee, and the social and ethics committee of that other company will perform the requisite functions of a social and ethics committee on behalf of that subsidiary company. [140]

An exemption granted by the Tribunal is valid for five years, or a shorter period as determined by the Tribunal. [141] Note that the Companies Commission may, on its own initiative or on request by a shareholder or a person who was granted standing by the Tribunal at the hearing of the exemption application, apply to the Tribunal to set aside an exemption on the ground that the basis on which the exemption was granted no longer applies. [142]

(iv) Functions of the social and ethics committee

The functions of the committee are wide-ranging. [143] Its main function is that of monitoring the company's activities, having regard to any relevant legislation, other legal requirements or prevailing codes of best practice with regard to matters relating to:

(a) social and economic development; [144]
(b) good corporate citizenship;
(c) the environment, health and public safety, including the impact of the company's activities and of its products or services;
(d) consumer relationships, including the company's advertising, public relations and compliance with consumer protection laws; and
(e) labour and employment.

The social and ethics committee is also required to bring matters within its mandate to the attention of the board of directors as occasion requires and to report (through one of its members) annually to the shareholders at the company's annual general meeting on the matters within its mandate. [145]

The social and ethics committee is empowered to require from any director, prescribed officer or employee of the company any information or explanation necessary for the performance of the committee's functions; to attend any shareholders' meeting; and to receive all notices and other communications relating to any shareholders' meeting. The committee is also entitled to be heard at any shareholders' meeting on any part of the business of the meeting that concerns its functions. [146]

(v) Expenses

The company must pay all the expenses reasonably incurred by its social and ethics committee. These expenses may include the costs of the fees of any consultant or specialist who may be engaged by the committee in the performance of its functions. [147]

The wide-ranging functions and the powers given to the social and ethics committee to carry out its functions are evidence of the strong emphasis the Act places on identifying and managing social and ethical issues in companies. See further the discussion on the social and ethics committee in 14.2.4.2 and the enlightened shareholder value approach in 14.2.4.

12.18.4 Recommended committees

The King III Report recommends that companies should appoint the following committees:

(i) an audit committee – to oversee the internal audit (mandatory in terms of the Act for public and state-owned companies);
(ii) a remuneration committee – to assist the board of directors in setting and administering remuneration policies;
(iii) a nomination committee – to assist with the process of identifying suitable candidates for the board of directors; and
(iv) a risk management committee – to assist the board of directors in carrying out its risk responsibilities.

See further Chapter 13: Corporate governance.

12.19 Board meetings

Directors exercise their powers by passing resolutions at board meetings. These meetings must be properly convened. Proper notice must be given to all the directors and a quorum must be present at the meetings.

12.19.1 Calling a meeting

A director authorised by the board may call a board meeting at any time. Subject to the Memorandum of Incorporation, which may specify a higher or a lower number of directors, a meeting must be called if required by at least 25 per cent of the directors where the board has 12 or more members, or by at least two directors where the board has fewer than 12 members. [148]

As previously discussed, where a profit company (other than a state-owned company) has only one director, the provisions of the Act relating to board meetings do not apply to the governance of that company. [149]

12.19.2 Notice

The form of notice and the notice period may be determined by the board of directors, provided there is compliance with the Memorandum of Incorporation and the rules of the company. [150]

A board meeting may not be convened without notice being given to all the directors. [151] But, except to the extent that the Memorandum of Incorporation provides otherwise, if all the directors of the company acknowledge actual receipt of the notice, are present at the meeting or waive notice of the meeting, the meeting may proceed even if the company had failed to give the notice of the meeting, or if there was a defect in the giving of the notice. [152]

Where no specific time limits are prescribed in the Memorandum of Incorporation for the calling of board meetings, fair and reasonable notice of the meeting must be given to every director who is within reach. This does not mean that a valid meeting cannot be held if notice has not been given to one or more directors who were inaccessible, for example, through being indisposed or overseas. The general rule is that the more contentious the business of the meeting, the greater the inaccessibility needed before notice to a director may be dispensed with. Fair and reasonable notice to attend a directors' meeting depends on the circumstances and on the structure, practice and affairs of the company. [153]

It is generally not strictly necessary for the business to be transacted at the meeting to be specified in the notice of the meeting, but this is often done, because in practice it is regarded as being prudent to do so.

12.19.3 Quorum

Except to the extent that the Memorandum of Incorporation provides otherwise, the quorum for board meetings is a majority of directors. [154] A quorum must consist of directors who are capable of voting on the business before the board, otherwise there will not be a quorum. Moreover, a quorum must be a disinterested quorum: a director who has an interest in a matter may not vote on the matter. [155]

12.19.4 Voting

Each director has one vote on a matter before the board, except to the extent that the Memorandum of Incorporation provides otherwise. [156] It is possible for directors to have loaded votes, which means that greater voting rights may be attached to some shares than to others. Except to the extent that the Memorandum of Incorporation provides otherwise, the approval of a resolution requires a majority of the votes cast. [157]

Except to the extent that the Memorandum of Incorporation provides otherwise, in the case of a tied vote, the chairperson has a casting vote only if he or she did not have or cast a vote initially, but in any other case the matter being voted upon will fail, ie it will not be passed. [158]

Directors may not bind themselves by a voting agreement in terms of which they

bind themselves to vote in accordance with the directions and instructions of some other person. This would be contrary to their fiduciary duty not to fetter their discretion. [159]

12.19.5 Minutes and resolutions

A company must keep minutes of its board and committee meetings. [160] The minutes of a meeting serve the purpose of verifying the business that was discussed and resolved at the meeting. The minutes must include every resolution adopted by the board and any declarations given by notice or made by a director regarding his or her personal financial interests in a matter in terms of s 75 of the Act. [161] Resolutions adopted by the board must be dated and sequentially numbered and are effective as of the date of the resolution, unless the resolution states otherwise. [162] Every company must maintain the minutes of all meetings and resolutions of directors or directors' committees or the audit committee (if any) for a period of seven years after the date of each meeting or the date on which each resolution was adopted. [163] Minutes of directors' meetings are not open for inspection by members of the company unless the Memorandum of Incorporation permits this. The minutes of a meeting or resolutions signed by the chairperson of the meeting, or by the chairperson of the next board meeting, constitute evidence of the proceedings of that meeting or adoption of that resolution, as the case may be. [164]

12.19.6 Electronic communications

Board meetings may be conducted electronically, or one or more directors may participate in a meeting by way of electronic communication. [165] This is subject to the proviso that all participants are able to communicate concurrently with each other without an intermediary, and are able to participate effectively in the meeting. [166] Flexibility is maintained by permitting board meetings to be held electronically while at the same time permitting a company in its Memorandum of Incorporation to restrict electronic meetings if it so chooses. [167]

12.20 Decisions taken without convening a meeting

Instead of holding a formal meeting, the directors may consent in writing to decisions that could be voted on at a board meeting, in terms of a resolution informally known as a 'round robin' resolution. Such decisions have the same effect as if they had been approved by voting at a meeting. [168] Decisions may be taken by means of a round robin resolution only if every director has received notice of the matter to be decided. [169] Unless the Memorandum of Incorporation provides otherwise, board decisions may be adopted by the written consent of a majority of the directors. [170] The written consent may be given in person or by electronic communication [171] and the directors' signatures need not be contained on the same piece of paper.

12.21 Loans or other financial assistance to directors

Given that directors have control over the company's day-to-day activities and are able to exert a strong influence on their company or a company under their company's control, they are in a good position to effect loan transactions or other financial assistance for their own benefit. History has shown that, from time to time, directors have given in to the temptation to do so. Accordingly, the provision of loans or other financial assistance to directors has for a long time either been prohibited or subject to statutory regulation. For a discussion on loans and other financial assistance to directors see Chapter 10: Corporate finance.

Questions

1. Mr Benson is a director of Greenstock (Pty) Ltd. The board of directors comprises seven directors in total. Mr Benson has, without any apology, failed to attend any meetings of the board of directors for the past year.
    (a) Advise the board of directors of Greenstock (Pty) Ltd whether this is a ground for the removal of Mr Benson as a director. If so, advise them how they may remove Mr Benson as a director from the board of directors.
    (b) Assume that three directors on the board of directors wish to remove Mr Benson as a director on the board of directors and that three directors are opposed to this step. Advise the board of directors whether, and if so, how the deadlock might be resolved.
    (c) Assume that the board of directors votes to remove Mr Benson as a director of Greenstock (Pty) Ltd. Mr Benson is not happy at all about this decision. Advise Mr Benson of any legal remedies which he may pursue.
2. The board of directors of Shady (Pty) Ltd, an engineering company, wishes to appoint Mr Hatfield as a director on the board of directors. Mr Hatfield does not have much business experience or any experience in the engineering field. However, he has many close friends in the business community. Shady (Pty) Ltd has not been performing well and the board of directors is hoping that if they appoint Mr Hatfield as a director, he will be able to secure lucrative work for Shady (Pty) Ltd.

    Mr Hatfield informs the board of directors of Shady (Pty) Ltd that he is prepared to be a director of Shady (Pty) Ltd only if he is paid a minimum payment of R10 000 for attending each board meeting. The other directors on the board of directors are presently paid R5 000 to attend a board meeting.
    (a) Advise the board of directors of Shady (Pty) Ltd whether they have the power to appoint Mr Hatfield as a director on the board of directors.
    (b) Advise the board of directors of Shady (Pty) Ltd whether they may agree to remunerate Mr Hatfield an amount of R10 000 to attend each board meeting.

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[1] Section 66(1).
[2] Section 68(1).

[3] Section 68(3).

[4] *Fisheries Development Corporation of SA Ltd v Jorgensen; Fisheries Development Corporation of SA Ltd v AWJ Investments (Pty) Ltd* 1980 (4) SA 156 (W) 163.

[5] Ibid. See further Chapter 14: The duties and the liability of directors.

[6] 1965 (4) SA 646 (W).

[7] At 652.

[8] *S v Hepker* 1973 (1) SA 472 (W) 484.

[9] *Re Hydrodam (Corby) Ltd* [1994] BCC 161 at 163.

[10] J de Lacy 'The concept of a company director: Time for a new expanded and unified statutory concept' (May 2006) *Journal of Business Law* 267 at 291.

[11] See for example *S v De Jager* 1965 (2) SA 616 (A), where two directors of a company had resigned and had appointed two other persons as directors, who had acted simply on their instructions. It was held that even though the directors in question had formally resigned as directors they nevertheless continued to be directors for the purposes of their fiduciary duties as directors.

[12] MS Blackman et al *Commentary on the Companies Act* vol 2 (2002) (Revision Service 9, 2012) 8-9.

[13] Blackman (n 12) 8-10.

[14] See *Regal (Hastings) Ltd v Gulliver* [1942] 1 All ER 378 (HL), [1967] 2 AC 134 at 147.

[15] See *Cohen v Segal* 1970 (3) SA 702 (W).

[16] Regulation 38(1) of the Companies Regulations GNR 351 *GG* 34239 of 26 April 2011 ('the Regulations').

[17] Regulation 38(2).

[18] Section 30(4).

[19] *R v Mall* 1959 (4) SA 607 (N).

[20] *South African Broadcasting Corporation Ltd v Mpofu* [2009] 4 All SA 169 (GSJ).

[21] Section 73(5).

[22] Section 84(4) read with s 86(1).

[23] Section 34(2) read with s 84(1).

[24] Section 84(5).

[25] Section 90(2).

[26] Section 90(1).

[27] Section 90(1A).

[28] Section 66(2).

[29] Ibid.

[30] Section 66(3).

[31] Section 94(2) read with s 94(4).

[32] Regulation 43(4).

[33] Section 66(12).

[34] Section 57(3).

[35] For instance, certain provisions on removal of directors, the provisions on board meetings and the provisions on the passing of written resolutions do not apply to the governance of that company.

[36] Section 67(2).

[37] Section 66(11).

[38] Section 67(1).

[39] Section 66(4).

[40] Section 68(1).

[41] Section 68(2).

[42] Ibid.

[43] Ibid.

[44] Section 66(4).

[45] Blackman et al (n 12) 8-243. For the law relating to a director's fiduciary duty to exercise his or her powers for a proper purpose, refer to Chapter 14: The duties and the liability of

directors.
[46] Section 66(7).
[47] Section 66(6).
[48] Section 70(6). This must be done on Form CoR 39 (Notice of Change of Directors).
[49] *SA Post Office Ltd v Mampeule* (2010) 31 *ILJ* 2051 (LAC).
[50] Section 68(1).
[51] Section 71.
[52] Section 24(5).
[53] Section 24(1).
[54] Section 24(2).
[55] Section 24(3).
[56] Section 25.
[57] Section 26(1).
[58] Section 26(2).
[59] Section 26(3).
[60] Ibid. Part 3 of PAIA deals with access to records of private bodies and with grounds for refusal of access to records.
[61] Section 26(4).
[62] Ibid.
[63] Regulation 24(2) and (3).
[64] Section 26(5) and reg 24(4).
[65] Section 26(9). A person convicted of an offence in terms of the Act is liable to a fine or to imprisonment for a period not exceeding 12 months, or to both a fine and imprisonment (s 216).
[66] Section 15(3).
[67] Section 15(4).
[68] Section 69(1).
[69] Section 69(6).
[70] Section 69(7).
[71] For example, a person who has been declared by a court of law to be incapable of managing his or her affairs.
[72] Section 69(8).
[73] The prescribed minimum value of the fine has been prescribed by reg 39(4), and is presently an amount of R1 000.
[74] Section 69(6).
[75] Section 69(2).
[76] Section 69(4).
[77] Section 69(3).
[78] Section 69(11).
[79] Section 69(9).
[80] Section 69(10).
[81] Section 69(13).
[82] Regulation 39(3).
[83] Section 162(2), (3) and (4).
[84] Section 162(5).
[85] In terms of s 77(3)*(a)*, a director may not act in the company's name, sign anything on behalf of the company or purport to bind the company or authorise the taking of any action by the company while knowing that he or she lacks the authority to do so. Section 77(3)*(b)* prohibits a director from acquiescing in the carrying on of the company's business despite knowing that the business was being conducted recklessly, with gross negligence, with intent to defraud any person or for any fraudulent purpose, as prohibited by s 22(1) of the Act. Under s 77(3)*(c)* a director may not be a party to an act or omission by the company while knowing that that act or omission was calculated to defraud a creditor, employee or shareholder of the company or had another fraudulent purpose.
[86] In order for this ground to apply it is further required that (i) the person in question must

have been a director of each such company, or a managing member of each such close corporation, or responsible for the management or each such juristic person, at the time of the contravention that resulted in the conviction, administrative fine or other penalty; and (ii) the court must be satisfied that the declaration of delinquency is justified, having regard to the nature of the contraventions, and the person's conduct in relation to the management, business or property of any company, close corporation or juristic person at the time.

[87] Section 162(7).

[88] Section 69(8).

[89] Section 162(6).

[90] Section 69(5).

[91] Section 162(9).

[92] Section 162(10).

[93] Section 162(11).

[94] Ibid.

[95] Ibid.

[96] Section 162(12).

[97] Ibid.

[98] Section 70(1).

[99] Section 70(6). This must be done on Form CoR 39 (Notice of Change of Directors).

[100] Section 70(3).

[101] Ibid.

[102] Section 70(4).

[103] Section 68(3).

[104] Section 71(1) and (10).

[105] Section 71(3).

[106] Section 71(8).

[107] Section 137(5).

[108] Section 66(4).

[109] Section 71(1).

[110] Section 71(3).

[111] Section 71(4).

[112] Section 71(2) and (4).

[113] Section 71(5).

[114] Ibid.

[115] Section 71(6).

[116] Section 71(7).

[117] Section 71(8).

[118] Ibid.

[119] *PG Group (Pty) Ltd v Mbambo NO* (2004) 25 *ILJ* 2366 (LC).

[120] *SA Post Office Ltd v Mampeule* (2010) 31 *ILJ* 2051 (LAC).

[121] Section 71(9).

[122] Blackman et al (n 12) 8-285.

[123] Section 66(8).

[124] Section 66(9).

[125] Section 30(4).

[126] Section 72(1).

[127] Section 72(2).

[128] See ss 84(1) and 94(2) for these exemptions.

[129] Sections 34(2) and 84(1) of the Act.

[130] Section 94(2) and (4).

[131] Regulation 42.

[132] Section 72(4).

[133] Regulation 26(2) requires every company to calculate its public interest score at the end

of each financial year, calculated as the sum of the following: *(a)* a number of points equal to the average number of employees of the company during the financial year; *(b)* one point for every R1 million (or portion thereof) in third party liability of the company, at the financial year-end; *(c)* one point for every R1 million (or portion thereof) in turnover of the company during the financial year; and *(d)* one point for every individual who, at the end of the financial year, is known by the company (i) in the case of a profit company, to directly or indirectly have a beneficial interest in any of the company's issued securities; or (ii) in the case of a non-profit company, to be a member of the company, or a member of an association that is a member of the company.

[134] Regulation 43(4).

[135] Section 84(6).

[136] Ibid.

[137] Section 84(7).

[138] Section 72(5).

[139] Ibid.

[140] Regulation 43(2).

[141] Section 72(6).

[142] Section 72(7).

[143] See reg 43(5), where these functions are set out.

[144] This includes the company's standing in terms of the goals and purposes of the ten principles set out in the United Nations Global Compact Principles; the Organisation for Economic Co-operation and Development (OECD) recommendations regarding corruption; the Employment Equity Act 55 of 1998; and the Broad-Based Black Economic Empowerment Act 53 of 2003.

[145] Regulation 43(5).

[146] Section 72(8).

[147] Section 72(9).

[148] Section 73(1).

[149] Section 57(3).

[150] Section 73(4).

[151] Section 73(4).

[152] Section 73(5).

[153] *South African Broadcasting Corporation Ltd v Mpofu* [2009] 4 All SA 169 (GSJ) para 39.

[154] Section 73(5).

[155] Refer to s 75 of the Act. See further Chapter 14: The duties and the liability of directors.

[156] Section 73(5).

[157] Ibid.

[158] Ibid.

[159] See further Chapter 14: The duties and the liability of directors.

[160] Section 73(6).

[161] Ibid.

[162] Section 73(7).

[163] Section 24(3).

[164] Section 73(8).

[165] Section 73(3).

[166] Ibid.

[167] Ibid.

[168] Section 74(2).

[169] Section 74(1).

[170] Ibid.

[171] Section 74(1).

Chapter 13
Corporate Governance

Rehana Cassim

13.1 Introduction

Corporate governance is about the structures and processes associated with management, decision-making and control in organisations. [1] Corporate governance practices are essentially a performance management system to ascertain whether the directors have discharged their duties, and to assist them in the discharge of their duties. These practices are intended to provide guidance to directors on how to direct and control the business of their companies, and how to make successful company decisions. In recent years a series of highly publicised corporate scandals and high-profile corporate failures worldwide have prompted the further development of corporate governance principles and practices, and have highlighted the lack of effective accountability within companies.

Sound corporate governance is essential for the well-being of a company and supports the growth of South Africa's economy, particularly in attracting new investments. Companies which do not practice sound corporate governance are likely to feel the effects on their reputation, their share price and their sustainability. One of the very purposes of the Companies Act 71 of 2008 ('the Act') is to encourage transparency and high standards of corporate governance as a means of promoting the development of the South African economy. [2] This purpose encourages an interaction between the King Report on Governance for South Africa 2009 ('the King III Report') and the Act. The Act now also incorporates to a larger extent certain issues of corporate governance. [3]

In 1994 the King Committee, formed at the instance of the Institute of Directors in Southern Africa, published the King Report on Corporate Governance, which contained a Code of Corporate Practices and Conduct. This report was updated and superseded in 2002 by the King Report on Corporate Governance for South Africa 2002 ('the King II Report'), which also contained a Code of Corporate Practices and Conduct. The King III Report and the King Code of Governance for South Africa 2009 ('the Code'), which came into effect on 1 March 2010, have now replaced the King II Report and Code of Corporate Practices and Conduct. The King III Report, which sets out a number of key corporate governance principles, must be read together with the Code, which sets out best practice recommendations on how to carry out each principle. The Institute of Directors in Southern Africa issues Practice Notes to the King III Report which are intended to provide guidance to entities on implementing the key principles.

13.2 Application

The King III Report applies to all entities incorporated in and resident in South Africa, regardless of the manner and form of incorporation or establishment and whether such establishment is in the public, private or non-profit sectors. [4] In South Africa, compliance with the King III Report is mandatory for companies listed on the JSE, [5] but for all other entities there is no statutory obligation to comply with the King III Report nor any sanction for non-compliance. While corporate governance practices in South Africa may be voluntary, note that they are highly recommended and have considerable persuasive force.

13.3 Philosophy of 'apply or explain'

The approach adopted to corporate governance is that of 'apply or explain'. [6] This means that entities must make a positive statement to shareholders on how the corporate governance principles have been applied or not. For instance, in following the 'apply or explain' approach, the board of directors may conclude that to follow a recommendation will not, in the particular circumstances, be in the best interests of the company, and it may decide to apply the recommendation differently or to apply a different practice but nevertheless achieve the objective of the overarching corporate governance principles. Explaining how the corporate governance recommendations were applied, or the reasons for not applying them, will result in compliance. [7]

Significantly, as previously mentioned, the Act incorporates to a larger extent certain issues of corporate governance. Accordingly, the language used in the King III Report has been carefully chosen in that the word 'must' is used in the King III Report with regard to a principle or practice where that principle or practice is in line with the Act. [8] Where the application of the Report would result in good corporate governance the word 'should' has been used. [9] Thus where the word 'should' is used in regard to a recommendation, such recommendation is not contained in the Act. Accordingly, compliance with the King III Report results in compliance with the Act with regard to governance, but the converse does not apply. [10]

13.4 Principles and recommendations of the King III Report and the Code

The King III Report provides guidance on the following aspects related to corporate governance:

(i) ethical leadership and corporate citizenship;
(ii) boards and directors;
(iii) audit committees;
(iv) the governance of risk;
(v) the governance of information technology;
(vi) compliance with laws, codes, rules and standards;
(vii) internal audit;
(viii) governing stakeholder relationships; and
(ix) integrated reporting and disclosure.

The Report is divided into nine chapters. Each of the principles contained in the Report is set out in the Code, together with the recommended practices relating to each principle. Some of the main principles and practices of the King III Report are briefly discussed below.

13.4.1 Ethical leadership and corporate citizenship

The underlying philosophy of the King III Report revolves around leadership, sustainability and corporate citizenship. [11]

13.4.1.1 Leadership

The King III Report requires the board of directors to provide effective leadership based on an ethical foundation. [12] Ethics or integrity is the foundation of and the very reason for corporate governance. The board should set the values to which the company will adhere and these values should be incorporated in a code of conduct.

The board should ensure that all decisions and actions are based on the four ethical values underpinning good corporate governance, namely responsibility, accountability, fairness and transparency. [13] The board should ensure that each director adheres to the duties of a director.

13.4.1.2 Sustainability

Sustainability means having regard to the impact of a company's business operations on the economic life of the community in which it operates, and includes environmental, social and governance issues.

13.4.1.3 Corporate citizenship

This requires the board to ensure that the company is, and is seen to be, a responsible corporate citizen. [14] As a responsible corporate citizen, the company should protect, enhance and invest in the well-being of the economy, society and the environment. [15]

13.4.2 Boards and directors

13.4.2.1 Types of directors

The King III Report differentiates between executive, non-executive and independent non-executive directors.

(i) Executive directors

An executive director is involved in the day-to-day management of the company. He or she is in the full-time salaried employ of the company [16] and is generally under a contract of service with the company.

(ii) Non-executive directors

A non-executive director is a part-time director and is not an employee of the company. He or she is not involved in the management of the company, but plays an important role in providing objective judgment, independent of management, on issues facing the company. [17] Non-executive directors are usually appointed to the board of directors for the purpose of bringing an external, independent perspective to the management of a company. Generally, non-executive directors contribute to the development of management strategies and monitor the activities of the executive directors.

(iii) Independent non-executive directors

An independent non-executive director is one who does not have a relationship with the company outside his or her directorship. He or she is required to be independent in character and judgment and free of any relationships which could materially interfere with the independent exercise of his or her judgment. By independence is meant the absence of undue influence and bias that could be affected by the intensity of the relationship between the director and the company, rather than any particular fact such as length of service or age. [18] The Report suggests that any term beyond nine years for an independent non-executive director should be subject to a rigorous review by the board of directors. [19]

13.4.2.2 The responsibilities of the board of directors

The King III Report and the Code deal extensively with the responsibilities of the board of directors. It is for the board of directors to act as the focal point and custodian of corporate governance. [20]

13.4.2.3 Composition of the board

(i) Board structures

There are generally two types of board structures: unitary boards and two-tier boards.

A unitary board is composed of both executive and non-executive directors who interact directly with each other. A two-tier board comprises a management board and a supervisory board. The management board composed of executive directors runs the company, while the supervisory board composed of non-executive directors monitors how the management board discharges its functions. Both employees and shareholders are represented on the supervisory board. The King III Report expresses the view that, given the positive interaction and diversity of views that occur between individuals of different backgrounds, experiences and skills, the unitary board structure with executive directors and non-executive directors interacting in a working group is more appropriate for South African companies. [21]

(ii) Balance of power and authority

The King III Report states that there should be a balance of power and authority in the board and that no one individual or block of individuals should have sufficient power to dominate the board's decision-making. [22] The Report recommends that there should be a majority of non-executive directors on the board and that the majority of the non-executive directors should be independent non-executive directors, because this reduces the possibility of conflicts of interests and promotes objectivity. [23] The Code (2.18.5) recommends that every board should have a minimum of two executive directors, being the chief executive officer and the director responsible for the finance function.

(iii) Size of board

In determining the number of directors that should serve on the board, the collective knowledge, skills, experiences and resources required for conducting the business of the board should be taken into consideration (Code 2.18.3). Every board should consider whether its size, diversity and demographics make it effective (Code 2.18.4).

A board of directors which is too large may become very formal and may inhibit debate. On the other hand, a board of directors which is too small may become dominated by one individual and may lose the broader perspective which is provided by a greater diversity of views.

13.4.2.4 Board appointment

The procedures for the appointment of directors must be formal and transparent. [24] The Code recommends that the nomination committee should assist with the process of identifying suitable members of the board (Code 2.19.1). It suggests further that background and reference checks should be performed before the nomination and appointment of directors (Code 2.19.2). Full disclosure regarding each individual director should be made to enable shareholders to make their own assessment of the directors (Code 2.19.4).

13.4.2.5 Board meetings

It is recommended that the board meets as often as is required to fulfil its duties, but that board meetings should be held at least four times per year (Code 2.1.2). Non-executive directors should meet from time to time without the presence of any executive directors to consider the performance and actions of executive management. [25]

13.4.2.6 Board committees

While the board may delegate certain functions to committees, it must do so without abdicating its own responsibilities. [26] By establishing board committees, the board is not exonerated of complying with its legal responsibilities. [27] In general, the Code (2.23.7) recommends that committees should comprise a majority of non-executive directors, the majority of whom should be independent. The following committees should be appointed:

- (i) audit committee – to oversee the internal and external audit processes;
- (ii) risk committee – to assist the board in carrying out its risk responsibilities;
- (iii) remuneration committee – to assist the board in setting and administering remuneration policies;
- (iv) nomination committee – to assist with the process of identifying suitable members for the board of directors.

Certain companies must appoint a social and ethics committee. It is further recommended that the board considers the establishment of a governance committee, an information technology steering committee and a sustainability committee. [28] It may be onerous for smaller companies to set up all these committees and the King III Report accordingly provides that small companies need not establish formal committees to perform the recommended functions, but they should ensure that these functions are appropriately addressed by the board. [29]

13.4.2.7 Induction and training

It is recommended that the board of directors should ensure that a formal induction programme is established for new directors, and that continuing professional development programmes are implemented (Code 2.20.1 and 2.20.3). The mentorship of inexperienced directors by experienced directors is encouraged (Code 2.20.2).

13.4.2.8 Performance assessment

The King III Report requires the board, its committees and individual directors to be evaluated annually. [30] The evaluations should be performed by the chairperson or an independent provider (Code 2.22.2).

13.4.2.9 Remuneration

The King III Report deals with the remuneration of directors and senior executives in some detail. The remuneration packages of directors in listed public companies have been a central issue in the corporate governance debate. When setting the level of remuneration of directors, a company must balance its desire to attract, retain and motivate directors against its interest in not paying excessive remuneration to its directors. Some of the recommendations of the King III Report on this issue are as follows:

(i) A company should remunerate its directors and executives fairly and responsibly. [31]

(ii) The remuneration policies and practices adopted by a company should be aligned with the company's strategy and should be linked to the director's contribution to the performance of the company. [32]

(iii) A company should disclose the remuneration of each individual director and prescribed officer in its annual remuneration report. [33]

(iv) Non-executive directors' fees should be commensurate with the responsibilities borne by directors throughout the year, and not only during meetings. [34]

(v) In the event of early termination of a director's contract there should not be an automatic entitlement to bonuses or share-based payments. [35]

(vi) When an executive director's service is terminated arising from his or her failure, the contract of employment should not commit the company to make a payment to him or her. [36]

13.4.2.10 The chairperson

The King III Report requires the board of directors to annually elect as a chairperson someone who is an independent non-executive director. [37] It recommends that the chief executive officer of the company should not also fufil the role of the chairperson, [38] as this leads to excessive concentration of power in one person.

13.4.2.11 The chief executive officer (CEO)

The board should appoint a CEO, who will serve as the chief representative of the company. [39] The collective responsibilities of management vest in the CEO, who ultimately bears responsibility for all management functions. [40] The CEO plays a critical role in the operations and success of the company's business; his or her role and functions should be formalised, and his or her performance should be evaluated by the board against such criteria. [41]

13.4.2.12 The company secretary

The King III Report recommends that the board should be assisted by a competent, suitably qualified and experienced secretary. [42] The company secretary should not be a director of the company (Code 2.21.4). As the gatekeeper of good governance, it is important for the secretary to maintain an arm's-length relationship with the board of directors (Code 2.21.3). The secretary is required, inter alia, to provide guidance to the board on the duties of the directors and good governance, and to assist with the evaluation of the board and its committees as well as individual directors. See further Chapter 15: The auditor, financial records and reporting.

13.4.3 Audit committees

The King III Report requires the board of directors to ensure that the company has an effective and independent audit committee. [43] An independent audit committee plays a central role in corporate governance. Some of the functions of the audit committee are to oversee the integrity of the integrated report for which the board of directors is responsible; oversee the internal audit; form an integral component of the company's risk management process; recommend the appointment of the external auditor; and oversee the external audit process. The audit committee should report to the board of directors and shareholders on how it has discharged its duties. [44] See further Chapter 15: The auditor, financial records and reporting.

13.4.4 The governance of risk

The King III Report requires that the board of directors be responsible for the governance of risk and determine the levels of risk tolerance that the company is able

to bear in the pursuit of its objectives. [45] 'Risk' is defined as the taking of risk for reward. [46] There are various types of risk, such as market risk, credit risk, operational risk, reputational risk and business volume risk. The board should ensure that risk assessments are continually performed, [47] and that there are processes in place that enable timely, relevant and accurate risk disclosure to stakeholders. [48]

13.4.5 The governance of Information Technology (IT)

The King III Report acknowledges that IT has become an integral part of doing business and is fundamental to support, sustain and grow the business. [49] IT governance can be considered as a framework that supports efficient management of IT resources to facilitate the achievement of a company's strategic objectives. [50] The IT governance framework should include the relevant structures, processes and mechanisms to enable IT to deliver value to the business and to mitigate IT risks. [51] The board may appoint an IT steering committee or similar forum to assist with its governance of IT. [52]

13.4.6 Compliance with laws, rules, codes and standards

The King III Report requires the board of directors to ensure that the company complies with all applicable and relevant laws and that it considers adherence to non-binding rules, codes and standards. [53] A compliance culture should be encouraged through leadership, establishing the appropriate structures, education and training, communication and the measurement of key performance indicators relevant to compliance. [54]

13.4.7 Internal audit

The King III Report requires the board of directors to ensure that there is an effective risk-based internal audit. [55] An internal audit should evaluate the company's governance processes, perform an objective assessment of the effectiveness of risk management and the internal control framework, systematically analyse and evaluate business processes and associated controls, and provide a source of information regarding instances of fraud, corruption, unethical behaviour and irregularities (Code 7.1.2). An internal audit plays an important role in providing assurance to the board regarding the effectiveness of the system of internal controls and risk management of the company. [56]

13.4.8 Governing stakeholder relationships

13.4.8.1 Stakeholder-inclusive approach

The King III Report adheres to the 'triple context' or integrated approach, which acknowledges that companies should act with economic, social and environmental responsibility and directors should consider the economic, social and environmental factors when they manage a company. [57] Thus the Report advocates the notion that the board of directors is responsible not merely for the company's financial bottom-line, but rather for the company's performance within the triple context in which it operates ('triple bottom-line'). [58]

In whose interests must the interests of the company be managed: the shareholders' or the stakeholders'? Stakeholders are any group that may affect the company's operations or could be affected by the company's operations. Stakeholders include, but are not limited to, shareholders, institutional investors, creditors, lenders, suppliers, customers, regulators, employees, trade unions, the media, analysts, consumers, society in general, communities, auditors and potential investors. There are two main schools of thought relating to this question. Under the enlightened shareholder value approach the shareholders' interests retain primacy. This approach holds that directors may prioritise the interests of other stakeholders but only if this is likely to promote the success of the company for the benefit of the shareholders in general. This approach is a profit-maximising approach. On the other hand, the pluralist approach holds the view that companies have a social responsibility to society and that directors have a duty to balance the interests of shareholders and stakeholders, and they must give independent value to the interests of stakeholders, whose interests are not subordinate to those of shareholders. This is a profit-sacrificing, social responsibility approach.

The approach adopted by the King III Report is a stakeholder-inclusive corporate governance approach. In terms of this approach, a shareholder does not have a predetermined place of precedence over other stakeholders, but the interests of the shareholder or any other stakeholder may be afforded precedence based on what is believed to serve the best interests of the company at that point. [59] The King III Report recommends that the board of directors should strive to achieve the appropriate balance between its various stakeholder groupings, in the best interests of the company. [60]

13.4.8.2 Shareholder activism and shareholder apathy

Shareholder apathy means that the shareholders are passive and choose not to exercise their right to vote. One reason why shareholders are apathetic is said to be due to their perception that their efforts in exercising their right to vote will not bring about any noticeable change or compliance with corporate governance principles. In many private companies the directors and the shareholders are the same persons but in large companies ownership and control are split, that is, the control and management of the company rests in the hands of the directors while ownership of the shares rests with the shareholders. This separation of ownership and control has the potential to cause a divergence between the interests of the shareholders and those of the managers of the company, without there being any effective check on the power of the directors. The wide spread of ownership of shares results in no single shareholder or group of shareholders being able to exercise effective control over the directors. Shareholder apathy is also thought to be a result of the shareholders' lack of knowledge of their legal rights and powers. It is also costly to attend shareholders' meetings as this entails travel expense and a loss of productive working hours. Where shareholders are passive, this results in the directors tending to do as they please. The absence of shareholder activism thus undermines appropriate levels of managerial compliance.

The King III Report encourages shareholder activism because this results in shareholders constantly checking whether the directors are practising good corporate governance. For instance, the King III Report recommends that institutional investors [61] be encouraged to vote and engage with companies. [62] Large institutional shareholders are able to control sufficient shares to overcome the separation of ownership and control in large public companies and have a direct influence on management. The King III Report further recommends that the board of directors should encourage shareholders to attend annual general meetings and other company meetings, at which all the directors should be present. [63] It is hoped that since the Act permits voting to take place by electronic means the problem of shareholder apathy may be alleviated.

13.4.8.3 Dispute resolution

Alternative dispute resolution (ADR) has become a worldwide trend in resolving disputes. The ADR procedures take into account the needs of both parties and strive to achieve flexible solutions that may help to preserve relationships. The King III Report suggests that mediation and conciliation may be a more appropriate channel to resolve disputes compared to formal litigation proceedings where the interests of the disputing parties need to be addressed and where commercial relationships need to be preserved and even enhanced. [64] These processes are also cost-effective and can be concluded within a short period of time.

13.4.9 Integrated reporting and disclosure

The board of directors should ensure the integrity of the company's integrated report. [65] Integrated reporting means a holistic and integrated representation of the company's performance in terms of both its finances and its sustainability. [66] The integrated report should be prepared every year, and should convey adequate information regarding the company's financial and sustainability performance (Code 9.1.3 and 9.1.4). The annual financial statements should be included in the integrated report, and the board should include a commentary on the company's financial results, which should convey information to enable stakeholders to make informed assessments of the company's economic value. [67] The board should ensure that positive and negative effects on the company's operations and plans to improve those positives and eradicate those negatives in the financial year ahead are conveyed in the integrated report (Code 9.2.4). See further Chapter 15: The auditor, financial records and reporting.

Questions

1. Mickey and Minnie wish to start a business selling T-shirts. They have been advised that they should form a company for this purpose. They form a company with the name 'T-shirts for Africa (Pty) Ltd'. This is the first company that they have formed and they require guidance as to whether they have complied with good corporate governance practices as set out in the King Report on Governance for South Africa 2009 and the King Code of Governance for South Africa 2009. They advise you of the following facts:
    - The board comprises ten directors.
    - Eight of the directors on the board are executive directors and two are non-executive directors.
    - Meetings of the board of directors are to be held six times a year.

- The company secretary is also a director of the company.
- Should an executive director's employment contract be terminated early, he or she will be automatically entitled to a R100 000 payment.
- Mickey is the chief executive officer of the company and is also the chairperson of meetings of the board of directors.
- Two committees will be formed: an audit committee and a risk committee.

  (a) Advise Mickey and Minnie in each instance whether they have complied with good corporate governance practices, and if not, what they should do in order to comply with such practices.

  (b) Advise Mickey and Minnie of the consequences should they decide not to comply with any of the corporate governance practices set out in the King Report on Governance for South Africa 2009 and the King Code of Governance for South Africa 2009.

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[1] T Wixley & G Everingham *Corporate Governance* 3 ed (2010) 1.

[2] See s 7*(b)* of the Act.

[3] For a discussion of how the Act and the King III Report complement each other, see M King 'The synergies and interaction between King III and the Companies Act 71 of 2008' 2010 *Acta Juridica* 446.

[4] King III Report at 17.

[5] Paras 7.F.5 to 7.F.6 and para 8.63*(a)* of the JSE Listings Requirements.

[6] King III Report, preface, 7.

[7] Ibid.

[8] King III Report, preface, 17.

[9] Ibid.

[10] See King (n 3) 447.

[11] King III Report, preface, 10.

[12] Principle 1.1 of the King III Report.

[13] King III Report at 21 para 14.

[14] Principle 1.2 of the King III Report.

[15] King III Report at 22 para 19.

[16] Annex 2.2 of the King III Report.

[17] Annex 2.3 of the King III Report.

[18] King III Report at 38 para 66.

[19] King III Report at 40 para 77.

[20] Principle 2.1 of the King III Report.

[21] King III Report at 38 para 62.

[22] Principle 2.18 of the King III Report and King III Report at 38 para 63.

[23] King III Report at 38 para 64.

[24] Principle 2.19 of the King III Report and King III Report at 40 para 80.

[25] Annex 2.3 of the King III Report.

[26] Principle 2.23 of the King III Report.

[27] King III Report at 46 para 125.

[28] Ibid para 130.

[29] Ibid.

[30] Principle 2.22 of the King III Report.

[31] Principle 2.25 of the King III Report.

[32] King III Report at 48 para 147.

[33] Principle 2.26 of the King III Report read with Practice Note amending the King III Report and Code (February 2012) (published in May 2012).

[34] King III Report at 49 para 153.

[35] King III Report at 50 para 163.

[36] Ibid para 161.

[37] Principle 2.16 of the King III Report.

[38] Ibid.

[39] Principle 2.17 and King III Report at 37 para 56.

[40] King III Report at 36 para 48.

[41] Ibid para 51.

[42] Principle 2.21 of the King III Report.

[43] Principle 3.1 of the King III Report.

[44] Principle 3.10 of the King III Report.

[45] Principles 4.1 and 4.2 of the King III Report.

[46] King III Report at 74 para 11.

[47] Principle 4.5 of the King III Report.

[48] Principle 4.10 of the King III Report.

[49] King III Report at 82 para 1.

[50] Ibid para 2.

[51] King III Report para 3.

[52] King III Report at 83 para 18.

[53] Principle 6.1 of the King III Report.

[54] King III Report at 91 para 21.

[55] Principle 7.1 of the King III Report.

[56] King III Report at 95 para 12.

[57] King III Report at 22 para 18.

[58] Ibid para 16.

[59] King III Report, preface, 13.

[60] King III Report at 102 para 23.

[61] Institutional investors are organisations that pool large sums of money and invest those sums in companies on behalf of others. They include banks, insurance companies, retirement or pension funds, hedge funds and mutual funds. Their role in the economy is to act as highly specialised investors on behalf of others.

[62] King III Report, preface, 10.

[63] King III Report at 102 para 18. See the Code 8.2.4.

[64] King III Report at 105 para 43.

[65] Principle 9.1 of the King III Report.

[66] King III Report at 108 para 1.

[67] King III Report at 109 paras 8-9.

Chapter 14
The Duties and the Liability of Directors

Farouk HI Cassim

14.1 Introduction

14.1.1 General

The common-law duties of directors are the fiduciary duties of good faith, honesty and loyalty. In addition, directors have the duty to exercise reasonable care and skill. The duty to exercise reasonable care and skill is not a fiduciary duty. The fiduciary duties of directors and the duty to exercise care and skill are of fundamental importance to any developed corporate law system. Under the Companies Act 71 of 2008 ('the Act'), the fiduciary duties of directors are mandatory, prescriptive and unalterable, and apply to all companies. Directors cannot contract out of these duties. The object of these duties is to raise the standards of corporate and directorial behaviour. A further reason for imposing these duties on directors is deterrence. The fiduciary duties are protective of the company, its shareholders and the public interest.

In South Africa, the fiduciary duties of directors have been created and developed by the courts, based mainly on English law. The fiduciary duties of directors are now of even greater importance, because for the first time in our corporate law system the Act confers on the board of directors a new statutory power and duty to manage the business and the affairs of the company subject to the company's Memorandum of Incorporation. [1] Since this power is now derived from the Act instead of the constitution of the company, it is subject to shareholder control to a much lesser extent than before. In some respects, the scope and limits of the fiduciary duties are still uncertain.

14.1.2 The partial codification of directors' duties

A significant innovation of the Act is that, for the first time in our corporate law regime, the fiduciary duties of directors [2] and the duty to exercise reasonable care and skill have been partially codified or set out in a statute. It is not a comprehensive or self-contained code of fiduciary duties. The object of the partial codification of directors' duties is to make the law clearer and more accessible, particularly for directors. The common-law principles relating to the directors' fiduciary duties are preserved, with the result that there is a great deal of overlap between the statutory and the common-law sources of these duties. Directors, in the extended sense (see 14.2.1), must now comply with both the statutory and the common-law fiduciary duties. The 'statutory statement of directors' duties' adopts a 'one size fits all' approach.

As stated above, the justification for the statutory statement of directors' conduct is that it will provide much-needed clarification of these duties and make them more accessible, so that the directors of a company know what is expected of them. Directors, it is said, need no longer search in the law reports for the complex and inaccessible decisions of the courts relating to their common-law fiduciary duties. However, a statement of this nature reflects merely the theory underlying the statutory standard of directors' conduct; the reality is quite different. It is doubtful whether the partial codification of directors' duties will make our law more certain. As set out in ss 75 and 76 of the Act, these duties are couched in terms that are not free from ambiguity. Moreover, the statutory statement of directors' conduct cannot be properly understood without knowledge of the common law.

14.2 The fiduciary duties of company directors: general

The fiduciary duties are based on loyalty, good faith and the avoidance of conflicts of interest and duty.

The new approach to directors' duties is that persons who accept office as directors of a company undertake legal responsibility for ensuring that they know and understand the nature of the duties that they are required to comply with.

In examining the fiduciary duties of directors, it is important to bear in mind that these duties are largely derived from English law. This has been acknowledged by the courts on many occasions.

14.2.1 Who owes fiduciary duties to the company?

The directors of a company are fiduciaries who owe fiduciary duties to the company. There are of course many types of directors. Directors may be said to be the persons responsible for the management of the affairs of a company. But the legal definition of a 'director' of a company differs greatly from this description of a director.

The Act contains an open-ended, non-exhaustive definition of a director, which is unhelpful. The Act states that a 'director' means 'a member of the board of a company, as contemplated in s 66, or an alternate director and includes any person occupying the position of director or alternate director, by whatever name designated'. [3] This is an inadequate definition because all it does is to provide that certain persons may be regarded as directors, even though they are described by a different name.

The definition of a director in the Act is wide enough to include most types of directors, such as executive and non-executive directors and *de facto* directors, alternate directors, nominee directors, *ex officio* directors and also shadow directors. The definition of a director is clearly not limited to persons who are formally appointed as directors. Persons who for some or other reason have not been properly appointed as directors may also be regarded as being directors for the purposes of imposing fiduciary and statutory duties and liability on them. [4] Thus *de facto* and shadow directors would be subject to these fiduciary and statutory duties.

The wide, open-ended definition of a director ensures that most persons who have control over the management of companies fall within its ambit. The Act states that *ex officio* directors have all the duties, and are subject to all the liabilities, of any other director of the company. [5] An *ex officio* director is a person who holds office as a director of the company as a result of holding some other office, title, designation or similar status specified in the company's Memorandum of Incorporation, for example, the chief financial officer of the company. An alternate director also falls within the definition of a director. An alternate director is defined as a person elected or appointed to serve, as the occasion requires, as a member of the board of a company in substitution for a particular elected or appointed director.

Likewise, no distinction is drawn between executive and non-executive directors. [6] Executive and non-executive directors have the same fiduciary duties in law. [7]

The fiduciary and other statutory duties of a director are not, however, limited to directors only. The duties extend to senior employees or a senior manager of a division of the company. The Act further extends these statutory duties to prescribed officers [8] and members of an audit committee or a board committee. [9] The reason for this approach is that board committees and particularly the audit committee play an increasingly important role in the functioning of corporate boards. The fiduciary and the new statutory duties of directors should therefore apply also to their members. But the consequence of this approach is that persons who may be non-directors have burdensome duties thrust on them even though they may not have decision-making powers. The usual adage is 'no power without responsibility' and 'with greater power goes greater responsibility'. But here it is a case of greater responsibility without greater power.

The fiduciary relationship requires the fiduciary to act in good faith and in the interests of the beneficiary. A number of duties apply to the fiduciary relationship and are aimed at ensuring that a fiduciary does not abuse the fiduciary relationship of trust and confidence.

The general principle is clear: a director is a fiduciary and as such his or her paramount and overarching duty is to act in good faith and for the benefit of his or her company. This basic duty of loyalty is inflexible and must be strictly applied by the court. This is designed to ensure that a fiduciary does not abuse his or her position of trust. For this reason a lax attitude towards the observance of fiduciary duties must be avoided. The courts must continue to insist on a strict and scrupulous observance of fiduciary duties.

14.2.2 To whom do the directors owe their fiduciary duties?

The fundamental and overarching duty of company directors is to act *bona fide* in what they consider - not what a court may consider - to be in the interests of the company as a whole. Traditionally, directors have been required to manage the business of the company in the interests of its shareholders and to maximise profits for the benefit of shareholders. The courts have always insisted that directors must exercise their powers *bona fide* in what they believe - and not what a court may consider - to be in the best interests of the company. The basic goal of the directors of a company is the success of the company and the collective best interests of the shareholders of the company.

14.2.3 The duty to act in the best interests of the 'company'

The essence or the core of the fiduciary duties is the duty of loyalty and honesty. At the same time, though, it must be stressed that a fiduciary duty may be breached without dishonesty and even though the director was honest (discussed below). As against this, mere incompetence, by itself, is not necessarily a breach of fiduciary duty.

The common-law principle that a director must act in the best interests of the company is codified in s 76(3)*(b)* of the Act, which states that a director of a company, when acting in that capacity, must exercise the powers and perform the functions of director 'in the best interests of the company'. The wording of this provision removes any doubt that the directors of a company owe their duty to the company and the company alone. The duties are consequently enforceable only by the company. The problematic part of this provision is the meaning of the word 'company'.

The word 'company' is not defined for the purposes of this provision. [10] It consequently follows that the common-law meaning attributed to this word must apply to s 76(3)*(b)*. At common law, there is ample authority for the view that the word 'company' in this context refers to the interests of the collective body of present and future shareholders. Except in certain special circumstances, directors do not owe a duty to individual shareholders. [11]

It is thus trite law that the directors owe their duty to the 'company' as a whole, by which is meant the collective body of shareholders including future shareholders. In appropriate circumstances, the directors are entitled to balance short-term considerations affecting the present shareholders against the long-term considerations that affect future shareholders. Another way of expressing the same principle is that directors must act for the benefit of existing shareholders, and have regard to their future as well as their existing interests.

In *Parke v Daily News Ltd* [12] it was held that directors could not make voluntary redundancy payments to employees of a company because these were neither in the short- nor in the long-term interests of the company, which was being wound up. The directors had acted exclusively in the interests of employees instead of the interests of shareholders, whose interests they had entirely ignored. They had treated employees generously beyond their entitlement. The clear implication of the common-law principle that directors owe their fiduciary duties to the company, ie the collective body of shareholders, whether present or future shareholders, is that they do not as a general principle owe their fiduciary duties to individual shareholders; or to creditors of the company while the company is a going concern; or even to employees of the company. [13] All these principles continue to apply to our corporate law regime under the Act (see further 14.2.4).

A further important implication of the principle that directors owe their fiduciary duties to the 'company' is that, since the duties are owed to the company only, the company alone is entitled to enforce these duties against errant directors. This is done by way of the new derivative action instituted [14] on behalf of the company by a shareholder (or a director of the company, or any other person given the right to do so by the Act). Where the company incurs a loss as a result of a director's breach of fiduciary duty, only the company may sue in respect of that loss. A shareholder cannot claim from the errant director for a loss he or she may have incurred as a result of a fall in the value of his or her shares caused by the director's breach of fiduciary duty.

14.2.4 The pluralist and the enlightened shareholder value approach

As stated in 14.2.2 and 14.2.3, both at common law and in terms of the Act [15] a director is required to act in the best interests of the 'company', by which is meant the collective interests of present and future shareholders.

The implication of this common-law and statutory principle is that the interests of stakeholders other than the shareholders of the company have received no formal, legal recognition under the Act. [16]

This again raises the issue whether a company is just another business structure or whether it is an integral part of society. Does modern corporate law still insist that the fundamental purpose of a company is wealth creation or profit maximisation? Should the directors, especially of large listed companies, be required to manage a company only for the benefit of shareholders, or should they be required also to act in the interests of other stakeholders such as employees of the company, its creditors, customers, suppliers, the environment and the interests of the local community in which the company functions? The crux of the matter is whether the directors should be allowed to be public-spirited with corporate funds that do not belong to them. It is because the funds of the company do not belong to the directors that the courts have insisted that charitable donations must be *bona fide* and reasonably incidental to the business of the company and for its benefit.

The two different approaches to this issue are known as the 'stakeholder' or 'pluralist' approach and the 'enlightened shareholder value' approach. The pluralist approach emphasises that a socially responsible company [17] will consider the impact of its activities on its stakeholders. In *AP Smith Manufacturing Co v Barlow*, [18] in deciding that a charitable donation made by a company was validly made, the court stated that 'modern conditions require that corporations acknowledge and discharge social as well as private responsibilities as members of the communities within which they operate'. According to the pluralist approach, the directors must ignore shareholder interests in favour of stakeholder interests where this would be in the interests of the company. [19]

But it remains controversial whether the directors of a company must take into account the interests of stakeholders, all of whom are generally affected in one way or another by the activities of the company. The law appears to have been settled in both the USA and the UK that non-shareholder interests *may* be taken into account, but only if the interests of the company, ie of its shareholders as a collective body, are thereby served. In other words, profit maximisation still remains the ultimate goal of a company. Stakeholder interests may be taken into account only where this would promote the interests of shareholders of the company in the long term. In the event of a conflict between the interests of shareholders and stakeholders, it is the interests of shareholders that must prevail. This approach is known as the 'enlightened shareholder value' approach.

In terms of this approach, company directors must consider the importance of maintaining a good, positive relationship with stakeholders, because this ultimately promotes the interests of the company. The enlightened shareholder value approach is to the effect that a balance must be drawn between the interests of different stakeholders and shareholders in order to benefit the shareholders in the long run. This approach is essential to the success of the company in modern times, as opposed to the narrower approach of having regard only to the interests of shareholders. The company benefits from the improved retention of employees, customers and suppliers, and it enhances the goodwill and the image of the company in the local community in which it operates. The modern approach is that it makes good business sense for companies to embrace wider social responsibilities. It also takes cognisance of the fact that the very character of large public companies has changed from being purely economic entities to being entities that also have social functions to fulfil. But this is more of a corporate governance issue than an issue concerning the fiduciary duties of the directors of companies. The gist of the matter is that the Act itself does not impose any mandatory and legally enforceable duty on directors to take stakeholder interests into account.

The common-law principles laid down by the courts many decades ago are similar to the modern enlightened shareholder value approach. In *Hutton v West Cork Railway Co* [20] the board of directors of a company that was being wound up proposed to give redundancy payments to corporate officers for loss of employment. The court held that these payments were invalid as the gratuitous payments were not in the interests of the company. This principle is, as stated above, similar to the modern enlightened shareholder value approach. Corporate philanthropy is acceptable only if expected to benefit the company and its shareholders. Directors are allowed to have a social conscience only if it is in the interests of the company.

14.2.4.1 The King Code of Governance for South Africa 2009

Stakeholder interests, as stated above, have received no formal legal recognition under the Act as a constituency of a company. The promotion and protection of stakeholder interests have been left to specific legislation such as the Labour Relations Act 66 of 1995 (ss 78-94), environmental law, the Broad-Based Black Economic Empowerment Act 53 of 2003 and the Consumer Protection Act 68 of 2008. There is, in addition, on a voluntary rather than on a mandatory basis, the King Code of Governance for South Africa 2009 ('the Code'), which has an inclusive corporate governance approach towards stakeholders. [21] The fact that the King III Code is not legally enforceable should not mislead one to disregard it or dismiss it as legally irrelevant. The courts do occasionally take corporate governance practices into account. [22]

The Code strongly emphasises the importance of stakeholder interests and the

triple bottom line or integrated approach that requires companies to have regard to social, economic and environmental concerns. The Code is not confined to listed companies only. It applies to all business structures and even to business trusts. It remains however a recommended or a voluntary code of best practices. The result is that the promotion of stakeholder interests remains permissive.

14.2.4.2 The social and ethics committee

The Act [23] requires every listed company and every state-owned company to appoint a social and ethics committee (unless the company is a subsidiary of a holding company that already has a social and ethics committee that would perform the prescribed functions on behalf of the subsidiary company, or it is exempted by the Companies Tribunal from the requirement to appoint a social and ethics committee).

This requirement applies also to a significant private or other type of company if it is desirable in the public interest to appoint a social and ethics committee.

The social and ethics committee must comprise no fewer than three directors or prescribed officers, at least one of whom must be a director who is not involved in the day-to-day management of the company's business and must not have been so involved within the previous three financial years. [24]

The function of the social and ethics committee is to monitor the company's activities, having regard to any relevant legislation, such as the Broad-Based Black Economic Empowerment Act, or prevailing codes of best practice, such as the United Nations Global Compact Principles and the recommendations of the Organisation for Economic Co-operation and Development on corruption.

The social and ethics committee must also monitor the company's activities with regard to good corporate citizenship (ie corporate social responsibility, as discussed in 14.2.3 and 14.2.4), including-

(i) the company's promotion of equality and the prevention of unfair discrimination;
(ii) its contribution to the development of the communities in which the company's activities are predominantly conducted;
(iii) its record of sponsorship, donations and charitable giving;
(iv) the environment, health and public safety;
(v) consumer relationships; and
(vi) labour and employment.

This in effect is the legislative adoption of the enlightened shareholder value approach and of corporate social responsibility. The problem with this particular regulation is that it could easily be turned into a mere box-ticking exercise. [25]

14.3 The fiduciary duties of directors and the standards of directors' conduct

The duties of directors are now derived from two sources, namely the Act and the common law as found in the decisions of the courts. The two sources apply in parallel.

Section 76(3)*(a)* and *(b)* states that a director of a company, when acting in that capacity, must exercise the powers and perform the functions of director-

(i) in good faith and for a proper purpose; and

(ii) in the best interests of the company.

At common law, the duty to act in good faith and in the best interests of the company is the paramount and overarching fiduciary duty of directors from which all the other fiduciary duties flow. These duties are discussed in turn below. As stated above, the standards of directors' conduct prescribed by the Act apply to all directors, including an alternate director, prescribed officers, and members of a board committee or audit committee (irrespective of whether or not such persons are also members of the company's board of directors).

14.3.1 The duty to act in good faith and in the best interests of the company

The basic fundamental duty of good faith is now imposed by both the common law as well as the Act. 'It is a well-established rule of common law that directors have a fiduciary duty to exercise their powers in good faith and in the best interests of the company.' [26] Good faith depends largely on honesty. Honesty is subjective.

In *Re Smith & Fawcett Ltd* [27] the court laid down the longstanding legal principle that the directors are bound to exercise the powers conferred upon them *bona fide* in what *they* consider - not what a court may consider - is in the interests of the company. A director's duty is thus to act in what he or she in good faith honestly considers to be in the best interests of the company.

The directors of a company have more knowledge, time and expertise at their disposal to evaluate the best interests of the company than judges. It is not for the courts to review the merits of a decision that the directors arrived at in honesty.

The duty of good faith entails the duty to exercise an independent judgment (see 14.3.3) and the duty to act within the limits of authority discussed in 14.3.4. Section 76(3)*(a)* (set out above) couples the duty of good faith with the duty of a director to exercise his or her powers for a proper purpose.

As stated above, the test of good faith is subjective and not objective, since the question is whether the director honestly believed that he or she acted in the interests of the company. But there are limits to the subjective test. The absence of a reasonable ground for believing that the director is acting in the interests of the company may be the basis for finding lack of good faith.

14.3.2 Proper purpose

Section 76(3)*(a)* requires that the directors must exercise their powers for a 'proper purpose'. 'Proper purpose' is not defined, but at common law it has always been taken to mean that directors must exercise their powers for the objective purpose for which the power was given to them and not for a collateral or ulterior purpose.

There are thus two duties referred to in s 76(3)*(a)*, namely, good faith and proper purpose. These duties are separate and distinct. Yet they are also cumulative, with the result that even if the directors have acted honestly in the interests of the company, they could still be in breach of their duty to exercise their powers for a proper purpose.

The director's duty to exercise powers for a 'proper purpose' is now both a statutory and a common-law obligation. It is an abuse of power for directors to exercise their powers for a purpose other than the purpose for which the power was conferred on them. Unlike the duty of good faith, which is subjective, the test for 'proper purpose' is objective.

The courts have held in a number of cases that directors must not exercise their fiduciary power to issue shares of the company for the purpose of defeating a takeover bid, or for the purpose of destroying an existing majority or to create a new majority or for the purpose of entrenching themselves in office.

In *Howard Smith Ltd v Ampol Petroleum Ltd* [28] the board of directors of RW Miller (Holdings) Ltd was in favour of a higher takeover bid by Howard Smith Ltd, which they preferred to a competing and lower takeover bid made by a majority shareholder, Ampol Petroleum Ltd and another company. The board consequently allotted further shares to Howard Smith Ltd in order to dilute the majority shareholding of Ampol Petroleum Ltd and to ensure the success of the takeover bid made by Howard Smith Ltd. In setting aside the allotment of shares to Howard Smith Ltd, the court stated that it was unconstitutional for directors to use their fiduciary powers to issue shares of a company for the purpose of destroying an existing majority or creating a new one. This applies even if the directors believed in good faith that they were acting in the best interests of the company and even though there was no desire by the directors to obtain a personal advantage for themselves or to retain their position as directors of the company.

In *Howard Smith Ltd v Ampol Petroleum Ltd* there was both a desire to raise further share capital or finance for the company and a desire to defeat a takeover bid made by Ampol Petroleum. The court found on the facts that it was the latter purpose that was the primary or substantial purpose of the issue of further shares. The court consequently set aside the allotment of shares. The directors had exercised their powers for an improper purpose.

In *Punt v Symons & Co Ltd* [29] the directors had issued shares to their friends and supporters with the object of creating a sufficient majority to enable them to pass a special resolution to alter the constitution of the company to deprive certain shareholders of special rights conferred on them by the company's constitution. In

Piercy v Mills [30] the directors had likewise issued further shares to create a sufficient majority to enable them to resist the election of additional directors that would have resulted in the incumbent directors becoming a minority on the board. In both cases, the directors were held to have exercised their powers for an improper purpose. An issue of shares in order to distort or manipulate the balance of voting power is an improper exercise of the power to issue shares.

It is not an easy task to identify from the facts of a particular case the purpose for which a director has exercised his or her power. Where there are multiple purposes for the exercise of a power, the court must determine what the substantial or dominant purpose was. If the dominant purpose is found to be improper, the court must regard the exercise of the power as being voidable (ie the court may set it aside). Conversely, if the exercise of the power is found to be proper and in the interests of the company, the fact that an incidental effect of it is to defeat a takeover bid or to enable the directors to maintain themselves in office will not make the exercise of the power improper.

In *Extrasure Travel Insurances Ltd v Scattergood* [31] the court stated that the law relating to proper purpose is clear. It is not necessary to prove that a director was dishonest or that the director knew that he or she was pursuing a collateral purpose. There is a four-step test to be applied by the court. The court must-

(i) identify the particular power that is being challenged;
(ii) identify the proper purpose for which the power was given to the directors;
(iii) identify the substantial purpose for which the power was in fact exercised; and
(iv) decide whether this purpose was proper.

Where the directors' exercise of their powers is improper and is consequently set aside, the directors will be jointly and severally liable to compensate the company for any loss suffered as a result of the improper exercise of the power. [32]

14.3.3 The duty to exercise an independent judgment

The common-law principle is that in the exercise of their powers and in deciding what is in the best interests of the company, the directors must exercise an independent and unfettered discretion. Directors must consider the affairs of the company in an unbiased and objective manner. Accordingly, a voting agreement under which a director binds him- or herself to vote or to exercise his or her powers in accordance with the instructions of some other person, thereby fettering the director's discretion, will not be enforced by the court. The effect of such a voting agreement (if it were to be binding) would be that the directors would disable themselves from acting honestly in what they believed to be the best interests of the company.

The duty to exercise an independent judgment is an aspect of the directors' duty to act *bona fide* in the interests of the company. This perhaps explains why this specific common-law duty is not referred to in s 76. On this basis, the duty to exercise an independent judgment continues to form part of the fiduciary and statutory duties of directors.

As a general principle, directors may not bind themselves on how to vote in future. It is irrelevant to this duty whether or not the director derives any personal benefit from such an agreement. In *Fulham Football Club Ltd v Cabra Estates Plc* [33] a football club and its directors undertook in return for a substantial payment to vote in a particular way. The court rejected the argument that the *board of directors* may never make a contract by which they bind themselves to the future exercise of their powers in a particular way, where the contract as a whole is for the benefit of the company. The board was in this case binding itself under a commercial contract which had conferred benefits on the company and which at the time the board had honestly believed was in the best interests of the company. There is a distinction between the situation in which the entire board of directors has entered into such an agreement and one in which an individual director has done so. The former but not the latter may in certain circumstances be beyond reproach, as shown in the *Fulham Football Club* case.

The duty to exercise an independent judgment is particularly important to nominee directors. A nominee director is a person who is appointed by a nominator to represent his or her interests at board meetings. A nominee director is a lawfully elected director appointed to the board of directors by a creditor, a financier or a significant shareholder who controls sufficient voting power for this purpose. For instance, a holding company may appoint a nominee director to the board of directors of a subsidiary company. To take another common example, it may be agreed that a bank that has financed a company may appoint a representative to that company's board of directors. Joint venture companies also make frequent use of the practice of appointing nominee directors.

The nominee director is expected to represent the interests of the nominator. This means that a nominee director has a duty to a person other than the company, in addition to the fiduciary duty owed to the company. A nominee director may even be expected to report to his or her nominator on any developments that may affect the interests of the nominator. Yet the legal principle as laid down by the courts is that nominee directors are under a duty to act in the interests of the company of which they are directors instead of the interests of their nominator.

The practice of appointing nominee directors is widespread. It is a commercial reality. The courts have ruled that there is nothing inherently dishonest or improper about nominee directors. In most cases no harm is done to the company, mainly because the interests of the nominator often coincide with those of the company, since they both desire the company to prosper. This enables nominee directors to comply with their duties both to the company as well as to their nominators. However, when the interests of the company clash with those of the nominator there is a manifest conflict of interest that puts the nominee director in a difficult position.

In *Fisheries Development Corporation of SA Ltd v Jorgensen; Fisheries Development Corporation of SA Ltd v AWJ Investments (Pty) Ltd* [34] the court stated that a director's duty is to exercise an independent judgment and to take decisions according to the best interests of the company. Even though nominee directors may in fact be representing the interests of the persons who nominated them, they are in law obliged to serve the interests of the company to the exclusion of the interests of their nominators. As directors, they cannot be subject to the control of any employer or principal other than the company. In a nutshell, a director may not serve two masters, as this gives rise to conflicting loyalties. It is the interests of the company, and not that of the nominator, that are paramount.

The relevant legal principle may be formulated as follows: a nominee director may, without being in breach of fiduciary duty to the company, take the interests of his or her nominator into account, provided that the nominee director's decisions as a director are in what he or she genuinely considers to be in the best interests of the company.

A nominee director must exercise an independent judgment for the benefit of the company. Nominee directors must not blindly follow the judgment or the instructions of those who have appointed them; nor, in the event of a conflict of interests, must they prefer the interests of their nominator above those of the company of which they are directors. Certainly a nominee director may not be a 'dummy' or a 'puppet'. Thus in *S v Shaban* [35] the court cautioned that 'puppets' cannot be lawfully employed in our company law system. By 'puppets' the court meant persons placed on the board of directors of a company who pretend to have taken part in resolutions of which they know nothing, or persons who pretend to have taken part in the management of a company while having no idea what they have signed.

Regarding any expectation of the nominator that the nominee director would convey relevant corporate information to him or her, this is curtailed by the Act [36] which prohibits a director from using any information obtained in his or her capacity as a director to gain an advantage for a person other than the company or a wholly-owned subsidiary of the company (discussed in 14.4.2.1) or to knowingly cause harm to the company or its subsidiary.

As previously stated, there is no specific reference in the Act to the duty of a director to exercise an independent judgment. This is because this duty is essentially an aspect of the fundamental duty of a director to act *bona fide* in the best interests of the company. [37]

14.3.4 The duty to act within their powers

At common law, directors have a distinct fiduciary duty not to exceed their powers or the limits of their authority. An important aspect of this duty is that they may not enter into an *ultra vires* contract on behalf of the company or a contract that is illegal.

Regarding *ultra vires* contracts, the Act [38] confers on companies all the legal powers and the capacity of an individual, subject to the company's Memorandum of Incorporation. [39] If a company's Memorandum of Incorporation limits its capacity, ie its powers or activities, the directors of the company would be exceeding their powers by entering into a contract that is inconsistent with such a provision. They will consequently incur liability to the company for breach of their fiduciary duty not to exceed their authority, unless their act has been ratified by a special resolution of the company's shareholders. However, a contract that contravenes the Act may not be ratified. [40]

If directors exceed the powers conferred on them by the company, they will be liable to the company for breach of their fiduciary duty. Similarly, if a director has made payments as a result of transactions that are beyond the capacity of the company, he or she may be called upon to compensate the company. This liability for a breach of fiduciary duty arises irrespective of the *bona fides* of the director in question or any fault on his or her part.

Once again there is no specific reference in the Act to this fiduciary duty as a separate and distinct duty. This duty is nevertheless an aspect of the fiduciary and statutory duty of directors to exercise their powers in good faith for a proper purpose, and in the best interests of the company. [41]

The Act [42] imposes liability on a director for any loss, damages or costs sustained by a company as a consequence of the director having done some act in the name of the company, signed anything on behalf of the company, or purported to bind the company or authorise the taking of any action by or on behalf of the company despite knowing that he or she lacked the authority to do so.

Also relevant is that the Act [43] confers a right on each shareholder to claim damages from any person who intentionally, fraudulently or due to gross negligence causes the company to do anything inconsistent with the Act or with a limitation, restriction or qualification of the powers and activities of the company, unless this is ratified by a special resolution of the shareholders of the company.

14.4 Conflict of interest

14.4.1 The common law

The duty to avoid a conflict of interest is one of the most important fiduciary duties of directors. Before turning to the Act, a discussion of the relevant common-law principles that continue to apply in South African company law is essential to obtain a proper understanding of the statutory provisions that now relate to this duty.

Company directors are under a fiduciary duty to avoid placing themselves in a position in which their duties to the company conflict with their personal interests. Furthermore, directors may not, without the informed consent of the company,

make a profit in the course of and by means of their office as directors, ie while performing their duties as directors. This duty ensures that such profits made by directors from their position as directors are disgorged by them and restored to the company. The duty to avoid a conflict of interest is undoubtedly the core duty of a fiduciary. It requires the director to account for any profit he or she has received in breach of this fiduciary duty.

The rule is an inflexible one that must be applied strictly by a court. [44] The reason for the 'strict ethic' in this area of law is that the fiduciary duties are meant to be preventative and deterrent. The objective of the no-profit rule is to preclude directors from making improper use of their positions as directors for their own personal advantage.

Directors may also not, without the consent of the company, place themselves in a situation in which they have conflicting duties to some other person. This may arise in multiple directorships, where a director is also a director of another company, or in the case of a nominee director. (See the discussion in 14.3.3 on nominee directors and the duty to exercise an independent judgment.) The rule (ie duty to avoid a conflict of interest) does not depend on fraud or absence of good faith, or on whether the company has incurred a loss as a result of a breach of fiduciary duty. The liability to account arises from the mere fact of a profit having been made by the director for him- or herself.

14.4.1.1 The no-profit rule

According to the no-profit rule, directors may not retain any profit made by them in their capacity as directors while performing their duties as directors. Profits made by a director by reason of, and in the course of, his or her office as a director must be disgorged or restored to the company, unless the majority of shareholders in general meeting have consented to the director making the profit. The rule applies even if the company itself could not have made the profit, that is to say, even if the director had not made the profit at the expense of the company. It must be emphasised that 'profit' in this context is not confined to money, but includes any gain or advantage obtained by a miscreant director.

The strict application of the no-profit rule is best illustrated by the leading case of *Regal (Hastings) Ltd v Gulliver*. [45] The facts of this seminal case, which has been followed many times in many jurisdictions, are as follows:

Regal (Hastings) Ltd ('R Co') owned a cinema. The directors resolved to acquire two further cinemas with the intention of selling all three cinemas as a going concern. For this purpose, R Co formed a subsidiary ('Hastings Amalgamated Cinemas Ltd') ('A Co') to acquire the cinemas. The directors of R Co were also the directors of A Co. The owner of the cinemas was prepared only to lease but not to sell the cinemas to A Co and then, too, only if the directors of R Co either gave their personal guarantee for the payment of the rent (which the directors were not willing to furnish) or if A Co had an issued and paid-up share capital of P5 000. R Co simply did not have the financial resources to acquire more than 2 000 shares of P1 each in A Co. Consequently, four of the five directors of R Co decided to subscribe for 2 000 shares of P1 each in A Co. The balance of 1 000 shares was taken up by R Co's attorney and an outsider. Having thus acquired the minimum P5 000 share capital, A Co thereafter duly obtained the leases over the two cinemas. A few weeks later, all the shares in R Co and A Co were sold. The four directors of R Co sold their shares in A Co at a profit. After the conclusion of this transaction, the new controllers of R Co instituted a derivative action on behalf of R Co, demanding that the four former directors of R Co account to R Co for the profits they had made on the sale of their shares in A Co.

The House of Lords ruled that the defendants (the four former directors of R Co) were accountable to R Co for the profits made by them on the sale of the shares in A Co. This was because the profits had been made by them in their capacity as directors of R Co while in the course of performing their duties as directors of R Co. The opportunity to acquire the shares in A Co had come to them only because they were directors of R Co, which also gave them access to all relevant information regarding the value of the shares in A Co, including its financial statements. It was irrelevant that due to its lack of financial resources, R Co was unable to take for itself the opportunity to acquire the shares in A Co. The fact that the profits made by the defendants were not made at the expense of R Co was irrelevant to the directors' duty to account, nor was it relevant that the defendants had acted in good faith and in the interests of R Co, and that there had been no fraud. The liability to account arises from the mere fact of the profit having been made. No matter how honest and well-intentioned the defendants may have been, they remained under the duty to account for the profits made by them.

Ironically, the company's attorney and the outsider who had also purchased shares in A Co were able to keep the profits made by them on the sale of their shares in A Co, since they owed no fiduciary duty to the company. Even more ironically, the defendants would have been permitted to retain the profits made by them had they complied with the formality of obtaining the consent of the majority of the shareholders in general meeting to keep the profits made by them. This formality would have presented no difficulty as the defendants were in fact the majority shareholders of R Co.

The result of the decision in *Regal (Hastings) Ltd v Gulliver* was that the new purchasers of the shares of R Co had received an undeserved windfall or discount. Theirs was not a meritorious claim. An equitable principle was, in effect, taken to an unfair and inequitable conclusion.

The Supreme Court of Appeal in *Phillips v Fieldstone* [46] stated in accordance with the principles laid down in *Regal (Hastings) Ltd v Gulliver* that once a breach of fiduciary duty has occurred, it is of no relevance that the company has suffered no loss or damage, or that the profit was not made at the expense of the company; nor is it relevant that the company could not have made use of the opportunity or the information. The court furthermore accepted that the duty of the fiduciary to avoid a conflict of interest may extend beyond the term of his or her employment (discussed in 14.4.1.5).

The no-profit rule must be distinguished from the corporate opportunity rule.

14.4.1.2 The corporate opportunity rule

In sharp contrast to the no-profit rule is the corporate opportunity rule. The corporate opportunity rule prohibits a director from appropriating (or taking for himself or herself) any contract, information or other opportunity that properly belongs to the company and that came to him or her as director of the company. Since the opportunity belongs to the company, it is a breach of fiduciary duty for directors to divert the opportunity for themselves. Until recently, the courts regarded the corporate opportunity rule as an aspect of the no-profit rule or the rule against secret profits. But in the recent decision of the Supreme Court of Appeal in *Da Silva v CH Chemicals (Pty) Ltd* [47] the court acknowledged the corporate opportunity rule by stating:

> A consequence of the rule is that a director is in certain circumstances obliged to acquire an economic opportunity for the company if it is acquired at all. Such an opportunity is said to be a 'corporate opportunity' or one which is the 'property' of the company.

Although there is no all-embracing definition of a corporate opportunity, a corporate opportunity is one that the company was actively pursuing or one that falls within the company's 'existing or prospective business activities', or is related to the operations of the company within the scope of its business, or falls within its line of business. It is of no consequence that the opportunity would not or could not have been taken up by the company - the opportunity would, according to *Da Silva v CH Chemicals (Pty) Ltd*, remain a corporate opportunity.

The opportunity must not only be in the line of the business of the company or be closely associated with it, but in addition, the company must have been justifiably relying on the director to acquire it for the company, eg where the director has a general mandate from the company to acquire business opportunities for the company, or where he or she is authorised to obtain a specific opportunity for the company. [48]

A corporate opportunity is seen in law to be a corporate asset that belongs to the company. The corporate opportunity rule is not, however, confined only to property or assets - it extends to confidential corporate information which directors have used to make a profit for themselves. In *Sibex Construction (SA) (Pty) Ltd v Injectaseal CC* [49] the court held that directors may not use confidential information obtained by virtue of their office as directors to acquire a business opportunity for themselves.

14.4.1.3 Illustrative cases on the corporate opportunity rule

This section discusses a few relevant cases to illustrate the corporate opportunity rule. The cases are also used to show the critical distinction between the corporate opportunity rule and the no-profit rule.

(i) Cook v Deeks

The classic illustration of a corporate opportunity is *Cook v Deeks*. [50] In this case, three of the four directors who were also equal shareholders of T Co, a railway construction company, decided to appropriate for themselves a new lucrative construction contract that was expected to be offered to T Co by the Canadian Pacific Railway Co, which had previous dealings with T Co. T Co had in the past built railway lines for the Canadian Pacific Railway Co. The new contract involved the continuation of a railway line that had already been laid by T Co. Instead of obtaining the new construction contract for T Co, the defendants had intercepted the contract for themselves to the exclusion of T Co. They thereafter sought, at a general meeting of the shareholders of T Co, to obtain approval of what they had done by passing a resolution in terms of which T Co declared that it had no interest in the new construction contract from the Canadian Pacific Railway Co. The defendants were able to pass the resolution as a result of their 75 per cent shareholding in the company. The court ruled that the benefit of the contract belonged to T Co and that the resolution was of no effect. Directors, the court said, could not validly use their voting power to divert an opportunity for themselves. While ostensibly acting for the company, the directors had diverted in their own favour business that should properly have belonged to the company which they represented. The benefit of the contract thus belonged to the company. The court held further that directors holding a majority of the votes are not permitted to make a gift to themselves. To do this would be to allow the majority to oppress the minority shareholders. The defendants were in this case making a gift of corporate assets to themselves. The new contract was held to be an asset of the company.

The distinction between the no-profit rule and the corporate opportunity rule is that the no-profit rule requires the consent of a majority of the shareholders for a director to retain the profit made by him or her. The corporate opportunity rule, on the other hand, requires the unanimous approval of the shareholders for a director to take the opportunity for him- or herself. *Cook v Deeks* illustrates that even a 75 per cent majority approval for directors to take a corporate opportunity for themselves is not sufficient.

(ii) Robinson v Randfontein Estates Gold Mining Co Ltd

In *Robinson v Randfontein Estates Gold Mining Co Ltd* [51] Robinson, a director and chairperson of the board of directors of the plaintiff company, had purchased a farm for himself through an agent when the company, which had been keen to purchase the farm, could not reach finality with the sellers. Robinson then sold the farm to the company at a massive profit. The court held that the company was entitled to claim

from Robinson the profit made by him on the basis that, where a man stands in a position of confidence in relation to another involving a duty to protect the interests of that other, he is not permitted to make a secret profit at the expense of the other or to place himself in a position where his interests conflict with his duty.

The pivotal difference between *Robinson v Randfontein Estates Gold Mining Co Ltd* and *Regal (Hastings) Ltd v Gulliver* [52] (which, as discussed in 14.4.1.1, is the classic example of the no-profit rule) is that in *Regal (Hastings)* the company simply did not have the funds to subscribe for more shares in A Co, whereas in *Robinson v Randfontein Estates Gold Mining Co Ltd* the company had a definite interest in acquiring the farm for itself - it was actively pursuing that opportunity. The same may be said of the new construction contract that was expected to be offered to the company in *Cook v Deeks*. Furthermore, the contract, in both *Cook v Deeks* and *Robinson v Randfontein Estates Gold Mining Co Ltd*, was in the line of the business of the company.

(iii) Industrial Development Consultants Ltd v Cooley

In *Industrial Development Consultants Ltd v Cooley* [53] the court was arguably faced with the corporate opportunity rule rather than the no-profit rule, although this is contentious. The facts of this case were as follows: the defendant, an architect and managing director of the plaintiff company, had entered into negotiations with the Eastern Gas Board to secure certain valuable construction contracts for the plaintiff company. The Eastern Gas Board was not prepared to enter into any business with the plaintiff company, but a year later the board approached the defendant in his private capacity and offered the contract personally to him. The defendant, on the pretext of ill health, resigned as managing director of the plaintiff company and took for himself the contract offered by the Eastern Gas Board. The contract in question was substantially the same contract that the plaintiff company had been attempting to obtain for itself in the previous year. The court held that the defendant was accountable to the plaintiff company for the profits made by him on the contract with the Eastern Gas Board. The court found that the defendant had placed himself in a position in which his duty to the company had conflicted with his personal interests. He had one capacity at the time and that was as managing director of the plaintiff company. Information which came to him while he was managing director was information which he had a duty to convey to the plaintiff company. The fact that he had resigned as managing director was irrelevant; it did not relieve him of his fiduciary duty to avoid a conflict of interest, because the opportunity had come to him while he was a managing director of the plaintiff company. It was consequently an opportunity that belonged to the company.

The actual basis of the decision was the no-conflict rule and the fact that the defendant had used for himself information that had come to him in his capacity as a managing director. But it is cogently arguable that *Industrial Development Consultants Ltd v Cooley* concerned a corporate opportunity that belonged to the company, as there had been no decision by the board of directors of the plaintiff company to abandon the possibility of obtaining the contract from the Eastern Gas Board. The company could thus still be said to be pursuing the opportunity. The defendant had consequently taken for himself an opportunity that belonged to the company, in breach of the corporate opportunity rule.

14.4.1.4 Summary

This discussion of the common-law fiduciary duty of a director to avoid a conflict of interest shows that there are several other rules that are derived from this fiduciary duty: there is a duty to avoid a conflict of interest and a duty to avoid a conflict of duties; there is the no-profit rule and the corporate opportunity rule; and there is a considerable overlap between these various rules. All these common-law principles developed by the courts continue to be relevant to the statutory standards of directors' conduct under the Act. Before proceeding to the statutory standards of directors' conduct, a brief discussion of the issue of the post-resignation duties of directors is apt.

14.4.1.5 The post-resignation duties of directors

A director cannot, by resigning, divest him- or herself of the fiduciary duty not to usurp a corporate opportunity. The fiduciary duty to avoid a conflict of interest cannot be evaded simply by resigning. The underlying basis of the liability of a director who exploits a corporate opportunity after his or her resignation is that the opportunity belongs to the company and the director is thereby appropriating for himself an opportunity that belongs to the company. A director will not escape liability by first resigning before seeking to exploit an opportunity that the company was actively pursuing, or one within the scope of the company's business activities which the director became aware of while in the course of performing his or her duties, but deliberately concealed from the company.

This is an issue with which the court has been increasingly confronted. [54] The issue arose in *Industrial Development Consultants Ltd v Cooley* [55] and in *Canadian Aero Service v O'Malley*, [56] where the court laid down the principle that a director is precluded from exploiting a corporate opportunity where his resignation 'may fairly be said to have been prompted or influenced by a wish to acquire for himself the opportunity sought by the company, or where it was his position with the company rather than a fresh initiative that led him to the opportunity he later acquired'. If, on the other hand, the opportunity arose after the resignation of the director or is one of which the director had been unaware before his or her resignation, the director is at liberty to exploit it for him- or herself in the absence of any contractual restraints. [57]

The general principle is that, subject to restraints in a contract of service and in the company's constitution, a director may resign simply by tendering his or her resignation even though this may not be in the best interests of the company, and irrespective of the damage his or her resignation may cause to the company. Resignation is a unilateral act that is not dependent on the concurrence of the company. It consequently follows that, if the director's motive for resigning is found not to be for the purpose of exploiting or usurping a corporate opportunity for him- or herself the resignation will not be in breach of his or her fiduciary duty to the company.

In *Da Silva v CH Chemicals (Pty) Ltd* [58] the court approved of and applied the relevant legal principles discussed above. The court reaffirmed that a director will not escape liability by first resigning before seeking to exploit an opportunity which the company was actively pursuing, or one within the scope of the company's business activities which the director had become aware of in the performance of his or her duties as a director. But if the opportunity did not fall within the scope of the company's business or is one that arose only after the resignation of the director, he or she would be free in the absence of contractual restraint to exploit it to the full. The director may then resign and set up business in competition with his or her former company or obtain employment with a competing company. The general policy of the courts is not to impose undue restraints on post-resignation activities. [59]

Guiding principles relating to the post-resignation duties of a director have been suggested by Rehana Cassim. [60] In terms of these, directors will be held accountable to their company for the appropriation of a corporate opportunity that occurs after their resignation where-

(i) they resign to take up personally a maturing business opportunity that the company was actively pursuing; or
(ii) they pursue an opportunity which their company is unable to take, without the company having finally abandoned the opportunity; or
(iii) their resignation is prompted or influenced by a desire to acquire the opportunity for themselves; or
(iv) their position with the company led them to the opportunity, which they subsequently acquired after their resignation.

14.4.2 The Act and the duty to avoid a conflict of interest

The above common-law principles provide the background against which the provisions of the Act relating to the fiduciary duty to avoid a conflict of interest may be properly understood.

14.4.2.1 Section 76(2)*(a)*: The duty to avoid a conflict of interest

Section 76(2)*(a)*(i) and (ii) states that a director (in the extended sense) of a company must not use the position of director, or any information obtained while acting in the capacity of director-

(i) to gain an advantage for the director, or for another person other than the company or a wholly-owned subsidiary of the company; or

(ii) knowingly to cause harm to the company or a subsidiary of the company.

Underlying this section is the director's duty of loyalty and fidelity and the duty of directors not to make a profit out of their position as directors. Directors may not use

information that has come to them as directors of the company for their personal advantage, or for any other person except the company (or a wholly-owned subsidiary of the company). They may also not use this information knowingly to cause 'harm' to the company (or its subsidiary). The section is wide enough to include both a duty to avoid a conflict of interest and a conflict of duties, as discussed in 14.4.1.

The section is aimed at deterring directors from making use of their positions as directors for personal benefit, or from using corporate information obtained while acting as directors of their companies. The section would deter any self-dealing that directors may be tempted to engage in.

The director's honesty is not relevant to this provision. Directors (and prescribed officers) may contravene this statutory provision even if they have no intention of acting dishonestly. It is inappropriate and unacceptable for directors to use their positions as directors or to use corporate information to gain a personal advantage for themselves. It is also irrelevant whether or not the company has suffered any loss or whether it was deprived of any opportunity that it might have used for its own advantage.

The inclusion of a subsidiary represents an important extension of the common-law principle. At common law, a director of a holding company does not owe any fiduciary duty to its subsidiary.

Section 76(2)*(a)*(i) (as set out above) encapsulates the common-law 'no-profit' rule (as discussed in 14.4.1) and imposes a mandatory and positive duty on directors to avoid a conflict of interest. But, while s 76(2)*(a)* encapsulates the common-law no-profit rule, what is left uncertain is the corporate opportunity rule. It is submitted, however, that s 76(2)*(a)*(i) and (ii) is wide enough to apply to both the no-profit rule and the corporate opportunity rule. There is nothing in the section to indicate otherwise. This would also include the post-resignation duties of directors (as discussed in 14.4.1.5).

14.4.2.2 Section 76(2)*(b)*: The duty to communicate information to the company

Section 76(2)*(b)* of the Act states that a director of a company must-

(b) communicate to the board at the earliest practicable opportunity *any* [emphasis added] information that comes to the director's attention, unless the director-
  (i) reasonably believes that the information is-
    (aa) immaterial to the company; or
    (bb) generally available to the public, or known to the other directors; or
  (ii) is bound not to disclose that information by a legal or ethical obligation of confidentiality.

This section is based on the common-law principle that the directors are the custodians and treasurers of corporate information. The section imposes a duty on a director to communicate to the board of directors at the earliest practicable opportunity *any* information that comes to his or her attention, unless the director reasonably believes that the information is immaterial to the company, generally available to the public, or known to the other directors. Directors are however exempt from disclosing such information if they are bound by a legal or ethical obligation of confidentiality that forbids them from doing so, or where they may have signed a non-disclosure or confidentiality agreement with a third party.

In a nutshell, the information that must be communicated to the company is essentially relevant corporate information of a sensitive nature. The information that comes to the attention of the director need not be confidential information, nor need it be information that comes to the director in his or her capacity as a director.

14.5 Duty of care, skill and diligence

14.5.1 The common law before the Act

A discussion of the common law before the Act is once again of importance for a proper understanding of s 76(3)*(c)* of the Act, which relates to the director's duty to exercise reasonable care, skill and diligence. This duty (as stated in 14.1.1) is a non-fiduciary duty.

The broad general principle is that directors are liable for negligence or carelessness in the performance of their duties. The issue is the extent to which the directors, whether executive or non-executive, are liable for loss caused to the company by their incompetence or carelessness, and the standard of care that is expected of them.

In striking contrast to the directors' fiduciary duty of good faith, honesty and the avoidance of a conflict of interest, which (as discussed above) have been rigorously enforced, the courts have adopted a lenient attitude to the common-law duty of a director to exercise reasonable care, skill and diligence in the performance of his or her duties. In the past the courts simply adopted the view that the shareholders were ultimately responsible for unwise appointments of directors of the company. If shareholders appointed foolish directors they had only themselves to blame. In recent years, however, at least in other jurisdictions, a more rigorous approach has been adopted.

The duty of care, skill and diligence is not a fiduciary duty but is based on delictual or Aquilian liability for negligence. This duty has been formulated by the courts in largely subjective terms - terms that depend on the skill, experience and the ability of the director in question. The consequence has been that an unreasonably low standard of care was required of directors. Directors were expected to exercise only that degree or level of care and skill that they were capable of, so that the more inexperienced or incompetent a director was, the lower the standard of care expected of him or her. According to this subjective test of care and skill, it was the director's ignorance or inexperience that protected him or her from liability, since the less the director knew, the less was expected of him or her. [61]

Unlike a professional person, a director is not required by law to have any special qualifications for his or her office. Directors are not members of a professional body, and no objective standard of skill is thus applicable to directors. It is also very difficult to formulate a single objective standard that will apply to all directors of all companies, ranging from small owner-managed companies to large multinational ones. Not only are there different types of companies, there are also different types of directors. An executive director will naturally be expected to know more than a non-executive director about the internal affairs of a company. This makes it extremely difficult for the courts and even the legislature to lay down one common, objective standard for all directors of companies. Consequently the duty of care and skill must depend on the type of company, the type of director, senior manager or employee, and his or her particular skills and knowledge, position in the company and responsibilities. There clearly are practical difficulties in prescribing an appropriate and acceptable standard of care and skill for company directors across the board.

At common law, a director was required, in the performance of his or her duties, to exercise the care and skill that could be expected of a person with *his or her* knowledge and experience. In *Re Brazilian Rubber Plantations & Estates Ltd* [62] the directors were unsuccessfully sued for losses as a result of their disastrous speculation in rubber plantations in Brazil. The directors had based their decision to invest in rubber plantations on a false and fraudulent report on the output of rubber plantations. In dismissing the proceedings, the court held that a director's duty is to act with such care as is reasonably to be expected from him, having regard to *his* knowledge and experience. The court stated that a director is not bound to bring any special qualifications to his office. He may undertake the management of a rubber company in complete ignorance of anything connected with rubber, without incurring responsibility for the mistakes which may result from such ignorance. On the other hand, if he is acquainted with the rubber business, he must give the company the benefit of his knowledge when transacting the company's business. More important, it was held that a director is not liable for damage caused by errors of judgment (ie for imprudence).

Built into the test of care and skill laid down by the court in *Re Brazilian*

Rubber Plantations & Estates Ltd was a bias in favour of the inexperienced director. At the same time, the test subjected the more experienced director to a higher risk of liability for the failure to exercise reasonable care and skill.

In *Re City Equitable Fire Insurance Co Ltd*, [63] in approving the subjective test laid down in *Re Brazilian Rubber Plantations & Estates Ltd*, the court in its classic judgment laid down three basic legal propositions, which over 50 years later were simply adopted without any critical examination in *Fisheries Development Corporation of SA Ltd v Jorgensen; Fisheries Development Corporation of SA Ltd v AWJ Investments (Pty) Ltd*. [64] The three legal propositions laid down in *Re City Equitable Fire Insurance Co*, which are relevant to a proper understanding of the Act, are as follows:

(i) First, a director need not exhibit in the performance of his or her duties a greater degree of skill than may reasonably be expected from a person of *his or her* [emphasis added] knowledge and experience.

This legal principle leaves no doubt that at common law the standard is not the objective standard of a reasonable director. It is a subjective standard.

(ii) Second, a director is not bound to give continuous attention to the affairs of the company. His or her duties are of an intermittent nature to be performed at periodical board meetings.

This legal principle might perhaps in the past have been relevant to non-executive directors who may not have been required by their contracts or by the terms of their appointments to attend all board meetings. But in modern times, this second principle no longer reflects what is expected even of a non-executive director.

(iii) Third, in respect of all duties that, having regard to the exigencies of business (and the company's constitution), may properly be left to some official, a director is, in the absence of grounds for suspicion, justified in trusting that official to perform such duties honestly.

A director is thus entitled, in the absence of grounds for suspicion, to rely on the company's accountant, auditor or attorney or other such persons to perform their functions properly and honestly. Unquestioning reliance on others is however not acceptable.

14.5.2 The statutory duty of care and skill

The Act tightens up and upgrades the director's duty of care and skill. Section 76(3)*(c)* imposes a less subjective test and a slightly more demanding standard of care on directors and prescribed officers than the common law. The statutory amendments to this common-law duty correctly reflect the modern commercial fact that nowadays a company director, particularly of a listed company, is often a highly skilled professional with considerable business experience.

Section 76(3)*(c)* of the Act states the following:

> (3) Subject to subsections (4) and (5), a director of a company, when acting in that capacity, must exercise the powers and perform the functions of director-
>
> . . .
>
> *(c)* with the degree of care, skill and diligence that may reasonably be expected of a person-
>
> (i) carrying out the same functions in relation to the company as those carried out by that director; and
>
> (ii) having the general knowledge, skill and experience of *that* [emphasis added] director.

The section imposes a mandatory duty which (like the other fiduciary duties) is owed to the company and not to the shareholders. It requires a director to exercise the reasonable care, skill and diligence that would be exercised by a person carrying out the same functions as the director and with the same general knowledge, skill and diligence that the director has.

Section 76(3)*(c)* (set out above) introduces a twofold dual standard that is partly objective and partly subjective. The test or standard is objective to the extent that the first limb of the section, ie 76(3)*(c)*(i), requires a director to exercise the degree of care, skill and diligence that may *reasonably* be expected of a person carrying out the same functions as the director. On the other hand, the test is subjective to the extent that the second limb, ie s 76(3)*(c)*(ii), requires that the knowledge, skill and experience of the director in question must also be taken into account. This means that if the director has any special skill or is more experienced or knowledgeable, his or her conduct must be measured against this higher subjective standard.

The effect is that the more skilled, knowledgeable and experienced the director is, the higher the level of care and skill he or she must exercise. On the other hand, the more inexperienced he or she is, the lower the level of care and skill expected of him or her, provided that he or she does at the very least exercise reasonable care and skill. This is the objective minimum standard of care, skill and diligence with which every director must comply.

The subjective standard of skill, knowledge and experience is taken into account only when it increases or improves the objective standard of care or skill expected of a reasonable director. If the skill or knowledge of the particular director exceeds that of a reasonably diligent person, the higher level of knowledge, skill and experience must be taken into account in deciding whether the particular director has exercised reasonable care and skill.

In determining the degree of care, skill and diligence that may reasonably be expected of a director, the courts will in all likelihood take into account the nature of the company, the nature of the decision in question, the position of the director and the nature of the responsibilities undertaken by him or her. The scope of the director’s duty will vary according to the knowledge, the skill and the experience of the director.

But it must be emphasised that directors are not required to take all possible care - only reasonable care is required of them. Directors are not infallible. They do make mistakes, but provided they exercise reasonable care and skill, they are not likely to incur liability for negligence. As a general principle, directors will not incur liability for a mere mistake or an error of judgment (see further 14.5.4).

Failure to attend board meetings without a reasonable excuse for non-attendance will now, unlike in the past, be seen as a failure to exercise reasonable care and diligence. Failure to attend board meetings without a good reason, such as illness or absence from the country, is irresponsible behaviour.

14.5.3 Delegation

14.5.3.1 Common-law principles

It is inevitable, particularly in large companies, that the directors will delegate certain functions and tasks to employees of the company, and rely on the advice of experts. Delegation to auditors, accountants and managers is an essential part of the way in which the business of large companies is conducted.

In *Re City Equitable Fire Insurance Co Ltd* [65] the third legal proposition laid down by the court (see 14.5.1) was as follows:

> In respect of all duties that, having regard to the exigencies of business, and the articles of association, may properly be left to some official, a director is, in the absence of grounds for suspicion, justified in trusting that official to perform such duties honestly.

This principle was approved in *Fisheries Development Corporation of SA Ltd v Jorgensen*; *Fisheries Development Corporation of SA Ltd v AWJ Investments (Pty) Ltd* [66] where the court stated that a director is entitled to accept and rely on the judgment, information and advice of management, provided that the director does not act blindly.

Even though directors may rely on others and delegate some of their functions and

duties, they remain legally responsible for the proper performance of these tasks. Directors, it is said, may delegate but may not abdicate their responsibilities, ie they cannot avoid accountability simply by delegating authority to some other person. Directors must carry out their supervisory and monitoring duties - they must supervise the discharge of the delegated functions. While directors may delegate functions, they cannot delegate responsibility for the task in question.

14.5.3.2 Delegation under section 76(4)*(b)* and (5) of the Act

The common-law principles (discussed above in 14.5.3.1) have been modernised, expanded and codified in s 76(4)*(b)* and (5) of the Act. In essence, s 76(4)*(b)* and (5) provides that directors may now rely on the performance of an employee, a professional person, an expert, or a board committee, provided that they reasonably believe that such persons are reliable and competent or merit confidence. Directors may also rely on a person to whom the board has reasonably delegated the authority or duty to perform a delegable function. The effect is that, provided the requirements of the section are complied with, directors are entitled to rely on the performance of such persons, as well as information, opinions, recommendations, reports or statements prepared by them. There must be no 'red flags' that warn a director of the incompetence of the person or the committee to whom some task or function has been delegated.

If directors have complied with the requirements of this section, they will not incur liability for the actions of persons on whom they have they have relied. Thus a director will not be liable if he or she relied on a delegate to whom the board had reasonably delegated the authority to perform a delegable board function. Similarly, if legal counsel incorrectly advises that a particular contract is valid, or if the company auditor incorrectly states that the company is solvent and liquid, the director will not incur liability for the error or the loss caused to the company. But, as stated above, the director's reliance on the competence of such persons must be justified. If directors know a delegate to be incompetent or dishonest, their reliance on that person will be unreasonable, with the result that they may incur liability for the wrongdoing of the delegate. Reliance on the delegate must be in good faith and in the reasonable belief that the delegate or employee in question is competent and reliable.

14.5.4 The business judgment rule (a safe harbour from liability for directors)

Section 76(4)*(a)* encompasses a new US-style business judgment rule that has been adopted in Australia and Hong Kong but rejected in the UK and New Zealand. The rule has applied in the USA for over 160 years, where it is regarded as a cornerstone of corporate law. It is a rule that prevents a court from interfering, with the benefit of hindsight, in honest and reasonable business decisions of the directors of the company. Under the Act, the business judgment rule will have the practical effect of countering or alleviating the new and more rigorous duty of directors [67] to exercise reasonable care, skill and diligence in the performance of their duties.

According to s 76(4)*(a)*, in respect of any particular matter arising in the exercise of the powers or the performance of the functions of director, a particular director of

the company is deemed or presumed to have exercised his or her powers or performed his or her functions in the best interests of the company and with reasonable care, skill and diligence if-

(i) the director has taken reasonably diligent steps to become informed about the matter;
(ii) either-
  (aa) the director had no material personal financial interest in the subject matter of the decision, and had no reasonable basis to know that any related person had a personal financial interest in the matter; or
  (bb) the director complied with the requirements of section 75 with respect to any interest contemplated in subparagraph *(aa)*; and
(iii) the director made a decision, or supported the decision of a committee or the board,

> with regard to that matter, and the director had a rational basis for believing, and did believe, that the decision was in the best interests of the company.

The first requirement for the application of the business judgment rule is that the decision must be an informed one, and, second, the director must have no 'personal financial interest', that is to say, he or she must not be self-dealing, or alternatively, the director must (in accordance with s 75) make due and proper disclosure to the board of directors of his or her interest in the matter. The interest in the matter could be his or her own, or that of a related person. (This is discussed in 14.6.) Third, the director must have had a reasonable basis for believing, and must have believed, that the decision was in the best interests of the company.

A few important matters must be noted with regard to the third requirement. The test of reasonableness is objective. The belief must not be one that no reasonable person in the position of the director would hold. An irrational decision is not protected. The requirement of reasonableness is a pivotal ingredient of the business judgment rule. The decision made by the directors must be a reasonable one - if it is, the court will not substitute its own decision for that of the board. If it is not a reasonable decision, the business judgment rule cannot apply to protect the director.

Section 76(4)*(a)* (as set out above) thus protects only informed and reasonable business decisions. If the requirements of the section are satisfied, a director will not be liable for honest and reasonable mistakes or honest errors of judgment that he or she may have made in managing the business of the company. The director will be deemed to have complied with his or her duty to act in the best interests of the company and the duty of reasonable care, skill and diligence.

To summarise, there are three requirements for a director to be protected by the business judgment rule:

(i) He or she must have made an informed decision.
(ii) There must have been no self-dealing or, alternatively, there must have been proper disclosure of any material personal financial interest of the director or a related person (see further 14.6).
(iii) There must be a reasonable basis for believing that the director was acting in the best interests of the company.

Fraudulent or dishonest business decisions are not protected.

By way of illustration, a decision by the directors of a company to sell the business of the company at a price that subsequently turns out to be undervalued will be protected by the business judgment rule provided that the above requirements are satisfied, and the directors will incur no liability for their decision. The same will apply if the directors of the company relied on valuators to estimate the value of the company's business, provided that their reliance on the valuators' opinion was reasonable in the circumstances.

14.6 The disclosure of the director’s personal financial interests

14.6.1 Introduction

It is the duty of a director who is in any way interested in a contract or a proposed contract with the company to declare the nature of his or her interest to the company.

This aspect of the no-conflict rule and the self-dealing rule is clearly an important one that requires statutory regulation.

The no-conflict rule (as discussed in 14.4.1) requires that directors avoid putting themselves in a situation in which their personal interests conflict with their duties to the company. The most obvious form of conflict of interest and duty situation, or self-dealing, arises where a director has a material interest in a contract entered into by his or her company.

There is a real possibility of directors abusing their positions as directors whenever they enter into contracts with their companies. It consequently makes sense to subject such contracts to additional restrictions and safeguards.

14.6.2 Proposed transactions

The general principle is that a director [68] is required by the Act to disclose any ‘personal financial interest’ that he or she or a related person has in respect of a matter to be considered at a meeting of the board of directors. This provision does not apply to persons merely because they are members of an audit committee. The declaration or disclosure of the director’s interest in the matter must be made before the matter (or contract) is considered by the board of directors. [69]

The meaning of the phrase ‘personal financial interest’ lies at the core of the statutory provision. A ‘personal financial interest’ is defined in the Act to mean ‘a *direct* [emphasis added] material interest of that person, of a financial, monetary or economic nature, or to which a monetary value may be attributed’. [70] The director’s interest must be a ‘direct’ material interest, not an indirect one.

The financial interest must not only be a direct one, it must also be material. A

material’ interest is defined [71] as an interest that is of consequence in determining the matter or one that might reasonably affect a person’s judgment or decision in the matter. In view of this definition, there are no hard and fast rules as to when a financial interest would be ‘material’. The word ‘material’ is clearly not an exact concept that can be accurately defined; its meaning will depend on the particular facts and circumstances.

Disclosure must be made when a director or related person [72] (to the knowledge of the director) has a direct material financial interest in a matter (such as a contract) to be considered by the board of directors. [73] The section requires disclosure rather than approval of the director's personal financial interest in the matter to be decided. If disclosure is made, and the board duly makes a decision or approves of the transaction or agreement, then the decision, transaction or agreement will be valid despite any personal financial interest of a director or a related person. [74] Alternatively, the transaction may be ratified by ordinary resolution of the shareholders.

A court, on application by an interested person, may declare valid a transaction or agreement approved by the board, despite a failure by the director to disclose his or her interest in the transaction to the board of directors.

The following matters must be disclosed by the director:

(i) the personal financial interest that he or she or a related person has and its general nature, before the matter is considered at the meeting;

(ii) any material information relating to the matter and known to him or her (this must be disclosed at the meeting);

(iii) any observations or pertinent insights relating to the matter. These may be disclosed if requested by the other directors.

Disclosure must of course be made before the company enters into the transaction or before the particular matter in question is considered by the board.

All that is required is disclosure of the fact of the interest held by him or her and its '*general nature*'. Having made the disclosure, the director, if present at the meeting, must leave the meeting immediately and may not take part in the consideration of the matter, save to disclose to the meeting any material information and any observations or pertinent insights relating to the matter, as discussed above. [75] These provisions embody the new 'disclose and recuse' approach. [76]

14.6.3 Declaration of an interest in existing contracts [77]

If a director (or a related person to the knowledge of the director) acquires any personal financial interest in an agreement or other matter in which the company has a material interest *after* the agreement or matter was approved by the company, the director must 'promptly' disclose to the board of directors [78] the nature and extent of the interest and the material circumstances relating to the acquisition of the interest. One can only assume that by 'promptly' in this context is meant that disclosure must be made as soon as is reasonably practicable after the acquisition of the interest by the director (or a related person).

14.6.4 General notice in advance

The Act [79] provides that a director may at any time disclose any personal financial interest in advance, by delivering to the board of directors [80] a general notice or a standing notice in writing stating the nature and the extent of his or her interest. This saves the director from the inconvenience of having to declare his or her interest at every board meeting. The general notice remains operative until it has been changed or withdrawn by the director by written notice. [81]

14.6.5 Disclosure to whom?

Disclosure must be made to the board of directors.

In the case of a private company with one director, disclosure will entail disclosure to oneself. To avoid this ludicrous situation, the Act [82] provides that if the sole director of the company is not also the sole shareholder (or sole beneficial securities holder) of the company, disclosure must be made to the shareholders of the company, and their approval must be obtained by way of an ordinary resolution.

14.6.6 Where no declaration of interests is necessary

According to the Act, [83] no declaration of personal financial interests is required in the following cases:

(i) decisions generally affecting all the directors in their capacity as directors;
(ii) decisions generally affecting a class of persons of which the director is a member, unless the only members of that class are the director or persons related or interrelated to him or her;
(iii) a proposal to remove that director from office (in terms of s 71); or
(iv) where one person holds all the beneficial interests of all the issued securities of the company and that person is the sole director of the company.

14.6.7 Failure to comply with the disclosure requirement

A board decision, a transaction or an agreement approved by the board [84] is valid despite any personal financial interest of a director (or a person related to the director) only if it was approved following disclosure or if, despite non-disclosure, it has been subsequently ratified by an ordinary resolution of the shareholders after disclosure of the interest, or if it is declared to be valid by a court. A court may on application by an interested person declare valid a transaction or agreement that had been approved by the board [85] despite the failure of a director to satisfy the disclosure requirements of s 75.

14.7 Indemnification and directors' and officers' insurance

14.7.1 Introduction

There are three important methods that companies have relied on in the past in order to limit the extent to which their directors are exposed to personal liability for negligence, breach of fiduciary duty, breach of trust or other default in the performance of their duties. First, companies have inserted provisions in their constitutions that have exempted directors from liability for negligence, breach of fiduciary duty or breach of trust. Second, indemnities have been given to directors that protected them from loss as a result of some default, breach of duty or negligence. A third method has been to effect and to pay for directors' liability insurance, which indemnifies a director from liability arising out of his or her service to the company. The extent to which these methods are valid and permissible has a direct influence on the effectiveness of the fiduciary and statutory duties imposed on directors.

Their main justification is that, without these mechanisms, it would be difficult for companies to find suitable persons willing to serve as directors. Now that the Act provides a more effective means of enforcing the duties of directors and a more effective derivative action, the need for such protective measures for directors is perceived to have been magnified.

14.7.2 Exemptions, indemnities and insurance

The Act [86] essentially prohibits, subject to certain exceptions, any exemptions or indemnities for directors. 'Directors' is used in the extended sense of the word to include an alternate director and even a 'former' director. A 'former' director is not defined in the Act, but presumably the section will apply to directors who have resigned or vacated their offices as directors after having committed during their periods of office a breach of duty or trust, having been negligent, or having been in default in some way in the performance of their duties. The prohibition also applies to members of a board committee or an audit committee and to prescribed officers of the company, whether or not they are directors.

14.7.3 Exemption from duty or liability

The Act provides that [87] a provision in an agreement, the Memorandum of Incorporation, the rules or a resolution of the company, whether express or implied, is void if it purports to-

(i) relieve a director of a duty to disclose a personal financial interest or a duty in terms of the standards of directors' conduct, including a fiduciary or a statutory duty. This provision reinforces the mandatory nature of these duties;

(ii) relieve a director of any liability contemplated in s 77 (discussed below); or

(iii) negate, limit or restrict any legal consequences arising from an act or omission that constitutes wilful misconduct or wilful breach of trust on the part of the director.

This wide prohibition is pruned down by permitting a company in certain circumstances to indemnify a director and to purchase insurance protection for its directors and officers.

14.7.4 Indemnification

14.7.4.1 When an indemnity is prohibited

The Act [88] prohibits the indemnification by a company of its directors with regard to-

(i) any liability arising in terms of s 77(3)*(a)*, *(b)* or *(c)* (ie knowingly acting without authority on behalf of the company; knowingly acquiescing in the fraudulent or reckless conduct of the company's business contrary to s 22; and knowingly being a party to conduct calculated to defraud a creditor, employee or shareholder of the company or for another fraudulent purpose) (discussed below);

(ii) liability arising from wilful misconduct or wilful breach of trust on the part of the director; or

(iii) any fine imposed on the director of the company (or of a related company) who has been convicted of an offence, unless the conviction was based on strict liability. [89]

14.7.4.2 When an indemnity is permissible

Subject to the above exceptions and to any contrary provisions of the company's Memorandum of Incorporation, the Act permits indemnification of *any* [emphasis added] liability incurred by a director. [90] This means there is now a considerably wider scope for the indemnification of the directors (and prescribed officers) of a company. It seems that a company may indemnify a director in respect of liability arising from the negligence of that director.

14.7.4.3 Advances and indemnities to defend legal proceedings [91]

Except to the extent that the company's Memorandum of Incorporation provides otherwise, a company may advance expenses to a director to defend any legal

proceedings that arise out of the director's service to the company, and may (directly or indirectly) indemnify a director in respect of such litigation expenses, irrespective of whether or not the company has advanced these expenses, if the legal proceedings-

(i) are subsequently abandoned or exculpate the director; or

(ii) relate to liability for which the company may indemnify the director (see above).

A welcome change in the statutory provisions is that, unlike under the 1973 Act, companies may now make a loan in advance to directors to allow them to meet their legal costs to defend litigation arising out of their service with the company. This will include the fees of legal counsel. Legal costs frequently involve substantial amounts of money. It is not required that the company should wait until the court has made its decision in the legal proceedings.

The Act permits a company to indemnify a director for litigation expenses, irrespective of whether or not it actually advances the expenses. Where the company does in fact advance the expenses, if the decision of the court is unfavourable to the director with the result that the director has not successfully defended the legal proceedings, the money advanced to him or her by the company must be repaid to the company. On the other hand, if the director has successfully defended the legal proceedings (or if they were abandoned), the director may retain the money advanced to him or her as part of the indemnity that was granted to him or her.

14.7.5 Directors' and officers' liability insurance

A company may purchase and maintain insurance on behalf of its directors (in the extended sense) or prescribed officers of the company during their periods of office to protect them against liability incurred in their capacity as directors or prescribed officers of the company. This type of insurance is known in other jurisdictions as 'directors and officers liability insurance' (D&O insurance). It confers protection on directors and prescribed officers against liability or expenses for which a company is permitted to indemnify a director. Insurance policies of this nature may also provide protection to directors and prescribed officers in the event of the company being unable to honour the indemnification payments it has undertaken. The D&O liability insurance policies must of course provide insurance cover only for those matters that are permitted by the Act. This type of policy usually affords insurance cover for damages for an error, a negligent or misleading statement, or breach of duty, but may not protect against liability arising from a fraudulent, dishonest or an illegal act or against wilful default or a wilful breach of a duty owed to the company.

The company may also effect insurance to protect itself against the expenses that it is allowed to advance to a director, or against the liability for which it is permitted to indemnify a director. [92]

14.8 Condonation and relief

14.8.1 Relief by the court

The Act provides: [93]

> In any proceedings against a director, other than for wilful misconduct or wilful breach of trust, the court may relieve the director, either wholly or partly, from any liability set out in this section, on any terms the court considers just if it appears to the court that-
>
> *(a)* the director is or may be liable, but has acted honestly and reasonably; or
>
> *(b)* having regard to all the circumstances of the case, including those connected with the appointment of the director, it would be fair to excuse the director.

There are two grounds for relief under this provision:

(i) The director must have acted honestly and reasonably; or

(ii) The circumstances must be such that he or she ought fairly to be excused from liability (under s 77) for his or her negligence, breach of duty or other default, excluding wilful misconduct or wilful breach of trust.

It must be emphasised that this provision requires a director to act both honestly and reasonably. It is most unlikely that the provision will apply to a director who had knowingly acquiesced in the fraudulent, reckless or grossly negligent conduct of the company's business. Gross negligence cannot be reasonable conduct.

14.9 The liability of directors and prescribed officers

The liability of the directors, prescribed officers and members of a board committee or audit committee is set out in s 77 of the Act.

The Act also provides [94] that each shareholder of a company has a claim for damages against any person who intentionally, fraudulently or due to gross negligence causes the company to do anything inconsistent with the Act or a limitation, restriction or qualification in the company's Memorandum of Incorporation on its purposes, powers or activities (or a limitation on the authority of the directors), unless this is ratified by special resolution. It must be stressed that an act that contravenes the Act is not ratifiable.

The liability of a person in terms of s 77 is joint and several with that of any other person who is also liable for the same act. [95] There is a three-year prescriptive period for legal proceedings lodged in terms of s 77.

The liability of a director under s 77 is as follows:

14.9.1 Breach of fiduciary duty

A director may be held liable, in accordance with the principles of the common law relating to breach of a fiduciary duty, for any loss, damages or costs sustained by the company as a consequence of-

(i) any breach by a director or a failure to disclose his or her personal financial interests;
(ii) improper use of position or corporate information or failure to communicate relevant information to the company;
(iii) a breach of the duty to act in good faith and for a proper purpose; and
(iv) a breach of the duty to act in the best interests of the company.

Section 77 links the statutory duties with the common-law fiduciary duties.

14.9.2 Breach of the duty of care and skill or other provisions

A director will be liable in accordance with the principles of the common law relating to delict for any loss, damages or costs sustained by the company as a consequence of any failure to exercise reasonable care, skill and diligence. [96] This preserves the traditional common-law principles in so far as delictual liability is imposed for breach of the director's duty of care and skill. Directors would also be liable for failure to comply with any provision of the company's Memorandum of Incorporation.

The duties referred to in s 77 are owed to the company, not to its shareholders. It is consequently the company that must proceed against the miscreant director in terms of these provisions.

14.9.3 Liability under s 77(3)

A director is liable for any loss, damages or costs sustained by the company as a direct or indirect consequence of that director's having-

(i) acted in the name of the company, or signed anything on behalf of the company, or purported to bind the company or authorise the taking of any action by or on behalf of the company, despite knowing that he or she lacked authority to do so;

(ii) acquiesced in the conduct of the company's business fraudulently or recklessly with gross negligence contrary to s 22(1) (this ground of liability is discussed in more detail in 14.10);

(iii) been a party to an act or omission by the company despite knowing that the act or omission was calculated to defraud a creditor, an employee or a shareholder of the company, or had another fraudulent purpose;

(iv) knowingly signed, consented to or authorised the publication of any financial statements that were false or misleading in a material respect, [97] or a prospectus, or a statement to the effect that a person has consented to be a director when no such consent had been given; In each of these circumstances, the director must have known that the statement was false, misleading or untrue, as the case may be; or

(v) attended a meeting [98] or participated in the making of a decision and failed to vote against any one of the resolutions or actions proposed to be taken in the following eight circumstances:

   (a) the issue of any unauthorised shares, despite knowing that the shares had not been authorised; [99]

   (b) the issue of authorised securities, despite knowing that the issue was made without the prescribed shareholder approval and special resolution;

   (c) the granting of options despite 'knowing' that the shares for which the options could be exercised, or the shares into which any securities could be converted, were unauthorised;

   (d) the provision of financial assistance to any person for the 'acquisition' of securities, despite knowing that such financial assistance was inconsistent with the requirements of the Act or the company's Memorandum of Incorporation;

   (e) the provision of financial assistance to a director, despite knowing that it was inconsistent with the requirements of the

Act or the company's Memorandum of Incorporation;

(f) a resolution approving of a distribution, despite knowing that it had failed to comply with the requirements of the Act;

(g) the acquisition by a company of its own shares or the shares of its holding company, despite knowing that it was in contravention of the requirements for a valid distribution [100] or the requirements [101] for a valid share repurchase; or

(h) the allotment of shares, despite knowing that it was contrary to the requirements of the Act relating to offers to the public for the securities of the company.

In respect of wrongful distributions, a director is liable for a wrongful distribution if he or she was present at the board meeting that approved of the distribution (or participated in the making of the decision) and failed to vote against the distribution, despite knowing that the distribution was contrary to the requirements of the Act. Essentially, this will entail a failure to satisfy the solvency and liquidity test immediately after completing the proposed distribution. [102] According to s 77, [103] liability arises only if it was also unreasonable at the time of the decision to conclude that the company would satisfy the solvency and liquidity test after the distribution had been made. It consequently follows that, provided there were reasonable grounds at the time of the decision for concluding that the company would satisfy the solvency and liquidity test, the directors will not incur liability to the company even if the company was not in fact solvent and/or liquid.

The Act limits the liability of the directors for a wrongful distribution to the difference between, on the one hand, the amount by which the value of the distribution exceeded the amount that could validly have been distributed without causing the company to fail to satisfy the solvency and liquidity test and, on the other hand, the amount, if any, that was recovered by the company from the persons to whom the distribution was made. [104]

14.10 Fraudulent, reckless and insolvent trading

14.10.1 Introduction

Section 22(1) of the Act provides that a company must not-

> carry on its business recklessly, with gross negligence, with intent to defraud any person or for any fraudulent purpose.

The section initially prohibited a company from trading under insolvent circumstances. The provision was subsequently pruned down (discussed in 14.10.3).

A director of a company is liable for any loss, damages or costs sustained by the company as a 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 s 22(1)'. Furthermore, a court must make an order declaring a person to be a delinquent director if the person acquiesced in the fraudulent or reckless conduct of the company's business. [105] Fraudulent or reckless trading will consequently result in a director being held personally liable to the company as well as being declared a delinquent director, which will thereby disqualify him or her from holding office as a director subject to such conditions as the court deems appropriate for a period of seven years or longer. [106] Disqualification from holding office as director is an inherent effect of being declared a delinquent director.

Furthermore, it is a criminal offence if a person is 'knowingly' a party to an act or omission by a company calculated to defraud a creditor or employee of the company, or a holder of the company's securities, or with another fraudulent purpose. [107] The offence is punishable by a fine or imprisonment for a period not exceeding ten years, or both. [108]

A further important statutory provision that must not be overlooked in this context is that any person who contravenes any provision of the Act is liable to any other person for any loss or damage suffered by that person as a result of that contravention. [109]

All these statutory provisions emphasise the seriousness of a contravention of s 22(1). No director or prescribed officer should treat s 22 lightly.

To return to s 22, the section prohibits not only fraudulent or reckless trading but also attempts to regulate trading under insolvent circumstances.

14.10.2 Fraudulent or reckless trading

The object of s 22 is twofold: first, to render liable all persons, not only directors, who 'knowingly' participate or acquiesce in the fraudulent or reckless conduct of the company's business, and second, to provide a meaningful remedy for the abuses at which s 22 is directed.

For liability to arise, the following requirements must be satisfied: the business of the company must have been carried on-

(i) fraudulently or recklessly or with gross negligence;
(ii) to the knowledge of the wrongdoer; and
(iii) with the acquiescence of the wrongdoer.

For criminal liability to arise, the Act requires that the defendant, in order to be found guilty of an offence, must 'knowingly' have been a 'party' to the fraudulent conduct prohibited by s 22(1). [110] Similarly, for a director to be held liable for the company's loss or for damages, the director must have acquiesced in the carrying on of the company's business despite 'knowing' that it was being conducted fraudulently or recklessly.

Knowledge is very widely defined in the Act to mean actual knowledge or knowledge which a person ought reasonably to have or knowledge which a person could reasonably be expected to have, had he or she investigated the matter. [111] Thus, under the Act a person who could have acquired knowledge by the exercise of reasonable diligence would fall within the scope of the prohibition against the fraudulent or reckless conduct of the company's business.

But knowledge alone is not sufficient. In addition to knowledge, for the criminal offence, the Act requires the defendant to be a 'party' to the fraudulent conduct of the company's business, while for civil liability [112] the director must have 'acquiesced' in the carrying on of the company's business despite knowing that it was being conducted in a fraudulent or reckless manner. This means that the wrongdoer must have taken part in or concurred in the fraudulent trading of the company. It is not necessary to take positive steps in the conduct of the company's business - it is enough to support or concur in the company's business. The wrongdoer's supine attitude may in certain circumstances amount to concurrence in the wrongful conduct. [113] Likewise, in *Nel v McArthur* [114] the court approved and applied the principle that to be a 'party' to the conduct of the company's business, no positive steps need be taken. But an auditor of a company cannot be a 'party' to the carrying on of a company's business merely by virtue of performing his or her duties as an auditor. [115] However, a *de facto* director, and perhaps even a shadow director, will fall within the ambit of the prohibition.

A single isolated act of dishonesty committed by those responsible for managing the affairs of the company has been held by the courts to be a sufficient basis for the imposition of personal liability on such persons. [116]

Fundamental to the prohibition is the issue of when the business of the company can be said to be carried on 'recklessly, with gross negligence, with intent to defraud any person or for any fraudulent purpose'.

In practice, there is seldom direct evidence of the dishonest or fraudulent intention of the defendant. Fraudulent intention is invariably proved by inference. The guiding principle laid down many years ago in *Re William Leitch Bros Ltd* [117] is:

> If a company continues to carry on business and to incur debts at a time when there is to the knowledge of the directors no reasonable prospect of the creditors ever receiving payment of those debts, it is, in general, a proper inference that the company is carrying on business with intent to defraud.

This principle in effect distinguishes factual insolvency from commercial insolvency. To put it differently, factual insolvency relates to the insolvency of the company in the sense of liabilities exceeding assets, ie balance sheet insolvency, while commercial insolvency relates to liquidity, or the company's ability to pay its debts as they become due in the ordinary course of business. Commercial insolvency is simply illiquidity, ie the company is unable to pay its debts as they fall due, even though its assets may equal or exceed its liabilities (cash flow insolvency).

'Recklessly' is used in contradistinction to the term 'fraudulently'. In this context, 'recklessly' implies the existence of an objective standard of care that would be observed by the reasonable man in the conduct of the business of the company. There is more than ample authority that 'recklessly' (in the context of s 424 of the Companies Act 61 of 1973 ('the 1973 Act')) means gross negligence. [118] The same will arguably apply to s 22(1) of the 2008 Act. Recklessness is not an error of judgment - it is rather a disregard for the consequences of one's actions.

In considering whether the business of the company has been carried on 'recklessly', the court must have regard to the scope of the operations of the company, the role, functions and powers of the directors, the amount of the debts involved, the extent of the company's financial difficulties, and the prospects, if any, of recovery. [119]

Sometimes, reckless trading may be established by proof of a lack of any genuine concern for the prosperity of the company. Recklessness is not to be easily found. [120] The test of recklessness is partly objective to the extent that the defendant's actions

are measured against the standard of a reasonable man, and partly subjective in so far as the defendant's knowledge is taken into account. [121] Actual dishonesty is not an essential element of 'recklessness'.

In *Ozinsky NO v Lloyd* [122] the court laid down the general principle that if a company continues to carry on business and to incur debts when, in the opinion of reasonable businessmen, standing in the shoes of the directors, there would be no reasonable prospect of the creditors receiving payment when due, it will in general be a proper inference that the business is being carried on recklessly. In *McLuckie v Sullivan* [123] the court stated that 'recklessly' (in the context of the 1973 Act) consists in failing to give any consideration to the consequences of one's actions, in other words, an attitude of reckless disregard for the consequences of one's actions. In deciding this matter, the court must have regard to-

(i) the scope of the business operations;
(ii) the functions and powers of the shareholders or directors;
(iii) the amount of the debts of the company;
(iv) the extent of the company's financial difficulties;
(v) the prospects of recovery; and
(vi) the extent to which the directors departed from the standards of a reasonable person.

In *Fourie NO v Newton* [124] the court likewise stated that acting 'recklessly' consists in an entire failure to give consideration to the consequences of one's actions. In this case, the court accepted that a credible business plan or strategy that is being implemented or a business plan that could be implemented to rescue a company would be taken into account in deciding whether the company's business was being conducted fraudulently or recklessly. A business that may appear on analysis of past performance to be a hopeless case may legitimately be perceived as a golden opportunity for business rescue.

14.10.3 Trading while unable to pay company debts

The Act [125] provides that if the Companies and Intellectual Property Commission ('the Companies Commission') has reasonable grounds to believe that a company is carrying on its business recklessly, with gross negligence, with intent to defraud any person or for any fraudulent purpose, or that the company is unable to pay its debts as they become due and payable in the normal course of business, the Companies Commission may issue a notice to the company to show cause why the company should be permitted to continue carrying on business, or to trade, as the case may be.

This provision is aimed at deterring companies from trading or carrying on business while commercially insolvent, ie a company experiencing cash flow problems. Its object is to ensure that the directors of a company do not irresponsibly incur debts and liabilities if the company is in a near insolvency situation.

The Companies Commission must have reasonable grounds for its belief that the company is unable to pay its debts as they become due and payable in the normal course of its business. The Regulations [126] require that the notice must be in prescribed form (CoR 19.1) and must clearly set out the grounds upon which the Companies Commission has formed the belief that the notice is justified.

The duty to cease trading is a new and modern approach to the protection of creditors and the public. This new duty discourages directors and companies from continuing to trade or to chase rainbows at the expense of creditors. As a result of limited liability, directors in the past suffered no additional losses as a result of persisting in continuing to trade instead of winding up the company or placing it under business rescue. They now have very strong reasons to refrain from this type of conduct.

The Act provides that if a company to which a notice has been issued fails within 20 business days to satisfy the Companies Commission that it is not engaging in conduct prohibited by s 22, or that it is able to pay its debts as they become due and payable in the normal course of business, the Companies Commission may issue a compliance notice requiring the company to cease carrying on its business or trade. This in effect, is a 'stop trading' notice. The Act thus confers on the Companies Commission the power to determine initially whether the company is engaging in fraudulent or reckless trading or trading while unable to pay its debts as they become due and payable in the normal course of business.

The Regulations [127] provide that if the person who has received a notice provides information to the Companies Commission within 20 business days after receiving the notice, the Companies Commission, after considering that information, must issue either-

(i) a notice accepting the information, and confirming the company's right to continue carrying on its business activities; or
(ii) a compliance notice.

As stated above, a director is liable for loss, damages or costs sustained by the company as a direct or indirect consequence of acquiescing in the fraudulent or reckless conduct of the company's business contrary to the provisions of the Act. [128] Directors of the company are best advised to monitor regularly the company's financial status to determine its solvency and liquidity. If the company is in near insolvent circumstances, their most appropriate step would be to place the company under business rescue and thereby obtain the benefit of a temporary moratorium. [129] For this purpose they have access to the financial statements of the company, including its profit and loss accounts and other accounting records that must be maintained by companies. In the case of public companies, the directors would also have the benefit of guidance and information provided by professional advisers. Directors must acquaint themselves with the company's financial position. They can no longer safely remain ignorant of the financial affairs of the company.

Whenever a company is in financial difficulties, the directors have a difficult decision to make: whether to close down and go into liquidation, [130] or whether to continue trading in the hope of turning the corner. If the directors decide to close down immediately and cause the company to go into early liquidation, they may be criticised on other grounds. In this situation they are in a real and unenviable dilemma. The directors of a company now have a strong reason either to put the company under business rescue or to put it under liquidation if the company is experiencing severe financial or cash flow difficulties. They must obviously take some form of remedial action early instead of prolonging the problem of maintaining an unviable business and of incurring the risk of personal liability for loss, damages or costs sustained by the company or by a third party.

Questions

1. Sam and Susan form a company with the name 'Purity Limited' ('Purity'). Purity's sole business is to develop and sell a piece of property that it owns. Susan owns 80 per cent of the issued share capital of Purity and Sam holds 20 per cent. One day while on business for Purity, Sam meets an old school friend who offers to sell to Sam a piece of property with potential for development. The property is situated very near to the property owned by Purity. Sam decides to take up this personal offer and purchases the property for himself. Sam thereafter offers to sell the property to Purity but at twice the price that he paid for it.

   When Susan discovers the facts, she is furious and threatens to sue Sam for not acquiring the property for Purity in the first place.

   Advise Sam of his legal position.
2. Rambi and Bambi are directors of Dot (Pty) Ltd, a company that sells electronic equipment. The company has seven directors and ten shareholders. Rambi and Bambi were requested by the board of

directors to negotiate the sale by Dot (Pty) Ltd of electronic equipment to Soweto High School. Rambi and Bambi secretly form their own company called Com (Pty) Ltd, of which they are the sole directors and shareholders. The company also sells electronic equipment. Acting on behalf of Com (Pty) Ltd, Rambi and Bambi conclude the contract for the sale of the electronic equipment to Soweto High School. They thereafter inform the board of directors and the shareholders of Dot (Pty) Ltd that the negotiations with Soweto High School were unsuccessful. Six months later the board of directors and the shareholders of Dot (Pty) Ltd discover the truth of what Rambi and Bambi did.

(a) Advise the company, its directors and its shareholders of the various legal remedies they may have against Rambi and Bambi.

(b) Would Rambi and Bambi escape incurring liability for breach of their fiduciary duties by resigning as directors of Dot (Pty) Ltd?

(c) Assume that Rambi and Bambi are no longer directors of Dot (Pty) Ltd, but they instruct Wimpy on what to do. Wimpy always acts on the instructions of Rambi and Bambi. Discuss whether Wimpy would incur any liability to Dot (Pty) Ltd for breach of his fiduciary duties to the company. In the course of your answer, discuss whether Rambi and Bambi could also be held liable for Wimpy's breach of fiduciary duty.

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[1] In this regard, see s 66(1) of the Act.

[2] Including senior employees or top level management and prescribed officers.

[3] Section 1.

[4] For a discussion of the types of directors, see Chapter 12: Governance and the board of directors.

[5] Section 66(4)*(a)*(ii).

[6] *Howard v Herrigel* 1991 (2) SA 660 (A) 678A.

[7] The duty of care and skill expected of executive and non-executive directors does, however, differ (see below).

[8] Section 1 defines prescribed officers as the holders of an office within a company that has been designated by the Minister in terms of s 66(10). Regulation 38 of the Companies Regulations GNR 351 *GG* 34239 of 26 April 2011 ('the Regulations') provides that a prescribed officer is a person who exercises general executive control over and management of the whole or a significant portion of the business and activities of the company, or a person who regularly participates to a material degree in the exercise of general executive over and management of the whole, or a significant portion of the business and activities of the company. This definition would apply, for instance, to a shadow director if for whatever reason a particular person does not fall within the definition of a director. The definition of prescribed officers is intended to identify persons who are closely involved in the management of a company. Senior executive officers and those closely involved in important decisions affecting the company's business would also be prescribed officers but not necessarily a company secretary.

[9] Even if the prescribed officers or members of these committees are not members of the company's board of directors and even if they do not have the right to vote at board level. Since the members of an audit committee must comprise non-executive directors, they would be members of the board of directors of the company.

[10] The word 'company' is defined in s 1 of the Act as 'a juristic person incorporated in terms of the Act'. This definition is of little relevance in the particular context of s 76(3)*(b)*.

[11] *Percival v Wright* [1902] 2 Ch 421 (ChD).

[12] [1962] 2 All ER 929 (ChD).

[13] *Hutton v West Cork Railway Co* (1883) 23 ChD 654 (CA) 673; *Parke v Daily News Ltd* (n 12).
[14] In terms of s 165. See Chapter 18: Shareholder remedies and minority protection.
[15] Section 76(3)*(b)*.
[16] Except for the social and ethics committee (discussed below).
[17] By which is generally meant a company that integrates social and environmental issues in its business activities and interacts with stakeholders. A socially responsible company is one that is engaged in the solution of society's major problems.
[18] 98 A2d 581 (NJ 1953) 586.
[19] See R Cassim & Maleka Femida Cassim 'The reform of corporate law in South Africa' (2005) *International Company and Commercial LR* 411 at 411-12.
[20] Supra (n 13) 673.
[21] See further Chapter 13: Corporate governance.
[22] See *South African Broadcasting Corporation Ltd v Mpofu* [2009] 4 All SA 169 (GSJ) and *Minister of Water Affairs and Forestry v Stilfontein Gold Mining Co Ltd* 2006 (5) SA 333 (W); and Chapter 13: Corporate governance.
[23] Section 72(4) read with reg 43.
[24] Regulation 43(4).
[25] For a discussion of the social and ethics committee, see Chapter 12: Governance and the board of directors.
[26] *Da Silva v CH Chemicals (Pty) Ltd* 2008 (6) SA 620 (SCA) 627B, para [13].
[27] [1942] Ch 304 at 306.
[28] [1974] AC 821 (PC).
[29] [1903] 2 Ch 506.
[30] [1920] 1 Ch 77.
[31] [2003] 1 BCLC 598 (ChD) 619.
[32] It must be stressed that the Act (s 77(2)*(a)*) provides that a director will be held liable in accordance with the principles of the common law relating to a breach of a fiduciary duty to act in good faith and for a proper purpose. See further 14.9.
[33] [1994] 1 BCLC 363 (Ch and CA).
[34] 1980 (4) SA 156 (W) 163.
[35] 1965 (4) SA 646 (W) 651. See also *S v De Jager* 1965 (2) SA 616 (A), where a director who had formally resigned as a director and had appointed a puppet director was held to be a director despite his resignation.
[36] Section 76(2)*(a)*(i) and (ii).
[37] As provided in s 76(3)*(a)* and *(b)*, which is set out in 14.3.
[38] Section 19(1)*(b)*.
[39] This topic is more fully discussed in Chapter 7: Corporate capacity, agency and the turquand rule.
[40] Section 20(2) and (3).
[41] As provided in s 76(3)*(a)* and *(b)*.
[42] Section 77(3)*(a)*.
[43] Section 20(6).
[44] *Parker v McKenna* (1874) LR 10 Ch App 96 at 124.
[45] [1942] 1 All ER 378 (HL); [1967] 2 AC 134. In *Dorbyl v Verster* [2011] JOL 27671 (GS), the court in applying *Regal (Hastings) Ltd v Gulliver* ruled that secret profits made by a director in breach of his fiduciary duty must be disgorged by him and paid to the company of which he was a director.
[46] 2004 (3) SA 465 (SCA) 479.
[47] 2008 (6) SA 620 (SCA) 627 para [18].
[48] RC Beuthin 'Corporate opportunities and the no profit rule' (1978) 85 *SALJ* 458.
[49] 1988 (2) SA 54 (T).
[50] [1916] 1 AC 554 (PC).
[51] 1921 AD 168.
[52] Supra (n 45).

[53] [1972] 2 All ER 162.

[54] See R Cassim 'Post-resignation duties of directors: The application of the fiduciary duty not to misappropriate corporate opportunities' (2008) 125 *SALJ* 731.

[55] Supra (n 53). See 14.4.1.3.

[56] (1973) 40 DLR (3d) 371 (SCC).

[57] See *Da Silva v CH Chemicals (Pty) Ltd* (n 47) at para [20]. See 14.4.1.3.

[58] Supra (n 47). See Maleka Femida Cassim '*Da Silva v CH Chemicals (Pty) Ltd*: Fiduciary duties of resigning directors' 2009 *SALJ* 61.

[59] Paragraphs [20] and [21].

[60] See R Cassim (n 54) 731.

[61] See Farouk HI Cassim 'Fraudulent or reckless trading and s 424 of the Companies Act of 1973' (1981) 98 *SALJ* 162.

[62] [1911] Ch 425 (CA) 437.

[63] [1925] Ch 407.

[64] Supra (n 34).

[65] Supra (n 63) 429.

[66] Supra (n 34) 166.

[67] Including prescribed officers and members of a board or audit committee.

[68] Including prescribed officers and members of a board committee (other than the audit committee), irrespective of whether they are also members of the company's board of directors.

[69] Section 75(5).

[70] Section 1. An interest held by a person in a unit trust or collective investment scheme is excluded from this definition, unless that person has direct control over the investment decisions of that fund or investment.

[71] In s 1.

[72] For the purposes of s 75, a 'related person' when used in reference to a director has the meaning set out in s 1, but also includes a second company of which the director or a related person is also a director, or a close corporation of which the director or a related person is a member (s 75(1)*(b)*).

[73] For the meaning of 'related persons' see generally ss 1 and 2 of the Act and Chapter 8: Groups of companies and related persons.

[74] Section 75(7).

[75] Section 75(5)*(d)* and *(e)*.

[76] The director's departure from the meeting does not affect the quorum for the meeting as he or she is deemed for this purpose to be present at the meeting. But for voting purposes and for determining whether the resolution has sufficient support for its adoption, he or she is regarded as being absent (s 75(5)*(f)*(i) and (ii)).

[77] Section 75(6).

[78] Or to shareholders in the case of a company that has only one director who is not the sole shareholder or beneficial securities holder.

[79] Section 75(4).

[80] Or shareholders in the case of a board consisting of one director who is not the sole beneficial securities holder.

[81] Section 75(4).

[82] Section 75(3).

[83] Section 75(2).

[84] Or by an ordinary resolution of the shareholders, in the case of a company with one director who is not sole beneficial securities holder.

[85] Or shareholders, as the case may be - see note 84.

[86] Section 78.

[87] Section 78(2), subject to s 78(4)-(6).

[88] Section 78(6).

[89] Or in the case of a one-person private or personal liability company or a company in which all the shareholders are related persons and there are no directors other than such related persons.

[90] Section 78(5).

[91] Section 78(4).

[92] In accordance with s 78(4)*(a)* and *(b)* or to protect itself against any indemnifiable liability or any other contingency in accordance with s 78(5) and (6).

[93] Section 77(9)*(a)* and *(b)*.

[94] Section 20(6).

[95] Section 77(6).

[96] Section 77(2)*(b)*.

[97] The underpinning basis of this liability is that the directors of a company are now under a duty and responsibility to read and to understand the contents of a company's annual financial statements before approving them in order to ensure that the information in the company's annual financial statements is accurate. The directors are of course entitled to rely on others including external advisers. Directors, however, are not necessarily auditors. Nevertheless, the obligation to approve the annual financial statements rests on the directors of a company.

[98] A decision need not be made at a formal meeting of the board. It could be adopted by the written consent of the majority of the board given either personally or by electronic communication.

[99] See the wide definition in s 1 of 'knowing'.

[100] Section 46.

[101] Section 48.

[102] Section 46(1)*(b)*.

[103] Section 77(4)*(a)*(ii).

[104] Section 77(4)*(b)*(i) and (ii).

[105] The word 'director', as has already been pointed out, is used in its extended sense to include an alternate director, a prescribed officer or a member of a committee of the board or the audit committee, even if such persons are not directors.

[106] Section 162(5)*(c)*(iv)*(bb)*.

[107] Section 214(1)*(c)*(i).

[108] Section 216*(a)*.

[109] Section 218(2).

[110] Section 214(1)*(c)*.

[111] Section 1 of the Act.

[112] In terms of s 77(3)*(b)*.

[113] *Philotex v Snyman* 1998 (2) SA 138 (SCA).

[114] 2003 (4) SA 142 (T).

[115] *Powertech Industries Ltd v Mayberry* 1996 (2) SA 742 (W).

[116] *Re Gerald Cooper Chemicals Ltd* [1978] 2 All ER 49 at 53; *Gordon and Rennie v Standard Merchant Bank Ltd* 1984 (2) SA 519 (C); Farouk HI Cassim (n 61) 163. In *Re Gerald Cooper Chemicals* the court stated that '[i]t does not matter ... that only one creditor was defrauded, and by one transaction, provided that the transaction can properly be described as a fraud on a creditor perpetrated in the course of carrying on business'.

[117] [1932] All ER 892 at 895.

[118] *Philotex v Snyman* (n 113).

[119] *Fisheries Development Corporation of SA Ltd v Jorgensen; Fisheries Development Corporation of SA Ltd v AWJ Investments (Pty) Ltd* (n 34) 170B-C; *Philotex v Snyman* (n 113) 144B.

[120] *Philotex v Snyman* (n 113).

[121] *Philotex v Snyman* (n 113).

[122] 1992 (3) SA 396 (C) 414G.

[123] 2011 (1) SA 365 (GSJ).

[124] 2010 JDR 1437 (SCA).

[125] Section 22(2).

[126] Regulation 19(1).

[127] Regulation 19(2).

[128] Section 77(3)*(b)*.

[129] See Chapter 20: Business rescue and compromises.
[130] Or under business rescue.

Chapter 15
The Auditor, Financial Records and Reporting

Joanne Shev and Richard Jooste [*]

15.1 Introduction

Transparency, accountability and audit are significant factors to ensure the integrity of financial information. Numerous corporate scandals and collapses in recent years highlighted the need for certain aspects of good corporate governance to be legislated. Corporate governance was previously not legislated but rather addressed as best practice by the King Report on Corporate Governance in South Africa. The Companies Act 71 of 2008 ('the Act'), read together with the Companies Regulations, 2011 [1] ('the Regulations'), legislates several good corporate governance practices with respect to the integrity of financial information, the external auditor, external audit, audit committees and the company secretary.

15.2 Financial records and financial statements

15.2.1 Accounting records

Company records include accounting records. A company must maintain an accurate and complete set of accounting records in one of the official languages of South Africa. These records must be accessible from the company's registered office [2] and comprise documents used to prepare the financial statements of a company [3] including, but not limited to- [4]

(i) records of non-current assets, such as a fixed asset register;
(ii) a record of any property held by the company in a fiduciary capacity or that belongs to the consumer of that property (for example, a deposit or prepayment);
(iii) inventory records incorporating data from the annual inventory count and any other information required to determine the inventory value at the financial year-end;
(iv) a record of any loan between the company and a shareholder, director, prescribed officer, employee of the company, or a related person to any of these;
(v) a record of any guarantee, suretyship or indemnity granted by the company in respect of an obligation to a third party incurred by a shareholder, director, prescribed officer or employee of the company, or a related person to any of these;
(vi) a record of the company's revenue and expenditures; and
(vii) adequate records of revenue received from donations, grants and members' fees, or in terms of any funding contracts or arrangements with another party by a non-profit company.

Accounting records may be kept in written or electronic format. If electronic records are maintained, they must be available in a readable and printable format at all times. Precautions must be taken to avoid falsification, theft, loss and intentional or accidental damage or destruction of accounting records in written or electronic format. [5] It is an offence for- [6]

(i) a company or person to falsify any of the company's accounting records, or for a company to permit any person to do so; or
(ii) for a company, with an intention to deceive or mislead any person, to fail to maintain records that are accurate, complete and in accordance with any prescribed manner and form.

15.2.2 Financial statements

The term 'financial statement' is defined broadly in the Act and includes not only annual, provisional, group and consolidated financial statements, but also interim or preliminary reports and the financial information in a circular, prospectus or provisional announcement of results on which a shareholder, creditor, the Companies and Intellectual Property Commission ('the Companies Commission'), the Takeover Regulation Panel or another regulatory authority may reasonably be expected to rely. [7]

The financial statements of a company are prepared based on the company's accounting records and must not be false, misleading or incomplete in any material respect. [8] If a company presents its financial statements to any person, those financial statements must- [9]

(i) satisfy any prescribed financial reporting standards as to form and content;
(ii) fairly present the state of affairs and business of the company, and explain the transactions and financial position of its business;
(iii) reflect the company's assets, liabilities, equity, income and expenses, and any other prescribed information;
(iv) set out the date on which the statements were published, and the accounting period to which the statements apply; and
(v) include a prominent notice on the first indicating–
    - whether or not the statements have been audited or independently reviewed in compliance with the Act; and
    - the name and professional designation, if any, of the individual who prepared, or supervised the preparation of, those statements.

The financial statements of a company or close corporation ('CC') may be compiled internally or independently. [10] Financial statements are considered to be internally compiled if they are not independently compiled. [11] Financial statements are independently compiled and reported if they are prepared by an independent accounting professional on the basis of financial records provided by the company or CC and in accordance with any relevant accounting standards. [12] An independent accounting professional- [13]

(i) is a registered auditor in terms of the Auditing Profession Act 26 of 2005 (‘the Auditing Profession Act’);
(ii) is a member in good standing of a professional body that has been accredited in terms of the Auditing Profession Act; or
(iii) is a person qualified to be appointed as an accounting officer of a CC in terms of the Close Corporations Act 69 of 1984 (‘the Close Corporations Act’; and
(iv) does not have, and is not related to any person who has, a personal financial interest in the company or CC, a related company or an inter-related company; and
(v) is not, or has not in the previous three years been–
- involved, or related to any person who has been involved, in the day to day management of the business of the company or CC; or
- a prescribed officer or full time executive employee of the company or CC, a related or inter-related company, or a person related to such an officer or employee.

The only professional body currently accredited by the Independent Regulatory Board for Auditors (IRBA) in terms of the Auditing Profession Act is the South African Institute of Chartered Accountants (SAICA). A member of SAICA who qualifies to be an accounting professional is known as a Chartered Accountant (South Africa).

A company may present a summarised version of its financial statements, provided that the summary complies with any prescribed requirements and the first page of the summary states prominently- [14]
(i) that it is a summary and identifies the underlying financial statements;
(ii) whether the underlying financial statements were audited or independently reviewed;
(iii) the name and professional designation, if any, of the individual who prepared, or supervised the preparation of, the underlying financial statements; and
(iv) the steps required to obtain a copy of the underlying financial statements.

Any person who is party to the preparation, approval, dissemination or publication of financial statements or a summary thereof, knowing or reasonably expected to know

that these statements or the summarised version do not comply with the abovementioned requirements, is guilty of an offence. [15]

15.2.3 Financial reporting standards

Companies Regulation 27 prescribes financial reporting standards for financial years beginning on or after 1 May 2011. These standards promote sound and consistent accounting practices, which allow financial statements to be compared from one year to the next and across different companies. Furthermore, as South Africa has harmonised its standards with International Financial Reporting Standards (IFRS) and IFRS for Small and Medium Enterprises (IFRS for SMEs), financial statements are often comparable between countries.

Every company and CC must calculate its public interest score at the end of each financial year. Among other things, the public interest score is used to determine the prescribed financial reporting standards for companies and CCs. The public interest score is calculated for a company (and similarly for a CC) as the aggregate of- [16]

(i) one point for each employee comprising the average number of employees of the company during the financial year;
(ii) one point for every R1 million, or part thereof, in third party liability of the company, at the financial year-end;
(iii) one point for every R1 million, or part thereof, in turnover during the financial year; and
(iv) one point for every individual who, at the end of the financial year, is known by the company–
- in the case of a profit company, to directly or indirectly have a beneficial interest in any of the company's issued securities; or
- in the case of a non-profit company, to be a member of the company, or a member of an association that is a member of the company.

It is not clear whether the reference to an indirect beneficial interest implies that one point should be allocated for each beneficiary of a trust that has a beneficial interest in the securities of a company or CC, as opposed to one point being allocated for the beneficial interest of the trust as a whole. The lack of clarity regarding this principle applies similarly to the shareholders of a company that has a beneficial interest in another company.

The prescribed financial reporting standards for each type of company and CC are as follows: [17]

Applicable financial reporting standard	**Structures**
IFRS, but in the case of any conflict with any requirements in terms of the Public Finance Management Act 1 of 1999, the latter prevails	• State-owned companies; and • non-profit companies that are subject to an audit, being- • state or foreign controlled; or • incorporated primarily to perform a statutory or regulatory function in terms of the law
IFRS	• Public companies listed on an exchange
IFRS or IFRS for SMEs*	• Public companies not listed on an exchange; and • private companies, personal liability companies, non-profit companies that are not subject to an audit and CCs, whose public interest score for the particular year is at least 350
IFRS, IFRS for SMEs* or SA GAAP**	• Private companies, personal liability companies, non-profit companies that are not subject to an audit and CCs, whose public interest score for the particular year is- • at least 100 but less than 350, or • less than 100, and whose annual financial statements are independently compiled
The Financial Reporting Standards as determined by the company unless a Financial Reporting Standard is prescribed	• Private companies, personal liability companies, non-profit companies that are not subject to an audit and CCs, whose public interest score for the particular year is less than 100, and whose annual financial statements are internally compiled

* *IFRS for SMEs may only be used if its scoping requirements are met.*
** *SA GAAP refers to the South African Standards of Generally Accepted Accounting Practice, which will no longer apply in respect of financial years commencing on or after 1 December 2012 due to their withdrawal.*

Reporting standards differ for the various categories of companies and CCs. More rigorous standards are required for some entities than others. For example, a listed public company, in which there is a public interest, is subject to IFRS, whereas many private companies are subject to less stringent standards, such as IFRS for SMEs. Nothing precludes a company or CC that is- [18]

(i) required to prepare its financial statements in accordance with IFRS for SMEs from preparing its financial statements in accordance with IFRS instead; or
(ii) not subject to any financial reporting standards from preparing its financial statements in accordance with IFRS, IFRS for SMEs or SA GAAP.

15.2.4 Financial year

The annual accounting period of a company is known as its financial year. [19] The date of the financial year-end must be stated in the Notice of Incorporation. The first financial year of a company begins on the registration date of the company's incorporation and ends no later than 15 months thereafter. [20] Each subsequent financial year extends for 12 months unless the company changes its year-end date.

Such a change may only be made once during any financial year and may not result in a financial year extending more than 15 months after the end of the preceding financial year. [21]

15.2.5 Annual financial statements

A company must prepare annual financial statements within six months after the end of its financial year. [22] The annual financial statements must- [23]

(i) include an auditor's report, if audited;
(ii) include a directors' report with respect to the state of affairs, the business and profit or loss of the company, or of the group of companies if the company is part of a group, including any matter material for the shareholders to appreciate the company's state of affairs and any prescribed information;
(iii) be approved by the board and signed by an authorised director; and
(iv) be presented at the first shareholders' meeting after being approved by the board.

Furthermore, the annual financial statements of a company that is required in terms of the Act to have its annual financial statements audited must disclose remuneration and benefits received or receivable by a director or prescribed officer of the company or attributable to the rendering of services to the company, or a company within the same group of companies. This detailed disclosure is aimed at enhancing the transparency of directors' remuneration and benefits, and includes- [24]

(i) fees paid to directors for services rendered to the company or on behalf of the company;
(ii) salaries, bonuses and performance-related payments;
(iii) expense allowances, to the extent that the director is not required to account for these;
(iv) the value of any option or right given directly or indirectly to a director, past director or future director, or person related to any of them;
(v) financial assistance to a director, past director or future director, or person related to any of them, for the subscription of options or securities issued or to be issued by, or the purchase of securities of, the company or a related or inter-related company;
(vi) with respect to any financial assistance by the company to a director, past director or future director, or a person related to any of them, or any loan made by a third party to any such person, if the company is a guarantor of that loan, the value of any interest deferred, waived or forgiven;
(vii) the amount of any pensions paid or payable to current or past directors or prescribed officers, or to a pension scheme on their behalf, and any other contributions paid under any pension scheme;
(viii) the amount of any compensation paid in respect of loss of office to current or past directors or prescribed officers;
(ix) the number and class of any securities issued to a director or prescribed officer, or to any person related to them, and the related consideration received by the company; and
(x) details of service contracts of current directors and prescribed officers.

15.2.6 Responsibility for financial statements

The directors of a company are responsible for the preparation of the financial statements and the external auditor or independent reviewer provides assurance by reporting on these financial statements. To avoid compromising the independence of an external auditor or independent reviewer, he or she must not prepare the financial statements upon which he or she is reporting. [25] In terms of Section 90(2)*(b)* of the Act an auditor may not be or have been, in the five years preceding appointment, involved in habitually or regularly performing the duties of accountant or bookkeeper for the company. It is important to note that this provision of the Act does not apply retrospectively and the five-year period only commences on 1 May 2011.

15.2.7 Access to financial statements or related information

A person who holds or has a beneficial interest in any securities of a company is entitled to- [26]

(i) receive, without demand, a notice of the publication of any annual financial statements of the company, outlining the steps to obtain a copy thereof; and
(ii) receive, on demand, without charge, one copy of any annual financial statements of the company.

A company that fails to accommodate such a request for a copy of the financial statements, or frustrates the exercise of such a right, will be guilty of an offence. [27]

15.2.8 Financial Reporting Standards Council

Section 203(1) of the Act establishes the Financial Reporting Standards Council (FRSC), which replaces the Accounting Practices Board. The FRSC's function is to- [28]

(i) receive and consider any relevant information relating to the reliability of, and compliance with, financial reporting standards;
(ii) adapt international reporting standards for local circumstances;
(iii) consider recommendations of the Companies Commission for amendments to the financial reporting standards, to secure better reliability and compliance;
(iv) advise the Minister responsible for companies on matters relating to financial reporting standards; and
(v) consult with the Minister responsible for companies on the setting of regulations establishing financial reporting standards which promote sound and consistent accounting practices.

15.3 Annual return

Every company must file an annual return within 30 days of the anniversary date of its incorporation in South Africa. A company that is required in terms of the Act or the Regulations to have its annual financial statements audited in a particular year must file a copy of those statements as a supplement to its annual return. Any other company must either-

(i) file a copy of its audited or reviewed statements as a supplement to its annual return; or
(ii) file a financial accountability supplement to its annual return. [29]

15.4 Audit and independent review

In the past, all companies were required to have a financial statement audit. In contrast, the annual financial statements of CCs were not subject to audit and an accounting officer was merely required to report on a CC's annual financial statements. For financial years beginning on or after 1 May 2011 (ending on or after 30 April 2012), only certain companies will require a financial statement audit, while others may require an independent review or be exempt from these requirements. In addition, the annual financial statements of some CCs will be subject to an audit or independent review. It must be noted that annual financial statements must be prepared by every company and CC even if those financial statements are subject to neither audit nor independent review. [30]

The annual financial statements of every public company and state-owned company must be audited. [31] Other companies and CCs must have their financial statements audited if an audit is desirable in the public interest of the integrity of the financial statements, having regard to the economic or social significance of a company, as determined by any relevant factors, including the annual turnover of the entity, the entity's workforce size, or the nature and extent of the entity's activities. [32] The Regulations require an audit of the annual financial statements of- [33]

(i) a company or CC which, in the ordinary course of its primary business activities, holds assets in a fiduciary capacity for persons not related to the company, where the aggregate value of the assets held at any time during the year exceeds R5 million;

(ii) a non-profit company incorporated–
- directly or indirectly by the state, a state organ, a state-owned company, an international entity, a foreign state entity or a foreign company; or
- primarily to perform a statutory or regulatory function in terms of any legislation, or to carry out a public function at the direct or indirect initiation or direction of a state organ, a state-owned company, an international entity, or a foreign state entity, or for a purpose ancillary to any such function; or

(iii) any other company or CC with a public interest score in that financial year of at least 350, or, if its financial statements for the year were internally compiled, at least 100.

The financial statements of companies and CCs not requiring an audit must be either audited voluntarily or independently reviewed. [34] A voluntary audit may be required in terms of a company's Memorandum of Incorporation, a shareholder resolution or a board resolution. While an audit must be performed in terms of the International Standards on Auditing issued by the International Auditing and Assurance Standards Board (IAASB) and provides a reasonable level of assurance, an independent review must be conducted in accordance with ISRE 2400, [35] the International Standard on Review Engagements issued by the IAASB, and offers moderate assurance. Assurance is the confidence which the auditor or independent reviewer adds to the information being reported upon. A review engagement involves less comprehensive procedures than an audit, resulting in a lower degree of assurance being provided by an independent review than by an audit.

Only a registered auditor approved by the IRBA may perform an audit. An independent review must be performed by a registered auditor, a member in good standing of a professional body accredited by the IRBA or, if the company's public interest score is less than 100, a person qualified to be appointed as an accounting officer of a CC. [36] To qualify for the position of accounting officer, a person must be a member of a recognised profession such as SAICA, the South African Institute of Professional Accountants or the South African Institute of Chartered Secretaries and Administrators. Every profession recognised as having members who are qualified to be appointed as accounting officers for the purposes of performing an independent review on the financial statements of a CC, must annually file a report with the Companies Commission demonstrating that- [37]

(i) it has proper mechanisms to ensure that its members participate in continued professional development and maintain professional competence;
(ii) it has disciplinary measures for its members where appropriate;
(iii) it is, and is likely to continue to be, financially and operationally viable for the foreseeable future;
(iv) it maintains a proper register of its members;
(v) it is actively attempting to achieve the objective of being representative of all sectors of the South African population; and
(vi) it meets any other requirements determined by the Companies Commission from time to time.

Assuming that an audit or independent review is not required in terms of any other laws or an agreement, s 30(2A) of the Act exempts the financial statements of a company and CC from the audit or independent review requirements, provided that-

(i) every person who is a holder, or has a beneficial interest in, any securities issued by the company or CC is also a director of that entity; and
(ii) the annual financial statements are not required to be audited, in the public interest, by regulation made in terms of the Act, or by any other law or agreement. [38]

In the Companies Commission's opinion, this exemption will not apply to a company or CC with shareholders or members who are juristic persons, as directors must be natural persons. As the definition of 'juristic person' includes a trust, a company or CC will not be considered to be owner-managed if a trust is a shareholder or member of that company or CC. A company whose shares are held by another company will also not qualify for the exemption. It must be noted, however, that the financial statements of a company or CC cannot be exempt from-

(i) audit, if required by the Act or Regulations; or
(ii) audit or independent review, if this is required in terms of some other law or an agreement.

The forms of engagement, the persons eligible to perform such engagements and the business structures to which these apply are as follows:

Form of engagement	**Person eligible to perform engagement**	**Structure**
		• State-owned company

Audit	Registered auditor	• Public company
		• A non-profit company that-
		  • is state- or foreign-controlled; or
		  • was incorporated primarily to perform a statutory or regulatory function in terms of the law
		• A company or CC that
		  • holds assets in a fiduciary capacity, in its ordinary course of business, in excess of R5 million;
		  • has a public interest score of 350 or more; or
		  • has its annual financial statements internally compiled and a public interest score of at least 100 but less than 350

Independent review*	Registered auditor/ Chartered Accountant (South Africa)**	• A private company, personal liability company, non-profit company that is not subject to audit, or a CC, which has:
		  • its annual financial statements independently compiled; and
		  • a public interest score of at least 100 but less than 350

	Registered auditor/ Chartered Accountant (South Africa)**/ Accounting officer	• A private company, personal liability company, non-profit company that is not subject to audit, or a CC, which has a public interest score less than 100

* *The s 30(2A) exemption from audit or independent review may apply*.
** *This may be any member in good standing of a professional body accredited by the IRBA*.

An accounting officer's report must be prepared for a CC's financial statements that are subject to neither audit nor independent review.

See further Chapter 24: Close corporations.

15.5 Independent review and 'reportable irregularities'

The independent reviewer of a company or CC is responsible for the reporting of an irregularity when he or she is satisfied, or has reason to believe, that a reportable irregularity is taking place, or has taken place in respect of that company or CC. [39] For the purposes of independent review, a reportable irregularity is defined as- [40]

> 'any act or omission committed by any person responsible for the anagement of a company [or CC], which-
>
> (i) unlawfully has caused or is likely to cause material financial loss to the company [or CC] or to any member, shareholder, creditor or investor of the company [or CC] in respect of his, her or its dealings with that entity; or
> (ii) is fraudulent or amounts to theft; or
> (iii) causes or has caused the company [or CC] to trade under insolvent circumstances.'

The procedures to be followed by the independent reviewer to report an irregularity with respect to a company (or CC, if read in context) are as follows: [41]

(i) Send a written report to the Companies Commission immediately, giving particulars thereof.
(ii) Within three business days, provide written notification of the sending of the report and the relevant provisions of the Regulations to the members of the board, accompanied by a copy of the report.
(iii) Within 20 business days from the issue of the report to the Companies Commission, take all reasonable measures to discuss the report with the members of the board of the company and give them an opportunity to make representations in respect thereof.

(iv) Within the same 20 days, send a second report to the Companies Commission, together with detailed supporting information, stating that he or she is of the opinion that no reportable irregularity has taken place or is taking place, the suspected reportable irregularity is no longer taking place and, if relevant, adequate steps have been taken for the prevention or recovery of any loss as a result thereof; or that the reportable irregularity is continuing. [42]

If the second report states that the reportable irregularity is continuing, the Companies Commission- [43]

(i) must, as soon as possible after the receipt of such a report, provide any appropriate regulator with a copy of the report and written details of the reportable irregularity; and
(ii) may investigate any alleged contravention of the Act.

In order to fulfil these reporting responsibilities, an independent reviewer- [44]

(i) may conduct any investigations that he or she considers necessary; and
(ii) must consider all information that comes to his or her attention, irrespective of whether that information was gathered during the independent review or from another source.

15.6 The auditor

The enhanced accountability and transparency provisions of the Act relating to auditors deal with auditor appointment, resignation, removal, vacancies, rotation, rights and restricted functions.

In addition to a company or CC that is required by the Act or the Regulations to have an audit, any company or CC that voluntarily opts in terms of its Memorandum of Incorporation to appoint an auditor must, to the extent elected therein, comply with these enhanced accountability and transparency provisions of the Act. [45] For the purposes of a CC, these enhanced accountability and transparency provisions must be read in context.

15.6.1 Appointment of the auditor

An auditor must be appointed upon incorporation and at every annual general meeting (AGM) by every public company and state-owned company. [46] In addition, any other company or CC requiring an audit in terms of the Act or the Regulations must appoint an auditor annually and, if the requirement to have its financial statements audited applies to that company when it is incorporated, upon incorporation. [47] If a company is required to appoint an auditor upon incorporation and fails to do so, the directors of the company must appoint the first auditor of the company within 40 business days after the company’s date of incorporation. The first auditor of a company holds office until the conclusion of the first AGM of the company. If a company’s AGM does not appoint or reappoint an auditor, the directors must fill the vacancy within 40 business days after the date of the meeting. [48]

A retiring auditor may be automatically reappointed at an AGM without any resolution being passed, unless- [49]

(i) the retiring auditor is no longer qualified for, or no longer willing to accept, appointment and has notified the company thereof;
(ii) rotation of auditors is required in terms of the Act;
(iii) the audit committee objects to the reappointment; or
(iv) the company has notice of an intended resolution to appoint any other person or persons.

To be appointed as a company auditor, a person or firm must be both a registered auditor and acceptable to the company's audit committee as being independent of the company. [50] To determine whether an auditor is independent of a company, the audit committee must, in relation to the company and any company forming part of the same group of companies- [51]

(i) ascertain that the auditor does not receive any direct or indirect remuneration or other benefit from the company, except as auditor or for the rendering of non-audit services approved by the audit committee;
(ii) consider whether the auditor's independence may have been prejudiced as a result of any previous appointment as auditor or having regard to any consultancy, advisory or other work undertaken by the auditor for the company; and
(iii) consider compliance with other criteria relating to independence or conflict of interest as prescribed by the IRBA, including the IRBA's Code of Professional Conduct.

A person, firm, or related person of that person or firm, may not be appointed as an auditor of a company or firm if that person or firm is, or has been at any time during the five financial years immediately preceding the date of appointment- [52]

(i) disqualified in terms of s 69(8) of the Act to serve as a director of a company;
(ii) a director or prescribed officer of the company;
(iii) an employee or consultant of the company who was or has been engaged for more than one year in the maintenance of any of the company's financial records or the preparation of any of its financial statements;
(iv) a director, officer or employee of a person appointed as company secretary; or
(v) a person who, alone or with a partner or employees, habitually or regularly performs the duties of accountant or bookkeeper, or performs related secretarial work, for the company.

If a company appoints a firm as auditor, the individuals determined by that firm to be responsible and accountable for that audit, in terms of the Auditing Profession Act, must satisfy these requirements for appointment. [53]

15.6.2 Resignation or removal of auditors and vacancies

The resignation of an auditor is effective when the notice is filed. [54] An auditor may resign from office by giving the company one month's written notice or, with the approval of the board, less than one month's notice. If the auditor is removed from office by the board, the auditor may give written notice to the company to include a

statement, setting out the auditor's contention as to the circumstances that resulted in the removal, in the directors' report in the annual financial statements for that financial year. [55]

Should a vacancy arise in the office of auditor of a company, the board of the company- [56]

(i) must appoint a new auditor within 40 business days, if there was only one incumbent auditor of the company; and
(ii) may appoint a new auditor at any time, if there was more than one incumbent auditor, but while the vacancy continues, the remaining auditor may act as auditor of the company.

Before filling a vacancy the board must propose to the company's audit committee, within 15 business days after the vacancy occurs, the name of at least one registered auditor to be considered for appointment as the new auditor. The board may proceed to appoint the proposed registered auditor if the audit committee does not reject the proposal in writing within five days. [57]

If a company appoints a firm as its auditor, any change in the composition of the members of that firm does not by itself create a vacancy in the office of auditor for that year and should not be considered a resignation, unless by comparison with the membership of the firm at the time of its latest appointment, fewer than half of the members remain. [58]

15.6.3 Rotation of auditors

Rotation of auditors was introduced to enhance the independence of auditors. It is the individual serving as auditor, or designated auditor, who is required to rotate and not the audit firm. The same individual may not serve as auditor or designated auditor of a company for more than five consecutive financial years. If an individual has served as auditor or designated auditor of a company for two or more consecutive financial years and then ceases to be the auditor or designated auditor, that individual may not be reappointed as the auditor or designated auditor of that company until after the expiry of at least two further financial years. [59]

When a company appoints two or more persons as joint auditors, the company must manage the rotation of auditors to ensure that not all of the joint auditors relinquish office in the same year. [60]

15.6.4 Rights and restricted functions of auditors

The auditor of a company has the right of access to the company's accounting records, books and documents and all current and former financial statements of any

subsidiary of that company. [61] The auditor of a company is also entitled to, and may apply to a court to enforce his or her right to- [62]

- (i) require from the directors or prescribed officers of the company or its subsidiary any information and explanations necessary for the performance of the auditor's duties; and
- (ii) attend, receive all notices of and other communications relating to, and be heard on any part of the business of the meeting that concerns the auditor's duties or functions, at any general shareholders' meeting.

It is also important to note that s 93(3) of the Act provides that an auditor appointed by a company may not perform for that company-

- (i) any services that would place the auditor in a conflict of interest as prescribed or determined by the IRBA; or
- (ii) non-audit services not approved by the company's audit committee.

See further Chapter 12: Governance and the board of directors.

15.7 The Auditing Profession Act

The Auditing Profession Act regulates the auditing profession in South Africa and provides for- [63]

- (i) the establishment of the IRBA;
- (ii) the education, training and professional development of registered auditors;
- (iii) the accreditation of professional bodies;
- (iv) the registration of auditors;
- (v) regulation of the conduct of registered auditors; and
- (vi) other related matters.

15.7.1 Registration as registered auditors

Individuals or firms may be registered by the IRBA as registered auditors. An individual may be registered, if the IRBA is satisfied that the individual- [64]

- (i) has complied with the prescribed education, training and competency requirements for a registered auditor;
- (ii) has arranged for his or her continuing professional development in the case where the individual is not a member of an accredited professional body;
- (iii) is resident within South Africa;
- (iv) is a fit and proper person to practise the profession; and
- (v) has met any additional requirements prescribed by the IRBA.

However, an individual may not be registered by the IRBA if that individual- [65]

(i) has at any time been removed from an office of trust because of misconduct related to the duties of that office;

(ii) has been sentenced to imprisonment without the option of a fine, or to a fine

exceeding a limit prescribed by the Minister of Finance for being convicted of theft, fraud, forgery, producing a forged document, perjury, an offence under the Prevention and Combating of Corrupt Activities Act 12 of 2004, or any offence involving dishonesty;

(iii) is for the time being declared by a competent court to be of unsound mind or unable to manage his or her own affairs; or

(iv) is disqualified from registration by a sanction imposed by the Auditing Profession Act.

The IRBA may also decline to register an individual who is an unrehabilitated insolvent, has entered into a compromise with creditors or has been provisionally sequestrated. [66]

Although firms may be registered as auditors, registration is limited to firms with individual registered auditors. The only firms that may be registered by the IRBA are- [67]

(i) a partnership of which all the partners are individuals who are registered auditors;

(ii) a sole proprietor where the proprietor is a registered auditor; or

(iii) a company–

- that is incorporated and registered under the Companies Act with a share capital, and whose Memorandum of Incorporation provides that its directors and past directors are jointly and severally liable, together with the company, for its debts and liabilities that were contracted during their periods of office;
- in which every shareholder is an individual who is a registered auditor;
- in which every shareholder is a director, and every director is a shareholder; and
- whose Memorandum of Incorporation provides that–
    - it may, without confirmation by a court, purchase on such terms as it may consider expedient any shares held in the company, and the shares purchased are available for allotment in accordance with the Memorandum of Incorporation; and
    - a person who is not a member of the company may not act as proxy for a member at any meeting of the company.

Only a registered auditor may engage in public practice, purport to be a registered auditor in public practice or use a designation or description likely to form the impression of being a registered auditor in public practice, including the titles- [68]

(i) public accountant;

(ii) certified public accountant;
(iii) registered accountant and auditor; and
(iv) accountant and auditor in public practice.

A person who is not a registered auditor must not engage in any of the abovementioned conduct and may also not- [69]

(i) perform any audit unless in the service of or by order of and under the direction, supervision and control of or in association with a registered auditor who assumes responsibility for the audit;
(ii) use the name of any registered auditor; or
(iii) perform any act indicating or intentionally leading others to believe that he or she is a registered auditor.

This does not prohibit a person who is not a registered auditor from- [70]

(i) using the title 'internal auditor' or 'accountant';
(ii) acting as auditor for a not-for-profit club, institution or association, if that person is a member thereof and he or she receives no fee or other consideration for such audit; or
(iii) being appointed by the Auditor-General to perform any audit, on his or her behalf, which that person is required to undertake in terms of the Public Audit Act 25 of 2004.

Except with the consent of the IRBA, a registered auditor may not knowingly employ- [71]

(i) any person suspended from public practice in terms of the Auditing Profession Act;
(ii) any person who is no longer a registered auditor as a result of the termination or cancellation of that person's registration; or
(iii) any person whose application for registration was declined owing to–
    - removal from an office of trust due to misconduct related to the duties of that office;
    - conviction and sentencing to imprisonment without the option of a fine, or to a fine exceeding a limit prescribed by the Minister of Finance, for theft, fraud, forgery, producing a forged document, perjury, an offence under the Prevention and Combating of Corrupt Activities Act, or any offence involving dishonesty;
    - that person being declared by a competent court to be of unsound mind or unable to manage his or her own affairs; or
    - that person being disqualified from registration under a sanction imposed under the Auditing Profession Act.

In addition, a registered auditor may not- [72]

(i) practise under a firm name or title unless every letterhead bearing the firm's name includes the first names or initials and surname of the registered auditor, the managing or active partners in the case of a partnership, or the directors in the case of a company;
(ii) sign any account, statement, report or other document which purports to represent an audit unless the audit was performed by, or under the personal supervision or direction of, that registered

auditor and any partners, co-directors or co-members;

(iii) perform audits unless adequate risk management practices and procedures are in place;

(iv) engage in public practice during any period in respect of which the registered auditor has been suspended from public practice;

(v) share any profit derived from performing an audit with a person that is not a registered auditor; or

(vi) engage in public practice unless all prescribed fees have been paid.

15.7.2 Registered auditor's duties in relation to an audit

Immediately after being appointed as the external auditor of an entity, a firm must elect the individual registered auditor or registered auditors within the firm responsible and accountable for that audit. [73] This is significant because some duties, such as the reporting of reportable irregularities, and the related offences are isolated to the individuals responsible for the audit. See further 15.11.3: Auditors' liability and 'reportable irregularities'.

For the purposes of the auditor, a 'reportable irregularity' is defined in s 1 of the Auditing Profession Act as-

> any unlawful act or omission committed by any person responsible for the management of the entity, which-
>
> *(a)* has caused or is likely to cause material financial loss to the entity or to any partner, member, shareholder, creditor or investor of the entity in respect of his, her or its dealings with that entity; or
>
> *(b)* is fraudulent or amounts to theft; or
>
> *(c)* represents a material breach of any fiduciary duty owed by such person to the entity or any partner, member, shareholder, creditor or investor of the entity under any law applying to the entity or the conduct or management thereof.

The audit report issued by a registered auditor expresses an opinion on whether or not the audited financial statement or supplementary information attached thereto fairly presents in all material respects the financial position of the entity and the results of its operations and cash flows, in accordance with the basis of accounting and the relevant financial reporting framework. The registered auditor may not, without qualification, express an opinion to the effect that such financial statement or supplementary information is fairly presented in all material respects, unless the registered auditor is satisfied that the following criteria have been met: [74]

(i) the audit must have been conducted free from any restrictions and in compliance with the applicable auditing pronouncements;

(ii) the registered auditor must have satisfied him- or herself of the existence of all assets and liabilities shown on the financial statements;

(iii) proper accounting records, in at least one of the official languages of South Africa, must have been kept for the entity so as to correctly and adequately reflect and explain all its transactions and record all its assets and liabilities;

(iv) all information, vouchers and other documents, which in the registered auditor's opinion were necessary for the proper performance of his or her duties, must have been obtained;

(v) the registered auditor must not have had occasion, during the period to which the auditing services relate, to report a reportable irregularity to the IRBA or, if such an irregularity was reported, the registered auditor must have been able, prior to expressing the opinion, to send the IRBA a notification that he or she was satisfied that no reportable irregularity took place or is taking place;

(vi) the registered auditor must have complied with all laws relating to that entity's audit; and

(vii) the registered auditor must be satisfied as to the fairness or correctness of the financial statements.

A registered auditor's independence may be compromised if he or she or a member of his or her audit firm is responsible for keeping the books, records or accounts of an entity subject to audit by that registered auditor. The registered auditor must therefore indicate his, her or the firm's dual responsibility when reporting on anything in connection with the business or financial affairs of the entity. It must be noted that keeping the books, records or accounts does not include the passing of closing entries, assisting with adjusting entries or framing any financial statements or other document from existing records. [75]

In addition, a registered auditor may not audit any financial statements of an entity if he or she has or had a conflict of interest, as prescribed by the IRBA, in respect of that entity. [76]

15.8 Audit committee

The enhanced accountability and transparency provisions of the Act relating to the audit committee deal with the appointment and duties of the audit committee. In addition to a public company or state-owned company that is required to appoint an audit committee, any company or CC that voluntarily opts to do so in terms of its Memorandum of Incorporation must, to the extent elected therein, comply with these provisions of the Act. [77] For the purposes of a CC, these provisions must be read in context.

15.8.1 Appointment of the audit committee

At each AGM, a public company, a state-owned company or any other company that has voluntarily determined in its Memorandum of Incorporation to have an audit committee must elect a committee comprising at least three members, unless- [78]

(i) the company is a subsidiary of another company (a holding company) that has an audit committee; and

(ii) the audit committee of the holding company will fulfil the required audit committee functions on behalf of that subsidiary company.

The first members of the audit committee may be appointed by the incorporators of the company or by the board within 40 business days after the incorporation. [79] Any vacancies on the audit committee must be filled by the board of directors within 40 business days of the vacancy arising. [80]

Each member of the audit committee must be a director and at least one-third of the audit committee members must also have academic qualifications, or experience, in economics, law, corporate governance, finance, accounting, commerce, industry, public affairs or human resource management at any time. [81] In addition, the audit committee members must not be- [82]

(i) or have been at any time during the previous financial year, involved in the day-to-day management of the company's business;
(ii) or have been at any time during the previous three years, a prescribed officer, or a full-time employee, of the company or a related or inter-related company;
(iii) a material supplier or customer of the company, such that a reasonable and informed third party would conclude in the circumstances that the integrity, impartiality or objectivity of that director is compromised by that relationship; or
(iv) related to any of the abovementioned persons.

15.8.2 Duties of the audit committee

It is the duty of an audit committee to nominate a registered auditor for the company who, in the opinion of the audit committee, is independent of the company. A public company may, at an AGM, legitimately appoint an auditor other than the one nominated by the audit committee provided that the audit committee is satisfied that the proposed auditor is independent of the company. [83] The other duties of an audit committee are to- [84]

(i) determine the auditor's fees and terms of engagement;
(ii) ensure that the auditor's appointment complies with any legislation related thereto;
(iii) determine the nature and extent of, and pre-approve, any non-audit services that the auditor may or may not provide to the company or a related company;
(iv) comment, in a report to be included as part of the annual financial statements, on the company's financial statements, accounting practices, internal financial control, how the audit committee carried out its functions, and whether the audit committee is satisfied that the auditor was independent of the company;
(v) receive and deal appropriately with any concerns or complaints relating to the company's accounting practices, internal financial controls, financial statements or audits;
(vi) make submissions to the board on any matter concerning the company's accounting policies, financial control, records and reporting; and
(vii) perform other functions determined by the board, including tasks to

improve the effectiveness of the company's risk management, control, and governance processes.

All expenses reasonably incurred by the audit committee in the discharge of its duties, including the fees of any consultant or specialist, must be paid by the company. [85] Despite the audit committee's duties, the responsibilities of a company's board and the directors are only reduced with respect to the appointment, fees and terms of engagement of the auditor. [86]

See further Chapter 12: Governance and the board of directors.

15.9 Company secretary

The enhanced accountability and transparency provisions of the Act relating to the company secretary deal with the appointment, duties, resignation, removal and registration of the company secretary. In addition to a public company or state-owned company that is required to appoint a company secretary, any company or CC that voluntarily opts to do so in terms of its Memorandum of Incorporation must, to the extent elected therein, comply with these provisions of the Act. [87] For the purposes of a CC, these provisions must be read in context.

15.9.1 Appointment of the company secretary

A public or state-owned company must appoint a company secretary. [88] Any other company must appoint a company secretary if required to do so in terms of its Memorandum of Incorporation. [89] A company secretary is accountable to the board of the company and must be a permanent resident of South Africa who is knowledgeable or experienced in relevant laws. [90] Every company that appoints a company secretary must maintain a register of its company secretaries. [91]

The first company secretary of a public or state-owned company may be appointed by the incorporators of the company, or within 40 business days after the incorporation of the company, by either the company's directors or an ordinary resolution of the shareholders. [92] It is the board's responsibility to fill any vacancy for a company secretary, with a suitably knowledgeable and experienced person, within 60 business days of the vacancy arising. [93]

A company secretary does not have to be an individual. A juristic person or partnership may be appointed as company secretary provided that- [94]

(i) no employee or partner who provides company secretary services is disqualified from serving as a director of that company in terms of s 69(8) of the Act; and
(ii) at least one employee or partner is resident in South Africa and possesses the required knowledge and experience.

If these requirements continue to be satisfied, a change in the membership of a juristic person or partnership that holds the office of company secretary does not create a vacancy in that office. Should these requirements no longer be satisfied, the juristic person or partnership must immediately notify the company directors and will be regarded as having resigned upon giving this notice. No action taken by a juristic person or partnership in the performance of its functions as company secretary will be invalidated merely because the juristic person did not satisfy the necessary requirements at the time of the action. [95]

15.9.2 Duties of the company secretary

A company secretary's duties include, but are not restricted to- [96]

(i) providing the directors of the company with guidance as to their duties, responsibilities and powers;
(ii) making the directors aware of any law relevant to or affecting the company;
(iii) reporting to the company's board any failure on the part of the company or a director to comply with the Memorandum of Incorporation or rules of the company or the Act;
(iv) ensuring the proper recording of the minutes of all shareholder, board, board committee and audit committee meetings;
(v) certifying in the annual financial statements whether the company has filed the required returns and notices in terms of the Act, and whether all such returns and notices appear to be true, correct and up to date;
(vi) ensuring that a copy of the company's annual financial statements is sent to every person who is entitled thereto; and
(vii) taking responsibility, if applicable to and designated by the company, for compliance with Chapter 2 Part C (transparency, accountability and integrity of companies) and Chapter 3 (enhanced accountability) of the Act.

15.9.3 Resignation or removal of the company secretary

A company secretary may resign from office by giving the company one month's written notice or, with the approval of the board, less than one month's notice. [97]

If the company secretary is removed from office by the board, he or she may give written notice to the company to include a statement in the directors' report in the annual financial statements, relating to that financial year, setting out his or her contention as to the circumstances that resulted in the removal. [98]

15.9.4 Registration of the company secretary

Within ten business days of the appointment or termination of service of a company secretary, a company must file a notice thereof. The Notice of Incorporation of a company may, however, include the notice of appointment of a company's first company secretary. [99]

See further Chapter 12: Governance and the board of directors.

15.10 The King III Report and corporate governance

Corporate governance is the system whereby entities are directed and controlled. It is underpinned by the ethical values of responsibility, accountability, fairness and transparency. [100] The King Report was first published in 1994 and was the first formal document to address corporate governance in South Africa. It addressed the conflicting interests of the owners (eg shareholders) of an entity and the managers of that entity, who act as the owners' agents in the day-to-day management of the business. In the late 1990s, there was a renewed interest in corporate governance due to high-profile corporate collapses. This resulted in the need for a revised King Report (King II) addressing not only the interests of the owners and the management of entities, but also the interests of other stakeholders, including employees, creditors and the general public.

The King Report on Corporate Governance for South Africa 2009 ('the King III Report') was implemented in 2010 as a result of the corporate law reform in South Africa, which resulted in a new Companies Act. It also addresses changes in local and international governance trends such as the move towards integrated sustainability reporting. The King III Report applies broadly to all entities, recognising that good governance is relevant to all entities.

15.10.1 Audit committees

The audit committee plays an important role in identifying financial risks, managing these risks, ensuring the integrity of internal financial controls and ensuring the integrity of integrated reporting. [101] Further to the statutory requirement [102] for a public and state-owned company to appoint an audit committee, the King III Report recommends the voluntary appointment of an audit committee for a private company, personal liability company and non-profit company. The composition and duties of such a committee should be outlined in the Memorandum of Incorporation. [103] In addition every audit committee should be issued with written terms of reference, approved by the board, to ensure the fulfilment of all the audit committee's responsibilities. [104]

To ensure an effectively functioning audit committee, the King III Report recommends that the audit committee should- [105]

(i) meet at least twice a year and, if necessary, more frequently to complete its functions;
(ii) meet with the internal and external auditors at least once a year without management being present;
(iii) comprise at least three members;
(iv) be chaired by an independent non-executive director;
(v) not be chaired by the chairperson of the board, although the

chairperson of the board may attend audit committee meetings by invitation; and

(vi) consist of members with a basic level of qualification and experience who collectively have an understanding of financial reporting, integrated reporting, internal financial controls, the external and internal audit processes, corporate law, risk management, sustainability issues, information technology governance as it relates to integrated reporting, and the governance processes within the company.

In addition to these recommendations, the audit committee of a public company and state-owned company must comprise only independent non-executive directors. [106]

See further Chapter 12: Governance and the board of directors.

15.10.2 Company secretary

The company secretary plays a crucial role in the corporate governance of a company. Accordingly, the King III Report recommends the appointment of a competent, suitably qualified and experienced person to this office. [107] It is the board's responsibility to appoint and remove the company secretary. [108] Ideally a director of the company should not be appointed as company secretary and an arm's length relationship should be maintained between the board (and its directors) and the company secretary, who is considered to be the 'gatekeeper of corporate governance'. [109] Although the company secretary should be available to provide practical guidance and support to all of the directors, he or she should have a direct

channel of communication to the chairman of the board and should, in particular, provide support to the non-executive directors and the chairmen of the board, board committees and the audit committee. [110]

In addition to the duties mentioned in the Act and in 15.9.2, the King III Report recommends that the company secretary's should- [111]

(i) ensure that the procedures for the appointment of directors are followed and assist with the proper induction, orientation, training and education of directors;

(ii) provide guidance and advice to the board, and within the company, on matters of good governance and changes in legislation;

(iii) ensure that the board and board committee charters and terms of reference are kept up to date;

(iv) assist with the proper and timely compilation of board agendas; and

(v) assist the board with the annual evaluation of the board, its individual directors and senior management.

See further Chapter 12: Governance and the board of directors.

15.10.3 Integrated reporting and disclosure

The King III Report recommends integrated reporting that gives a holistic and integrated representation of a company’s performance in terms of both its finances and its sustainability. [112] The substance of this report should prevail over its form, as effective reporting on a company’s goals, strategies, and economic, social and environmental issues can assist with the alignment of company and stakeholder interests, in due course building or restoring stakeholder confidence. [113] An integrated report should- [114]

(i) be prepared annually by a company;
(ii) disclose information that is complete, timely, relevant, accurate, honest, accessible, and comparable with past company performance; and
(iii) include forward-looking information.

The board has the ultimate responsibility to ensure the integrity of the integrated report. [115] In this light, controls should exist within the company to verify and safeguard the integrity of the report. [116] The audit committee should also ensure the reliability of the reporting of sustainability issues and that no inconsistencies arise between the financial and sustainability information included in the report. [117]

The credibility of financial and sustainability reporting is equally important. The financial reporting standards formalise the requirements for financial reporting. Although there is no such equivalent for sustainability reporting, the accepted

international standard for sustainability reporting is the third-generation Global Reporting Initiative guidelines of 2007. As a global standard, these guidelines facilitate benchmarking and comparability across companies. [118] Listed companies in South Africa also often take guidance from the JSE Socially Responsible Investment Index (SRI) criteria. [119] It must, however, be remembered that these are only guidelines and each company must take its own its own operations and stakeholder needs into account in deciding on the appropriate reporting of sustainability issues.

The King III Report recommends that an entity should obtain independent assurance over its sustainability reporting and disclosure in the integrated report. [120] Providing assurance on sustainability reporting has its complexities because sustainability information is not subject to set standards. Globally, two assurance standards exist for sustainability:

(i) Accountability’s AA1000 Assurance Standard (AA1000AS); and
(ii) the IAASB’s International Standard on Assurance Engagements (ISAE 3000), which must be complied with by all auditing professionals in South Africa. [121]

AA1000AS aligns the assurance process with the material concerns of stakeholders in terms of the integrated report as a whole, whereas ISAE 3000 focuses on verifying the accuracy and completeness of information, assessing the performance of the underlying systems, and evaluating compliance with the company’s defined scope. These standards are complementary and the King III Report recommends that they be used in combination to ensure that both the needs of stakeholders and the company are met. [122]

15.11 Auditors' liability

15.11.1 Criminal liability

In the course of his or her duties, an auditor may incur criminal liability in a number of instances laid down in the Auditing Profession Act. In terms of this Act, an auditor is guilty of an offence if he or she-

(i) fails to report a reportable irregularity in accordance with s 45 of the Auditing Profession Act; [123]

(ii) for the purposes of, or in connection with, the audit of any financial statement, knowingly or recklessly expresses an opinion or makes a report or other statement which is false in a material respect; [124]

(iii) contravenes ss 41, 43 or 44 of the Auditing Profession Act relating to public practice;

(iv) contravenes any provision of s 47 of the Auditing Profession Act (which relates to public practice) [125] or obstructs or hinders any person in the performance of functions under s 47; [126]

(v) having been duly summoned to a disciplinary hearing [127] under s 50 of the Auditing Profession Act, fails, without sufficient cause, to attend at the time and place specified in the summons, or to remain in attendance until excused from further attendance by the chairperson of the disciplinary committee; [128]

(vi) having been called to a disciplinary hearing under s 50 of the Auditing Profession Act, refuses to be sworn or to affirm as a witness or fails without sufficient cause to answer fully and satisfactorily to the best of his or her knowledge and belief all questions lawfully put concerning the subject of the hearing; [129]

(vii) having been called to a disciplinary hearing under s 50 of the Auditing Profession Act and having possession, custody or control of any information, including but not limited to any working papers, statements, correspondence, books or other documents, refuses to produce it when required to do so; [130]

(viii) is a witness before a disciplinary committee and, having been duly sworn or having made an affirmation, gives a false answer to any question lawfully put or makes a false statement on any matter, knowing the answer or statement to be false; [131]

(ix) wilfully hinders any person acting in the capacity of a member of a disciplinary committee in the exercise of any power conferred upon him or her by or under s 51 of the Auditing Profession Act; [132] or

(x) contravenes any of the following provisions of the Companies Act: s 26(6), s 28(2) and (4), s 29(6), s 213(1), s 214(1) and (3), or s 215(1) and (2).

15.11.2 Civil liability to client and third parties

A clear distinction must be made between an auditor's civil liability to the company that he or she is auditing (the client) and his or her civil liability to third parties. The reason for the distinction is of course that the client has a contract with the auditor, whereas usually there is no contract between the auditor and the third party.

15.11.2.1 Civil liability to the client

(i) Duties to the client

Auditors may incur civil liability to their client by failing to comply with the statutory duties they owe to the client they are auditing, as well as the additional duties undertaken by them in terms of their contract with the client.

Additional duties may include tax advisory and compliance work or consultancy work on aspects of financial management or information systems.

In the performance of his or her duties, the auditor must not act maliciously, fraudulently or negligently. 'Negligently' means acting without reasonable care and skill.

(ii) Reasonable care and skill

As stated above, in carrying out his or her statutory duties, the auditor must not act negligently; in other words, he or she must 'bring to bear on the work he [or she] has to perform that skill, care and caution which a reasonably competent, careful and cautious auditor would use'. [133] This is an objective test. The duty to act with 'reasonable care and skill' is a term of the contract implied by law.

The standard of care required of an auditor is not static but must meet changed circumstances. As Moffitt J said in *Pacific Acceptance Corporation Ltd v Forsyth*: [134]

> It is not a question of the court requiring higher standards because the profession has adopted higher standards. It is a question of the court applying the law, which by its content expects such reasonable standards as will meet the circumstances of today, including modern conditions of business and knowledge concerning them. However, now as formerly, standards and practices adopted by the profession to meet current circumstances provide a sound guide to the court in determining what is reasonable.

The duty to act with due care and skill does not impose on the auditor a duty to approach the audit suspecting dishonesty. Thus Lopes J said in *In re Kingston Cotton Mill Co (2)*: [135]

> [A]n auditor is not bound to be a detective, or as was said, to approach his work with suspicion or with a foregone conclusion that there is something wrong. He is a watchdog, but not a bloodhound.

Specialist advice, such as legal advice on a point of law, must be sought when necessary. [136]

> If an auditor's suspicion is aroused, he or she must conduct further enquiries.

Auditors must be careful to supervise and review the work of employees under them, particularly inexperienced ones - the auditor is responsible for their work.

In determining whether an auditor has acted negligently, the courts have held that they must be careful not to make a scapegoat of the auditor, nor to be influenced by hindsight.

(iii) Grounds for liability to the client

- *Breach of contract*

An auditor may be liable to the client on the basis of breach of contract, if the following is established:

(i) a contract exists;
(ii) the auditor has breached the contract;
(iii) the auditor has acted maliciously, fraudulently or negligently in breaching the contract; and
(iv) loss has been suffered by the client as a result of the breach.

In *Thoroughbred Breeders' Association v Price Waterhouse* [137] it was held that the Apportionment of Damages Act 34 of 1956 does not apply to contractual claims. Therefore the auditor cannot raise the negligence of the client in an action brought by the client against the auditor.

In the *Thoroughbred Breeders'* case T had employed PW as its auditors since 1990. During January 1994 PW had audited T's financial statements in respect of the year ended 31 October 1993 (the 1993 audit). T alleged that in doing so PW had breached the auditing agreement between them by failing to detect that several substantial sums of cash had been stolen by T's financial manager, M. After the 1993 audit, M had gone on to steal a further R1 389 801.90 from the appellant before his activities were uncovered.

T argued that, had PW properly (that is, with the exercise of reasonable care and not negligently) carried out the 1993 audit, M's activities would have been discovered and the resultant losses to T prevented. T accordingly instituted a claim for damages in the amount of R1 389 801.90 plus interest against PW. PW denied breaching the audit agreement; alternatively it denied that any breach it might have committed had caused the loss, and raised various other defences based on the fact that T had been aware that M had a previous conviction for theft but had nevertheless employed him in a senior financial position without proper supervision, and thus only had itself to blame. It thus argued that T's claim had to be reduced because its own (contributory) negligence meant that the Apportionment of Damages Act 34 of 1956 was applicable.

The court held that the auditor had been negligent in aspects of the audit and hence in breach of its contract with the company. The company's loss flowed naturally and generally from the auditor's breach and was thus not too remote. The company was itself negligent in failing to properly supervise the activities of the financial manager, despite its awareness that he had previously been convicted of theft. Both sets of negligence thus contributed to the loss. However, the Apportionment of

Damages Act 34 of 1956 was not applicable to a contractual claim for damages and accordingly was not available to the auditor to counter or curtail the company's claim. The claim was allowed in full.

- *Delict*

An action can be brought against the auditor by the client on the basis of delict (a delict is a civil wrong which does not arise out of contract).

The common-law delictual action arises through the duty of care imposed on the auditor by virtue of the auditor's relationship with the client.

Therefore, independently of the liability attaching to the auditor on the basis of breach of contract, the client will also have a delictual action in terms of the common law. The client can thus bring action on the basis of either breach of contract or delict. In fact, action can be brought in the alternative (although damages in respect of the loss suffered can be recovered only once).

In order for the auditor to be liable in a common-law delictual action, it will have to be proved that-

(i) the auditor acted negligently, fraudulently or maliciously;
(ii) the client suffered loss; and
(iii) the loss was caused by the auditor's malice, fraud or negligence.

In delict the contributory negligence of the client can result in an apportionment of damages between the company and the auditor. As seen above, it has been held that this is not the case in an action based on breach of contract.

15.11.2.2 Civil liability to third parties

(i) The common law

It is readily apparent that it is not only the client who is interested in the audit of the company. Third parties also may very well be interested. They may wish, for example, to transact with the company, or invest in securities of the company, or make loans to the company. A clean audit report on the financial statements of the company may give them the assurance to do so.

The question, of course, that arises in these circumstances is: what liability does the auditor incur to a third party if the clean audit report should have been qualified and is therefore misleading? Is the auditor liable for the loss that the third party might have suffered as a result of having relied on the audit report? Is the auditor liable for the misrepresentation he or she has made to the third party?

In answering this question, one must bear in mind two factors 'which traditionally have caused considerable uncertainty in modern legal systems about the limitation, and even the recognition, of liability for negligent misrepresentation causing mere financial loss'. [138]

In the famous words of Lord Pearce: [139]

> [Words are] more volatile than deeds. They travel fast and far afield. They are used without being expended ... Yet they are dangerous and can cause vast financial damage. In the result a good deal of judicial caution has shown itself in the approach to harm caused by words. Secondly, there is the traditional fear that a general remedy not only for physical injury to person or property, but also for mere pecuniary or economic loss, would result in an unmanageably wide liability. It would impose an 'almost intolerable burden on legitimate human activity', lead to unnecessary duplication or multiplicity of actions so that more harm than good would be done by such an extension, and result in overwhelming potential liability which is indeterminate and socially calamitous.

It was these factors that led Cardozo J to deny liability in the New York Court of Appeals in this oft-quoted statement in *Ultramares Corporation v George A Touche*: [140]

> If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries may expose accountants *to a liability in an indeterminate amount for an indeterminate time to an indeterminate class*. The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences.

As Naude says, [141] since the *Ultramares* case, 'the three indeterminates appearing in italics have been repeated in some judgments almost as though they reveal a self-evident truth'. But , he says, the attraction and force of the language ought not to lead to uncritical acceptance of that sort of argument.

In South Africa the existence of an action for negligent misstatement causing financial loss was first recognised in *Herschel v Mrupe* [142] (the case did not involve an auditor although the principles are the same) and followed in a number of other cases since.

Of particular importance is Rumpf CJ's judgment in the *Trust Bank* case in which he recognised the importance of the particular circumstances and policy considerations in deciding whether a legal duty not to make a misstatement to the plaintiff in the particular circumstances was established. [143] At the same time he recognised that reasonable foreseeability by the auditor of reliance by the third party on the auditor's report was also a factor that had to be taken into account. The duty of care here is different from the traditional duty of care doctrine, which does not take policy considerations into account, but places all emphasis on foreseeability.

Another way of explaining what Rumpf was saying is as follows. In terms of the traditional duty of care doctrine, delictual liability only arises if a person, X, makes a negligent statement and knows that Y will rely on it, or does not know, but could reasonably have foreseen that Y was going to rely on it. This knowledge or 'reasonable foreseeability' imposes a 'duty of care' on the part of X towards Y. In the absence of such a duty of care, X has no delictual liability for the loss suffered by Y in relying on X's statement. In the context of an auditor's delictual liability to third parties, reasonable foreseeability is, however, not enough to create a duty of care. In addition to reasonable foreseeability the particular circumstances of each case must be taken into account in determining whether there is a duty of care as well as, very important, 'policy considerations'. These extra factors are taken into account in an attempt to guard against unlimited liability. So this means that if the auditor could reasonably have foreseen that the third party would rely on his or her audit report, that is not enough to create a duty of care which is essential for delictual liability to arise. In addition, the particular circumstances and policy considerations must be taken into account.

Naude's comments on 'policy considerations' promote understanding of the legislature's attempts to limit an auditor's liability to third parties. There seems no

doubt that Naude's comments had a significant impact on the drafting of the legislation which was introduced to regulate an auditor's liability (see below).

Regarding policy considerations, Naude may be paraphrased as follows:

(i) The actual policy considerations involved cannot be neatly listed with any pretension of comprehensiveness.
(ii) The usual considerations referred to in defense of claims for financial loss arise from the traditional fear of an unmanageably wide liability.
(iii) Other policy considerations involve notions such as 'fair and reasonable' or 'instinctive justice as to what is fair and just'.
(iv) The great and growing importance of the commercial information contained in companies' annual financial statements does imply a responsibility for auditors – but not unrestricted liability.
(v) By restricting liability within reasonable bounds the law in fact promotes the important social policy of encouraging the flow of commercial information so vital to the operation of the economy.
(vi) A legal duty to a third party whose intended reliance is not actually known or in the particular circumstances reasonably foreseeable, is not reasonable.
(vii) This branch of the law should be such that professional persons of integrity can feel confident that they will not be held liable except where it is reasonable to do so in view of their particular situation.
(viii) The simple fact is that every auditor knows perfectly well, or ought at least reasonably to foresee, that annual financial statements are widely used by existing or potential members and creditors for investment or business decisions, sometimes, but by no means necessarily, at the inducement of the client company. In essence this is true of all companies, although there are obvious differences in degree regarding the typical private company, the typical public company and the public listed company, respectively. This knowledge or foreseeability arises purely from the fact that a person is acting as an auditor. However, there is no doubt that holding negligent auditors liable on the strength of this knowledge or foreseeability simply inferred from their professional position would fly in the face of all the general policy considerations mentioned above. It would inhibit the flow of commercial information, and could ruin the profession.

(ix) So the knowledge of the auditor of intended reliance by a third party on annual financial statements referred to in regard to a legal duty, in the absence of which there is no wrongfulness, is an actual awareness and not an inference from his or her professional position.

(x) Similarly, it is of fundamental importance that the reasonable foreseeability of reliance by the third party on the annual financial statements must be dependent on the actual circumstances of the particular case and, again, not be an inference based on the auditor's office or from considerations applying to all auditors generally.

The common-law position as it stands is that a third party bringing a delictual action against the auditor of the company on the basis of negligence will have to establish that-

(i) the auditor acted negligently in providing a clean audit report when it should have been qualified;

(ii) the auditor owed the third party a duty of care (as stated above, the current duty of care doctrine, contrary to the traditional doctrine, embraces both foreseeability in the particular circumstances and policy considerations);

(iii) the third party relied on the auditor's negligent misstatement (the unqualified audit report); and

(iv) the third party, as a result, suffered loss (the element of causation).

There has been no reported case in South Africa in which an auditor has been sued successfully by a third party for damages caused by the auditor's negligent misstatement. In the only reported case in which such action has been brought by a third party, *International Shipping Co (Pty) Ltd v Bentley*, [144] IS, a finance and shipping company, agreed to make certain financial facilities available to the D Group of companies early in 1976. B was appointed auditor to the D Group in November 1977. In March 1979 B issued reports in respect of the financial statements of each of the companies comprising the D Group, as well as the Group financial statements, for the year ended 20 December 1978. B did not qualify any of these reports in any way. IS continued to provide these financial facilities until the liquidation of the companies comprising the D Group in April 1981. At the time of such liquidation the total indebtedness of the D Group to IS amounted to R977 318, of which the sum of only R593 826 was recovered by IS, who thus sustained a loss in the amount of R383 492. IS sued B, alleging that the financial statements were materially false and misleading in a number of respects; that in so reporting B had acted fraudulently or, alternatively, negligently towards IS, who had relied thereon in reviewing and deciding to maintain and increase the facilities accorded to the D Group; that, had the financial statements fairly presented the financial position of the D Group and its constituent companies, IS would have terminated the facilities and have required the Group to make good its indebtedness to IS; and that the loss sustained by IS constituted damage for which B was accordingly liable to compensate IS.

The court held that-

(i) the financial statements were, to some extent, false and misleading;

(ii) negligence by B had been established;

(iii) the following facts and considerations established a duty of care:
- there was a statutory duty upon B to furnish his report on the financial statements;
- the nature and context of the relationship between the parties created a direct link between IS and B;
- B was aware that, in monitoring and reviewing the facilities of the D Group, IS would rely upon the financial statements in a serious and business context; and
- there were no considerations of public policy which induced the court to deny liability in the case; and

(iv) IS had failed to prove that B's misstatement had caused the loss suffered. There was not a sufficiently close connection between B's negligence and the loss for legal liability on B's part.

B accordingly won the case as the requirement of causation had not been proved.

(ii) Legislative intervention

The concern about the auditor's liability to third parties being potentially too severe and also too uncertain has led to legislative intervention. First, s 20(9) was introduced into the Public Accountants' and Auditors' Act 80 of 1991 in an attempt to restrict the liability and to provide certainty. The Auditing Profession Act replaced the Public Accountants' and Auditors' Act in 2004 and the relevant provisions are now to be found in s 46 of that Act. The new provisions are similar to but not exactly the same as the old provisions.

(iii) Current position regarding an auditor's duty of care

Reading s 46 of the Auditing Profession Act together with the common law, the position regarding an auditor's duty of care appears to be as set out below. [145] (It is assumed that the company's annual financial statements are misleading; the auditor has been negligent in the performance of his or her duties resulting in a misleading audit report; the third party has relied on the audit report, and, as a result, the third party has suffered loss - all these requirements must be met.)

(a) An auditor is not liable to all third parties who, relying on the annual financial statements, enter into a transaction with the company or anyone else, and suffer financial loss as a result. [146] The fact that the third party is a member of the client company, or that the client is a private company or a public company lodging its annual financial statements with the registrar or a listed company, makes no difference. It is also not relevant that the third party has inspected the annual financial statements at the company's registered office,

or that those statements have been published.

(b) A duty to the third party not to make a misstatement arises where the auditor, at any time during the performance of his or her duties for the client company, in fact knows that the annual financial statements will be used by his or her client to induce the third party to enter into a specific transaction with the client or any other person. [147]

(c) A duty also arises where the auditor, at any time during the performance of his or her duties for the client company, in fact knows that the third party intends to or would rely on the annual financial statements for the purposes of entering into a specific transaction with the client or any other person. [148]

This is illustrated by the following example. While performing an audit the

auditor is informed by the client company that it is negotiating with X for a loan of R50 000 (or for making a takeover offer to the members), and that X requires the annual financial statements for that purpose. Because of the auditor's negligence he or she makes an unqualified report on the annual financial statements, which materially misstate the financial position of the company. In reliance on them X makes the loan (or a successful takeover offer) and suffers loss. The auditor is liable.

For the legal duty in points *(b)* and *(c)* to arise, it is not necessary that the auditor concerned should be aware of the third party's identity, or know him or her as an individual. It is sufficient that the auditor knows that the annual financial statements will be relied upon by a group or class of persons, and that the particular third party proves to be one of them, even though the auditor has never heard of him or her by name. For example, in the course of the negligent performance of his or her duties, the auditor is told by the client company that the annual financial statements are urgently needed in order to obtain a large loan from 'a bank'. The statements are materially misleading. Relying on them, Bank X later makes a loan and suffers loss. The auditor is liable to Bank X, which was one of several banks approached by the company after the completion of the annual financial statements.

If the auditor is told that the loan is to be obtained from Bank X, and the bank refuses, but the loan is then made by Bank Y on the strength of the annual financial statements, the auditor is probably not liable to Bank Y.

(d) If the transaction entered into by the third party in reliance on the annual financial statements is not the specific one mentioned in points *(b)* and *(c)* above, but a substantially similar one, the negligent auditor would still be liable. For example, an auditor negligently conducts an audit and issues an unqualified report on annual financial statements which give a favourable impression of an

insolvent company. The auditor was informed that the company intended to exhibit the financial statements to X as a basis for applying for credit for the purchase of goods. But X, in reliance on those statements, buys a substantial block of shares in the company and suffers financial loss as a result. The auditor is not liable to X.

If the auditor was informed that X would be asked to extend credit for the purchase of vacuum cleaners, and credit is extended instead for the purchase of refrigerators, the auditor is liable to X.

If the auditor was informed that X would be asked for a loan to the company of R10 000, and X is in fact asked for and grants a loan of R100 000, the auditor is not liable to X. On the other hand, a loan of R12 000 is not necessarily a different transaction. The question is whether the difference in amount is such that it cannot be regarded as essentially the same transaction.

(e) In the first four points above, the situations have involved annual financial statements. These are of course not the only documents in respect of which liability can arise. Other obvious examples are financial statements made out for a specific purpose, and prospectuses in respect of which the auditor has expressed an opinion.

(f) A legal duty also arises where a reasonable auditor, while performing his or her audit duties, would in the particular circumstances of the case have foreseen the reliance on the annual financial statements by the third party. Hence, where the auditor ought to have known in the circumstances that the third party intended to or would rely on the annual financial statements for the purposes of entering into the specific transaction into which he or she had entered, or a similar transaction, with the client company or any other person, the auditor is liable to the third party for financial loss suffered through reliance on negligent misstatements in those financial statements.

The indeterminate scope of application of the foreseeability test is, however, limited by s 46(5). As Naude says: [149]

> [T]he exclusion of reasonably foreseeability for the recognition of a duty is not justified; but it is of fundamental importance that reasonable foreseeability in the particular circumstances should not be inferred from the mere fact that the defendant is an auditor, or from considerations which apply to all auditors ... This goes to the heart of the danger of an unreasonably and dangerously wide liability of auditors to third parties. In fact, all auditors of all companies know that a variety of third parties rely on annual financial statements for all sorts of transactions, and in this respect the difference between public and private companies is one of degree only. This is not sufficient for a legal duty which is essential for wrongfulness, and is the effect of s 46(5).

The application of 'foreseeability' in terms of s 46(5) of the Auditing Profession Act is illustrated by the following example: every year, over a long period of time, a company has obtained a large loan from X who has regularly relied on the annual financial statements. The auditor is aware of this established financing pattern. He or she is not informed that X will again be approached. But while performing his or her audit duties, reliance by X on the new annual financial statements for the same purpose is reasonably foreseeable. Hence the auditor owes X a legal duty not to make a misstatement. If he or she does so negligently and causes X loss, he or she is liable.

(g) An auditor who, at any time after the completion of his or her duties in respect of the annual financial statements of a client company, makes a representation to a third party as to the correctness of those financial statements may be liable to the third party. This will be so if he or she in fact knew, or could in the particular circumstances reasonably have been expected to know, that the third party would rely on those financial statements for the purpose of acting or refraining from acting in some way or of entering into the specific transaction into which the third party entered, or any other transaction of a similar nature, with the client or any other person. [150]

The representation as to the correctness of the annual financial statements can be by word or conduct, and take many forms. For example, X asks an auditor for a copy of a client company's completed annual financial statements, informing the auditor that it is needed for purchasing all the company's shares.

The auditor shows X a copy, and allows him or her to make extracts therefrom. Those statements are in fact misleading, and the auditor has been negligent in the performance of his or her duties. On the facts the auditor makes an implied representation as to correctness of the annual financial statements, and he or she is liable for loss suffered by X through reliance thereon.

(h) A sophisticated third party like a financial institution can in effect create a legal duty to it for its own protection. If it expects that it will have to rely on a company's annual financial statements, it can inform the auditor of the intended reliance. The auditor will then owe that third party a duty when performing his or her duties in relation to the financial statements.

(i) An auditor may not escape liability through an agreement or in any other way limit the liability that such auditor may incur on the basis of the above principles. Appending a disclaimer of general liability to the auditor's report would thus not negate any liability to a third party (or to the client for that matter). This is the effect of s 46(8) of the Auditing Profession Act and overrides the common law, which permits disclaimers of liability to third parties (not clients).

15.11.2.3 Criminal and civil liability

If an auditor fails to report a reportable irregularity-

(i) this constitutes an offence; [151] and

(ii) the auditor may incur liability to any partner, member, shareholder, creditor or investor of the entity being audited. [152]

It appears that the civil liability referred to in (ii) is a strict liability. In other words, it does not have to be shown that the auditor's failure to report was due to malice, fraud or negligence. No doubt liability can arise only if loss is suffered and the loss was caused by the auditor's failure to report.

15.11.3 Auditors' liability and 'reportable irregularities'

As touched on earlier, an important aspect of corporate governance is the requirement [153] that an auditor of an entity who is satisfied or has reason to believe that a 'reportable irregularity' has taken place or is taking place in respect of that entity must, without delay, send a written report to the IRBA. [154]

Failure may result in liability to 'any partner, member, shareholder, creditor or investor of' the entity being audited. [155] The auditor may not, through an agreement or in any other way, limit or reduce the liability. [156]

A 'reportable irregularity' is defined in s 1 of the Auditing Profession Act. It means any unlawful act or omission committed by any person responsible for the management of an entity, which-

(i) has caused *or* is likely to cause material financial loss to the entity or to any partner, member, shareholder, creditor or investor of the entity in respect of his, her or its dealings with that entity; or
(ii) is fraudulent or amounts to theft; or
(iii) represents a material breach of any fiduciary duty owed by such person to the entity or any partner, member, shareholder, creditor or investor of the entity under any law applying to the entity or the conduct or management thereof.

The IRBA has issued a guide on reportable irregularities, entitled 'Reportable Irregularities: A Guide for Registered Auditors'. [157]

15.11.4 Disciplinary liability

An auditor (including a firm of auditors) is subject to potential disciplinary action in terms of Chapter V of the Auditing Profession Act if he or she [158] is guilty of improper conduct.

Improper conduct means any non-compliance with the Auditing Profession Act or any rules prescribed in terms of the Act or any conduct prescribed as constituting improper conduct. [159]

If the auditor is found guilty, the disciplinary committee must- [160]

(i) caution or reprimand the registered auditor;
(ii) impose on the registered auditor a fine;
(iii) suspend the right to practise as a registered auditor for a specific period; or
(iv) cancel the registration of the registered auditor concerned and remove his or her name from the register.

The disciplinary committee may impose more than one of these sanctions. A disciplinary committee may order any person who admitted guilt or whose conduct was the subject of a hearing to pay such reasonable costs as have been incurred by an investigating committee and the disciplinary committee in connection with the investigation and hearing in question, or such part thereof as the disciplinary committee considers just. [161]

The IRBA may, if it deems it appropriate, publish the finding and the sanction imposed. [162]

Questions

1. Dynamo Auditors Inc is a firm of auditors registered with the Independent Regulatory Board for Auditors. The firm has three directors, five audit managers, 30 trainee accountants, a receptionist and an office administrator. Dynamo Auditors Inc had a turnover of R12 million and liabilities to the value of R120 000 for the current financial year. The financial statements of Dynamo Auditors Inc are prepared internally by one of the trainee accountants.
   (a) Calculate the public interest score of Dynamo Auditors Inc.
   (b) Discuss whether an audit or independent review of Dynamo Auditors Inc's financial statements is required.
   (c) Comment on the person who would be eligible to perform the engagement.
2. Roadrunners Ltd is a wholesaler of motor vehicle spares. The company's AGM is approaching and an auditor has to be appointed for the forthcoming financial year. This audit engagement is a statutory requirement in terms of the Companies Act. State whether each of the following persons or firms is suitable for appointment as the company's auditor. Give reasons for your answer.
   (a) Jackson Hardy is a registered auditor and a director of Bright Auditors Inc, an audit firm in Gauteng. Bright Auditors has performed the audit of Roadrunners Ltd for the past ten financial years and Jackson has been the auditor responsible for that audit for the past six financial years.
   (b) Fran Hunt, a professional accountant registered with the South African Institute of Professional Accountants (SAIPA), has shown an interest in being appointed as the auditor of the annual financial statements of Roadrunners Ltd.
   (c) Bongani Motholo is a registered auditor with a significant shareholding in Roadrunners Ltd. Bongani has always shown a keen interest in Roadrunners Ltd.
3. When X Co appointed Mr A as its financial manager it did so knowing that Mr A had a previous conviction for theft.

   Subsequent to Mr A's appointment it came to light that Mr A had stolen a large sum of money from X Co. X Co could not recover the stolen money from Mr A, who had squandered it. X Co accordingly brought an action against its auditors, Tick and Vouch, alleging that if they had done their audit properly they would have discovered the disappearance of the funds in time for the stolen money to be recovered from Mr A.

On the basis of decided case law, advise X Co on the following:

(a) On what legal basis could a legal action by X Co be brought against Tick and Vouch?

(b) What are the legal requirements that have to be satisfied in order for X Co to be successful?

(c) If it can be shown that X Co, knowing of Mr A's previous conviction for theft, was not sufficiently vigilant in supervising Mr A, would that have any effect on Tick and Vouch's liability?

4. If an auditor of a company has acted negligently it is more difficult for a third person to bring an action successfully against the auditor than for the company to do so. Explain.

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[*] Joanne Shev wrote paras 15.1 to 15.10 and Richard Jooste wrote para 15.11.

[1] GNR 351 *GG* 34239 of 26 April 2011.

[2] Section 28(1) and (2) of the Companies Act.

[3] Section 1.

[4] Regulation 25(3) and (4) of the Companies Regulations.

[5] Regulation 25(5) and (6).

[6] Section 28(3) of the Act.

[7] Section 1.

[8] Section 29(2).

[9] Section 29(1).

[10] Regulation 27(1) of the Regulations.

[11] Regulation 27(2).

[12] Regulation 26((1)*(e)*.

[13] Regulation 26(1)*(d)*.

[14] Section 29(3) of the Act.

[15] Sections 29(6) and 214(2).

[16] Regulation 26(2) of the Regulations.

[17] Regulation 27(4).

[18] Regulation 27(3).

[19] Section 27(7) of the Act.

[20] Section 27(1) and (2).

[21] Section 27(4).

[22] Section 30(1).

[23] Section 30(3).

[24] Section 30(4)-(6).

[25] Section 90(2)*(b)* and reg 29(5) of the Regulations.

[26] Section 31(1) of the Act.

[27] Section 31(4).

[28] Section 204.

[29] Section 33(1) and reg 30(2)-(4) of the Regulations.

[30] Section 30(1) of the Companies Act and s 58(1) of the Close Corporations Act.

[31] Section 30(2)*(a)* of the Companies Act and reg 28(2) of the Companies Regulations.

[32] Section 30(2)*(b)* of the Companies Act.

[33] Regulation 28(2) of the Regulations.

[34] Section 30(2)*(b)* of the Act.
[35] Regulation 29(3) of the Regulations.
[36] Regulation 29(4).
[37] Regulation 29(12).
[38] Section 30(2A) of the Act.
[39] Regulation 29(6)*(a)* of the Regulations.
[40] Regulation 29(1)*(b)*.
[41] Regulation 29(6)-(8).
[42] Regulation 29(8)*(c)*.
[43] Regulation 29(9).
[44] Regulation 29(10).
[45] Section 62A of the Close Corporations Act and s 84(1)*(c)* of the Companies Act.
[46] Section 90(1) of the Companies Act.
[47] Section 90(1A).
[48] Section 90(4), (5) and (7).
[49] Section 90(6).
[50] Section 90(2)*(a)* and *(c)*.
[51] Section 94(8).
[52] Sections 84(5) and 90(2)*(b)*.
[53] Section 90(3).
[54] Section 91(1).
[55] Sections 89 and 91(6).
[56] Section 91(2).
[57] Section 91(3).
[58] Section 91(4) and (5).
[59] Section 92(1) and (2).
[60] Section 92(3).
[61] Section 93(1)*(a)* and *(b)*.
[62] Section 93(1)*(a)*, *(b)* and *(c)* and (2).
[63] Preamble to the Auditing Profession Act.
[64] Section 37(2) of the Auditing Profession Act.
[65] Section 37(3).
[66] Section 37(5).
[67] Section 38.
[68] Section 41(1).
[69] Section 41(2).
[70] Section 41(3).
[71] Section 41(4).
[72] Section 41(6) and (10).
[73] Section 44(1).
[74] Section 44(2) and (3).
[75] Section 44(4) and (5).
[76] Section 44(6).
[77] Section 62A of the Close Corporations Act and s 84(1)*(c)* of the Companies Act.
[78] Section 94(2) of the Companies Act.
[79] Section 94(3).
[80] Section 94(6).
[81] Section 94 (4) and (5) and reg 42 of the Regulations.
[82] Section 94(4) of the Act.
[83] Section 94(7) and (9).
[84] Section 94(7).
[85] Section 94(11).

[86] Section 94(10).
[87] Section 62A of the Close Corporations Act and s 84(1)*(c)* of the Companies Act.
[88] Section 86(1) of the Companies Act.
[89] Section 86(2).
[90] Sections 86(2) and 88(1).
[91] Section 85(1).
[92] Section 86(3).
[93] Section 86(4).
[94] Section 87(1).
[95] Section 87(2) and (3).
[96] Section 88(2).
[97] Section 89(1).
[98] Section 89(2) and (4).
[99] Section 85(3) and (4).
[100] King Report on Corporate Governance for South Africa 2009 ('the King III Report'), Principle 1.1.14.
[101] Principle 3.1.1.
[102] Section 94(2) of the Act.
[103] King III Report Principle 3.1.4.
[104] Principle 3.1.6.
[105] Principles 3.1.7, 3.1.8, 3.2.10, 3.3, 3.2.11 and 3.2.12.
[106] Principle 3.2.9.
[107] Principle 2.21.
[108] Principle 2.21.96.
[109] Principles 2.21.97 and 2.21.98.
[110] Principle 2.21.103.
[111] Principles 2.21.99, 2.21.100, 2.21.102, 2.21.104, 2.21.105 and 2.21.108.
[112] Principle 9.1.1.
[113] Principles 9.1.6 and 9.1.7.
[114] Principles 9.1.5 and 9.1.7.
[115] Principle 9.1.4.
[116] Principle 9.1.2.
[117] Principle 9.1.3.
[118] Principle 9.2.16.
[119] Principle 9.2.15.
[120] Principle 9.3.17.
[121] Principle 9.3.18.
[122] Ibid.
[123] Section 52(1) of the Auditing Profession Act. The duty to report reportable irregularities and the civil liability flowing therefrom is dealt with in 15.11.3.
[124] Section 52(1).
[125] Section 54.
[126] Ibid.
[127] See Chapter V of the Auditing Profession Act regarding disciplinary action and hearings. See also 15.11.4 regarding disciplinary liability.
[128] Section 53 of the Auditing Profession Act.
[129] Ibid.
[130] Ibid.
[131] Ibid.
[132] Ibid.
[133] *Per* Lopes LJ in *In re Kingston Cotton Mill Co (2)* [1896] 2 Ch 279 (CA) 288.
[134] (1970) 92 WN (NSW) 29 at 74.
[135] Supra (n 133) 288-9.

[136] *Fomento (Sterling Area) Ltd v Selsdon Fountain Pen Co Ltd* [1958] 1 All ER 11 (HL) 23.
[137] 2001 (4) SA 551 (SCA).
[138] See SJ Naude 'Auditors' liability to third parties' 1979 *MB* 121.
[139] *Hedley Byrne & Co Ltd v Heller & Partners Ltd* [1963] 2 All ER 575 (HL) 613I-614A.
[140] 74 ALR 1139 at 1145; 225 NY 170; 174 NE 441.
[141] Naude (n 138) 122.
[142] 1954 (3) SA 464 (A).
[143] *Administrateur, Natal v Trust Bank van Afrika Bpk* 1979 (3) SA 824 (A) 832H-833C.
[144] 1990 (1) SA 680 (A).
[145] This summary plus the illustrations are based on Naude's article. It in fact appears that both s 20(9) of the Public Accountants' and Auditors' Act and s 46(2), (3), (4) and (5) of the Auditing Profession Act are based on Naude's article.
[146] Section 46(3) of the Auditing Profession Act.
[147] Section 46(3)*(a)*.
[148] Section 46(3)*(b)*.
[149] Naude (n 138) 136-7.
[150] Section 46 of the Auditing Profession Act.
[151] Section 52(1)*(a)*.
[152] Section 46(7).
[153] Section 45.
[154] Section 45(1)*(a)*. It is to be noted that in certain circumstances the auditor has a duty to report acts or omissions in terms of other legislation, for example, the Financial Intelligence Centre Act 38 of 2001 (FICA) and the Prevention and Combating of Corrupt Activities Act (PRECCA).
[155] Section 46(7) of the Auditing Profession Act.
[156] Section 46(8).
[157] Issued on 30 June 2006.
[158] A firm is also subject to Chapter V of the Auditing Profession Act.
[159] Section 1.
[160] Section 51(3)*(a)*.
[161] Section 51(4)*(b)*.
[162] Section 51(5).

Chapter 16
Public Offerings of Company Securities

Jacqueline Yeats

16.1 Introduction

Companies need access to money in order to function and flourish. One of the ways in which companies raise money is by issuing shares to people who wish to invest in the company and who do so by paying cash in return for those shares. This issue of shares for money can take place either initially (when the company is starting up and needs money to commence trading) or later on, when it requires working capital to fund its operational requirements.

Chapter 4 of the Companies Act 71 of 2008 ('the Act') regulates public offerings of company securities. The aim of this legislation is to protect investors by ensuring that they are provided with adequate and accurate information about the affairs and prospects of a company before they subscribe for or purchase its shares. It does this by prohibiting offers to the public which do not comply with the stringent requirements laid down in the Act. Failure to comply with these requirements may result in both civil and criminal liability. Chapter 4 of the Act deals with *(a)* offers to the public of securities by a company to raise capital and *(b)* offers to the public by or on behalf of the holders of securities not concerned with the raising of capital.

While it is important to protect investors, not all types of offers (and not all investors) require equal protection and it would be commercially unwise and unfair for the Act to prescribe expensive and time-consuming requirements for offers where this level of protection is not necessary. Therefore the Act distinguishes between offers which require strict protective measures and those which do not. Offers which require the highest level of protection and supervision must be accompanied by a detailed information document (the prospectus) and offers which require less protection, or are already regulated by another body, such as an exchange on which the securities are listed, need only be accompanied by a written statement or are not regulated by Chapter 4 at all. There are also a number of additional restrictions and rules in the Act [1] which apply to the manner in which public offers must be conducted and which enhance the protective function of the prospectus.

16.2 Types of offers and the distinction between listed and unlisted securities

The Act distinguishes between primary and secondary offerings, as well as the securities of a listed and an unlisted entity. [2] There are basically three types of offers: an initial public offering, a primary offering and a secondary offering. Each type of offer may be made in relation to either listed or unlisted securities; and the Act prescribes different requirements in each of these situations.

16.2.1 Initial public offering

An initial public offering ('IPO') means an offer to the public of any securities of a company where no securities of that company have previously been offered to the public, or where all the securities of that company which were previously offered to the public have been reacquired by the company. [3] There is no doubt as to what is required of a company in these circumstances: a prospectus must be produced. [4]

16.2.2 Primary offering

Primary offers (offers made to the public by a company of its own securities or the securities of a company in the same group or of the securities of a proposed merger or amalgamation partner) [5] are divided into offers of listed securities and offers of unlisted securities. A primary offering of listed securities requires compliance with the rules of the relevant exchange (usually the JSE), whereas a primary offering of unlisted securities requires a prospectus that satisfies the requirements of the Act.

16.2.3 Secondary offering

Secondary offers (offers made for sale to the public of any securities of a company or its subsidiary, and which are made by or on behalf of a person other than that company or its subsidiary) are also, by implication, divided into offers for the sale of listed securities and offers for the sale of unlisted securities. The Act requires a secondary offer of unlisted securities to be accompanied by either the prospectus that accompanied the primary offering (appropriately updated) or a written statement that complies with the Act. [6] The written statement is essentially a synopsis of the state of affairs of the company and the particulars of the offer.

The fact that separate provision is made for offers pertaining to listed and unlisted securities should provide prospective investors with the requisite protection without unnecessary duplication or overregulation in terms of compliance with stock exchange and company law requirements. For example, an offer or making a primary offering of listed securities will not need to produce both a prospectus in terms of the Act and a listing circular which complies with the requirements of the JSE.

16.3 General restrictions on offers to the public

Aside from the provisions which prescribe that a prospectus or written statement or compliance with exchange requirements are required, the Act also contains some additional, more general restrictions regarding public offers. For example:

(i) Only the securities of a company may be offered to the public.
(ii) Nobody may issue a prospectus or a document that purports to be a prospectus, or a document that may reasonably be mistaken for a prospectus, unless it actually is a registered prospectus.
(iii) A prospectus may not be issued more than three months after the date of its registration, and if a prospectus is issued after this date it is regarded as unregistered. [7]

Any provision of an agreement is void if it requires an applicant for securities to waive compliance with a requirements of Chapter 4 of the Act. [8] This means it is not possible to contract out of the requirements set by the Act.

16.4 What constitutes an offer to the public?

Because Chapter 4 of the Act with all its requirements and restrictions only applies to offers to the public, it is vital to determine whether a particular offer qualifies as an offer to the public or not. If it does not, then Chapter 4 has no bearing on that offer at all and can be disregarded.

This is not always simple or easy to determine and there have been a number of complex court cases which turn on this very question. The Act stipulates the following:

(h) **'offer to the public'-**

(i) includes an offer of securities to be issued by a company to any section of the public, whether selected-

(aa) as holders of that company's securities;

(bb) as clients of the person issuing the prospectus;

(cc) as the holders of any particular class of property; or

(dd) in any other manner; but

(ii) does not include-

(aa) an offer made in any of the circumstances contemplated in section 96; or

(bb) a secondary offer effected through an exchange. [9]

This means that it is quite possible to make an offer of securities to a group of people (even a relatively small group) as opposed to the general public or the world at large and that such an offer could constitute an offer to the public. An offer made in any of the circumstances contemplated in s 96 or a secondary offer effected through an exchange are not offers to the public.

As the definition of 'offer to the public' in the Act is very similar to the definition that appeared in the 1973 Act, [10] the body of case law that has developed around this phrase should still assist the courts in their interpretation of the legislation. [11] Typically the type of factual scenario that presents a problem is one where an offer does not fall squarely into one of the specifically exempted categories and exhibits characteristics that make it difficult to determine whether such an offer is public or private in nature and, consequently, whether the offerees require legislative protection. [12] In any set of offer circumstances there are thus three possibilities: an offer is an offer to the public (because that is its true legal nature and it complies with the definition in the Act), an offer is an exempted non-public offer (because it is specifically exempted, [13] its true legal nature is irrelevant), [14] or an offer is a non-public offer (because, even though it does not fall within the s 96(1) exemptions, that is its true legal nature). Each case will need to be decided on its merits to the extent that a particular offer does not constitute a clearly public or clearly exempted or clearly non-public offer.

16.5 What does not constitute an offer to the public?

The Act lists a number of instances in which offers made are deemed not to be offers to the public [15] and are therefore not expected to meet the prospectus or other requirements of Chapter 4. The exempted offers are very specifically described in rather technical terms but the exemptions are generally based on the fact that in those specific instances the offerees do not require the protection of a prospectus because, for example, they are sophisticated investors or because they own shares in the company and are thus already in possession of the requisite information.

16.6 Advertisements

The Act envisages two scenarios in which an advertisement may be relevant in relation to an offer to the public. Either the offer may actually be made (or presented) by way of advertisement, or the advertisement may merely serve to draw the attention of the public to an offer made by way of a prospectus.

An offer to the public may be made or presented by way of an advertisement if the advertisement satisfies all the requirements of the Act with respect to a registered prospectus. [16] Furthermore, the advertisement will be subject to every provision of the Act relating to the making of a prospectus. An advertisement which serves to draw the attention of the public to an offer made by publishing a prospectus must include a statement clearly stating that it is not a prospectus and indicating where and how a copy of the registered prospectus may be obtained. In addition, it must not contain any untrue statement, or mislead a person reading the advertisement to reasonably believe that it is a prospectus, or be misleading as to any material particularly addressed in the prospectus relating to that offer.

An advertisement is deemed to be a prospectus if it does not comply with the requirements of the Act, and all the consequences of issuing a non-compliant prospectus will attach to the persons involved in issuing the document.

16.7 Prospectus requirements

The prospectus is a detailed information document. Its function is to provide potential investors with current, complete and accurate information regarding the affairs of a company.

The contents of the prospectus are very specifically regulated by the Act and Regulations. Not only do these stipulate the required content but they also prescribe the format of the prospectus such as format, style and layout.

The section [17] does not apply in respect of listed securities (these are subject to the rules and requirements of the exchange on which they are listed) except listed securities that are the subject of an initial public offering. [18] Basically a prospectus must contain all the information that an investor may reasonably require to assess the assets and liabilities, financial position, profits and losses, cash flow and prospects of the company in which a right or interest is to be acquired, as well as the securities being offered and the rights attached to them. The prospectus must also adhere to the prescribed specifications in legislation.

16.7.1 The contents of a prospectus

The Act [19] provides that a prospectus must adhere to the prescribed specifications. The Companies Regulations sets out the requirements of the prospectus with respect to-

(i) general requirements relating to form, style and layout;
(ii) signature, date and issue formalities and requirements;
(iii) additional information required if it is the intention to acquire a business undertaking or property; and
(iv) access to supporting documents.

In addition the Companies Regulations contain a host of prescribed specifications that deal in detail with the items required to be included in a prospectus. These are-

(i) a general statement of required information;
(ii) specific matters to be addressed in a prospectus for a limited offer and specific matters to be addressed in a prospectus for a general offer;
(iii) information about the company whose securities are being offered;
(iv) information about the offered securities;
(v) statements and reports relating to the offer (which must be included in the prospectus).

16.7.2 Consent to use name in prospectus

In any prospectus relating to the securities of a company, a person must not name another person as a director or proposed director of that company unless, before registration of that prospectus, the person to be named has consented in writing to act as a director, has not withdrawn the consent, and the return reflecting that person's particulars has been filed. Nor must the prospectus include any statement made by an expert or reference to any statement purporting to be made by an expert, unless the expert consented in writing to the use of that statement before the prospectus was filed, has not withdrawn the consent, and the consent is endorsed on or attached to a copy of the filed prospectus and the prospectus includes a statement that the expert has consented. Equally, the prospectus must not name any person as the auditor, attorney, banker or broker of the company unless it is accompanied by the written consent of the named person agreeing to be named in the stated capacity and to the use of his or her name in the prospectus. [20]

16.7.3 Variation of agreement mentioned in prospectus

For a period of one year after the date of filing a prospectus, a company must not vary or agree to vary any material terms of an agreement referred to in the prospectus, other than in the ordinary course of business, unless the variation was contemplated

and is set out in the prospectus, or if the specific terms of the variation are authorised or ratified by an ordinary resolution adopted at a general shareholders' meeting. [21]

16.8 Secondary offers to the public

A person making a secondary offering must ensure that the offering is accompanied either by the registered prospectus that accompanied the primary offering of those securities (together with any revisions required to address material changes since the date of registration of the prospectus) or, alternatively, a written statement. The written statement referred to must be dated and signed by the person making the offer or issuing, distributing or publishing the material. [22]

16.9 Liability

16.9.1 Introduction

If there were no legal consequences for failing to comply with the strict requirements for offering securities to the public and for producing a prospectus, these rules would be meaningless. Therefore the Act makes provision for both civil and criminal liability for those who fail to do so. This encourages legal compliance and provides recourse for investors where they have suffered harm as a result of a failure to comply There are two main areas of potential liability: liability for untrue statements and liability of experts involved in the preparation of the prospectus.

16.9.2 Liability for untrue statements in the prospectus

An 'untrue statement' includes a statement that is misleading in the form and context in which it is made. The ambit of this phrase is therefore wide - both false statements and misleading statements fall within the section. Furthermore, an untrue statement is regarded as having been included in a prospectus, written statement or summary directing a person to either a prospectus or a written statement if it is-

(i) contained in a report or memorandum that appears on the face of one of these documents; or
(ii) incorporated by reference in, or is attached to, or accompanies a prospectus, written statement or summary directing a person to either a prospectus or a written statement.

The statement need not therefore appear in the information document itself. This considerably extends the range of information and statements that need to be carefully weighed, considered and tested for accuracy by any person who may incur liability in respect thereof. Finally, an omission from a prospectus or a written statement that, in the context, is calculated to mislead by omission constitutes the making of an untrue statement, irrespective of whether the Act requires that matter to be included in the prospectus or the written statement. [23] The implication of this provision is that, where information is relevant to the investment decision of a member of the public, it must be included notwithstanding the fact that it falls outside one of the categories of information prescribed by the Act and Regulations. If securities are offered to the public for subscription or for sale pursuant to a prospectus, every director, promoter, and person who authorised the issue of the prospectus or who made the offer to the public is liable to compensate anyone who acquired securities on the faith of the prospectus for any loss or damage sustained as a result of any untrue statement in the prospectus. [24] There are a limited number of defences available [25] based on either reasonable belief, reliance on expert opinion or official documents or lack of consent to the publication of the prospectus.

16.9.3 Liability of experts [26] and others

If a person has consented to the use of his or her name or the inclusion of material in a prospectus and the person in question purports to be an expert, any untrue statement made will render the expert liable [27] unless he or she had withdrawn their consent or was competent to make the statement and reasonably believed that it was true.

16.10 Allotments and acceptance of subscriptions

Allotment refers to the process of distribution or allocation of shares to subscribers. Only once the share has been allotted (ie allocated or apportioned) to a subscriber may it be issued to him or her. The reason for distinguishing allotment from issue as different phases in the response of the company to the application for subscription is that sometimes an offer is 'over-subscribed'. This means that there are more willing investors than there are shares available for subscription. In the allotment process, the company determines how the shares will be allocated, usually pro rata to each applicant in line with the oversubscription ie if there are applications for twice as many shares as there are shares available for subscription, applicants will each be allotted half the shares they applied for. The Act contains a number of provisions relating to the time limit for an allotment following a public offer [28] as well as restrictions in relation to the form and process of allotments. [29] An allotment which contravenes these restrictions is voidable and the directors may be held liable for loss or damage suffered as a result. [30]

Questions

1. Farmer Brown starts a company which produces fertilizer from his surplus chicken manure. This proves to be extremely profitable and soon business is booming. He wants to raise money to expand the company by offering shares to everyone in the Western Cape who supports the Stormers rugby team. He has chosen this group because he wants to give people who share his passion for the game of rugby to have an opportunity to share in the future wealth which he hopes to create. Explain to him the legal and practical implications of this decision.
2. Mr Merlot owns a company which produces corks for the wine industry. As part of an offer to the public to acquire shares in his

company he, his brother (who is also a director of the company) and the company's attorneys and auditors produce a prospectus. They include all the information legally required. Before the prospectus is finalised, new legislation is enacted which levies a substantial special tax on the sale of young cork trees because they are not indigenous and are thus a threat to the environment. Mr Merlot does not want to include this information in the prospectus in case it discourages potential investors. Provide him with legal advice.

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[1] Section 99.

[2] Section 99(3).

[3] Section 95(1)*(e)*.

[4] Section 99(2).

[5] Section 95(1)*(e)*.

[6] Section 101(4)-(6).

[7] This is presumably because the information in a prospectus can become outdated quite rapidly and the document then no longer serves the purpose for which it was intended, ie to supply would-be investors with accurate, complete and up-to-date information regarding the company in which they intend to acquire securities.

[8] Section 95(5).

[9] Section 96.

[10] Note, however, that the original definition contained in the 1973 Act does not include the 'holders of any particular class of property' or a specific reference to the section itemising offers that do not constitute offers to the public in terms of the Act.

[11] Whether an offer to a group which does not constitute the general public is a public offer or not depends on a host of factors (including the size of the group, the intention of the offeror, the manner in which the members of the group were selected, whether there is any pre-existing relationship between the offeror and the selected group, whether there is a rational connection between the offeree group and the nature of the offer, the specific terms of the offer and so forth) but this will need to need to be determined on the facts of each particular case where there is any uncertainty.

[12] The most recent South African case on this point is *Gold Fields Ltd v Harmony Gold Mining Co Ltd* 2005 (2) SA 506 (SCA).

[13] In terms of s 96(1).

[14] Section 96(1)*(a)*.

[15] Section 96.

[16] Section 98.

[17] Section 100.

[18] Section 99(2).

[19] Section 100(2)*(b)*.

[20] Section 102.

[21] Section 103.

[22] This does not apply to listed securities.

[23] Section 95(4).

[24] Section 104.

[25] Section 104(3).

[26] In terms of s 95(1)*(d)*, an expert in this context means 'a geologist, engineer, architect, quantity surveyor, valuer, accountant or auditor, or any person who professes to be one of those persons or to have extensive knowledge or experience, or to exercise a special skill which gives or implies authority to a statement made by that person'. Thus the definition is comprehensive.

[27] Section 104.

[28] Section 107.

[29] Section 108.

[30] Section 109.

Chapter 17
Fundamental Transactions, Takeovers and Offers

Maleka Femida Cassim and Jacqueline Yeats [*]

17.1 Fundamental transactions: general

Fundamental transactions are transactions that fundamentally alter a company. The Companies Act 71 of 2008 ('the Act') provides for three types of fundamental transactions, namely-

(i) amalgamations or mergers;

(ii) disposals of all or the greater part of the assets or the undertaking of a company; and
(iii) schemes of arrangement.

Fundamental transactions may be used to create business combinations and carry out takeovers. Fundamental transactions may have the effect, for instance, of merging two companies into one, disposing of a company's assets or selling its business, reorganising a company's share capital or altering the rights of the company's shareholders, and even eliminating shareholders.

In view of these far-reaching effects, the Act requires fundamental transactions to be approved in the manner specified in the Act. The approval requirements are generally designed to ensure that the interests of shareholders and others are protected when a company undertakes a fundamental transaction. It is noteworthy that the Act applies substantially similar requirements for the approval of all three types of fundamental transactions. This is intended to remove or reduce the opportunities for regulatory arbitrage. There are nonetheless some important differences in the approval requirements for each fundamental transaction, as discussed further below.

The approval and the regulation of fundamental transactions have been reformed under the Act in order to facilitate and encourage the creation of business combinations. As a matter of policy, takeovers and fundamental transactions are increasingly seen as being beneficial to corporate efficiency, to the economy and to the creation of wealth. By creating flexibility for companies to restructure their businesses and thereby adapt to changing business conditions, economic growth will be promoted.

Also flowing from this policy is the introduction of the innovative concept of the 'amalgamation or merger'. This is one of the leading reforms of the Act, as South African law has never before had a merger procedure in its true sense. Commendably, the statutory merger is an additional procedure, and not a replacement, for the already existing methods of companies effecting business combinations and fundamental transactions, thus providing them with a further very useful option. The other available procedures are a disposal of the assets or undertaking of the company and a scheme of arrangement (as well as a takeover offer with compulsory acquisition of the securities of the minority). By extending the range of options available to companies, the Act accommodates differing circumstances, reasons and needs for fundamental transactions and business combinations.

Closely associated with the fundamental transactions is the new appraisal remedy. The appraisal right [1] is the primary protective measure for dissenting minority shareholders in fundamental transactions. Due to the availability of the appraisal remedy, there is no general or automatic requirement for the court to play a protective role in fundamental transactions. The involvement of the court is instead restricted to certain specified circumstances, as discussed in greater detail below.

17.2 Amalgamation or merger (the 'statutory merger') [2]

17.2.1 The concept of an 'amalgamation or merger'

17.2.1.1 Introduction

In broad terms, in an 'amalgamation or merger' the assets and liabilities of two or more companies are pooled together in a single company. The latter may either be one of the combining companies (referred to as the surviving company) or a newly formed company (referred to as the new company).

The 'amalgamation or merger' (or 'the statutory merger') is basically a simple, uncomplicated and effective procedure, whereby two or more companies merge by way of an agreement, with the approval of the prescribed majority of their shareholders. There is no general or automatic need for the approval of the merger by the court. It is a court-free procedure. The role of the court is instead restricted to certain specified circumstances only. [3]

By permitting a court-free merger by way of majority rule - that is, with the approval of the prescribed majority of the shareholders by special resolution - the Act makes it much easier in many ways to effect a business combination or fundamental transaction. This will assist companies to adapt to changing business conditions, which is in the interests of the growth of the economy.

17.2.1.2 Underlying policies

Essentially, the statutory provisions on mergers represent a balance between two conflicting policies: on the one hand, there is the policy of promoting the restructuring of businesses, in the interests of economic growth. This policy is reflected in the Act by the principle of majority rule (or rather, supermajority rule), which suffices to fundamentally change the nature of a company by way of a merger.

On the other hand, the opposing policy is the interests of shareholders in retaining their investments in a company, coupled with the protection of minority shareholders (who are disgruntled by a proposed merger) from discrimination at the hands of the majority shareholders (who by majority rule are able to approve the merger). The issue then arises as to the protection of minority shareholders who are dissatisfied with a merger: Dissenting minority shareholders, who disapprove of a merger, do not generally have recourse to a court of law to prevent or frustrate the merger. Instead, dissenting shareholders have the right to opt out of the merger, by withdrawing the fair value of their shares in cash from the company. They do this by

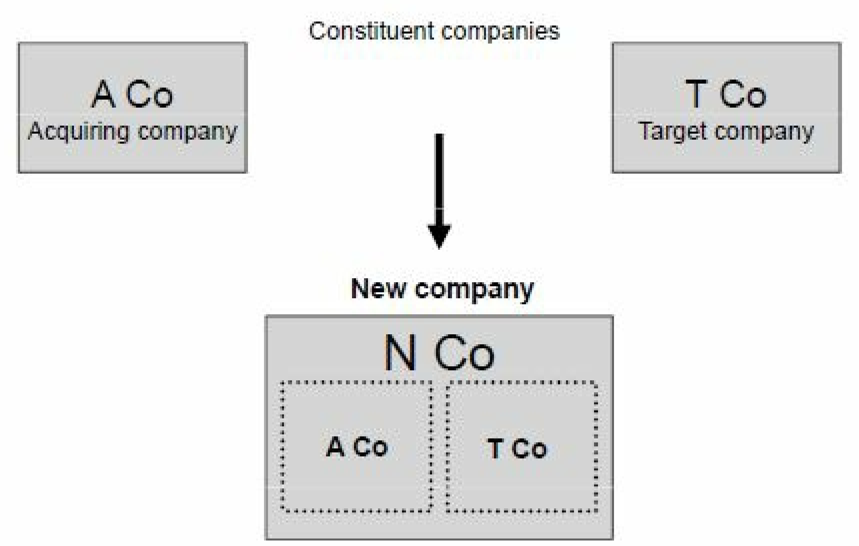
exercising their appraisal rights. The appraisal right is thus closely linked to the statutory merger. It is the key safeguard for minority shareholders in a merger.

17.2.1.3 Definition of an 'amalgamation or merger'

Significantly, no distinction is drawn in the Act between a 'merger' and an 'amalgamation'.

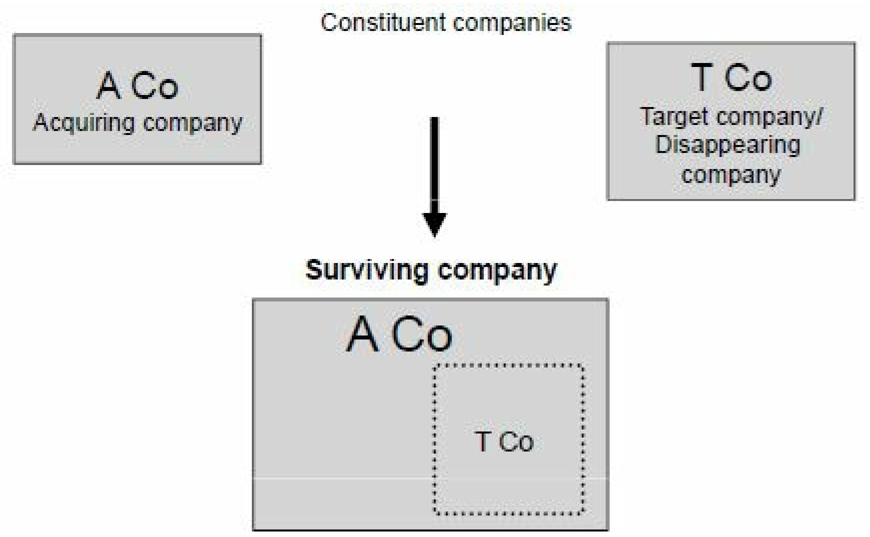
As appears from the definition of an 'amalgamation or merger', [4] the Act provides for two broad types of 'amalgamation or merger' structures. The first structure is where two (or more) companies (referred to as the 'constituent companies') fuse into a *new* company, with the result that both the constituent companies are dissolved in the process. The new company (which is formed or incorporated in the process of the merger) holds *all* the assets and liabilities that were previously held by the two constituent companies. The transmission of the assets and liabilities to the new company takes place automatically, simply by the operation of law, when the merger is effected. (See Diagram 17.1.)

Diagram 17.1: New company merger structure



In the second type of structure, one of the constituent companies fuses *into the other constituent company*, resulting in the survival of that company. The *surviving company* holds all the assets and liabilities that were previously held by the two constituent companies. The first constituent company (termed the 'disappearing company') disappears in the process. (See Diagram 17.2.)

Diagram 17.2: Surviving company merger structure



The technical difference between the two structures consequently is that, in the first structure, where an acquiring company (Co A) and a target company (Co T) wish to merge, *both* Co A and Co T are dissolved and a new company, Co N, is created. On the other hand, in the second structure, Co A would *survive* and continue to exist, while Co T would be the disappearing company and would be dissolved or deregistered. Accordingly, the first structure results in the fusion of both constituent companies into a new company, whereas the second structure results in the fusion of one constituent company into the other.

The above is, of course, a simplification. The Act also provides for transactions between more than two companies, and creates scope for the survival of more than one company or the formation of more than one new company. It even permits combinations of the two merger structures (whereby the merger results in at least one surviving company as well as the formation of one or more new companies). Merger structures could accordingly become quite complex and intricate.

In practice the choice between the two structures of an 'amalgamation or merger' will be determined by a number of factors, such as-

(i) the desire to portray the transaction as a true merger of equals. In this case the first structure above (which results in the formation of a new company) may be preferred; [5]
(ii) the need to preserve the goodwill or the identity of one of the constituent companies;
(iii) the material provisions of the Memorandum of Incorporation of the constituent companies;
(iv) the change-of-control provisions in valuable or important contracts between a constituent company and third parties.

But in any event, nothing turns on the distinction. Apart from the above technical differences, the procedure for and the effect of a merger is substantially similar, regardless of which of the two structures is used. For the sake of simplicity and clarity, the rest of this section is discussed with reference to the *surviving company* structure.

17.2.1.4 The nature and effect of a merger

The Act states that, when a merger is implemented, all the property and rights of the constituent merging companies simply 'become' the property and rights of the surviving company. [6] Furthermore, the surviving company 'is liable' for all the obligations of the constituent merging companies. [7] An important principle emerges from these provisions, namely that the assets and liabilities of the disappearing company are apparently transmitted to the surviving company *automatically*. In other words, the transmission of the assets and liabilities takes place simply by operation of law. Consequently, there is no need to comply with any of the legal formalities associated with transfer, such as delivery, cession, assignment, delegation etc. This is one of the greatest advantages of the statutory merger. It results in simplicity and efficiency, with savings of both costs and time.

However, there is one exception to the principle of automatic transmission of property by operation of law. Where any property of the disappearing company is registered in terms of a public regulation, such as immovable property, the transfer of the property to the surviving company must be registered in the relevant property registry. [8]

But the general principle of automatic transmission by operation of law has an attendant disadvantage: the surviving company is, conversely, also automatically liable for all the obligations and liabilities of the disappearing company. This includes unliquidated liabilities and contingent liabilities, and even, it seems, liabilities of which the acquiring company was unaware. This disadvantage may pose a significant deterrent to mergers in practice.

The question arises as to the contractual rights and obligations of the disappearing company, in terms of agreements between the disappearing company and third parties. Generally, the contractual rights and obligations of the disappearing company would also vest in the surviving company automatically (ie simply by operation of law). But, where a contractual clause specifically states that the contract will not survive a statutory merger, such a clause would evidently prevent the contract from vesting in the surviving company. It is thus essential for merging companies to undertake a proper and thorough due diligence.

An additional fundamental advantage of the statutory merger is that there is no need to formally wind up the disappearing company. The disappearing company is, instead, simply deregistered by the Companies and Intellectual Property

Commission ('the Companies Commission') on the implementation of the merger. A merger does not affect any existing liability of any of the constituent merging companies, or any of their directors, to be prosecuted for any criminal offences that they have committed (that notwithstanding the disappearance of the relevant constituent company in the merger). A merger also does not affect any civil, criminal or administrative action or legal proceeding pending by or against a merging company; or any conviction, ruling, order or judgment relating to a merging company. These may therefore continue to be prosecuted or enforced by or against the merged company. This aspect would clearly need to be very carefully considered by the parties involved in the merger and it can obviously have some serious consequences for the surviving company and its shareholders.

17.2.2 Procedure for a statutory merger

The merger procedure may, for purposes of analysis, be conveniently divided into five steps. These are as follows:

17.2.2.1 Merger agreement;
17.2.2.2 Solvency and liquidity test;
17.2.2.3 Special resolution of shareholders and other requisite approvals of the merger;
17.2.2.4 Notice to creditors; and
17.2.2.5 Implementation.

Notably, where a company is placed under business rescue and a merger transaction is pursuant to the company's (approved) business rescue plan, the company is exempted from certain aspects of the statutory merger procedure. A company under business rescue is exempt from the solvency and liquidity test, the requisite approvals of the merger, and the notice to creditors (as outlined in 17.2.2.2, 17.2.2.3 and 17.2.2.4 respectively).

The statutory merger procedure applies to mergers between profit companies, including holding and subsidiary companies. It also extends to domesticated companies, but not to foreign companies or external companies.

It is noteworthy, at the outset, that the approval of the court is not generally required in the five-step merger procedure (save in certain exceptional circumstances).

Each step of the merger procedure is discussed in turn below.

17.2.2.1 Merger agreement

The first step is that the companies proposing to merge (ie 'amalgamate or merge') must enter into a written agreement, which sets out the terms and the manner of effecting the merger. The merger agreement must deal with certain specified matters, including- [9]

(a) the proposed Memorandum of Incorporation of any new company which is to be formed by the merger;
(b) the names and identity numbers of the proposed directors of the merged company (or companies);
(c) the manner in which any shares (or securities) of the constituent merging companies are to be *converted into shares (or securities)* of a merged company, or *exchanged for other property*;
(d) if any securities of a merging company are not to be converted into securities of a merged company, the *consideration* that those shareholders (or securities holders) will receive instead;
(e) the manner of payment of any consideration instead of the issue of

fractional securities of a merged company or of *any other juristic person the securities of which are to be received in the merger*;

(f) details of the manner in which the assets and liabilities of the constituent merging companies will be allocated among the merged companies (this applies to mergers that result in more than one merged company);

(g) details of any arrangement or strategy necessary to complete the merger, and to provide for the subsequent management and operation of the merged company; and

(h) the estimated cost of the merger.

It is clear from the above provisions that the Act is widely drafted to provide flexibility in respect of the forms or types of merger consideration. The consideration under the merger agreement is usually paid to the shareholders of the target or disappearing company, in consideration for their shares in the disappearing company. The merger consideration may be in the form of shares or other securities, such as debentures. Securities in a foreign company may conceivably also be used as merger consideration. The consideration may even consist of the exchange of any *'other property'*. Significantly, a *cash* consideration is also permissible. [10] A further possibility is for shareholders to receive merger consideration in the form of *shares in another company* other than the surviving merged entity. [11] This is a vitally important form of consideration, because it facilitates the very useful triangular merger and reverse triangular merger structures. [12] The wide and liberal scope of the merger consideration gives merging parties numerous different options for their merger agreement. This creates latitude for merging companies to structure their merger transactions advantageously, in a manner that best suits their unique needs and objectives. Various merger structures may be devised under the liberal provisions of the Act, each with its own uses and advantages, thus accommodating different circumstances and needs for mergers. See further 17.2.6 on merger structures.

Finally, the Act states that if any securities of one constituent merging company are held by another constituent company, these securities must be cancelled when the merger becomes effective, without any repayment of capital. Furthermore, such securities cannot be converted into securities of the surviving merged company. [13]

The reason for this provision is to prevent the merged company from effectively holding shares in itself, and to prevent the merger from effectively resulting in an indirect reduction of the capital of the merged company.

17.2.2.2 Solvency and liquidity test

The second step in the merger procedure is that the board of directors of *each* constituent merging company must reasonably believe that the proposed *merged* company (or companies) would satisfy the solvency and liquidity test once the merger agreement is implemented. Compliance with the solvency and liquidity test is an essential requirement for a merger. A company satisfies the solvency and liquidity test if, considering all reasonably foreseeable financial circumstances of the company at that time, the assets of the company, fairly valued, equal or exceed the liabilities of the company, fairly valued; *and* 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. [14] If the board of directors reasonably so believes, it may submit the merger agreement for approval at a meeting of the shareholders of the merging company. Since the co-operation of the board of directors is required, the statutory merger is more suited to friendly or recommended transactions, as opposed to hostile transactions. A notice of the shareholders' meeting must be delivered to each shareholder of each merging company, and must include a copy or summary of the merger agreement and the provisions of the Act [15] relating to the required approvals for the transaction and the appraisal rights of dissenting shareholders. This is important, because shareholders may be unaware of their appraisal rights and the procedure for their exercise, or of the provisions regarding court approval of the merger in exceptional circumstances.

17.2.2.3 Requisite approvals of the merger

The third procedural step is that the merger must be approved by the shareholders of each merging company, at a meeting called for that purpose. It is worthy of emphasis that *each* constituent merging company must adopt a special resolution to approve of the merger. (This may be contrasted with the other fundamental transactions, where only one company is generally required to approve the transaction.)

The quorum for the meeting is constituted by shareholders holding at least 25 per cent of all the voting rights that are entitled to be exercised on the matter. [16] The merger must be approved by a special resolution of the shareholders. In other words, it must be approved by at least 75 per cent of the voting rights that are exercised on the resolution. It is noteworthy that both the quorum and the prescribed shareholder approval requirement relate not to the number of shareholders or the number of shares, but to the voting rights. The requirement of a special resolution for a statutory merger (as opposed to an ordinary resolution) ensures more appropriate protection of minority shareholders, while at the same time it preserves sufficient flexibility for companies to effect fundamental changes without being frustrated by a troublesome minority.

It is important to note that the quorum of 25 per cent may be increased - but may not be decreased - in a particular company's Memorandum of Incorporation. In contrast, the requirement of 75 per cent for the approval of the special resolution may not be altered in a company's Memorandum of Incorporation. It apparently is a fixed threshold of 75 per cent. [17] However, this does not leave shareholders without a solution: if the shareholders of a particular company wish to have more protection in the event of a fundamental transaction, they may simply raise the quorum for the meeting in the company's Memorandum of Incorporation. In this way, they would indirectly boost the total number of voting rights that are needed to approve the transaction. For instance, the usual or default approval requirement for a merger is a favourable vote by at least 75 per cent, out of a quorum of at least 25 per cent of the voting rights, ie a vote of just over 18,75 per cent of the company's total voting rights is sufficient. But if the company's Memorandum of Incorporation provides for a raised quorum of 50 per cent, then a merger of the company would require the approval by special resolution of at least 75 per cent, out of the raised quorum of (at least) 50 per cent of the voting rights, ie a favourable vote by more than 37,5 per cent of the company's total voting rights would be needed for the merger to proceed. For the purpose of the special resolution, it is significant that any voting rights controlled by an acquiring party [18] (or a person related to an acquiring party, or a person acting in concert) are disqualified from voting. [19] This is a welcome provision. It prevents a conflict of interest, when a party is simultaneously both the *acquiring party* in a merger (eg the surviving company) as well as a *shareholder in the target company* which is to be acquired (eg the disappearing company). In other words, one of the merging parties stands on both sides of the merger transaction and thus has a conflict of interest. In these cases, the acquiring party with the conflict of interest is disqualified from voting its shares on the *target company's* merger resolution. This provision may go a long way towards protecting the minority shareholders of the target or acquired company. It may be regarded as a 'majority-of-minority-vote' provision in an interested transaction.

Apart from the approval by special resolution of each merging company, there are also other approvals that may be required for a merger in certain circumstances. [20]

In this regard, the approval of the court is required in the circumstances contemplated by the Act. Court approval is not a general or automatic requirement for fundamental transactions, but is limited to certain specified circumstances. Court approval is discussed separately in 17.2.3.

The final approval requirement is that, if the company is a 'regulated company' that is subject to the takeover provisions of the Act and the Takeover Regulations, [21] the company may not implement a fundamental transaction unless the Takeover Regulation Panel has issued a compliance certificate in respect of the transaction or has exempted the transaction.

(It must be stressed that the above approval requirements apply not only to statutory mergers, but also to the other fundamental transactions, ie disposals of all or the greater part of the assets or undertaking of a company and schemes of arrangement. For all three types of fundamental transactions, the shareholder approval requirements, the exceptional requirement of court approval and the appraisal rights of dissenting shareholders are largely similar (although this is subject to some significant differences). Accordingly, this discussion in 17.2.2.3 pertains to fundamental transactions in general and not just mergers alone.

17.2.2.4 Notice to creditors

The fourth step in the merger procedure is that a notice of the merger must be given (in the prescribed manner and form) to all known creditors of the merging companies. [22]

A creditor may (within 15 business days after delivery of the notice of merger) seek leave to apply to a court for a review of the merger, only on the ground that the creditor will be materially prejudiced by the merger. A court may grant leave (or permission) to a creditor to apply for a review of the merger only if it is satisfied that: *(a)* the creditor is acting in good faith; *(b)* if the merger were to be implemented it would materially prejudice the creditor; and *(c)* there are no other remedies available to the creditor.

Until the court has disposed of any such proceedings involving creditors, the merger may not be implemented at all. The implementation of the merger is subject to the order of the court. Legal proceedings by creditors may thus have a substantial impact on the timing and the implementation of a merger.

(It is noteworthy that these provisions of the Act relating to creditors apply specifically to mergers, and not to the other fundamental transactions.)

17.2.2.5 Implementation of the merger

The fifth and final step is that the merger is implemented or ‘perfected’. The parties may proceed to implement the merger once the transaction has satisfied all the applicable approval requirements discussed in 17.2.2.3, as well as the requirements set out in 17.2.2.4.

To implement the merger, a notice of amalgamation or merger [23] must be filed with the Companies Commission, together with certain other documentation including a Memorandum of Incorporation for any newly formed company (which is incorporated in the merger process), confirmation that the merger has satisfied the requirements of the Act, and confirmation that any other applicable regulatory approvals have been obtained (such as approval in terms of the Competition Act 89 of 1998, or approval in terms of the Banks Act 94 of 1990, where so required).

The Companies Commission thereafter deregisters any company that disappears under the merger, without the need for any formal winding-up of the company. This is convenient, and constitutes one of the useful practical advantages of the statutory merger procedure. The Companies

Commission also issues a registration certificate for any new company that has been newly incorporated under the merger.

The merger takes effect in accordance with the merger agreement, and subject to any conditions set out in the merger agreement. [24] For a discussion of the effects of the implementation of a merger on the property, rights, contracts, obligations and liabilities of the constituent merging companies, refer to 17.2.1.4.

17.2.3 The exceptional requirement of court approval

The approval of the court is not generally required in the five-step merger procedure. It is only required in certain exceptional circumstances. [25] The governing principle is that, where a proposed fundamental transaction has been approved by the requisite majority (or supermajority) of the shareholders of a company, the dissenting minority shareholders are not generally able to prevent or frustrate the fundamental transaction against the wishes of that majority. Instead, the recourse of the dissenters is to rely on their appraisal rights to obtain the fair value of their shares, and thereby opt out of the company. It is only in certain specified circumstances that a merger resolution may be reviewed by the court and possibly set aside. This approach to court approval applies equally to all the fundamental transactions, with the effect that schemes of arrangement and disposals of a company's assets or undertaking will require court approval in the same circumstances as mergers.

The Act provides that, even if the shareholders had adopted a special resolution approving of a fundamental transaction, there are two circumstances in which a company may not implement the transaction without first obtaining the approval of a court:

(i) First, court approval is required where the special resolution was opposed by at least 15 per cent of the exercised voting rights, and [26] any person who had voted against it specifically requires the company to seek court approval. In other words, where the merger resolution receives the support of less than 85 per cent (ie between 75 and 85 per cent support), any dissenting person who had voted against it may require the company to apply for court approval of the transaction. In this event the company must either treat the resolution as a nullity or, alternatively, apply to the court for approval, [27] in which case the company itself bears the costs of the court application.

(ii) Second, court approval is required where any shareholder who voted against the resolution makes a successful application [28] for leave (or permission) to apply to court for a review of the transaction. This applies regardless of the percentage support for the special resolution. The court may grant leave (or permission) only if it is satisfied that the applicant is in good faith; appears prepared and able to sustain the proceedings; and has alleged facts which, if true, would support an order to set aside the resolution. In these circumstances, the costs of the application for court approval would not necessarily be imposed on the company.

A shareholder may rely on these court approval provisions only if he or she (or it) had voted against the special resolution in respect of the merger or other fundamental transaction. In other words, the shareholder must in fact vote against the special resolution, as opposed to merely abstaining from casting a vote. Shareholders who were not entitled to vote on the resolution may not rely on this protective measure, nor for that matter may they rely on the appraisal remedy.

When reviewing a resolution in either of the above two circumstances, the court may set aside the resolution for the merger or other fundamental transaction only if-

(i) the resolution is manifestly unfair to any class of shareholders (or securities holders); or
(ii) the vote was materially tainted by a conflict of interest, inadequate disclosure, failure to comply with the Act, the Memorandum of Incorporation or any applicable rules of the company, or any other significant and material procedural irregularity.

The courts' interpretation of these grounds remains to be seen. The vote could be materially tainted by inadequate disclosure if, for instance, the board of directors failed to make disclosure to shareholders of sufficient and accurate information, to enable shareholders to reach a properly informed decision on how to vote on the merger resolution. In such circumstances, the resolution (even if it is adopted at the shareholders' meeting) would be flawed or tainted, and the appropriate remedy would be to set aside the merger. [29] Another example is that the vote could be materially tainted by a conflict of interest or inadequate disclosure if the directors of the target (or disappearing) company are self-interested in the merger, and stand to gain unfairly by way of excessive side-payments from the acquiring (or surviving) company offered to them as an inducement to secure their co-operation to the merger. The side-payments could, for instance, take the form of inflated severance payments, or directorships or even shares in the merged (or surviving) company. In these circumstances, the directors may not have negotiated the best price for the shareholders of the target company, and it may be appropriate to set aside the entire transaction. [30] Additional grounds for court review (which are not expressly mentioned in the Act) are likely to include fraud and material misrepresentation.

Accordingly, the court approval provisions enable the court to set aside a resolution before it is implemented by the company, and thereby to prevent the merger or other fundamental transaction from taking place. The exceptional requirement of court approval of a merger is undoubtedly an important safeguard. It serves a distinctly different purpose from the appraisal right. The court approval 'remedy' must be distinguished from the appraisal remedy and one must be careful not to confuse the two. The two remedies complement one another - they apply in different circumstances and they produce different results. First, the appraisal remedy is concerned with determining the fair value of shares in the company and does not prevent the implementation of the merger, while the court approval requirement is concerned with the review of the merger resolution and the possible setting aside of the merger. Second, the court approval requirement generally operates where there are procedural irregularities or unfairness. In such cases the appraisal right would be an ineffective safeguard. In contrast with the court approval 'remedy', the appraisal remedy (which is an exit mechanism and a safeguard against inadequate consideration) operates on a no-fault basis, where no wrongdoing need be alleged or proved (see further 17.2.4). It must be borne in mind that the right of shareholders to request a court review of a fundamental transaction is in addition to their appraisal rights. It must also be kept in mind that shareholders who are disgruntled by a fundamental transaction may possibly rely also on the oppression remedy, depending on the facts and the circumstances of the fundamental transaction. [31]

17.2.4 Appraisal right of dissenting shareholders

The innovative remedy of the appraisal right of dissenting shareholders is closely associated with the regime for fundamental transactions. The appraisal remedy applies not only in the context of statutory mergers, but also to schemes of arrangement and disposals of all or the greater part of the company's assets or undertaking. The appraisal right is best described as the right of a dissenting shareholder, who does not approve of a fundamental transaction, to have its shares bought out by the company in cash, at a price reflecting the fair value of the shares. Thus, instead of having recourse to a court of law to object to the transaction, aggrieved shareholders would generally exercise their appraisal rights and, in this way, opt out of the transaction.

The Act states that the holder of any voting rights in a company is entitled to seek relief under the appraisal remedy if he or she (or it) *(a)* had notified the company in advance of the intention to oppose the special resolution for the merger (or other fundamental transaction); and *(b)* had been present at the meeting and voted against that special resolution. The principal safeguard for dissenting minority shareholders in mergers and other fundamental transactions is the appraisal right, and not the sanction of the court. The crux of the appraisal right is that it merely gives dissenting shareholders the right to claim the fair value of their shares. As discussed above, where a proposed merger or other fundamental transaction has received the proper approval of the majority shareholders (by special resolution), the dissenting shareholders generally have no legal basis to prevent the transaction (save in certain limited circumstances where court approval of the transaction is required, as discussed in 17.2.3). Instead, their recourse is to rely on their appraisal rights to obtain the fair value of their shares from the company, and thus to opt out of the fundamental transaction and indeed opt out of the company.

The underpinning object of the appraisal right is to provide dissenting shareholders with a means of exit from the company (particularly where the merger consideration takes the form of shares in the merged company). The appraisal remedy has the equally important purpose of giving dissenting shareholders a means to challenge the adequacy and the fairness of the consideration that they are to receive in a fundamental transaction (particularly where the merger consideration takes the form of cash).

The appraisal right is thus closely linked to statutory mergers and fundamental transactions. It is a remedy that provides a balance between the rights of the majority shareholders and the rights of the minority shareholders in a company. To elaborate on this, the Act provides simplicity and leniency for the prescribed majority shareholders, by way of majority (or supermajority) rule, to approve a fundamental transaction; in turn, the lenient procedures for fundamental transactions are counterbalanced (or offset) by granting appraisal rights to the minority shareholders who disagree with the fundamental transaction. The importance of the appraisal right is that it enables the disgruntled shareholders to opt out of the fundamental transaction - but not to prevent it.

For a detailed discussion of the appraisal right, refer to Chapter 18: Shareholder remedies and minority protection.

17.2.5 Protective measures for shareholders and creditors in the merger procedure

The statutory merger procedure facilitates business combinations and fundamental transactions. Takeovers and fundamental transactions in general are increasingly viewed as being beneficial to corporate efficiency, to the economy, and to wealth creation. As a matter of policy, business combinations are now seen as an important market mechanism to replace inefficient management with more competent management. This is because if directors fail to run a company efficiently, this renders the company easy prey for a takeover by more efficient management. The result is that resources would be allocated to more productive use.

The emphasis is now placed on attaining the appropriate balance of the interests of all the shareholders. It is essential to avoid either minority oppression by the majority shareholders or, its converse, minority dictation (which would enable minorities perversely to obstruct the improved management of a company that could result from a merger).

A number of mechanisms are built into the statutory merger procedure to protect shareholders. The protective measures for shareholders include the following:

(i) Shareholder approval: Shareholder approval of merger agreements is required, in the form of a special resolution. This vital safeguard has been

discussed in detail in 17.2.2.3, including the significance of the quorum requirement, the 75 per cent approval threshold, and the minority protection measure in an interested transaction.

(ii) The appraisal right: This is the prime protective measure for shareholders in a merger, in that dissenting shareholders may have recourse to their appraisal rights to opt out of the merger (see 17.2.4).

(iii) Court approval: This is not a general requirement for a merger but is required only in certain exceptional circumstances (as discussed in 17.2.3). It enables the court to set aside or prevent the merger.

(iv) The role of the board of directors: The fiduciary duties of directors also provide protection for shareholders in the event that a merger is proposed.

Besides the protective measures for shareholders, the statutory merger procedure also contains inherent protective measures for creditors of the merging companies. The creditors of the merging companies clearly require protection, because after the merger the creditors of each of the merging companies would be in competition with one another. The protective measures for creditors include the following:

(i) The effect of the merger itself is that all the liabilities of the constituent merging companies automatically, by operation of law, become liabilities of the surviving merged company. [32] This includes unknown liabilities and contingent liabilities. In this way, creditors' claims are neither extinguished nor wiped out, although they are changed.

(ii) Creditors' interests are protected by the requirement that a merger may only be effected if each merged company would, upon implementation of the merger, satisfy the solvency and liquidity test. This is clearly a very important safeguard for creditors.

(iii) Written notice of the merger has to be given to all known creditors of the merging companies, thus ensuring that all creditors are made aware of the proposed merger.

(iv) Objecting creditors are provided with a remedy under the Act (as discussed in 17.2.2.4).

17.2.6 Types of merger structures

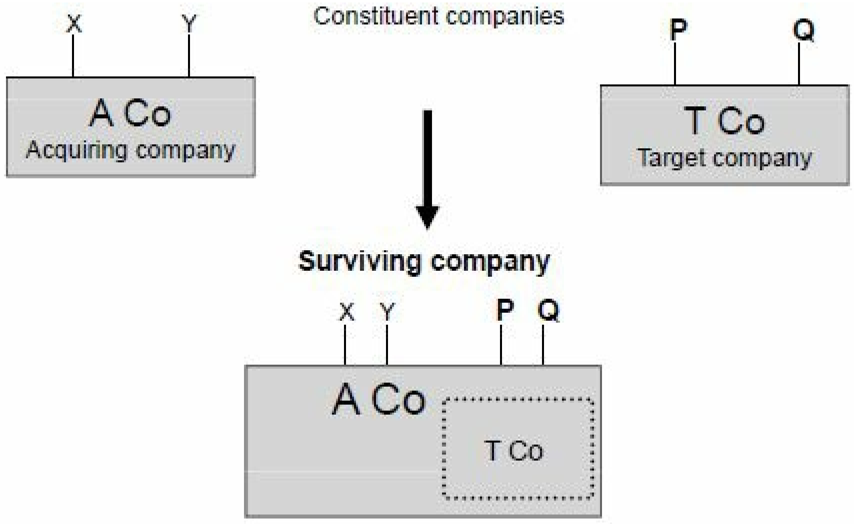
Various types of merger structures are permissible under the Act. As discussed in 17.2.2.1, the Act is widely drafted to permit substantial latitude in respect of the types of merger consideration. In turn, this makes it possible to devise an assortment of merger structures, each with its own particular uses and advantages. The availability of a variety of merger structures caters for differing circumstances and needs for mergers. A merger under the Act is not merely limited to the traditional concept of the pooling of two companies into one company. The Act also allows for cash mergers, freeze-out mergers, triangular mergers and reverse triangular mergers.

17.2.6.1 'Pooling'-type merger

The Act clearly encompasses the traditional concept of a merger as a 'pooling'-type transaction. In a pooling-type merger, two companies are pooled into one company that holds the combined pool of assets and liabilities previously held severally (or individually) by the two constituent merging companies, and the two sets of shareholders of the two merging companies are also pooled together and continue to participate as shareholders in the merged company.

With regard to the merger consideration, the general principle is that the consideration in a merger is usually or effectively paid to the shareholders of the target (or disappearing) company, in consideration for their shares in the target (disappearing) company. In the traditional 'pooling' type merger, the shareholders in the target (or disappearing) company usually receive their merger consideration in the form of *shares* in the acquiring (or surviving) company. (See Diagram 17.3.)

Diagram 17.3: 'Pooling' type merger

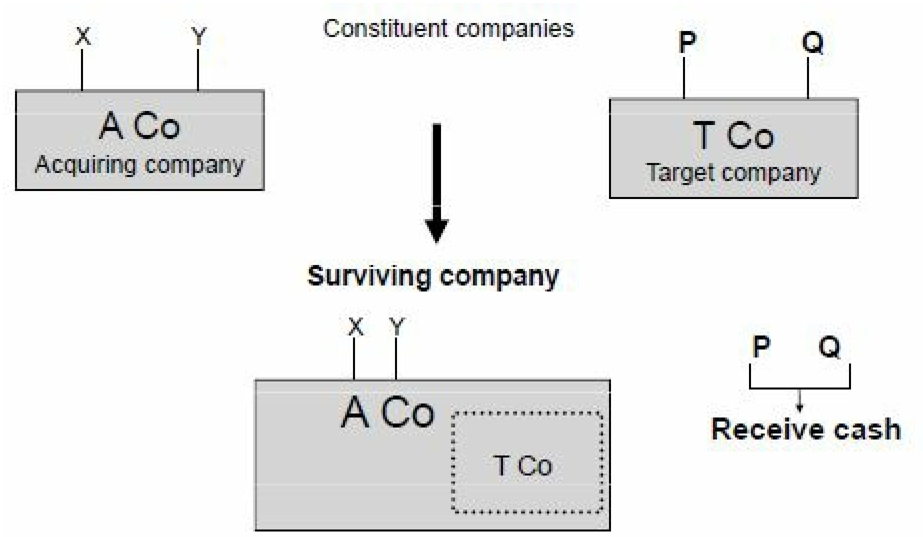


In this event, it seems that the shares of the disappearing company are conveniently *converted* [33] automatically (ie simply by operation of law) into shares of the surviving company upon the implementation of the merger agreement.

17.2.6.2 Cash merger

Significantly, a *cash* consideration is permissible under the Act. The relevant provisions on this possibility are quite liberal. The underpinning policy of paying a cash consideration to the shareholders of the disappearing company is simply that shareholders do not have a vested right to continue to hold their investment as shareholders of the surviving merged entity, but can instead be 'cashed-out'. In this way, shareholders may be compelled under a merger to disinvest from the company. (See Diagram 17.4.)

Diagram 17.4: Cash merger

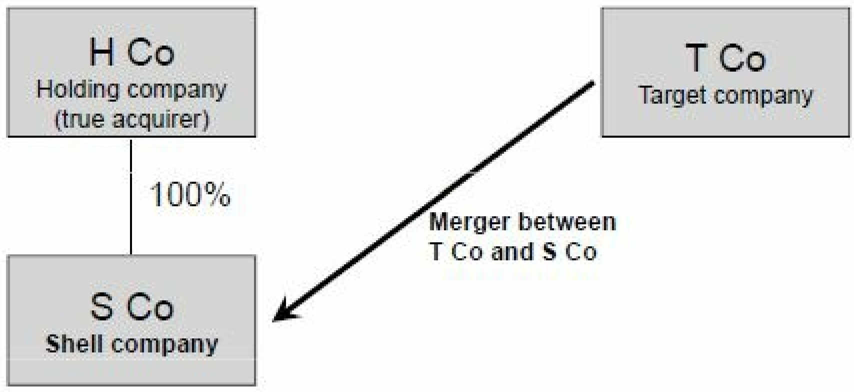


A cash merger creates a definite scope for using the statutory merger procedure as a means to 'squeeze out' or eliminate the minority shareholders of a company. This is done by compelling the minority shareholders, under the merger agreement, to exchange their shares for cash. (This may be referred to as a 'freeze-out merger' or 'cash-out merger'. [34])

17.2.6.3 Triangular and reverse triangular merger

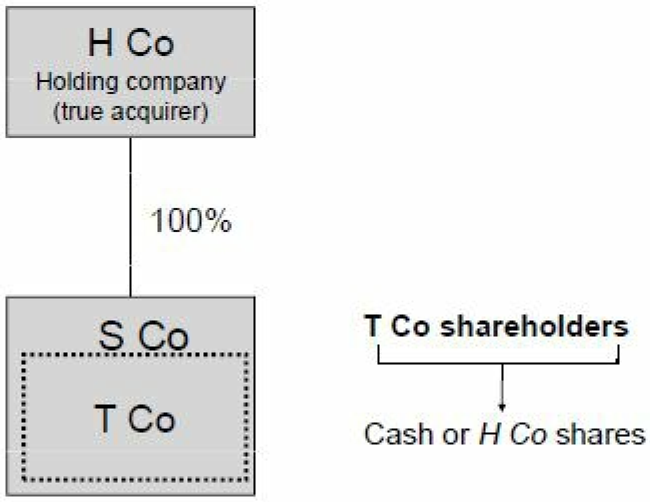
Another liberal form of merger consideration permitted by the Act is consideration in the form of *shares in another company* other than the surviving merged entity. [35] This is a vitally important form of consideration, because it facilitates the triangular merger and reverse triangular merger. In these merger structures, shareholders frequently receive shares in the *holding* company of the surviving merged company. They may alternatively receive cash. The triangular and reverse triangular mergers are popular and useful structures. A great disadvantage which plagues many merger structures (as discussed in 17.2.1.4) is the general rule that the liabilities of the disappearing (or target) company automatically become the liabilities of the surviving (or acquiring) company. This, in practice, may deter many mergers. However, a valuable means to circumvent this problem is provided by the triangular and reverse triangular mergers. One of the main benefits of the triangular and reverse triangular merger structures is that they enable an acquiring company to avoid assuming the liabilities of the target company. As its name suggests, the triangular merger involves three companies. On the target side of the transaction is the target company ('Co T'), while on the acquiring side of the transaction are two companies, being the holding company ('Co H') which is the *would-be* acquirer (or the true acquirer) in the transaction, together with its *wholly-owned subsidiary* ('Co S'). Co S is invariably a newly formed company, which is formed specifically for the purpose of the merger. It is also a shell company, which holds neither assets nor liabilities of its own. Co S functions as the acquisition vehicle in the merger. In other words, the merger is technically between Co T and Co S; Co H is *not* directly a party to the merger. (See Diagram 17.5.)

Diagram 17.5: Triangular Merger



The merger is structured so that Co T merges into Co S, ie Co T is the disappearing company, with Co S remaining in existence as the surviving company (see Diagram 17.6).

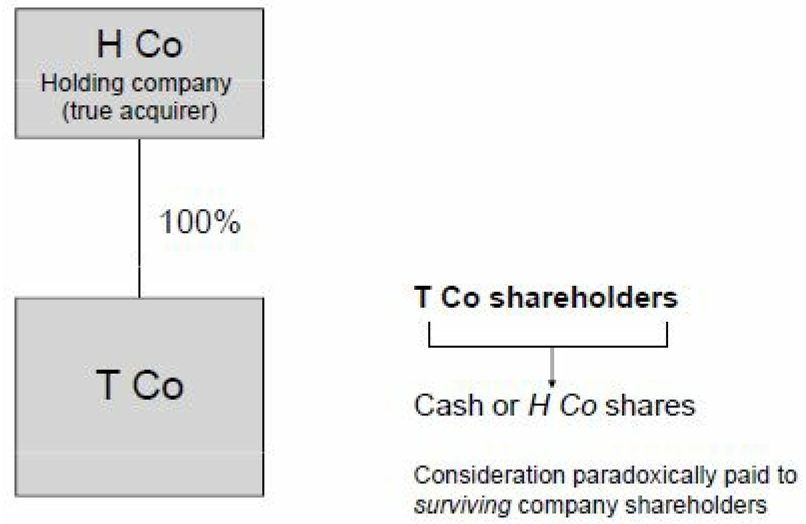
Diagram 17.6: Outcome of triangular merger



The end result is that, on the implementation of the merger, the target company (in substance) becomes the *wholly-owned subsidiary of Co H* (the true acquirer). This type of merger is called a triangular merger because there are three companies involved. The triangular merger may be contrasted with the standard (two-party) type of merger. In the standard merger, the disappearing or target company is *directly* absorbed or fused into the acquiring company. By contrast, in a triangular merger, the target company becomes the *subsidiary* of the true acquirer.

The advantage of the triangular merger structure is that it enables Co H to acquire and conduct the business of Co T in a separate wholly-owned subsidiary company. As such, it enables the business of the target company (as well as its customer relationships and goodwill) to remain substantially intact and unchanged. This is especially convenient where the businesses of Co H and the Co T are of different natures and are best kept separate and distinct. More importantly, the paramount advantage of the triangular merger is that it enables Co H to isolate (or ring-fence) Co T's liabilities in a separate legal entity (ie the wholly-owned subsidiary company). In this way, the true acquiring company is protected from the liabilities of the target company. The reverse triangular merger structure is similar to the triangular merger. The essential difference between the two is that in the triangular merger, Co T merges into Co S, with *Co S* remaining in existence as the surviving company; whereas in the reverse triangular merger the roles are reversed, so that it is Co S that merges into Co T, with the result that *Co T* (and not Co S) is the surviving company. (See Diagram 17.7.)

Diagram 17.7: Outcome of reverse triangular merger



The reverse triangular merger serves an important purpose in circumstances where it is vital to preserve Co T's corporate personality. This applies where Co T, for instance, has valuable licences, leases or other important contracts that would terminate if Co T were to disappear under a merger. In order to preserve these

contracts or licences, the legal existence of Co T would have to be maintained under the merger, and this may be achieved by using a reverse triangular merger.

17.2.6.4 Short-form merger

It is noteworthy that the Act fails to make provision for a simplified or short-form merger procedure in the case of a merger between a holding company and its wholly-owned subsidiary, or a merger between two wholly-owned subsidiaries of a holding company. This is disappointing. A simplified short-form merger procedure in these circumstances would undoubtedly generate many benefits and advantages for South African companies.

17.3 Disposal of all or the greater part of the assets or undertaking of a company

17.3.1 Concept of a disposal of all or the greater part of assets or undertaking

Where a company proposes to 'dispose of all or the greater part of its assets or undertaking', the approval requirements of the Act [36] are triggered. Accordingly, the meaning and interpretation of the terms 'dispose' and 'all or the greater part' are of key importance. These concepts are discussed below.

17.3.1.1 Meaning of 'dispose'

The general principle is that a 'disposal' of a company's assets or undertaking is a transaction that would have the effect of permanently depriving the company of its right to ownership of the assets involved. The term 'dispose' thus refers to a disposal in the form of a transfer of ownership. [37]

Consequently, a sale of the company's assets would clearly amount to a 'disposal', because it involves a permanent transfer of the ownership of the relevant assets.

But on the other hand, the passing of a mortgage bond over the company's assets does not constitute a 'disposal' for this purpose. This is because the passing of a mortgage bond is not an absolute disposal of ownership, and does not have the effect of depriving the company of its ownership of the assets. It is rather a transaction that exposes the company's assets to the risk of forced disposal due to borrowing. A mere encumbrance of assets, as in a mortgage, pledge or *cession in securitatem debiti*, does not amount to an out-and-out 'disposal'. Similarly, the grant of a pre-emptive right (or a right of first refusal to purchase the assets) is not a 'disposal' of any assets. All that the right of pre-emption does is to preclude the company from selling the assets to anyone else until the holder of the right of pre-emption has had the opportunity to exercise the right.

17.3.1.2 Meaning of 'all or the greater part' of the assets or undertaking

The requirements of the Act apply only where a company proposes to dispose of 'all or the greater part' of its assets or undertaking. The scale for 'all or the greater part of the assets or undertaking' of a company is as follows: [38]

- *(a)* in the case of the company's assets, more than 50 per cent of its gross assets fairly valued, irrespective of its liabilities; or
- *(b)* in the case of the company's undertaking, more than 50 per cent of the value of its entire undertaking, fairly valued.

The scale is thus tipped where more than 50 per cent of all the company's gross assets are or more than 50 per cent of the value of the company's entire undertaking (fairly valued) is disposed of. Once the disposal entails more than 50 per cent of the fair value of the company's gross assets or entire undertaking, this will trigger the shareholder protective mechanism of a special resolution to approve of the disposal and the other approval requirements of the Act.

Accordingly, in determining whether 'the greater part' of the assets or undertaking of a company is being disposed of, what is really required is a calculation of the value of the specific assets or undertaking being disposed of, in relation to the value of all the assets or the entire undertaking of the company. The method of calculation may be referred to as a quantitative test, which is based on a mathematical asset calculation, that is, the size of the transaction in relation to the company. South African law does not apply a qualitative approach which would take account of other factors such as the character of the assets being sold and the result.

The Act [39] states further that-

> [a]ny part of the undertaking or assets of a company to be disposed of ... must be fairly valued, as calculated in the prescribed manner, as at the date of the proposal, which date must be determined in the prescribed manner.

The intention is that the value of the relevant assets or undertaking must be calculated at a fair value (in the prescribed manner) as at the date of the proposal. The requirement of a fair value constitutes one of the protective measures for such transactions.

(See Diagrams 17.8 and 17.9 for an illustrative example of a disposal of the greater part of the assets of a company.)

Diagram 17.8: Disposal of the greater part of the assets of a company

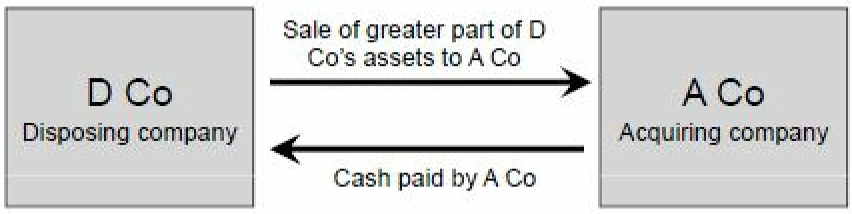


Diagram 17.9: Outcome of the disposal of the greater part of the assets of the company

17.3.2 Approval requirements for disposals of all or the greater part of the assets or undertaking

Once a proposed transaction amounts to a 'disposal' of 'all or the greater part' of a company's assets or undertaking, the approval requirements of the Act [40] are triggered. The Act states that a company may not dispose of all or the greater part of its assets or undertaking unless the transaction [41] has been approved by a special resolution of the shareholders and the company has satisfied all the other approval requirements, which are discussed below.

Notably, these requirements are similar to the requirements for the approval of an amalgamation or merger. The reader is accordingly cross-referred to the section on amalgamations or mergers where appropriate. As discussed above, the Act to a large extent harmonises the approval requirements for all three types of fundamental transactions, particularly the requirement of shareholder approval by special resolution, the exceptional requirement of court approval and the appraisal rights of dissenting minority shareholders (subject to some important differences).

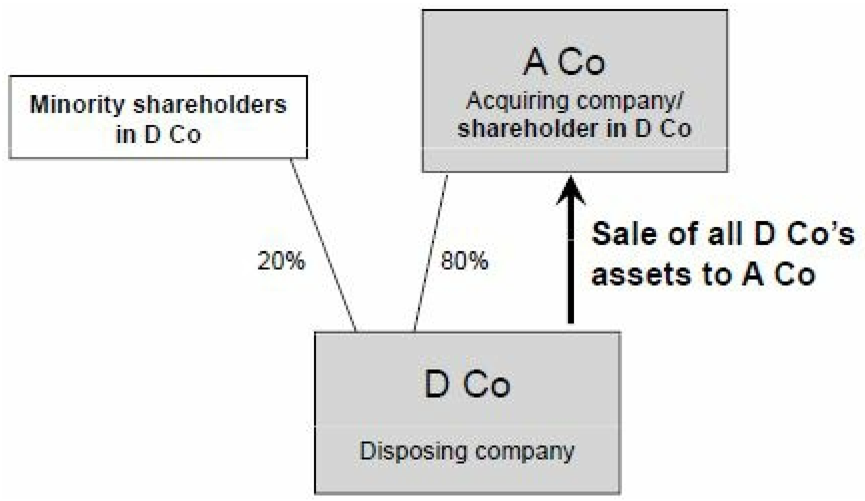
17.3.2.1 Special resolution of the shareholders

A company may not dispose of all or the greater part of its assets or its undertaking unless the disposal has been approved by a special resolution. It is the shareholders of the disposing company (ie the company that wishes to dispose of all or the greater part of its assets or undertaking) whose approval is required. The approval of the shareholders of the acquiring company (ie the company that wishes to acquire the relevant assets or undertaking) is not required. This may be contrasted with an amalgamation or merger, where the shareholders of both (or all) the constituent merging companies must approve the transaction.

The special resolution approving the proposed disposal must be adopted at a meeting called for that purpose. A notice of the shareholders' meeting to consider the resolution must be delivered to each shareholder of the company (within the prescribed time and in the prescribed manner), and must include a written summary of the precise terms of the transaction or series of transactions as well as the provisions of the Act [42] relating to the required approvals for the transaction and the appraisal right. (This is important, because shareholders may be unaware of their appraisal rights and how to exercise them, or of the court approval provisions.) The quorum for the meeting is constituted by the presence of at least 25 per cent of all the voting rights that are entitled to be exercised. A company's Memorandum of Incorporation may specify a higher percentage (but not a lower percentage) in place of the 25 per cent requirement for the quorum. The special resolution must be adopted with the support of at least 75 per cent of the exercised voting rights. [43] The requirement of a special resolution for disposals of all or the greater part of the assets or undertaking of a company - as opposed to an ordinary resolution - ensures more adequate protection of minority shareholders. It is a stricter requirement, which ensures that minority shareholders who disapprove of the transaction are not left overly vulnerable to oppression by the majority shareholders who are in favour of the transaction. [44] At the same time, the requirement of a special resolution is not too strict and still preserves enough flexibility for companies to effect fundamental changes without too easily allowing a troublesome minority to frustrate the transaction.

It is significant that any voting rights controlled by an 'acquiring party' (or a person related to or acting in concert with an acquiring party) must be excluded from the quorum and must be disqualified from voting on the special resolution. The underlying object is to introduce a minority protection measure, and to prevent a conflict of interest in an interested transaction which is not at arm's-length. In other words, where a party is simultaneously the *acquiring party* in a disposal (eg the purchaser) as well as a *shareholder in the disposing company* (eg the seller), the acquiring party stands on both sides of the transaction and thus has a conflict of interest. In such cases, the acquiring party (or purchaser) cannot vote its shares to support the disposal by the disposing company (or seller). For instance, A Co holds 80 per cent of the shares in D Co, while the remaining 20 per cent of D Co's shares are held by a number of minority shareholders. D Co (the disposing company) proposes to sell all its assets to A Co (the acquiring company). For this purpose, a special resolution of D Co's shareholders is required to approve the transaction. (See Diagram 17.10.)

Diagram 17.10: Illustration of an interested transaction



Since A Co is the *acquiring company* in the transaction, A Co is disqualified from voting any of its shares in D Co on the special resolution. Consequently, only the minority shareholders of D Co are able to vote on D Co's special resolution. [45] The special resolution will be adopted only if it has the support of 75 per cent or more of the voting rights exercised by D Co's minority shareholders. This protects the minority shareholders of D Co, and prevents a conflict of interest on the part of A Co.

It is noteworthy that the directors are prevented from obtaining a *general* authority to enter into any agreement for a disposal (of all or the greater part of the company's assets or undertaking) as they might in future deem advisable. A special resolution for a disposal is effective only to the extent that it authorises a *specific* transaction. The object of this requirement evidently is that the shareholders must exercise control over disposals.

It is significant that a disposal must be 'authorised' - but not 'ratified' - by special resolution. The previous reference in the Act to the 'ratification' of disposals has been abolished. [46]

See further 17.2.2.3 for a more detailed discussion of various important aspects of the shareholder approval provisions, including the quorum requirement, the requisite support for the special resolution, and the minority protection measure under the Act.

17.3.2.2 Special resolution of the holding company

A special resolution of the *holding* company is also required in certain circumstances. For the purpose of clarity it must be noted at the outset that this requirement relates to the disposing company's holding company, ie the parent of the company that is disposing of its assets or undertaking. When a disposal of all or the greater part of its assets or undertaking is proposed by a company that is a *subsidiary*, [47] and the disposal by the relevant subsidiary company will (having regard to the holding company's consolidated financial statements) constitute a disposal of all or the greater part of the assets or undertaking of the *holding company*, then in these circumstances the transaction must also be approved by a special resolution of the shareholders of the *holding company*. [48]

It must be emphasised that such transactions require the approval of both sets of shareholders, ie that of the disposing subsidiary company as well as that of its holding company. The special resolution of the holding company must be adopted in the same manner as required for the special resolution of the disposing subsidiary company itself (see 17.3.2.1).

This requirement of a special resolution by the holding company has the object of protecting the shareholders of the holding company. It gives them both voting rights and appraisal rights in respect of relevant disposals by a subsidiary company.

(This provision evidently applies only to disposals of all or the greater part of a company's assets or undertaking, and not to the other fundamental transactions.)

17.3.2.3 Takeover Regulation Panel

To the extent that the company is a 'regulated company', which is subject to the takeover provisions of the Act and the Takeover Regulations, [49] the company may not implement a disposal of all or the greater part of its assets or undertaking unless the Takeover Regulation Panel has issued a compliance certificate in respect of the transaction or has exempted the transaction.

17.3.2.4 Court approval

The approval of the court is not a general or automatic requirement for disposals of all or the greater part of a company's assets or undertaking (or for other fundamental transactions). Court approval is instead restricted to certain specified circumstances. For a detailed discussion of the requirement of court approval - including the circumstances in which court approval is required, the grounds on which a court may set aside a resolution in respect of a disposal, and the distinction and interplay between the 'remedy' of court approval and the appraisal remedy - refer to 17.2.5.

17.3.2.5 Appraisal right of dissenting shareholders

The appraisal right applies in respect of disposals of all or the greater part of the assets or undertaking of a company (and the other fundamental transactions). A person who holds any voting rights in the disposing company is entitled to have resort to the appraisal remedy if he or she *(a)* had notified the company in advance of the intention to oppose the special resolution for the fundamental transaction, and *(b)* had been present at the meeting and voted against that special resolution. Merely abstaining from voting does not suffice for this purpose. The importance of the appraisal right is that it allows the dissenting shareholders to opt out of the

fundamental transaction - but it does not allow them to prevent the transaction. For a discussion of the appraisal right in the context of fundamental transactions, refer to 17.2.6. (See also Chapter 18: Shareholder remedies and minority protection.)

17.3.2.6 Other

Finally, once a disposal of all or the greater part of the assets or undertaking of a company (or any other fundamental transaction) has been approved, any person to whom the assets or undertaking are to be transferred may, if necessary, apply for a court order to give effect to the transaction. This may include an order to effect the transfer of the relevant undertaking, assets and liabilities; the allotment and appropriation of any relevant shares or similar interests; the transfer of shares from one person to another; the dissolution without winding-up of a company, as contemplated in the transaction; any other relief necessary or appropriate to give effect to and properly implement an amalgamation or merger; or any incidental, consequential and supplemental matters that are necessary for the effectiveness and completion of the transaction. This provision applies to all three types of fundamental transactions.

It is essential to note that in a disposal of the assets or undertaking of a company, the parties must comply with the relevant legal formalities for the transfer of the assets or the undertaking. There is no automatic transfer of assets and liabilities, as occurs in the case of a statutory merger. As discussed in 17.2.1.4, the statutory merger has the great advantage that all the property and obligations of the constituent merging companies are automatically transmitted (ie transferred simply by operation of law) to the merged company. A second significant advantage of the statutory merger, as opposed to a disposal of the assets or undertaking of a company, is that the disappearing companies in a statutory merger are simply and conveniently deregistered by the Companies Commission without the need for any formal winding-up.

17.3.3 Exemptions

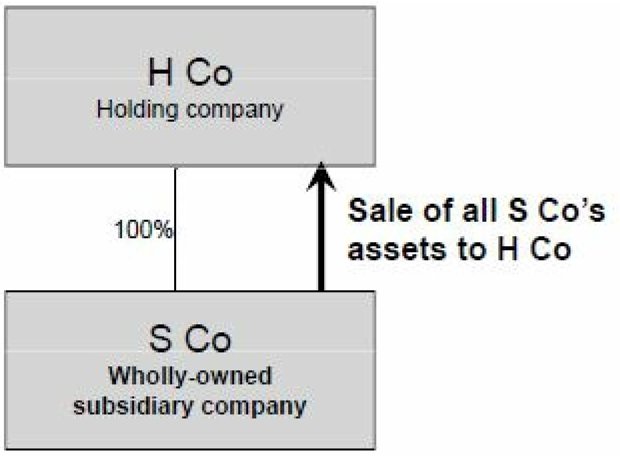
Certain proposals to dispose of all or the greater part of the assets or the undertaking of a company are exempt from the approval and other requirements set out in 17.3.2.

First, these requirements do not apply if the disposal is pursuant to a business rescue plan. [50]

Second, these requirements do not generally apply to intragroup disposals, that is, where a disposal takes place within a group of companies. To be more specific, a disposal of all or the greater part of a company's assets or undertaking is exempt from the approval requirements if the disposal is-

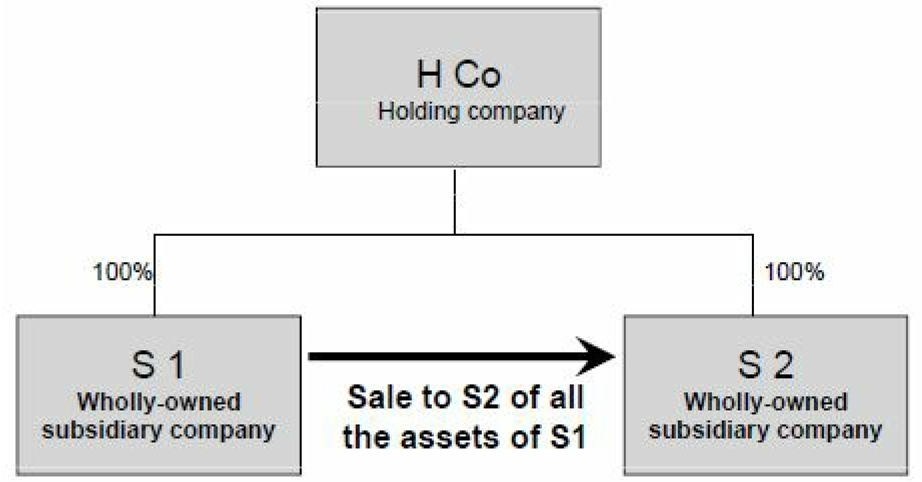
(i) between a wholly-owned subsidiary and its holding company (see eg Diagram 17.11);

Diagram 17.11: Exempted disposal between wholly-owned subsidiary and holding company



(ii) between or among two (or more) wholly-owned subsidiaries of the same holding company (see eg Diagram 17.12); or

Diagram 17.12: Exempted disposal between two wholly-owned subsidiaries of a holding company



(iii) between or among a wholly-owned subsidiary of a holding company, on the one hand, and its holding company and one or more wholly-owned subsidiaries of that holding company, on the other hand.

The exemption of these intragroup transactions avoids the unnecessary delay, costs and inconvenience of convening a shareholders' meeting to approve of the disposal. This applies particularly where the disposing company is the wholly-owned subsidiary,

in which the holding company holds all the voting rights. In such cases the special resolution of the wholly-owned subsidiary to approve of the transaction (if this were required) would be a non-issue or a superfluous formality, since all the voting rights are held by the holding company.

17.4 Schemes of arrangement

17.4.1 Introduction

A scheme of arrangement results in a binding agreement between the company and the holders of its securities. In terms of the principles of contract law, if a company wants to reorganise its structure or affairs in such a way that it in effect constitutes a new agreement with the holders of its securities, it needs to conclude a separate agreement with each and every one of the holders of its securities individually. This would be legally, logistically and practically very difficult to do and therefore the scheme of arrangement was created as a legal mechanism to assist with the implementation of such a reorganisation. In effect, provided that the company follows the correct procedures and obtains the necessary support from the holders of its securities, the new arrangement will become binding on the holders of all its securities, whether they specifically agreed to it or not. A scheme of arrangement is a fundamental transaction and therefore needs to comply with all the relevant requirements. [51] However, it must also meet certain requirements which apply only to schemes of arrangement.

17.4.2 Proposal for scheme of arrangement

The board of directors of a company may propose a scheme of arrangement between the company and the holders of any class of its securities. [52] The scheme of arrangement may be implemented if the approvals required in the Act are obtained [53] and the arrangement then becomes binding on the company and all its shareholders (including those who voted against the proposed scheme). The arrangement can be used for a number of purposes, including a reorganisation of the share capital of the company, which can be structured or effected in any number of ways. A scheme of arrangement is also sometimes used as a takeover mechanism. This happens as follows: Company A proposes a scheme of arrangement in terms of which its shareholders relinquish their shareholding in exchange for a specified monetary consideration (or shares in another company or a combination of the two). Company B, which wants to acquire the shares in Company A, hands over the cash or shares to Company A and the holders of securities hand over their securities certificates. Company A ensures that all the shares are now registered in the name of the acquiror (Company B), which becomes the sole shareholder and controller of Company A, and that all the consideration offered is paid to the previous shareholders.

17.4.3 Approval and other requirements for schemes of arrangement

17.4.3.1 General

Previously, under the 1973 Act, the approval of the court was always required to effect a scheme of arrangement. However, now the approval procedure for a scheme of arrangement is on par with the procedures for other fundamental transactions. A scheme of arrangement cannot be implemented unless and until it has been approved in terms of the Act. This means that a scheme of arrangement must be approved by a special resolution at a meeting called for that purpose. The quorum required is the presence of persons sufficient to exercise at least 25 per cent of the voting rights entitled to be exercised on that matter. A special resolution requires the support of at least 75 per cent of the voting rights exercised on that resolution in order to be adopted.

The scheme of arrangement may also require the approval of the court in exceptional circumstances. The approval is required where the special resolution was opposed by at least 15 per cent of the voting rights voted on it and any person who had voted against it requires the company to seek court approval. The approval of the court is also required when, regardless of the percentage of support for the resolution, any person who voted against the resolution successfully applies for leave to make an application to court for a review of the transaction.

17.4.3.2 Independent expert

The company must retain an independent expert to compile a report concerning the proposed scheme of arrangement. This is not a requirement for other fundamental transactions. The independent expert must-

(i) be qualified and have the necessary competence and experience;
(ii) be able to express opinions, exercise judgment and make decisions impartially;
(iii) not have any other relationship with the company or with a proponent of the arrangement which would lead a reasonable and informed third party to conclude that the integrity, impartiality or objectivity of the expert is compromised by that relationship;
(iv) not have had any such relationship within the immediately preceding two years;
(v) not be related to a person who has or has had such a relationship.

17.4.3.3 Report

The independent expert must prepare a report [54] to the board concerning the proposed arrangement. He or she must cause the report to be distributed to all holders of the company's securities.

17.4.3.4 Takeover Regulation Panel

If the Act and the Takeover Regulations apply to a company that proposes to implement a scheme of arrangement, the company may not do so unless the Panel has issued a compliance certificate in respect of the transaction or has exempted the transaction. [55]

17.4.3.5 Court approval

As explained above, the approval of the court is not a general or automatic requirement for schemes of arrangement or other fundamental transactions, but is instead restricted to certain specified circumstances. [56]

17.4.3.6 Appraisal rights of dissenting shareholders

Appraisal rights apply to all the fundamental transactions, including schemes of arrangement. The holder of any voting rights in a company is entitled to seek relief in terms of the provision dealing with the dissenting shareholders' appraisal rights [57] if that person *(a)* notified the company in advance of his or her intention to oppose the special resolution for the fundamental transaction, and *(b)* was present at the meeting and voted against that special resolution. [58] Merely to abstain from voting is not sufficient. The appraisal right allows dissenting shareholders to *opt out* of the fundamental transaction but not to prevent it.

17.4.3.7 Other

Once a scheme of arrangement (or other fundamental transaction) has been approved, any person to whom assets or an undertaking are to be transferred may, if necessary in the circumstances, apply to a court for an order to give effect to the transaction. In a scheme of arrangement the parties have to comply with the relevant legal formalities for the transfer of the assets (such as securities) or the undertaking. There is no automatic transfer by operation of law, as in the case of a statutory merger.

17.5 Takeovers and offers

17.5.1 General

This area of company law is primarily concerned with transactions which result, or may result, in the acquisition of control of a regulated company or a change in the control of a regulated company. These types of transactions (as well as the actions of the parties involved) are carefully monitored and regulated to ensure that all the holders of securities in the companies involved are treated equitably and fairly and have equal access to the same information. This protects the holders of securities who do not control the company (minority shareholders) as well as the integrity of the market. The great majority of the sections in the Act and the Regulations dealing with takeovers are aimed at achieving these objectives.

17.5.2 Legislation

The law which applies to takeovers and offers is contained in Part B and Part C of Chapter 5 of the Act and in the Takeover Regulations. The Takeover Regulations are made by the Minister, in consultation with the Takeovers Regulation Panel ('the Panel'). The JSE Listings Requirements also deal with takeovers and offers where one of the parties involved is a listed company, because the JSE requirements also contain, for example, requirements relating to disclosure, prohibited dealing, circulars and announcements.

17.5.3 Application of the Act

The law of takeovers and offers turns on certain key definitions in the Act. The Act and Takeover Regulations apply to 'an affected transaction' or an 'offer' involving 'regulated' companies. Therefore it is important to determine whether a particular transaction qualifies as an affected transaction or an offer (as defined) in order to establish whether it is subject to the relevant sections, Takeover Regulations and the jurisdiction of the Panel. This is not always easy, because offers and transactions can be structured in a number of complex ways.

The takeover provisions do not apply to all companies; they apply only to 'regulated companies'. A profit company is a regulated company if it is-

(i) a public company;
(ii) a state-owned company; or
(iii) a private company, but only if–
- more than a prescribed percentage of its securities have been transferred within a 24-month period; or
- its Memorandum of Incorporation expressly provides that the company and its securities are subject to Part B, Part C and the Takeover Regulations.

Any person making an offer-

(i) must comply with all the reporting or approval requirements set out in Part B or C or the Takeover Regulations; and
(ii) may not give effect to an affected transaction unless the Panel has issued a compliance certificate for the transaction. [59]

It is, however, possible for the Panel to exempt an affected transaction or an offer from the application of the Act.

17.5.4 Takeover Regulations

The Takeover Regulations deal with and regulate -

(i) the interpretation and application of the takeover provisions;
(ii) the general rules respecting negotiations and offers;
(iii) announcements and offers;
(iv) the duties and conduct of the offeree and directors; and
(v) procedures of the Panel.

While it is not possible to deal with all the Takeover Regulations in this chapter,

certain illustrative principles will be highlighted. For example, it sometimes happens that there are two or more offeror companies vying for control of the same target company (the offeree company) at the same time. One of the principles of the Takeover Regulations is that all offerors are entitled to receive the same information promptly from the offeree company, and the offeree company is bound to provide this to the preferred offeror and any other less welcome but *bona fide* offeror. [60] Furthermore, to preserve the integrity of the market and ensure fairness to the holders of securities of regulated companies, it is essential that all negotiations between an independent board and an offeror must be kept confidential. Strict confidentiality rules apply during the negotiations and the Takeover Regulations dictate the type and level of information to be disclosed in various mandatory public announcements.

The Takeover Regulations also deal with the manner in which offers must be conducted and public announcements prescribed in relation to the offer process generally. A series of public announcements is required during the course of the offer process. [61] The Takeover Regulations also prescribe the general timeline along which an offer must be structured. [62] The companies involved in an affected transaction or offer may be required to produce a circular, [63] a detailed information document issued by a company to the holders of its securities for the purpose of compliance with the Act and the Takeover Regulations. It is subject to strict information and disclosure requirements to ensure that the holders receive adequate and accurate information about the transaction.

The specific duties and the standard of conduct expected from the board of directors of an offeree and offeror company during the offer period are also prescribed in the Takeover Regulations. So, for example, the offeror is not permitted to make any appointments to the board of an offeree regulated company or exercise votes attaching to any securities held in the offeree regulated company. As far as the duties of the directors of offeree regulated companies are concerned, the directors must not resign during the offer period and it is vital that the board of directors of the offeree company make an independent, informed decision in order to express an opinion on an offer and on the offer consideration. There are detailed rules to ensure that only independent board members participate in the deliberations of the board and vote in respect of matters related to the offer. The legislation [64] also stipulates the action required by the independent board in order to arrive at a properly informed conclusion. This process includes obtaining appropriate external advice from an independent expert in the form of a fair and reasonable opinion, which must be communicated to the holders of its securities. [65] If the independent board is ultimately not unanimous in its opinion, all the differing opinions (with reasons) must be provided to holders of securities. [66]

17.5.5 The Takeover Panel

The Takeover Regulation Panel ('TRP' or 'Panel') is a juristic person. The Takeover Special Committee ('TSC') is a committee of the Panel which assists it with specific functions and duties. The efficient operation of these bodies is crucial to the functioning of an effective takeover regulation regime. The Panel is an extremely important and powerful body and has jurisdiction throughout South Africa. It is independent and subject only to the Constitution [67] and the law. It is an offence, punishable by a fine or imprisonment or both, [68] to hinder, obstruct or improperly attempt to influence the Panel when it is exercising a power or performing a duty delegated, imposed or conferred in terms of the Act. [69]

17.5.5.1 Functions

The specific responsibilities of the Panel are to-

(i) regulate affected transactions in accordance with the Act;
(ii) investigate complaints with respect to affected transactions and offers;
(iii) apply for a court order to wind up a solvent company in circumstances where there has been fraudulent or illegal activity and failure to comply with a compliance notice;
(iv) consult with the Minister in respect of amendments to the Takeover Regulations; and
(v) approve all documents relating to an affected transaction, including announcements and circulars, before posting or publication. [70]

In the performance of their functions and duties the Panel and the TSC will conduct hearings. The procedure to be followed at such hearings is based on court procedure but is informal. In addition, the TSC may hear and decide any matter referred to it by the Panel or the Executive Director and review compliance notices issued by the Executive Director.

17.5.5.2 Complaints to the Panel

Initiating a complaint

Any person may file a written complaint [71] with the Panel in respect of any matter contemplated in the Act or in the Takeover Regulations, alleging that-

(i) a person has acted in a manner inconsistent with the Act; or
(ii) the complainant's rights under the Act have been infringed; or
(iii) the complainant's rights under a company's Memorandum of Incorporation or the rules have been infringed.

No fee may be charged by the Panel in relation to the filing of a complaint except with the approval of the Tribunal. [72] A complaint may not be initiated more than

three years after the act or omission that is the cause of the complaint or (in the case of a course of conduct or continuing practice) the date on which the conduct or practice ceased. [73]

Investigation

The Panel may-

(i) refuse to investigate if the complaint appears frivolous or does not allege facts which support a remedy under the Act;
(ii) refer the complaint to the Tribunal or an accredited entity; or

(iii) direct an inspector to investigate the complaint as quickly as is practicable. [74]

Outcome of investigation

Once the Panel has received the inspector's report, the Panel may-

(i) excuse any person as a respondent in the complaint;
(ii) refer the complaint to another regulatory body;
(iii) issue a notice of non-referral;
(iv) commence court proceedings in the name of the complainant;
(v) refer the matter to the NPA if an offence has been committed; or
(vi) refer the matter to the Executive Director, who may issue a compliance notice. [75]

Issuance of compliance notices

The Executive Director may issue a compliance notice to any person whom he or she believes has contravened the Act or who has assented to, was implicated in or has benefited from such contravention. A compliance notice issued by the Executive Director may require the person to-

(i) cease, correct or reverse any contravening action;
(ii) take any action required by the Act;
(iii) restore assets or their value to a company or other person;
(iv) take any other reasonable steps designed to rectify the effect of the contravention. [76]

If the requirements of a compliance notice have been satisfied, the Executive Director must issue a compliance certificate. If the person to whom the compliance notice has been issued fails to comply with it, the Executive Director may either apply to court for the imposition of an administrative fine or refer the matter to the NPA to be prosecuted as an offence. [77]

Objection to notices

Any person issued with a compliance notice may apply to the TSC to review the notice. [78] Any decision made by the TSC (for example, to confirm, modify or cancel the compliance notice) is binding subject to any right of review by or appeal to a court. [79]

Referral of complaints to court

If the Panel issues a notice of non-referral in response to a complaint, the complainant has the right to apply to a court for leave to refer the matter directly to the court. [80]

Administrative fines

A court may impose an administrative fine on application by the Panel for failure to comply with a compliance notice. [81] The Act lists the factors to be considered by the court when determining an appropriate administrative fine. [82]

17.5.5.3 Powers to support investigations and inspections

The Panel would be powerless to conduct investigations and inspections properly and effectively without the ability to enforce its authority. To this end the Act has given the Panel the power, in specific circumstances, to issue a summons and enter and search premises under a warrant issued by the court. [83]

17.5.5.4 Administrative provisions applicable to Panel

The Act sets out a range of administrative provisions which apply to agencies (in this context the Companies Tribunal, the Panel or the Council). These provisions regulate the qualifications of Panel members, [84] conflicts of interest of Panel members, [85] resignations, removals from office and vacancies, appointment of inspectors, [86] the finances of the Panel, [87] review and reports to the Minister, [88] and confidential information submitted to the Panel. [89]

Questions

1. Co A, a prominent soft-drinks company, and Co T, a fruit-juice company, wish to combine their respective businesses by way of a statutory merger (or amalgamation). In terms of the merger, Co A will be the surviving company and Co T will be the disappearing company. This merger structure will enable them to preserve the identity of Co A and the goodwill that Co A enjoys as a leading soft-drinks company.
   (a) Advise Co A and Co T of the legal procedure and the formalities for the proposed merger.
   (b) Assume that Co A and Co T decide to proceed with the merger, and that they conclude a merger agreement in terms of which the shareholders of Co A are to remain as shareholders in the surviving merged company, while the shareholders of Co T are to receive a compensatory cash consideration. The prescribed majority of the shareholders of Co T approve of the merger by special resolution. X, a shareholder in Co T, is unhappy with the proposed merger, and in particular with the cash consideration. Advise X of any legal remedies that he may be able to resort to in this situation.
2. Co D, a company whose gross assets are fairly valued at R3 million, proposes to sell to Co A certain valuable machinery which it owns. The fair value of the machinery is estimated to be R2 million.
   (a) Does this constitute a fundamental transaction and, if so, exactly what type of fundamental transaction?
   (b) Advise Co D and Co A of the requirements for the approval of the above transaction.
   (c) Assume that Co D is a subsidiary of Co H. Explain the effect that this would have on your answer.
   (d) Assume that Co D is a wholly-owned subsidiary of Co A. How

would this fact affect your answer to *(b)*?

3. Ms Investa is a shareholder of Richco Limited. Richco proposes a scheme of arrangement in terms whereof its shareholders will return their shares to the company and will be paid R1 per share. All the shares will be transferred into the name of Winco, which will become the sole shareholder of Richco. Winco will be paying the funds to remunerate shareholders for their shares to Richco, which will then pass them on to the shareholders in return for the shares. Ms Investa thinks this is a dreadful idea and does not believe that R1 is adequate consideration. All the shareholders attend the meeting where they vote on the scheme. Ms Investa votes against the proposed scheme but 80 per cent of the Richco shareholders vote in favour thereof.
   (a) Does Ms Investa have any remedy in law or is she bound by the decision of the majority to sell her shares at R1 in terms of the scheme? Explain your answer.
   (b) Assume that the scheme of arrangement described in *(a)* is an 'affected transaction' within the meaning of the Act. At the same time that Winco suggests this scheme to the Richco board of directors, another company, Archco, also offers to acquire all the shareholding in the company at R1 per share. What specific duties, if any, do the directors of Richco have in terms of the Act and Takeover Regulations in relation to the competing offers in these circumstances?

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[*] Maleka Femida Cassim wrote sections 17.1 to 17.3 and Jacqueline Yeats wrote sections 17.4 and 17.5.

[1] See Chapter 18: Shareholder remedies and minority protection.

[2] The section on amalgamations and mergers in this chapter is largely derived from Maleka Femida Cassim 'The introduction of the statutory merger in South African corporate law: Majority rule offset by the appraisal right (Part I)' (2008) 20 *SA Merc LJ* 1 ('Maleka Femida Cassim (Part I)'); 'The introduction of the statutory merger in South African corporate law: Majority rule offset by the appraisal right (Part II)' (2008) 20 *SA Merc LJ* 147 ('Maleka Femida Cassim (Part II)'); 'The statutory merger in South African law' (2008) 16(2) *JBL* 40, and the authorities cited therein.

[3] Sections 113, 115 and 116 of the Act regulate amalgamations or mergers.

[4] See the definition of 'amalgamation or merger' in s 1.

[5] It may even involve a more complex structure where the merger results in the new company being the holding company, with each of the constituent merging companies being its separate wholly-owned subsidiaries.

[6] Or the new company, depending on the merger structure.

[7] Section 116.

[8] A copy of the merger agreement, together with a copy of the filed notice of amalgamation or merger, constitutes sufficient evidence to effect a transfer of the registration of that property.

[9] Section 113(2).

[10] The definition of 'consideration' in para (iv) above includes any money (s 113(2)*(d)* read with s 1).

[11] See s 113(2)*(c)* and *(e)* above; see further Maleka Femida Cassim (Part I) and (Part II) (n 2), and Maleka Femida Cassim 'Chapter 15: Fundamental transactions' in Farouk HI Cassim et al *Contemporary Company Law* 2 ed (2012) para 15.2.4 and paras 15.2.11-15.2.12.

[12] In which shareholders frequently receive shares in the *holding* company of the surviving merged company; see further 17.2.6.

[13] Section 113(3).
[14] Set out in s 4.
[15] Sections 115 and 164.
[16] To express it more accurately, the quorum is constituted by the presence of sufficient persons to exercise, in aggregate, at least 25 per cent of all the voting rights that are entitled to be exercised on that matter. 'Voting rights' means the rights of any shareholder or securities holder of the company to vote in connection with the matter.
[17] See further Maleka Femida Cassim in Farouk HI Cassim et al (n 11) para 15.2.4*(c)*.
[18] An acquiring party means a person who, as a result of the transaction, would acquire (direct or indirect) control or increased control over all or the greater part of a company, or all or the greater part of a company's assets or undertaking.
[19] They are also excluded from the calculation of the quorum for the meeting.
[20] Section 115 also requires a special resolution of the shareholders of the *holding* company, but this apparently applies only to transactions for the disposal of all or the greater part of the company's assets or undertaking, and not to statutory mergers.
[21] See further 17.5.
[22] Section 116.
[23] See s 116 and Form CoR 89 of the Companies Regulations GNR 351 *GG* 34239 of 26 April 2011 ('the Regulations').
[24] Once a fundamental transaction has been approved, and, if it is necessary in the circumstances, any person to whom assets are or an undertaking is to be transferred may apply for a court order to give effect to the transaction. This is discussed in 17.3.2.6.
[25] Section 115.
[26] Within five business days after the vote.
[27] Within ten business days after the vote.
[28] Within ten business days after the vote.
[29] This would also constitute a breach of the fiduciary duties of directors; see further Maleka Femida Cassim (Part II) (n 2) 171-2, and (Part I) (n 2) 15-16.
[30] Maleka Femida Cassim (Part II) (n 2) 171-2, and (Part 1) (n 2) 15-16.
[31] See Chapter 18: Shareholder remedies and minority protection.
[32] Or the newly formed company, depending on the merger structure.
[33] See s 113(2)*(c)* above.
[34] For further discussion of the freeze-out merger, see Maleka Femida Cassim (Part II) (n 2) and Maleka Femida Cassim in Farouk HI Cassim et al (n 11) para 15.2.14.
[35] Or newly formed company, depending on the merger structure. See 17.2.2.1; see further Maleka Femida Cassim (Part I) and (Part II) (n 2), and Maleka Femida Cassim in Farouk HI Cassim et al (n 11) paras 15.2.4, 15.2.11 and 15.2.12.
[36] Specifically, ss 112 and 115 of the Act.
[37] This submission is based on decisions of the court under the Companies Act 61 of 1973 ('the 1973 Act'), which are likely to continue to apply to the Act.
[38] Section 1.
[39] Section 112.
[40] As set out in ss 112 and 115.
[41] The approval requirements apply not only to an agreement but also to a 'series of agreements' to dispose of all or the greater part of a company's assets or undertaking.
[42] Sections 115 and 164.
[43] See 17.4.3 for a discussion of various important aspects of the shareholder approval requirement.
[44] Maleka Femida Cassim (Part I) (n 2) 8-11.
[45] The quorum for the meeting will be constituted by the presence of 25 per cent or more of the voting rights held by D Co's minority shareholders.
[46] By s 69 of the Companies Amendment Act 3 of 2011.
[47] Of either a South African company or an external company.
[48] For the definitions of a holding company and a subsidiary company, see Chapter 8: Groups of companies and related persons.

[49] See further 17.5.
[50] Which has been adopted.
[51] Section 115(1).
[52] However, the board is prohibited from doing so if the company is in liquidation or in the course of business rescue proceedings.
[53] Sections 114(1)-(3) and 115.
[54] Section 114(3).
[55] Sections 115(1)*(b)* and 119(4)*(b)* and (6).
[56] Section 115(3)-(6).
[57] Section 164.
[58] Section 115(8).
[59] Section 121.
[60] See further reg 92.
[61] See further reg 8.
[62] See further reg 102.
[63] Regulation 81*(c)*.
[64] Regulation 109.
[65] See further reg 110.
[66] Regulation 110(11).
[67] Constitution of the Republic of South Africa, 1996.
[68] Section 216.
[69] Section 215(1). See also the various offences set out in s 215(2).
[70] Regulation 119 read with s 119(4)*(a)*.
[71] Section 168.
[72] Regulation 170(1).
[73] Section 219.
[74] Regulation 169. Regulation 169(2) and (3) describes the further powers of the Panel and the appointed inspector during the investigation.
[75] Section 171.
[76] Section 171(2).
[77] Section 214(3).
[78] Section 172.
[79] Section 172(4).
[80] Except in respect of a respondent who has been excused in terms of s 170(1)*(a)*. See further s 174.
[81] As contemplated in s 171(7). The fine may not exceed the greater of 10 per cent of the respondent's turnover for the period of non-compliance and R1 000 000.
[82] Section 175(2).
[83] Sections 178 and 179.
[84] Section 205.
[85] Section 206.
[86] Section 209.
[87] Section 210.
[88] Section 211.
[89] Section 212.

Chapter 18
Shareholder Remedies and Minority Protection

Maleka Femida Cassim

This chapter discusses shareholder remedies and remedies that are important protective measures for minority shareholders. Included in this chapter are the remedy for relief from oppressive or prejudicial conduct, the derivative action, the appraisal rights of dissenting shareholders, the application to protect the rights of

securities holders and various other shareholder remedies. It is noteworthy that some of the remedies discussed in this chapter are not necessarily restricted only to shareholders or minority shareholders. In some cases, persons who are not shareholders may also rely on these remedies, as discussed below.

18.1 Relief from oppressive or prejudicial conduct

18.1.1 Introduction

Section 163 of the Companies Act 71 of 2008 ('the Act') provides a remedy to a shareholder who, in broad terms, complains of oppressive or prejudicial conduct. This remedy is also available to a director.

Section 163 ('the oppression remedy') states that a shareholder or a director of a company may apply to a court for relief if he or she has been oppressed or unfairly prejudiced or if his or her interests have been unfairly disregarded by-

(i) the result of any act or omission of the company, or a related person;
(ii) the manner in which the business of the company, or a related person, is being or has been carried on or conducted; or
(iii) the manner in which the powers of a director or prescribed officer of the company, or a person related to the company, are being or have been exercised.

The oppression remedy has traditionally and primarily served the purpose of protecting oppressed minority shareholders (mainly in smaller private companies). It may do so without necessarily setting aside the decisions of the majority shareholders.

The need for minority protection arises from the consideration that the business and acts of a company are generally conducted by its board of directors and by majority vote of its shareholders in general meeting. It is a fundamental principle of company law that, by becoming a shareholder, one undertakes to be bound by the decisions of the majority shareholders. However, since shareholders are bound by the resolutions of the company in general meeting (or by majority rule), a minority shareholder runs the risk of 'oppression' or being oppressed by majority rule. Shareholders are also at risk of 'oppression' by the directors or by managerial power. Company law provides a number of safeguards, and one of the available remedies to minority shareholders in such circumstances is the oppression remedy.

A leading reason for the predominance of the oppression remedy in smaller private companies or *quasi*-partnerships (ie owner-managed companies) is that in this type of company, shareholders commonly play an active role in the affairs of the company. This often results in disputes of a personal nature among the shareholders. It is difficult for a disgruntled minority shareholder to voluntarily exit the company by selling his or her shares, because a purchaser of a minority stake in a private company may be hard to come by. This is compounded by the restricted transferability of the shares of a private company. By contrast, in public companies, disputes tend to centre on quite different issues and there is greater reliance on other mechanisms to resolve disputes. Notably, disgruntled shareholders in public companies may exit the company much more easily by simply selling their shares, particularly in a listed company which has a ready market for its shares.

However, the oppression remedy is not limited to use by minority shareholders, nor is it limited to smaller private companies. It has furthermore been widened under the Act to provide legal standing not only to shareholders, but also to directors.

18.1.2 Persons who may apply for relief under s 163

Both shareholders and directors may apply for relief under s 163, but not creditors or employees.

One would generally qualify as an applicant if one is a shareholder or a director either of the relevant company or of a 'related person'. The concept of a 'related person' includes a holding company and subsidiary relationship, as well as the direct or indirect 'control' of a company or its business. [1] It is clear that in appropriate cases a shareholder or director could complain under s 163 of the conduct of a parent (or holding) company or, less commonly, the conduct of a subsidiary company.

With regard to shareholders as applicants, it seems that only a registered shareholder (who is entered as such in the company's securities register) may rely on the oppression remedy. Neither a beneficial owner of shares nor a holder of debt instruments appears to have legal standing under s 163.

With regard to directors as applicants, this includes alternate directors as well as a *de facto* director who occupies the position of a director, by whatever name he or she may be designated.

18.1.3 The requirements for relief under s 163

The applicant must satisfy two main elements under the oppression remedy:

(i) first, there must be relevant 'conduct'; and
(ii) second, such 'conduct' must be oppressive or unfairly prejudicial or unfairly disregard his or her interests.

18.1.3.1 Relevant 'conduct'

The applicant's complaint of oppression, unfair prejudice or unfair disregard of his or her (or its) interests must lie against one of the following instances of relevant 'conduct':

(i) the result of any act or omission of the company or a related person;
(ii) the conduct or carrying on of the business of the company or a related person; or
(iii) the exercise of the powers of a director or prescribed officer of the company or a person related to the company.

In view of these wide grounds, the oppression remedy is capable of extending quite broadly over the general conduct of corporate affairs. Among other things, it covers control of both shareholders' voting powers and directors' powers. Furthermore, the

relevant conduct may emanate either from 'related persons' or from the company itself in which the applicant is a shareholder or director.

With regard to the first instance of relevant 'conduct' above, when an applicant complains of an act or omission of the company (or a related person), the focus is on the *result* of the act or omission. It is clear that what matters is whether the act or omission has had a result that is oppressive, or unfairly prejudicial to, or unfairly disregards the interests of the applicant. The act or omission in itself is not as relevant as the result of that act or omission.

An 'act or omission of the *company*' encompasses the resolutions of the board of directors and the acts of the board of directors. It also includes the acts of an individual who has been authorised by the board or to whom the powers of the board have been delegated. Acts of a managing director may perhaps constitute acts of the company. [2] The resolutions of shareholders in general meeting are also 'acts of the company'. However, the conduct by a shareholder of its own affairs, even a majority shareholder, cannot be an act or omission of the *company*, for instance a sale by a shareholder of its shares or voting in general meeting.

The oppression remedy covers both positive acts as well as omissions of the company. It applies not only to isolated acts or omissions, but also to continuing conduct.

With regard to the second instance of relevant 'conduct' above, when a complaint relates to the manner in which the company's business is conducted, it similarly appears that either the ongoing conduct or the past conduct of the business may form the basis of the complaint. However, in respect of threatened conduct of the business or a threatened act or omission - where the complaint relates to what will be done in the future - it seems that no relief will be available.

Regarding the third instance of relevant 'conduct' above, the exercise of 'the powers of a director or prescribed officer of the company or a person related to the company' is a new ground of relevant conduct that has been introduced by the Act. This ground will be particularly useful in cases where the exercise of powers by a director or prescribed officer [3] does not fall into any of the other categories of relevant 'conduct', ie where the director's or prescribed officer's exercise of powers amounts to neither the conduct of the company's business nor an act or omission of the company.

The relevant 'conduct' need not necessarily be that of the company in which the applicant is a shareholder or director, and may instead consist in the 'conduct' of a 'related person', as stated above. The inclusion of related persons significantly widens the scope of the oppression remedy. An example of the use of the oppression remedy based on the conduct of a related company is the case of *Scottish Co-operative Wholesale Society Ltd v Meyer*, [4] where the *society* had deliberately used its controlling powers to deprive a subsidiary company of its business of manufacturing rayon, as part of a policy to transfer the business of the subsidiary to one of its own departments. The result was that the subsidiary's business virtually came to a standstill, with a corresponding decline in the value of its shares. Relief was granted in this case to the minority shareholders of the *subsidiary* company on the basis of the oppression remedy.

18.1.3.2 Oppressive, unfairly prejudicial or unfairly disregards interests

This is the second main element that the applicant must establish in order to obtain relief in terms of s 163, the first element being relevant 'conduct' as discussed in 18.1.3.1 above. The applicant must prove that the relevant 'conduct' (in the sense of a relevant act or omission, conduct of business, or exercise of powers by a director or prescribed officer of the company or a related person) is 'oppressive or unfairly prejudicial to, or unfairly disregards the interests of, the applicant'.

The exact ambit and meaning of this wide phrase is undefined. Based on earlier decisions of the courts (in relation to the previous Companies Act 61 of 1973), the following principles are likely to continue to apply:

(i) Relief would be granted under the oppression remedy if the applicant is able to establish 'a lack of probity or fair dealing, or a visible departure from the standards of fair dealing, or a violation of the conditions of fair play on which every shareholder is entitled to rely ... The emphasis is on the unfairness of the conduct complained of. It must be conduct which departs from the accepted standards of fair play, or which amounts to an unfair discrimination against the minority.'

(ii) The test of the oppression remedy is *unfairness*, as opposed to unlawfulness. The relevant 'conduct' does not necessarily have to be unlawful, in the sense that it infringes any legal *rights* of the applicant, for instance, rights under the Act or the company's Memorandum of Incorporation. Instead, the court may also take account of the applicant's *interests*, which are broader than 'rights' and may include wide equitable considerations. The inclusion in the Act of the unfair disregard of the applicant's '*interests*' now emphasises this principle.

(iii) In certain circumstances equitable principles would render it unfair for the majority (or those conducting the business of the company) to exercise their strict legal powers, where this would be to the prejudice of another shareholder.

(iv) The court would grant relief under the oppression remedy when, for instance, the majority shareholders use their 'greater voting power unfairly in order to prejudice' a minority shareholder, or when they act in a manner which does not enable such a shareholder to enjoy a fair participation in the affairs of the company.

(v) When one is able to readily rid oneself of the alleged prejudice or to put an end to it (for instance, as a majority shareholder or controlling shareholder), then

one may not complain of unfair prejudice or unfair disregard of one's interests - the court will not intervene, on the basis that there is no '*unfair*' prejudice or '*unfair*' disregard of interests.

(vi) The courts have granted relief in the 'standard case' of a *quasi*-partnership. The *quasi*-partnership type of case serves as a useful illustration of the oppression remedy. A *quasi*-partnership (or owner-managed company) usually involves a small private company that is formed on the basis of an agreement, an understanding or an intention that the shareholders will generally all be directors and participate in the management of the company, for instance, because the return on investment is to take the form of directors' remuneration rather than dividends on shares. Where the majority shareholders subsequently use their voting power to unjustifiably remove a shareholder from his or her office as a director, [5] without giving him or her the opportunity to withdraw his or her capital upon reasonable terms, the courts have granted relief to the shareholder on the basis of the oppression remedy.

(vii) Despite the wide ambit of s 163, it must be borne in mind that the conduct of the majority shareholders must be evaluated in light of the fundamental corporate law principle that, by becoming a shareholder, the shareholder undertakes to be bound by the decisions of the majority shareholders. A minority shareholder accordingly cannot obtain relief merely because he or she (or it) is outvoted on a certain issue, or is constantly outvoted; nor may relief be granted merely on the basis of a loss of confidence in or dissatisfaction with the conduct of the company's affairs. Thus not all acts which prejudicially affect shareholders or directors, or which disregard their interests, will entitle them to relief – it must be shown not only that the 'conduct' is prejudicial or disregardful but also that it is *unfairly* so.

A useful illustration of the oppression remedy is provided by the recent case of *Bayly v Knowles*. [6] Knowles, who had been invited to acquire shares in a company, was unable to afford the full purchase price for the shares. Knowles consequently introduced Bayly to the company as his co-investor, and Knowles and Bayly each acquired 25,5 per cent of the company's shares. They entered into this relationship on the understanding that they would participate equally in the management of the company. Bayly was the managing director of the company, while Knowles was its sales and marketing director.

The relationship between Knowles and Bayly subsequently deteriorated and in view of that, Bayly proposed to acquire Knowles' shares in the company. The payment of Knowles' salary and medical aid contributions was withheld, and Knowles was locked out of his office and the business premises, and generally excluded from participation in the company's business activities. Knowles rejected Bayly's offer to purchase his shares, and instead made a counter-proposal to purchase Bayly's shares.

Knowles subsequently applied for a court order for the sale to him of Bayly's shares, and alternatively for the winding-up of the company, on the basis of the oppression remedy.

The Supreme Court of Appeal stated that Bayly's offer for Knowles' shares had been a fair offer. The court acknowledged that the deliberate alienation of Knowles from his right to participate in the management of the company was inequitable or unfair conduct on the part of the company. However, the court declared that a minority shareholder may not continue to complain about oppression after he has failed to accept a reasonable offer for his shares, and thereby leave the company. As a general (although not an absolute) principle, the unfairness disappears if the minority shareholder is offered a fair price for his shares. The court took account also of the interests of the company and the remaining shareholders, including the fact that Bayly was more involved in the management and the affairs of the company. The court accordingly held that Knowles had not been the victim of oppressive or unfairly prejudicial conduct.

18.1.4 Available relief under s 163

The court has a discretion to make *any* interim or final order or orders it thinks fit.

Section 163 sets out an extensive, but non-exhaustive, list of possible remedies. The open-ended list includes the following remedies, some of which are far-reaching:

(i) an order restraining the conduct of which the applicant complains;
(ii) an order appointing a liquidator, which may be made only if the company appears to be insolvent;
(iii) an order placing the company under supervision and commencing business rescue proceedings, if the grounds for business rescue are satisfied;
(iv) an order to regulate the company's affairs by directing the company to:
- amend its Memorandum of Incorporation; or

- create or amend a unanimous shareholder agreement.

When an order directs the company to amend its Memorandum of Incorporation, the company must not make any further amendment to the Memorandum of Incorporation that will alter, limit or negate the effect of the court order unless and until a court orders otherwise. (The amendment of the Memorandum of Incorporation in this case is effected by a resolution of the board of directors of the company as opposed to a special resolution of the shareholders.)

(v) an order directing an issue of shares or an exchange of shares;
(vi) an order appointing directors in place of or in addition to (all or any of) the directors then in office;
(vii) an order declaring a director to be delinquent or to place a director under probation;
(viii) an order directing the company or any other person to restore to a shareholder any part of the consideration that the shareholder paid for shares, or to pay the equivalent value;
(ix) an order varying or setting aside a transaction or agreement to which the company is a party and compensating the company or any other party;
(x) an order requiring the company, within a time specified by the court, to produce to the court or an interested person financial statements in a form required by the Act, or an accounting in any other form the court may determine;
(xi) an order to pay compensation to an aggrieved person, subject to any other law entitling that person to compensation;
(xii) an order directing rectification of the registers or other records of a company;
(xiii) an order for the trial of any issue as determined by the court.

The section does not explicitly refer to an order to purchase the shares of a shareholder (whether by other shareholders or by the company), even though this has been the most common remedy granted by the courts in practice. But the court would in all probability be able to make such an order, since the list of orders under the section is non-exhaustive and open-ended.

Based on earlier decisions of the courts, a person who applies for relief under the oppression remedy should indicate the general nature of the relief he or she (or it) seeks. The court, however, is not necessarily limited to the relief sought by the applicant, and may grant other more appropriate relief.

18.2 The derivative action

18.2.1 Introduction

A company is a separate legal person that is capable of suing and being sued in its own name. Where a wrong is done to a company, the 'proper plaintiff' is the company itself. This principle is commonly known as the rule in *Foss v Harbottle*. [7] It usually is the board of directors that has the authority to institute legal proceedings in the name of or on behalf of the company. [8]

The derivative action, in terms of s 165 of the Act, is an exception to the proper plaintiff principle. A derivative action is brought by a person on behalf of a company in order to protect the legal interests of the company. It is worth repeating that a derivative action is brought by another person, such as a minority shareholder, in order to protect the legal interests *of the company*. Consequently, the need for another person to bring a derivative action to protect the company's legal interests will generally arise where the claim is not brought by the company itself. The derivative action is so called because the shareholder (or other applicant) 'derives' his or her right of action from that of the company.

This must be distinguished from the situation where shareholders wish to enforce their *own shareholder* rights. In this regard, where a wrong is done to a shareholder (for instance, in the case of a wrongful refusal of the right of a shareholder to cast a vote at a meeting) and the shareholder consequently wishes to assert his or her individual shareholder rights - as opposed to the rights of the company - the derivative action would not be appropriate. [9]

The classic case of the derivative action is where those who commit a wrong against the company are the controllers of the company. For instance, the company is defrauded by its directors, who are also the majority shareholders - so the wrongdoers subsequently use their control or influence over the company to prevent the company from instituting legal proceedings against them to remedy the wrong done to the company.

The derivative action is an important minority shareholder protection measure. It protects the minority shareholders from the effects of corporate personality and majority rule. It enables a minority shareholder who learns of a wrong that is done to the company and that has been left unremedied by management (often because they are the wrongdoers) to institute proceedings on behalf of the company and thereby protect the legal interests of the company.

But the derivative action in terms of s 165 is much wider than this. It is available to a wider class of applicants than just minority shareholders, as discussed in 18.2.2. Moreover, its use is not limited to wrongs that are committed by the management or the controllers of the company - it even extends to wrongs that are committed by third parties or outsiders (although practically it could be more difficult to bring a claim in such circumstances).

A derivative action may be brought only under s 165 of the Act. The common-law derivative action has been abolished. The procedure for the derivative action, as set out in s 165, is discussed below.

18.2.2 Persons who have legal standing under s 165

The derivative action is available to the following categories of persons:

(i) Shareholders: This includes shareholders of the company, shareholders of a related company, and persons entitled to be registered as shareholders of the company or a related company.

(ii) Directors or prescribed officers: This includes the directors [10] and prescribed officers [11] both of the company and of related companies.

(iii) Registered trade unions representing employees of the company, or other representatives of employees.

(iv) Any person who has been granted legal standing by the court. The court has the discretion to grant legal standing to other persons where it is satisfied that it is necessary or expedient to protect a legal right of that other person. [12]

18.2.3 The demand

The applicant must serve a demand on the company, requiring the company to institute legal proceedings to protect its legal interests. The requirement of a demand gives the company the opportunity to reconsider the conduct complained of, and to take suitable remedial action itself to protect its own interests.

The demand may relate to the protection of any 'legal interests' of the company. The term 'legal interests' appears to be wider than the 'rights' of the company. The derivative action is not restricted to protecting any particular type of legal interest or cause of action, nor is there any restriction to any particular class of wrongdoer. The scope of the derivative action includes a breach of fiduciary duty committed by a director of the company, but is wider than this. The wrongdoers may conceivably be the directors, one or more prescribed officers, the majority shareholders or even outsiders (including, but not limited to, those outsiders against whom the controllers of the company decline to act by reason of their wish to shield the outsider).

The demand may concern the *commencement* or the *continuation* of legal proceedings or *related steps* to protect the legal interests of the company. This, first, allows scope for a person to bring (or defend) derivative proceedings on behalf of the company in the event that the company has failed to initiate proceedings. Second, it creates scope for a person to intervene in proceedings that the company has already commenced in its own name, and to continue these proceedings as derivative proceedings. Third, it permits a person to take related steps to protect the company's legal interests which could comprise, for instance, settling or compromising legal proceedings on the company's behalf. The applicant's demand may relate to legal proceedings in which the company is the plaintiff, as well as legal proceedings that are brought against the company.

18.2.4 Application to set aside the demand

The company may, within 15 business days, apply to a court to set aside the demand, only on the grounds that the demand is frivolous or vexatious or without merit.

This is one of the safeguards directed at protecting the company from frivolous or vexatious demands made by shareholders (or other applicants). It is an important safety measure that is designed to prevent abuse of the right of applicants to bring a derivative action.

18.2.5 Investigation of the demand

Upon receipt of a demand (and on the assumption that it is not set aside by the court on the basis that it is frivolous, vexatious or without merit), the company must appoint an independent and impartial person or committee to investigate the demand. The investigator or the committee must report to the board on-

(i) the facts or circumstances that may give rise to the cause of action, or may relate to the proceedings, contemplated in the demand;
(ii) the probable costs that would be incurred if the company pursued the cause of action or continued the proceedings; and
(iii) whether it appears to be in the best interests of the company to pursue the cause of action or continue the proceedings.

18.2.6 Company's response to the demand

Within 60 business days after being served with the demand (or such longer time as the court may permit) the company must either-

(i) initiate or continue legal proceedings, or take related legal steps to protect its legal interests, as contemplated in the demand; or
(ii) serve a notice on the person who made the demand, refusing to comply with it.

18.2.7 Application to court for leave

A person (who has served a demand on the company) [13] may apply to a court for leave (or permission) to sue on behalf of the company. This may be done only if-

(i) the company has failed to take any particular step relating to the investigation of the demand and its response to the demand (as discussed in 18.2.5 and 18.2.6); or
(ii) the company appointed an investigator or committee who was not independent and impartial; or
(iii) the company accepted a report that was inadequate in its preparation, or was irrational or unreasonable in its conclusions or recommendations; or
(iv) the company acted in a manner that was inconsistent with the reasonable report of an independent, impartial investigator or committee; or
(v) the company has served a notice refusing to comply with the

demand.

If the company complies with the demand (by initiating or continuing legal proceedings or taking related legal steps to protect the legal interests of the company, as the case may be), the court will generally not grant leave to an applicant to sue on behalf of the company. This is logical and sensible. Where the company itself engages in legal proceedings to protect its own legal interests, it will generally be unwarranted to allow an applicant to sue on the company's behalf.

18.2.8 The discretion of the court to grant leave

18.2.8.1 The guiding criteria

A key role is accorded to the court under s 165. The court has a discretion to grant or refuse leave to the applicant, on the basis of three guiding criteria. The court may grant leave to the applicant to bring or continue proceedings in the name and on behalf of the company only if it is satisfied that-

(i) the applicant is acting in good faith;
(ii) the proceedings involve the trial of a serious question of material consequence to the company; *and*
(iii) it is in the best interests of the company that the applicant be granted leave.

18.2.8.2 The rebuttable presumption

The best interests requirement is coupled with a rebuttable presumption. A rebuttable presumption arises that it would *not* be in the best interests of the company to grant leave if it is established that-

(i) the proceedings are by the company against a *third party*, or by a third party against the company;
(ii) the company has decided not to bring the proceedings (or not to defend the proceedings, or to discontinue, settle or compromise the proceedings, as the case may be); *and*
(iii) all of the directors who participated in that decision–
   - acted in good faith for a proper purpose;
   - did not have a personal financial interest in the decision, and were not 'related' to a person who had a personal financial interest in the decision (for instance, a spouse or child of the director or a company 'controlled' by the director); [14]
   - informed themselves about the subject matter of the decision to the extent they reasonably believed to be appropriate; and
   - reasonably believed that the decision was in the best interests of the company.

These requirements are cumulative, and must all be satisfied for the presumption to arise. (Since the presumption is rebuttable, it may be disproved by evidence to the contrary.)

For the purposes of the first limb of the rebuttable presumption, the Act states that a person is a ‘third party’ if the company and that person are not ‘related’ or ‘inter-related’. The effect is that, when a wrong is committed against the company by a *third party*, a rebuttable presumption arises that it *not* be in the best interests of the company for the court to grant leave for derivative proceedings. To express it differently, it is more difficult to bring derivative proceedings against third parties. In contrast, when a wrong is committed against the company by a *related person*, the court would more easily grant leave for derivative proceedings. In this regard, a ‘related’ person includes a holding company or a person that directly or indirectly ‘controls’ the company or its business. [15] Section 165 reflects a sensible approach in so far as it differentiates between third parties and related persons, This is because the need to bring a derivative action frequently arises when those who are in control of the company - such as related persons - commit a wrong against the company, and subsequently use their control or influence to prevent the company from proceeding against them.

It is surprising that the same position does not apply to the directors of a company. Under s 165, the directors of a company may be regarded as ‘*third parties*’ to the company, and not as ‘related persons’ (unless the director also happens to ‘control’ [16] the company). This means that it would be more difficult to bring derivative proceedings against a director of the company. This is not an ideal approach, bearing in mind that the derivative action, as discussed above, is invariably relied on to protect the company against wrongdoing directors.

Parallels may be drawn between the third limb of the rebuttable presumption and the business judgment rule. [17] Its effect is to give some degree of weight to the directors’ decision not to pursue legal proceedings against a third party, by treating it like any other business judgment or business decision that is normally left to the directors to determine. This takes account of the general principle that the court should not interfere with the internal affairs of companies and with honest and reasonable business decisions of the board of directors. The provision thus constitutes a control for unwarranted interference and unwarranted overriding of the directors’ authority to determine whether a company should pursue legal proceedings.

18.2.8.3 General comments

To sum up, once the court is satisfied that it is in the best interests of the company to grant leave (bearing in mind the rebuttable presumption); that the applicant is in good faith; *and* that the proceedings involve the trial of a serious question of material consequence to the company, the court may grant leave for derivative proceedings. Once leave has been granted, the applicant is in a position to commence or continue the derivative proceedings on behalf of the company.

It is noteworthy that a derivative action involves a two-pronged process: the first step is that a successful application must be made to the court for leave for derivative proceedings, and the second step is the derivative action itself.

The court thus has a crucial role in the statutory derivative action. Its discretion to grant leave for derivative proceedings must be exercised with reference to the above criteria. The approach that the courts take in exercising their discretion to grant leave will have a great impact on the effectiveness (or lack thereof) of s 165. It is to be hoped that the courts will adopt a flexible and liberal approach that will advance and promote the use of the derivative action, as opposed to a restrictive interpretation that will stultify this useful minority shareholder remedy. Good and effective legal protection for minority shareholders is fundamental to a developed corporate law system.

However, it is an equally important policy consideration that checks and balances be built in, to prevent the abuse of the derivative action. There is a risk of applicants bringing frivolous or vexatious proceedings, or of applicants using s 165 for 'strike suits' or 'greenmail' in order to extract personal benefits for themselves as opposed to the company. The main control measure or safeguard against this is that the leave of the court is required for derivative proceedings.

18.2.9 Information

The person to whom leave has been granted is entitled (on giving reasonable notice to the company) to inspect any books of the company for any purpose connected with the legal proceedings. This is an important right.

It takes account of the fact that information about company affairs is generally held by the controllers and directors of the company (who often are the wrongdoers or their supporters in this context), and that the essential information is not necessarily available to the person to whom leave is granted. This provision thus ensures that such a person has access to relevant information, which is fundamental to the effectiveness of the derivative action.

18.2.10 Costs orders, security for costs and remuneration

A court may make any order it considers appropriate about costs, and may do so at any time. The costs order may relate to the application for leave to bring derivative proceedings under s 165 and/or to the actual derivative proceedings themselves (that are instituted following the grant of leave). The costs order may concern the costs of the following persons: the person who applied for leave or was granted leave, the company, or any other party to the legal proceedings or to the court application for leave.

It must be borne in mind that the person who is granted leave brings a derivative action for the benefit of the *company*, and that the applicant does not directly gain from the derivative action. For instance, any damages awarded by the court must go to the company and not to the shareholder who brings the derivative action. Accordingly, the risk of being burdened with the legal costs may constitute a strong disincentive to the derivative action, even for a potential *bona fide* applicant.

Turning to security for costs, an order under s 165 may require security for costs. A court order that the applicant provide security for costs may be motivated by a desire to protect the interests of the company, and will also prevent vexatious and frivolous proceedings. But it has severe disadvantages, in that an order for security for costs could constitute a formidable disincentive for a potential *bona fide* applicant.

If a court grants leave to an applicant under s 165, the court must also make an order stating who is liable for the remuneration and expenses of the person appointed. This order may be varied by the court at any time. The persons who may be made liable under the order are the company, any or all of the parties to the application to the court for leave, or the parties to the derivative proceedings.

18.2.11 Other provisions

18.2.11.1 Substituting the person to whom leave is granted

When a court has granted leave to a person for a derivative action under s 165, another person who has *locus standi* (or legal standing) may apply to a court at any time for an order that they be substituted for the first person to whom leave was originally granted. The court may make such an order if it is satisfied that the applicant is acting in good faith and that it is appropriate to make the order in all the circumstances. This provision enables an applicant to take over existing derivative proceedings.

18.2.11.2 Effect of ratification or approval by shareholders

If the shareholders of a company have ratified or approved any particular conduct of the company, such ratification or approval does not prevent an applicant from relying on s 165. In other words, the shareholders' ratification or approval (or condonation) of a wrong does not mechanically or automatically prevent a derivative claim. This is to be welcomed. It fosters flexibility and enables the court to consider each case based on its own facts and merits.

Furthermore, the ratification or approval will prejudice neither the outcome of an application for leave, nor the outcome of the derivative action itself. But the court may take the ratification or approval into account in making its judgment or order.

18.2.11.3 Permission to discontinue, compromise or settle proceedings

An additional safeguard is that the leave of the court is required before discontinuing, compromising or settling proceedings that are brought (or intervened in) with leave under s 165. This is another vital control measure which is designed to counter abuse of the section by shareholders and other applicants.

18.3 Dissenting shareholders' appraisal rights [18]

18.3.1 Introduction

The appraisal right may be described as the right of dissenting shareholders, who do not approve of certain triggering events, to have their shares bought out by the company in cash, at a price reflecting the fair value of the shares.

The appraisal right is not a general right, but is triggered in certain specified circumstances only. It arises in only four circumstances, three of which relate to fundamental transactions. In terms of s 164 of the Act, the appraisal right is triggered where a company proposes to pass a special resolution to-

(i) dispose of all or the greater part of its assets or undertaking;
(ii) enter into an amalgamation or merger;
(iii) implement a scheme of arrangement; or
(iv) amend its Memorandum of Incorporation by altering the preferences, rights, limitations or other terms of any class of its shares in any manner materially adverse to the rights or interests of the holders of that class of shares (ie an alteration of class rights). [19]

However, it is notable that appraisal rights do not apply in any circumstances relating to a transaction, agreement or offer pursuant to a business rescue plan.

The grant of appraisal rights in these four triggering circumstances takes account of the consideration that these triggering events may have significant and far-reaching consequences for shareholders. This is because the nature of the company as well as the rights of shareholders could be drastically altered.

The appraisal right is a measure or a remedy that balances the rights and interests of minority shareholders with those of the majority. On the one hand, fundamental transactions and alterations of class rights are subjected to majority rule (or supermajority rule), in that they may be effected with the approval of the prescribed majority of the shareholders by special resolution. This provides flexibility for the majority shareholders to fundamentally change or restructure the company and alter investors' rights, in order to adapt to changing business and other conditions. On the other hand, the disgruntled minority shareholders (or dissenting shareholders, who disapprove of and dissent from the transaction) are granted appraisal rights as an exit strategy, so that effectively they are not compelled to go along with the decision of the majority shareholders. The appraisal right enables the dissenting minority shareholders to choose to opt out of the company, by giving up their shares in exchange for their fair value in cash. The appraisal right is essentially a minority buy-out right or a put option.

It should be noted that the appraisal remedy is a no-fault remedy. To trigger the appraisal right, no fault, unfairness or wrongdoing need be alleged or proved.

There are three important underpinning objects of the appraisal right. First, appraisal is traditionally justified as an exit mechanism for dissenters, whose expectations have been disappointed. Failing that possibility, a dissenting shareholder would otherwise have been locked into a newly restructured company, with a different set of assets, risks and returns, in which it had no desire to invest. The more modern (and second) justification is that the appraisal right is a vital remedy for unfairness. Minority shareholders who, for instance, are not satisfied with the price offered for their shares under a merger or other fundamental transaction, may rely on the appraisal remedy to challenge and dispute the fairness or adequacy of the offered price. The appraisal right also functions as a check on opportunism by directors. The third object is that it serves as a deterrent or a restraint on bad business judgments by directors. This is because the greater the number of dissenting shareholders who wish to exercise their appraisal rights, the more likely it is that the board would be persuaded to reconsider the triggering transaction, especially since appraisal may constitute a serious drain on the cash resources of the company.

18.3.2 The appraisal procedure

18.3.2.1 Overview

In order for disgruntled shareholders to acquire the right to demand that the company pay them the fair value of their shares they must, on the occurrence of a triggering event, follow the intricate appraisal procedure as set out in s 164 of the Act.

Although this is discussed fully below, it is worth emphasising at the outset that a dissenting shareholder becomes entitled to be paid the fair value of his or her (or its) shares only if the dissenter has taken the mandatory steps to ‘perfect’ the appraisal right. The shareholder must take action as soon as a triggering event is merely proposed for approval, by making his or her objection to the proposal known. The dissenter does this by sending a written notice of objection to the company *before* the special resolution is put to the vote. Further steps to ‘perfect’ the appraisal right are that the dissenter must in fact vote against the resolution (as opposed to merely abstaining from voting); deliver to the company a written demand for the fair value of the shares, once the resolution has been adopted by the company; and comply with all the procedural requirements of s 164.

Once the dissenting shareholder's appraisal right has been perfected, the company must make a written offer to pay the dissenter an amount considered by the directors to be the fair value of the shares. The fair value is determined at the time immediately before the company adopted the relevant resolution that triggered the appraisal right. Should the shareholder consider the company's offer to be inadequate, the shareholder is entitled to apply to court for a determination of the fair value of the shares. The involvement of the court in the appraisal procedure is minimal and occurs only at the final stages of the appraisal procedure, if at all. One of the most appealing features of the appraisal right is that it is, to a large extent, not a court-driven procedure.

The numerous steps of the appraisal procedure are fleshed out in more detail below.

18.3.2.2 Statement of appraisal rights

When a company gives notice to shareholders of a meeting to consider adopting a special resolution to effect one of the triggering events above (ie an alteration of class rights or a fundamental transaction), the notice must include a statement informing shareholders of their rights under s 164.

18.3.2.3 Notice of objection by shareholder

A dissatisfied shareholder must give the company a written notice objecting to the resolution. This must be done *before* the relevant resolution is put to the vote. The importance of this requirement should not be overlooked. A notice of objection is one of the key prerequisites for invoking the appraisal right. Should a shareholder fail to submit a written notice of objection to the company, the shareholder may lose or forfeit the appraisal right.

The underlying object of the notice of objection is to alert the company to the number of dissenters. This enables the company to estimate the amount of the cash payment that will be required upon appraisal. Demands for appraisal constitute a potential drain on the cash resources of the company that is obliged to purchase the appraised shares. The requirement of the notice of objection (given prior to the vote) provides scope for the board of directors to rethink its strategy, especially where large numbers of minority shareholders indicate their intention to dissent. [20]

18.3.2.4 Notice of adoption of the resolution

Within ten business days after the company has adopted the relevant resolution (on the assumption that it is adopted), the company must send out notices of the adoption of the resolution. These must be sent to each objecting shareholder who gave the company a written notice of objection, and who has neither withdrawn that notice nor voted in support of the resolution.

18.3.2.5 Demand by dissenting shareholder

A dissenting shareholder is entitled to demand that the company pay him or her (or it) the fair value for all his or her shares, but only if all the following requirements in terms of the Act have been satisfied:

(i) first, the shareholder must have sent a notice of objection;
(ii) second, the resolution must subsequently have been adopted by the company;
(iii) third, the shareholder must have voted its shares against the resolution. It is important to note that a mere *abstention* from voting will not suffice;
(iv) fourth, the shareholder must have complied with all the procedural requirements of s 164; and
(v) fifth, in the case of an amendment to the company's Memorandum of Incorporation to alter class rights, the shareholder must hold shares of a class that is materially and adversely affected by the amendment.

In respect of the fifth requirement above, it is likely that an alteration of class rights will trigger a shareholder's appraisal rights only if there has been a direct alteration of the rights (or other terms) of his or her class of shares, but not if there has merely been an indirect reduction in the value of those rights. If, for instance, the Memorandum of Incorporation has been amended to reduce the voting rights or the rights to dividends of Class 'A' shares, this would trigger appraisal rights for the Class 'A' shareholders. But if the Memorandum of Incorporation has been amended to improve the voting rights of the Class 'B' shares - which has the effect of reducing the value of the voting rights of the Class 'A' shares (whose voting power has been indirectly diluted or diminished, in consequence of the improvement of the Class 'B' voting rights) - this would not trigger appraisal rights for the Class 'A' shareholders.

A shareholder who satisfies the five above requirements is entitled to demand that the company pay him or her (or it) the fair value for all of his or her shares. In so doing, the shareholder 'perfects' the appraisal right. A demand is made by delivering a written notice to the company, within 20 business days after the receipt of a notice of adoption of the resolution. The demand must state the shareholder's name and address, the number and class of shares in respect of which he or she seeks payment, and a demand for payment of the fair value of those shares. The demand must also be delivered to the Takeover Regulation Panel.

The consequence of sending a demand is that the dissenting shareholder relinquishes all his or her rights in respect of the shares, other than the right to be paid their fair value. This accords with the approach that the dissenter has elected to opt out of the company with effect from this point, and all that remains is the payment for his or her shares. The shareholders would thus lose, for instance, their rights to future dividends and voting rights.

(Despite this, all the shareholder's rights in respect of the shares are reinstated without interruption in three circumstances: First, if the dissenter withdraws the demand before the company makes an offer, or allows an offer made by the company to lapse; second, if the company fails to make an offer and the shareholder withdraws the demand; and third, if the company revokes the adopted resolution that gave rise to the shareholder's appraisal rights in the first place. The company must revoke the resolution by a subsequent special resolution, with the attendant costs and inconvenience of once again seeking shareholder approval.)

18.3.2.6 Offer by the company

Once dissenting shareholders have made their demands, the company must send to them a written offer, within a specified time period, to pay an amount that the directors consider to be the 'fair value' of the relevant shares. The 'fair value' is determined as at the date on which, and the time immediately before, the company adopted the relevant resolution. The company's offer must be accompanied by a statement showing how that value was determined.

Every offer in respect of shares of the same class or series must be on the same terms.

If the company's offer is not accepted within 30 business days after it was made, the offer lapses. In this event, all the shareholder's rights in respect of the shares are reinstated without interruption.

18.3.2.7 Shareholder's acceptance of the offer

A shareholder has the discretion to accept or reject the offer made by the company.

If a shareholder accepts the offer, the company must pay the shareholder the agreed amount within ten business days (after the shareholder accepted the offer and complied with the relevant steps to surrender or transfer the shares to the company).

18.3.2.8 Application to court to determine fair value

This step of the appraisal procedure applies if the company has made an offer that a dissenting shareholder considers to be inadequate (provided that the offer has not lapsed), or if the company has failed to make an offer at all. In these circumstances a dissenting shareholder may apply to a court to determine a fair value of the relevant shares. Consequently, the involvement of the court is not an inevitable or automatic feature when the appraisal right is invoked. Court involvement occurs only at the final stages of the appraisal procedure, and in the ideal situation it may even be unnecessary where the company and the dissenter are in accord as to the fair value of the shares. The minimisation of court involvement is one of the best features of the appraisal right.

On an application to the court for a judicial appraisal of the shares, all dissenting shareholders who have not accepted an offer from the company must be joined as parties and are bound by the decision of the court. The court must determine a fair value in respect of the shares of all dissenting shareholders. The fair value is determined as at the date on which, and time immediately before, the company adopted the resolution that triggered the shareholders' appraisal rights. It is noteworthy that the reference point for valuation is the date of adoption of the resolution and not the later date of the effectuation of the relevant corporate action, nor the earlier date of the announcement of the transaction (if any). This impacts on the question whether dissenters may claim a portion of the gains generated by the transaction itself.

The Act, however, does not specify the method of valuation in appraisal proceedings, nor does it define the meaning of the key phrase 'fair value'. It must be emphasised that 'fair value' is not necessarily equivalent to market value alone. In many circumstances the market value is not appropriate or reflective of the true worth of the company or the fair value of the shares, for instance, where the shares are undervalued on the market or in a depressed market or where there is no market for the shares. [21] In some case the news of the proposed merger may itself have the effect of depressing the market value. In view of the significance and the complexity of appraisal valuation methodology, it is commendable that the Act allows for the discretionary appointment by the court of one or more appraisers, who will assist the court in determining the fair value of the shares.

Besides determining the fair value of the shares, the court must also make an order requiring the dissenting shareholders to either withdraw their respective demands or take the necessary steps for the surrender or transfer of their shares to the company and be paid the fair value. It thus seems that each dissenting shareholder has a choice either to accept the court's determination of fair value or, alternatively, to withdraw its demand and be reinstated as a shareholder of the (now restructured) company. Although this gives recognition to the shareholders' proprietary interests in their shares, it is open to abuse by shareholders. But the prospect of being saddled with a costs order in respect of the court application may, to some extent, deter potential abuse of this avenue by dissenters. Moreover, at any time before the court has made its determination of fair value, the dissenters have the choice of accepting the company's offer of fair value. This is intended to promote settlement, but may also be subjected to abuse by shareholders.

It must be stressed that the shares of a company that are surrendered to the company in the exercise of appraisal rights have the same status as shares that have been authorised but not issued. They may not be held by the company as treasury shares, but are instead cancelled.

It is notable that the making of a demand, tendering of shares, and payment by a company to a shareholder in terms of s 164 do not constitute a 'distribution' by the company, or an acquisition of its shares by the company within the meaning of s 48. They are therefore not subject to the provisions of that section, nor subject to the solvency and liquidity test.

A company may apply to a court for an order varying its obligations to pay the fair value to dissenting shareholders when there are reasonable grounds to believe that payment by the company of the fair value would result in the company being unable to pay its debts as they fall due and payable for the ensuing 12 months. The court may in these circumstances make an order that is just and equitable, having regard to the financial circumstances of the company, and that ensures that the dissenting shareholder is paid at the earliest possible date compatible with the company satisfying its other financial obligations as they fall due and payable. [22]

18.3.3 Disadvantages and shortcomings of the appraisal procedure

The appraisal procedure is thus a complex, technical and rigid one. It involves a number of specified steps and specified notices, each coupled with a strict time limit. The procedural requirements for the appraisal right may undermine its effectiveness as a shareholder protection measure. A shareholder must comply meticulously with each procedural step in order to 'perfect' and to exercise the appraisal right. This renders the appraisal procedure a potential minefield for dissenting shareholders. It makes it difficult for a shareholder to exercise his or her appraisal rights without legal assistance and attendant legal expenses. Significantly, the dissenting shareholder may forfeit or lose the appraisal right if he or she fails to comply with certain procedural steps within the strict time limits prescribed by the section.

A second shortcoming of the appraisal right from the perspective of the dissenting shareholder is the time delays, during which the shareholder's investment in the company is frozen and the shareholder is deprived of the use of his or her funds. (As discussed above, once a shareholder has sent the written demand to the company, he or she loses all further rights in respect of those shares, except for the right to be paid their fair value. But the fair value is paid only at the end of the appraisal proceedings. Until then the shareholder is deprived of the use of his or her funds.)

The costs of the appraisal proceedings constitute a third disadvantage. In this regard, the court has the discretion to make an appropriate order of costs, having regard to any offer made by the company and the final determination of the fair value by the court. The discretionary nature of the costs order may, to some extent, encourage parties to reach agreement on the fair value of the shares without unnecessarily resorting to the courts. However, the possibility of being saddled with an adverse costs order may discourage the shareholder from asserting the appraisal right in the first place.

It must be borne in mind that the valuation of shares is not an exact science but merely a prediction or an estimate. A judicial determination of the fair value creates uncertainty, and a risk that the shareholder's estimate of the fair value may be higher than the valuation made by the court. As stated above, the Act is silent on the method of valuation of the 'fair value' of shares.

The other side of the coin, from the perspective of the company, is that the company is obliged to purchase the appraised shares. This may result in a drastic cash drain on the company. The potential cash drain on the company, to satisfy shareholder demands for appraisal, could well result in the abandonment of a triggering transaction that would otherwise have been in the interests of the company. This is particularly so where there is a large number of dissenting shareholders. Experience in other jurisdictions that have adopted the appraisal remedy suggests that the appraisal remedy has not been all that successful. [23] This perhaps could be due to the reasons stated above.

18.4 Application to protect the rights of securities holders

This remedy has the object of protecting the shareholders and the holders of other securities [24] of a company. It enables shareholders and other securities holders to seek a declaratory order as to their rights, and to rectify any harm done to them.

To elaborate, s 161 of the Act, first, enables a securities holder to apply to a court for an order determining any of his or her (or its) rights in terms of the Act, the company's Memorandum of Incorporation, the rules of the company, or any applicable debt instrument. Second, a securities holder may also apply for any appropriate order that is necessary to protect any such right. Third, a securities holder may apply under s 161 for any appropriate order necessary to rectify any harm done to him or her-

(i) by the company, as a consequence of an act or omission that violated any such right or contravened the Act, the Memorandum of Incorporation, rules or applicable debt instrument; or
(ii) by any of its directors, to the extent that they are or may be held liable in terms of s 77 (which deals with the liability of directors and prescribed officers).

Section 161, for instance, appears to provide scope for inter alia declaratory orders, interdicts to restrain breaches of relevant rights of securities holders, as well as orders to direct compliance with such rights. This remedy may perhaps be relied on, for example, where there is a wrongful refusal of the right of a shareholder to cast a vote, in which case an appropriate order (depending on the circumstances) could be an interdict to restrain the company from acting on an improperly passed resolution.

Section 161 is particularly remarkable in that it permits direct recourse by a shareholder (or securities holder) against a *director*. This right of recourse is likely to be of limited use, bearing in mind that directors' breaches of their duties and the provisions under s 77 will, in the majority of cases, cause harm to the company itself as opposed to its shareholders. [25] Generally, directors' duties are not owed to the shareholders individually, but to the company. However, there may be circumstances in which harm is done to a shareholder by a director's breach of duty, in which event the shareholder may be able to seek redress under s 161.

18.5 Other shareholder remedies

18.5.1 Restraining the company from contravening the Act, and damages

Shareholders have a right under the Act to restrain the company from violating any provision of the Act. Shareholders also have a statutory right to restrain the company from an *ultra vires* action or transaction.

In this regard, s 20(4) provides that one or more shareholders or directors or prescribed officers of a company, or a trade union representing employees of the company, may apply to the High Court for an appropriate order to restrain the company from doing anything inconsistent with the Act. It is noteworthy that this provision is limited to contraventions of the Act only, and does not encompass contraventions of the company's Memorandum of Incorporation.

Section 20(4) is complemented by s 20(5), which enables one or more shareholders, directors or prescribed officers of a company (but not trade unions or employee representatives) to apply to the High Court for an appropriate order to restrain the company or the directors from doing anything inconsistent with any limitation, restriction or qualification of the capacity of a company or the authority of the directors in terms of its Memorandum of Incorporation. Section 20(5) does not apply to all contraventions of the Memorandum of Incorporation but is limited to provisions dealing with the company's capacity and the authority of its directors. [26]

Turning to damages, each shareholder of a company has a claim for damages (in terms of s 20(6)) against any person who intentionally, fraudulently or due to gross negligence causes the company to do anything inconsistent with the Act (or anything inconsistent with a limitation of the capacity of the company or its directors' authority that has not been ratified by special resolution).

Furthermore, in terms of s 218(2), any person who contravenes any provision of the Act is liable to any other person for any loss or damage suffered by that person as a result of the contravention.

Section 20(6) provides a remedy for damages, not against the company, but against the person who intentionally, fraudulently or due to gross negligence causes the company to act inconsistently with the Act. In contrast, s 218(2) creates scope for a claim for damages against any person who contravenes the Act. A second difference between s 20(6) and s 218(2) is that the latter applies even if the defendant contravened the Act innocently, as long as the plaintiff suffered damage as a result of the contravention. Section 20(6), on the other hand, requires proof of intention, fraud or gross negligence. A third difference is that, while shareholders have legal standing to claim damages under both s 20(6) and s 218(2), s 218(2) additionally provides wider standing to 'any other person' who has suffered damage.

18.5.2 The common-law personal action

Where a wrong is done to a shareholder and the shareholder consequently wishes to assert his or her (or its) *individual shareholder rights* - as opposed to the rights of the company - the common-law option of bringing a personal action in his or her own name remains.

In practice, aggrieved shareholders who have grounds for common-law personal actions often have the alternative option of resorting to the more inviting and effective avenue of the oppression remedy in terms of s 163 (as discussed in 18.1).

18.5.3 Overlap between shareholder actions and corporate actions

There may be an overlap between personal or individual shareholder actions and corporate actions in certain circumstances. In other words, certain conduct may

amount to both a wrong done to the company (which may give rise to a derivative action) as well as a wrong done to the individual shareholder (which may give rise to a shareholder action).

However, when both the company and the shareholder have a claim against the directors (or other persons) based on the same set of facts, and the shareholder's loss consists merely in a fall in the value of his or her shares or a loss of dividends, the shareholder will not be able to recover his or her loss. This is because the shareholder's loss merely reflects the loss suffered by the company, as a result of the wrong that was done to the company.

For instance, in *Stein v Blake*, [27] where the company's assets had been misappropriated, the loss sustained by a shareholder by a reduction in the value of his shares was held to be recoverable only by the company, and not by the shareholder, on the basis that the shareholder had suffered no loss that was distinct from that suffered by the company. In truth, the fall in the value of the shares held by the shareholder merely reflected the loss suffered by the company consequent on the misappropriation of its assets.

The rationale for this 'no reflective loss' principle is that it prevents double recovery if the company were also to sue. Moreover, it prevents the individual shareholder from recovering at the expense of the company and its creditors and other shareholders.

In cases where the loss suffered by the shareholder and that suffered by the company are distinguishable, the 'no reflective loss' rule will not pose an obstacle.

18.5.4 Other remedies

Finally, it is notable that there are other remedies under the Act which are dealt with in other chapters, as appropriate. For instance, the veil may be pierced in the event of an abuse of the separate juristic personality of a company, solvent companies may be wound-up by court order in certain specified circumstances, and there is the possibility of having errant directors declared by a court to be delinquent or placed under probation. In addition there is, inter alia, the prohibition against reckless trading, and the statutory liability of directors as set out in s 77.

Questions

1. Two directors of XYZ Ltd sold their own property to XYZ Ltd at a highly inflated price. P and Q, who are, respectively, a minority shareholder and a prescribed officer of XYZ Ltd, wish to bring a legal action on behalf of XYZ Ltd against the two directors, to recover the loss suffered by the company.
   (a) Explain whether the wrong has been done to XYZ Ltd, or to P and Q.
   (b) Is there any remedy on which P and Q may rely? If so, explain the procedure that must be followed.
2. Slick and Whitney form a private company on the basis of an understanding that Slick will be the majority shareholder, and that both Slick and Whitney will be directors who will participate equally in the management of the company. Two years later the relationship between Slick and Whitney sours, due to personal disputes and animosity between them. Slick locks Whitney out of the office, withdraws payment of her director's salary and other benefits, and eventually removes her as a director. Whitney is unable to find a purchaser for her shares in the company. Slick refuses to purchase her shares.
   (a) Advise Whitney what her most effective remedy would be in the circumstances.
   (b) How would your answer differ if Slick had offered to purchase Whitney's shares at a fair and reasonable value?

3. Blueberry Ltd has resolved to enter into a merger with ABC Ltd. The merger has been approved by a special resolution of the shareholders of each of the two companies. Bug, who is a minority shareholder in Blueberry Ltd, disapproves of the merger and has voted against it. What is the primary remedy for minority shareholders, such as Bug, who do not approve of a merger, and what exactly does this remedy entail? Explain the procedure that Bug would have to comply with in order to rely on this remedy.

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[1] Or the direct or indirect 'control' of each of them or the business of each of them by a third person. 'Control' includes the direct or indirect control of the exercise of a majority of the voting rights of the company, or the right to appoint or elect directors who control a majority of the votes at board meetings (whether alone or together with any related or inter-related person), or the ability to materially influence the policy of the company. See further Chapter 8: Groups of companies and related persons.

[2] See MS Blackman et al *Commentary on the Companies Act* Vol 1 (2010 revision) 9-9.

[3] Prescribed officers are persons who, despite not being directors of the company (and regardless of the title of their office or function), exercise general executive control over and management of the whole, or a significant portion, of the business and activities of the company; or participate regularly to a material degree in the exercise of general executive control over, and management of, the whole, or a significant portion, of the business and activities of the company.

[4] [1959] AC 324. (The relief granted in this case was based on the consideration that the society had effectively determined the conduct of the subsidiary.)

[5] This is usually as a result of personal disputes among the shareholders, for instance, over remuneration or the future objectives of the company.

[6] 2010 (4) SA 548 (SCA), which was decided in terms of the equivalent section (s 252) of the Companies Act 61 of 1973.

[7] (1843) 2 Hare 461; 67 ER 189.

[8] There is a common-law exception to the effect that, when the board refuses or is unable to institute action on behalf of the company, the shareholders in general meeting may intervene in the powers of the board.

[9] See further 18.4 and 18.5.

[10] Directors include alternate directors and any persons occupying the position of a director or alternate director, by whatever names those persons may be designated.

[11] See note 3.

[12] The right of a person under s 165 may be exercised by that person directly, or by the Companies Commission or the Takeover Regulation Panel, or by another person on his or her behalf in the manner permitted by s 157.

[13] In exceptional circumstances, a person may apply to a court for leave to bring proceedings in the name of a company without first making a demand (or without affording the company time to respond to the demand). The court may grant leave in such circumstances only if it is satisfied that the delay required for these procedures to be completed may result in irreparable harm to the company, or substantial prejudice to the interests of the applicant or another; that there is a reasonable probability that the company may not act to prevent that harm or prejudice, or to protect the company's interests that the applicant seeks to protect; and that the three criteria for leave (discussed in 18.2.8) are satisfied.

[14] See further Chapter 8: Groups of companies and related persons, for the meaning of 'related' persons and 'control'.

[15] See further Chapter 8: Groups of companies and related persons, for the definition of 'related' persons, 'inter-related persons' and 'control'.

[16] Control' in this context is defined to mean, in broad terms, the ability to control the exercise of a majority of the voting rights of the company, or the right to appoint or elect directors of the company who control a majority of the votes at board meetings. See further Chapter 8: Groups of companies and related persons.

[17] See further Chapter 14: The duties and the liability of directors.

[18] This discussion on appraisal rights is largely derived from Maleka Femida Cassim 'The introduction of the statutory merger in South African corporate law: Majority rule offset by the appraisal right (Part I)' (2008) 20 *SA Merc LJ* 1 and Maleka Femida Cassim 'The introduction of the statutory merger in South African corporate law: Majority rule offset by the appraisal right (Part II)' (2008) 20 *SA Merc LJ* 147, and the authorities cited therein.

[19] See further 18.3.3.

[20] There are two exceptions to the requirement of a notice of objection: first, if the company failed to include a statement of the shareholders' appraisal rights in the notice of the meeting, or second, if the company failed to give notice of the meeting at all.

[21] See further Maleka Femida Cassim (Part II) (n 18) 167-71 and the authorities cited therein, for a discussion of the valuation of shares in the context of appraisal.

[22] If a shareholder's appraisal rights were triggered by a resolution that authorised the company to amalgamate or merge with another company, with the result that the relevant company has ceased to exist, the obligations of that company under s 164 are the obligations of its successor resulting from the amalgamation or merger.

[23] See further Maleka Femida Cassim (Part II) (n 18) 164-7.

[24] The term 'securities holders' has a much wider meaning than shareholders. It means the holders of any shares, debentures or other instruments, irrespective of their form or title, issued by a profit company.

[25] See further Chapter 14: The duties and the liability of directors.

[26] Section 20(5) is discussed in detail in Chapter 7: Corporate capacity, agency and the Turquand rule.

[27] [1998] 1 All ER 724 (CA).

Chapter 19
Enforcement and Regulatory Agencies

Maleka Femida Cassim

19.1 Introduction and underlying policy

One of the key objectives of the Companies Act 71 of 2008 ('the Act') is to 'provide a predictable and effective environment for the efficient regulation of companies'. [1]

Flowing from this objective, company law has been extensively decriminalised. Experience under the previous Company Act ('the 1973 Act') [2] showed that criminal penalties are ineffective as a means of ensuring compliance with company law. This is largely due to the failure and reluctance to prosecute for technical offences. Rather than relying on criminal sanctions, the Act relies primarily on a system of administrative enforcement combined with a minimum number of criminal sanctions.

The enforcement of the Act takes place through various bodies or regulatory agencies. These are the Companies and Intellectual Property Commission ('the Companies Commission'), the Takeover Regulation

Panel ('the Panel'), the Financial Reporting Standards Council ('the FRSC') and the Companies Tribunal, which is a new regulatory agency established by the Act.

There are four avenues for addressing complaints regarding alleged contraventions of the Act or for the enforcement of rights. The aggrieved party (or any other person with standing) may-

(i) apply to the High Court;
(ii) file a complaint with the Companies Commission or the Panel;
(iii) apply to the Companies Tribunal for adjudication; or
(iv) use alternative dispute resolution.

These procedures are dealt with in this chapter. The inclusion of these alternative procedures is expected to alleviate the burden on the courts, and to save costs, time and other relevant resources. The High Court nevertheless remains the primary forum for resolving disputes, and for the interpretation and enforcement of the Act. [3]

The Act preserves several pre-existing remedies (some of which are wider than before), while simultaneously introducing various new remedies and establishing certain general principles on remedies. The general principles include an extended right of standing to apply for remedies. Most of the remedies under the Act have been discussed in other chapters of this book, where appropriate. This section discusses the few remaining remedies, and the general principles relating to remedies.

19.2 General principles on remedies

19.2.1 Extended standing (or *locus standi*) to apply for remedies

When a matter may be brought before (or an application may be made to) a court, or to the Companies Commission, the Companies Tribunal or the Panel, the right to do so may be exercised- [4]

(i) directly by a person contemplated in the relevant provision of the Act;
(ii) by a person acting on their behalf, if they cannot act in their own name;
(iii) by a person acting as a member of (or in the interest of) a group or a class of affected persons, or an association acting in the interest of its members; or
(iv) by a person acting in the public interest, with leave of the court.

A key innovation introduced by this provision is the class action. This enables one or more persons to bring an action in the interest of a class of persons who have a common interest in the same cause of action. These wide provisions are new to company law and did not form part of the 1973 Act.

The section, furthermore, enables the Companies Commission or the Panel (acting on its own motion and in its absolute discretion) to commence court proceedings in the name of a person who made a written request that it do so; or to

apply for leave to intervene in court proceedings in order to represent any interest that would not otherwise be adequately represented.

19.2.2 Remedies must promote the purpose of the Act

When a court determines a matter (or makes an order) in terms of the Act, the court must develop the common law as necessary to improve the realisation and enjoyment of rights under the Act. [5]

More importantly, the spirit, purpose and objects of the Act must be promoted by the courts, the Companies Commission, the Panel and the Companies Tribunal when determining matters (or making orders) under the Act. Provisions of the Act and documents in terms of the Act (which can be reasonably construed to have more than one meaning) must be interpreted in a way that best promotes the spirit and purpose of the Act. The purposes of the Act [6] which must be promoted are as follows:

(i) to balance the rights and obligations of shareholders and directors within companies;
(ii) to encourage the efficient and responsible management of companies;
(iii) to provide a predictable and effective environment for the efficient regulation of companies;
(iv) to reaffirm the concept of the company as a means of achieving economic and social benefits;
(v) to continue to provide for the creation and use of companies, in a manner that enhances the economic welfare of South Africa as a partner within the global economy;
(vi) to promote the development of companies within all sectors of the economy, and encourage active participation in economic organisation, management and productivity;
(vii) to promote compliance with the Bill of Rights, as provided for in the Constitution, in the application of company law;
(viii) to promote the development of the South African economy by–
  - encouraging entrepreneurship and enterprise efficiency;
  - creating flexibility and simplicity in the formation and maintenance of companies; and
  - encouraging transparency and high standards of corporate governance as appropriate, given the significant role of enterprises within the social and economic life of the nation;

(ix) to promote innovation and investment in the South African markets;
(x) to create optimum conditions for the aggregation of capital for productive purposes, and for the investment of that capital in enterprises and the spreading of economic risk;
(xi) to provide for the formation, operation and accountability of non-profit companies in a manner designed to promote, support and enhance the capacity of such companies to perform their functions;

and

(xii) to provide for the efficient rescue and recovery of financially distressed companies, in a manner that balances the rights and interests of all relevant stakeholders.

19.2.3 Protection for whistle-blowers

The Act establishes a regime for the protection of 'whistle-blowers', that is, persons who disclose irregularities or contraventions of the Act. [7] This is intended to harmonise with the Protected Disclosures Act 26 of 2000, which provides certain protective measures for employees.

In broad terms, the Act grants protection and safeguards to certain categories of persons who disclose information in good faith, relating to unlawful or irregular conduct on the part of a company or its directors or prescribed officers. The disclosure may relate to matters such as a contravention of the Act, harm to the environment, endangerment of health and safety, unfair discrimination against any person, failure by the company to comply with a statutory obligation and various other matters.

The categories of persons who may disclose information and benefit from the protection of the Act include shareholders, directors, company secretaries, prescribed officers or employees of the company, registered trade unions or other employee representatives, and suppliers of goods or services to the company. A number of protections are granted to such 'whistle-blowers': first, they have qualified privilege in respect of the disclosure; and second, they are immune from any liability (be it civil, criminal or administrative liability) for the disclosure. Furthermore, the 'whistle-blower' is entitled to compensation in certain circumstances for damage suffered by him or her. This applies, for instance, if another person intentionally causes detriment to the whistle-blower as a result of an actual disclosure that was made, or even a possible disclosure that he or she is entitled to make.

19.3 Regulatory agencies

The enforcement of the Act takes place through various regulatory agencies. These bodies are the Companies and Intellectual Property Commission, the Companies Tribunal, the Takeover Regulation Panel and the Financial Reporting Standards Council. This section considers the first two regulatory bodies. (The Takeover Regulation Panel is discussed in Chapter 17: Fundamental transactions, takeovers and offers, and the Financial Reporting Standards Council in Chapter 15: The auditor, financial records and reporting.)

19.3.1 The Companies and Intellectual Property Commission

19.3.1.1 General

The Companies and Intellectual Property Commission ('the Companies Commission') is not so much a newly established entity as a transformed entity. It is a transformation of the previous Companies and Intellectual Property Registration Office ('CIPRO') which, under the 1973 Act, had exercised many of the functions

assigned to the Registrar of Companies (and the Minister). The Companies Commission, however, is not only a transformation of CIPRO, but has additionally been granted a significant expansion of the powers and functions previously allocated to CIPRO.

The Companies Commission is a separate organ of state within the public administration. It is outside the public service. It has jurisdiction throughout the Republic of South Africa. The Companies Commission is independent, and it must be impartial and exercise its functions in the most cost-efficient and effective manner.

The objectives of the Companies Commission are: [8]

(i) the efficient and effective registration of companies as well as external companies, other juristic persons and intellectual property rights;
(ii) maintaining accurate, up-to-date and relevant information concerning companies, foreign companies, other juristic persons and intellectual property rights, and providing that information to the public (and other organs of state);
(iii) promoting education and awareness of company law and intellectual property laws (and related matters);
(iv) promoting compliance with the Act and other applicable legislation; and
(v) the efficient, effective and widest possible enforcement of the Act and other applicable legislation. [9]

The Commissioner is the head of the Companies Commission, and is appointed by the Minister. The Commissioner holds office for an agreed term not exceeding five years, but this is subject to reappointment. The Minister also appoints the Deputy Commissioner.

19.3.1.2 Functions of the Companies Commission

It is a fundamental function of the Companies Commission to enforce the Act. [10] It enforces the Act by, inter alia-

(i) monitoring proper compliance with the Act;
(ii) promoting the voluntary resolution of disputes arising between a company and a shareholder or director (see 19.6);
(iii) receiving and promptly investigating complaints concerning contraventions of the Act (see 19.5);
(iv) issuing and enforcing compliance notices; and
(v) various other means in the course of complaints made to the Companies Commission (see 19.5).

A second important function of the Companies Commission is to establish and maintain a companies' register as well as other relevant registers, such as a register of disqualified directors. The information in the registers must be made available to the public (and to other organs of state) in an efficient and effective manner. The

Companies Commission also registers and deregisters companies, directors, business names and intellectual property rights. Any person may, on payment of the prescribed fee, inspect a document that is filed under the Act, unless the document (or any part of it) contains confidential information. A person may similarly obtain from the Companies Commission a copy or an extract of a filed document that is open to inspection, or may obtain a certificate as to the contents of any document.

A novel function of the Companies Commission is the promotion of the reliability of financial statements. Among other things, the Companies Commission is now responsible for monitoring patterns of compliance with financial reporting standards as well as patterns of contraventions. It is also required to make recommendations to the Financial Reporting Standards Council on enhancing financial reporting standards. [11] (The Financial Reporting Standards Council acts in an advisory capacity to the Minister, and it is the Minister and not the FRSC who now sets the financial reporting standards.)

Regarding the functions of reporting, research and public information, the Companies Commission must report to the Minister on its registration and enforcement activities. It is also responsible for recommending to the Minister suitable changes to the law and the administration of the Act to bring it up to date and in line with international best practice. Public awareness of company law and intellectual property law matters must be promoted by the Companies Commission. This includes providing guidance to the public by issuing explanatory notices outlining its procedures and non-binding opinions on the interpretation of the Act.

19.3.2 The Companies Tribunal

19.3.2.1 General

The Companies Tribunal is a newly established body under the Act. It is an independent organ of state that has jurisdiction throughout South Africa. It must exercise its functions in accordance with the Act and in a transparent manner. The Companies Tribunal must be impartial, and must act without fear, favour or prejudice.

The Companies Tribunal consists of a chairperson (who may not be reappointed to a second term as chairperson), and no fewer than ten other members appointed by the Minister on a full- or part-time basis. Each member's term of service is five years, and members may be reappointed for a second term. The chairman and members must be eligible for membership as set out in the Act. A disqualified person would, for instance, be an office-bearer of any party or body of a partisan political nature; a person who is disqualified from serving as a director of a company; a person who has a personal financial interest that may conflict with his or her duties as a member of the Companies Tribunal; or a person who is subject to an order of court holding him or her to be mentally unfit or disordered. [12]

19.3.2.2 Functions of the Companies Tribunal

The Companies Tribunal has three chief functions: [13]

(i) First, it must adjudicate in relation to any application that may be made to it under the Act (see 19.7).
(ii) Second, it serves as a forum for the voluntary resolution of disputes (see 19.6).
(iii) Third, it must perform any other function assigned to it under the Act (or by any other relevant law).

Other functions assigned to the Companies Tribunal under various provisions of the Act include, for example, the following: granting an extension of time for a public company to convene an annual general meeting; issuing an administrative order convening a shareholders' meeting when, for instance, there are no directors; resolving disputes concerning company names; making a determination whether a director is ineligible, disqualified or incapacitated or has been negligent or derelict, in a company that has fewer than three directors; or issuing an administrative order exempting an agreement, transaction, arrangement, resolution or provision of a company's Memorandum of Incorporation or rules from an unalterable provision of the Act. [14]

A vital function of the Companies Tribunal is to review administrative decisions made by the Companies Commission, such as the review of compliance notices issued by the Commission. When the Companies Tribunal reviews a decision, notice or order made by the Companies Commission, the decision of the Tribunal is binding on the Commission. However, this is subject to any review by a court or appeal to a court. [15]

Matters referred to the Companies Tribunal are assigned either to a single member of the Tribunal (to the extent that the Act provides for this), or to a panel composed of any three members of the Tribunal (in any other case). Where a matter is decided by a panel, the decision of a majority of the members of the panel constitutes the decision of the Tribunal. The decision of a panel on any matter must be in writing and must include reasons for the decision.

It is important to note that an order of the Companies Tribunal may be filed in the High Court as an order of the court.

19.4 Alternative procedures for addressing complaints or securing rights

Aggrieved persons (or any other persons with standing) have four alternative procedures for addressing complaints regarding alleged contraventions of the Act or for the enforcement of rights or provisions - whether in terms of the Act, a company's Memorandum of Incorporation or rules, or a relevant transaction or agreement. The four procedures are as follows: [16]

(i) filing a complaint with the Companies Commission or the Panel (depending on which body has jurisdiction over the matter);
(ii) attempting to resolve the dispute (with a company or within a company) through alternative dispute resolution;
(iii) applying to the Companies Tribunal for adjudication (provided that the Act permits it in respect of the relevant matter); or
(iv) applying to the High Court for appropriate relief.

Each of these alternative procedures is discussed in turn below (in 19.5-19.7). Notably, the High Court remains the primary forum for the resolution of disputes, and the interpretation and enforcement of the Act.

19.5 Complaints to the Companies Commission

The Act extensively decriminalises company law, as discussed above, and generally relies on a system of administrative enforcement in place of criminal sanctions to ensure compliance with the Act. Any person who alleges that his or her (or its) rights have been infringed, or that another person has acted inconsistently with the Act, may file a complaint with the Companies Commission.

19.5.1 Initiating a complaint

Any person ('the complainant') may file a written complaint with the Companies Commission alleging that- [17]

(i) another person has acted in a manner inconsistent with the Act; or
(ii) their (ie the complainants') rights – whether under the Act or a company's Memorandum of Incorporation or rules – have been infringed.

Where a complaint concerns a matter within the jurisdiction of the Panel (ie a matter contemplated in the takeover provisions of the Act or the Takeover Regulations), the complaint must be filed with the Panel. [18] All other complaints are filed with the Companies Commission. A complaint may also be initiated directly by the Companies Commission, whether on its own motion or at the request of another regulatory authority. Furthermore, the Minister may direct the Companies Commission to investigate an alleged contravention of the Act or other specified circumstances.

Regarding the issue of prescription, there is a prescribed time limit for initiating complaints. A complaint may not be made to the Companies Commission more than three years after the act (or omission) that is the cause of the complaint. In the case of a course of conduct or a continuing practice, the time period of three years is calculated from the date that the conduct or practice ceased.

The Act also takes the double jeopardy principle into account. In this regard, a complaint may not be prosecuted in terms of the Act against any person who has been a respondent in proceedings under another section of the Act relating substantially to the same conduct.

19.5.2 Investigation by the Companies Commission

The Companies Commission may respond to a complaint in one of three ways: [19]

(i) It may notify the complainant that it will not investigate the complaint, if the complaint appears to be frivolous or vexatious or does not allege any facts that (if proven) would constitute grounds for a remedy under the Act.

(ii) If it thinks it expedient, it may recommend that the complainant seek to resolve the matter through alternative dispute resolution, and refer the complaint to the Companies Tribunal or an accredited entity [20] for this purpose.

(iii) In all other cases, it may direct an inspector or investigator to investigate the complaint.

An inspector is any suitable employee of the Companies Commission (or other suitable employee of the state) who is appointed as an inspector by the Commissioner, and is issued with a certificate of appointment. Additionally, the Commissioner may appoint a suitably qualified person to assist the Commission in carrying out an investigation. [21] In conducting an investigation, an inspector or investigator may investigate any person who is named in the complaint (or related to a person named in the complaint), or any person whom the inspector reasonably considers may have relevant information.

The Companies Commission has the power to issue a summons to any person who is believed to be able to provide information, documents or other objects relevant to an investigation. The summons may require the person to appear before the Commission or before an inspector or independent investigator to be questioned, or to deliver any document or other object. A warrant to enter and search premises may be issued by a judge of the High Court or a magistrate. This applies if, from information given on oath or affirmation, there are reasonable grounds for believing that a contravention of the Act has taken place (or is likely to take place) on those premises, or that anything connected with an investigation is in the possession or control of a person on those premises. [22]

19.5.3 Outcome of the investigation

After receiving the report of the inspector or independent investigator, the Companies Commission has several options. It may- [23]

(i) issue a compliance notice (see further 19.5.4);

(ii) refer the matter to the National Prosecuting Authority or other relevant regulatory authority (if the Commission alleges that a person has committed an offence under the Act or other legislation);

(iii) commence court proceedings in the name of the complainant (if the complainant has consented and has a right to apply to court in respect of the matter);
(iv) refer the complaint to the Companies Tribunal or the Panel, if the matter falls within their respective jurisdictions;
(v) propose that the complainant and any affected person meet with the Commission or the Companies Tribunal, with a view to resolving the matter by consent order (see further 19.5.5);
(vi) excuse any person as a respondent in the complaint (if the Commission considers it reasonable to do so, having regard to the person's conduct and co-operation in the investigation); or
(vii) issue a notice of non-referral to the complainant, together with a statement advising the complainant of any rights he or she (or it) may have to seek a remedy in court. If the Companies Commission issues a notice of non-referral, the complainant is entitled to apply for leave to refer the matter directly to a court. But no complaint may be referred to a court if it concerns a person whom the Commission had excused as a respondent in the complaint (see above). The court may grant leave only if it appears that the applicant has no other available remedy in terms of the Act. If after granting leave and conducting a hearing, the court finds that the respondent has indeed contravened the Act, the court may require the Companies Commission to issue a compliance notice to address that contravention. Alternatively, the court may make any other order is contemplated in the Act that is just and reasonable in the circumstances.

The Companies Commission, in its sole discretion, may publish the report of the inspector or independent investigator. Irrespective of whether it publishes the report, the Companies Commission must deliver a copy of the report to the complainant and any person who was a subject of the investigation.

19.5.4 Compliance notice

Once a complaint has been investigated the Companies Commission, as discussed above, has several options, one of which is to issue a compliance notice. This is an important and innovative provision of the Act. Failure to comply with a compliance notice may have severe consequences.

A compliance notice may be issued to any person (whether a company or an individual) that the Companies Commission, on reasonable grounds, believes- [24]

(i) has contravened the Act; or
(ii) assented to, was implicated in, or directly or indirectly benefited from, a contravention of the Act.

The Commission may issue a compliance notice only if an alleged contravention could not otherwise be addressed by an application to a court or to the Companies Tribunal.

A compliance notice may require a person to-

(i) cease, correct or reverse any action in contravention of the Act;
(ii) take any action required by the Act;
(iii) restore assets or their value to a company or to any other person;
(iv) provide a community service; or
(v) take any other steps reasonably related to the contravention and designed to rectify its effect.

The compliance notice must be in the prescribed form. It must set out the person or association to whom it applies and the provision of the Act that has been contravened, and must contain details of the nature and extent of the contravention. The notice must also specify the steps that must be taken and the period within which this must be done, together with the penalty that may be imposed for failure to do so. [25]

Upon satisfaction of the requirements of a compliance notice, the Companies Commission must issue a compliance certificate. Once a compliance certificate is issued, the compliance notice is discharged.

A compliance notice generally remains in force until a compliance certificate has been issued by the Companies Commission. However, a compliance notice may also be set aside by the Companies Tribunal or by a court, upon a review of the notice (see below).

19.5.4.1 Objection to a compliance notice

A person who has been issued with a compliance notice may challenge it before the Companies Tribunal or a court. [26] A decision by the Companies Tribunal (whether to confirm, modify or cancel all or part of the compliance notice) is binding, but is subject to any right of review by or appeal to a court. Failing a successful objection to a compliance notice, the person who has been issued with the notice is obliged to satisfy its terms and requirements.

19.5.4.2 Failure to comply with a compliance notice

If a person fails to comply with a compliance notice, the Companies Commission may either-

(i) apply to a court for the imposition of an administrative fine; or, alternatively,
(ii) refer the matter to the National Prosecuting Authority for prosecution as an offence.

However, the Companies Commission may not do both in respect of a failure to comply with a particular compliance notice. [27]

If the offence is prosecuted, any person convicted of the offence of failure to satisfy a compliance notice is liable to a fine or imprisonment for a period of up to 12 months, or to both a fine and imprisonment. Even though the Act generally uses a system of administrative enforcement rather than criminal sanctions to ensure compliance, it is noteworthy that the system of administrative enforcement may itself ultimately result in criminal sanctions. Since the failure to satisfy a compliance notice is an offence in itself, the complaints procedure may eventually result in a criminal

prosecution. But this is a matter of last resort. Moreover, the Companies Commission may alternatively apply to a court for an administrative fine, thereby bypassing any prosecution for the offence.

If an administrative fine is imposed for a failure to comply with a compliance notice, the administrative fine must be imposed by a court. The administrative fine may not exceed the greater of 10 per cent of the respondent’s turnover for the period during which the company failed to comply with the compliance notice, and the maximum prescribed by the Minister by way of regulation. The prescribed maximum administrative fine is currently set by the Companies Regulations at the amount of R1 million. [28] When determining the appropriate amount of an administrative fine, the court must consider the following factors: the nature, duration, gravity and extent of the contravention; any loss or damage suffered as a result; the behaviour of the respondent; the market circumstances in which the contravention took place; the level of profit derived from the contravention; the degree to which the respondent co-operated with the Companies Commission and the court; and whether the respondent has previously been found to be in contravention of the Act. [29] Administrative fines are paid into the National Revenue Fund.

19.5.5 Consent order

Where a matter has been investigated and the Companies Commission and the respondent have agreed on a resolution of the complaint, the Companies Commission may record the resolution in the form of an order. If the person who is the subject of the complaint consents to that order, the Companies Commission may apply to the High Court to have it confirmed as a consent order. [30]

The court may make the order as agreed and proposed in the application, or may indicate any changes that must be made to the draft order, or may refuse to make the order. Where the court confirms a consent order, this may include an award of damages. Unless the consent order includes an award of damages to a person, that person may apply for an award of civil damages. The consent order process is expected to promote the expeditious resolution and settlement of disputes.

19.6 Voluntary resolution of disputes

One of the alternative procedures for resolving complaints or securing rights under the Act is alternative dispute resolution, as discussed in 19.4. Alternative dispute resolution for these purposes means conciliation, mediation or arbitration.

As an alternative to applying for relief to a court, or filing a complaint with the Companies Commission, a person may refer a matter for resolution by mediation, conciliation or arbitration either to the Companies Tribunal or to an accredited entity or any other person. [31] The Act does not explicitly require the consent of the other party to alternative dispute resolution, but in view of the voluntary nature of alternative dispute resolution the consent of both parties would be necessary.

It is clear that successful alternative dispute resolution requires both parties to the dispute to participate in the process in good faith. If the Companies Tribunal (or the accredited entity or other person to whom the matter has been referred, as the case may be) concludes that either party to the conciliation, mediation or arbitration is not participating in that process in good faith, or that there is no reasonable probability of the parties resolving their dispute through that process, it must issue a certificate in the prescribed form stating that the process has failed.

On the other hand, when dispute resolution is successful, this may result in a consent order. To elaborate, where the Companies Tribunal (or the accredited entity or other person to whom the dispute has been referred) has resolved a dispute or has assisted the parties in resolving a dispute, it may record the resolution of that dispute in the form of an order. Provided that the parties to the dispute consent to that order, it may be submitted to a court to be confirmed as a consent order in terms of the rules of the court. [32] See further 19.5.5 on consent orders.

19.7 Companies Tribunal adjudication proceedings

Another of the alternative procedures available under the Act for addressing complaints or securing rights is the option of applying to the Companies Tribunal for adjudication, as set out in 19.4. A distinction must be drawn between alternative dispute resolution by the Companies Tribunal (as discussed in 19.6) and adjudication proceedings by the Companies Tribunal. These are two separate and distinct dispute resolution procedures.

The Companies Tribunal may adjudicate 'in relation to any application that may be made to it in terms of th[e] Act'. [33]

Adjudication proceedings must be conducted by the Companies Tribunal expeditiously and in accordance with the principles of natural justice. The Companies Tribunal may conduct adjudication proceedings informally. At the conclusion of adjudication proceedings, the presiding member must issue a decision together with written reasons for it. [34] Various matters are dealt with by the Act and the regulations, including the rules of procedure and the powers of the Companies Tribunal at an adjudication hearing, witnesses, and the right to participate in adjudication hearings.

19.8 Offences

A guiding policy for the Act is that company law should be decriminalised where possible, in order to promote predictability, effectiveness and efficiency in the regulation of companies. Rather than relying on extensive criminal sanctions for purely technical offences in the vein of the 1973 Act, the new Act relies primarily on a system of administrative enforcement, as discussed above. This is expected to enhance and improve compliance with the Act. Criminal sanctions in the context of company law, especially for technical offences, have been found to be ineffective for a number of reasons, and the trend internationally is to replace criminal sanctions with more meaningful administrative sanctions.

The Act, however, is not completely devoid of criminal sanctions. There are a number of offences under the Act. [35]

Several offences relate to false statements. The falsification of any accounting records of a company is an offence, and any person who is a party to such falsification is guilty of an offence. It is also an offence 'knowingly' [36] to provide false or misleading information, with a fraudulent purpose, in any circumstances in which the Act requires a person to provide information or to give notice to another person. 'Untrue statements' in a prospectus (or written statement) attract criminal penalties if one is a party to the preparation, approval, dissemination or publication of such a prospectus or written statement.

For the purpose of this offence, and also the offence of being a party to the preparation, approval, dissemination or publication of financial statements or summaries to the extent set out in s 29(6), [37] a person is a *party* to the preparation of a document if the document includes or is based on a scheme, structure or form of words or numbers devised, prepared or recommended by that person, which is of such a nature that the person knew or ought reasonably to have known that its inclusion or use in connection with the preparation of the document would cause it to be false or misleading. [38]

In relation to fraudulent trading or fraudulent conduct, it is a criminal offence for a person 'knowingly' to be a party to an act (or omission) by a company that is calculated to defraud a creditor, employee or security holder of the company, or with another fraudulent purpose. [39]

A failure to satisfy a compliance notice is itself an offence. This may result in a criminal prosecution, unless the Companies Commission (or the Panel, as the case may be) has applied to a court for the imposition of an administrative fine. (See also the discussion on compliance notices at 19.5.4.) It is also an offence to hinder the administration of the Act, by hindering, obstructing or improperly attempting to influence the Companies Commission, the Panel, the Companies Tribunal, an inspector or investigator, or a court when any of them is exercising a power or performing a duty under the Act. For instance, a person commits an offence if that person refuses to respond to a summons or give evidence, commits perjury, or improperly frustrates the execution of a warrant to enter and search.

There are in addition certain other offences under the Act, eg the failure by a company to keep accurate and complete accounting records, or keeping records other than in the prescribed manner and form with intent to deceive or mislead.

The general penalty for a person convicted of an offence in terms of the Act is a fine or imprisonment for a period not exceeding 12 months, or both a fine and imprisonment. However, in order to improve corporate accountability, certain offences carry a more stringent penalty consisting of a fine or imprisonment for a period of up to ten years, or both a fine and imprisonment. These include the offence of being a party to the falsification of accounting records, the other offences involving false statements, and the offence relating to fraudulent conduct.

19.9 Civil actions (Section 218(1))

An agreement, a resolution or a provision of a company's Memorandum of Incorporation or rules is automatically void if it is explicitly stated to be 'void' in terms of the Act. This is a sensible measure. A declaration of voidness by a court should not be required where a provision is void *ab initio* in terms of the Act.

However, an agreement, a resolution or a provision of a company's Memorandum of Incorporation or rules that either is prohibited or voidable or may be declared unlawful under the Act, would only be void if a court declares it to be void.

Questions

1. Explain the functions of:
   (a) the Companies Commission; and
   (b) the Companies Tribunal.
2. What are the various procedures for addressing complaints regarding alleged contraventions of the Act or for the enforcement of rights in terms of the Act?
3. Discuss the general policy approach of the Act to criminal sanctions as a means of ensuring compliance with company law. In what circumstances does the Act provide for the imposition of criminal sanctions? What are the underlying reasons for imposing criminal penalties in the circumstances prescribed by the Act?
4. X, a shareholder of ABC (Pty) Ltd, wishes to file a complaint with the Companies Commission in respect of certain conduct on the part of ABC (Pty) Ltd that was allegedly inconsistent with the Act. The relevant conduct relates to a continuing practice by ABC (Pty) Ltd that began 18 months ago and continues to occur.
   (a) Advise X fully on the procedure for initiating a complaint, and all the possible responses of the Companies Commission to the

complaint.

(b) Explain what a compliance notice is, and the circumstances under which a compliance notice may be issued.

(c) Assume that the Companies Commission has issued a compliance notice to ABC (Pty) Ltd, requiring it to reverse all its actions in contravention of the Act and to restore certain assets to specified persons. ABC (Pty) Ltd is of the view that it has valid grounds for challenging the compliance notice, and it consequently wishes simply to ignore the compliance notice. Advise ABC (Pty) Ltd of the wisdom of this course of action. Include in your answer a discussion of the consequences of a failure to comply with the compliance notice; whether it is possible to challenge a compliance notice; and, if so, in which forum this must be done.

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[1] Section 7.

[2] Act 61 of 1973.

[3] *Memorandum on the Objects of the Companies Bill, 2008*, Companies Bill [B 61D-2008] para 3.

[4] Section 157.

[5] Section 158.

[6] Section 7.

[7] Section 159.

[8] Section 186.

[9] Including, inter alia, the Close Corporations Act 69 of 1984; the Copyright Act 98 of 1978; the Counterfeit Goods Act 37 of 1997; the Patents Act 57 of 1978; the Trade Marks Act 194 of 1993; and Part A of Chapter 4 of the Consumer Protection Act 68 of 2008.

[10] Except for matters that are within the jurisdiction of the Panel; see s 187.

[11] Section 186.

[12] Section 205. See further s 206 on conflicting interests of agency members, and s 207 on resignation and removal from office.

[13] Section 195(1).

[14] Sections 61(7) and (11), 71, 160 and 6(2), respectively. In respect of s 160, see further Chapter 6: Formation of companies and the company constitution.

[15] Sections 172 and 195.

[16] Section 156.

[17] Section 168. See also reg 135 and Form CoR135.1.

[18] The Panel is discussed in Chapter 17: Fundamental transactions, takeovers and offers. This section focuses on the Companies Commission. However, it should be borne in mind that these provisions apply equally to complaints to the Panel.

[19] Section 169.

[20] The entity may have been accredited by the Companies Commission or designated by the Minister.

[21] Sections 209 and 169.

[22] See further ss 176-9, in relation to the summons, authority to enter and search under warrant, powers to enter and search, and the conduct of entry and search.

[23] Section 170.

[24] Section 171.

[25] See also reg 139 of the Companies Regulations GNR 351 *GG* 34239 of 26 April 2011 ('the Regulations') and Forms CoR 139.1 and 139.2.

[26] See further s 172.

[27] Section 171.

[28] Regulation 163. The method of calculating assets and turnover is set out in reg 164.

[29] Section 175.

[30] Section 173.

[31] Section 166.

[32] Section 167.

[33] Section 195; see also s 156. Regrettably, the Act does not clearly set out the matters in respect of which the Companies Tribunal may adjudicate.

[34] Section 180.

[35] Sections 213-17.

[36] The term 'knowingly' means that the person either *(a)* had actual knowledge of that matter; or *(b)* was in a position in which the person reasonably ought to have: (i) had actual knowledge; or (ii) investigated the matter to an extent that would have provided the person with actual knowledge; or (iii) taken other measures which, if taken, would reasonably be expected to have provided the person with actual knowledge of the matter (s 1).

[37] Ie in the case of financial statements, knowing that those statements do not comply in a material way with the requirements of s 29(1) or that they are materially false or misleading; and in the case of a summary, knowing that the summary does not comply with the requirements of s 29(3) or is materially false or misleading, or that the statements that it summarises do not comply with the requirements of s 29(1) or are materially false or misleading.

[38] Section 214(2).

[39] Section 214(1)*(c)*.

Chapter 20
Business Rescue and Compromises [*]

Farouk HI Cassim

20.1 Introduction: a rescue culture

One of the major themes of the Companies Act 71 of 2008 ('the Act') is the creation of a system of 'corporate rescue appropriate to the needs of a modern South African economy'. [1] This is amplified in the Act, which states that one of the purposes of the Act is to 'provide for the efficient rescue and recovery of financially distressed companies, in a manner that balances the rights and interests of all relevant stakeholders'. [2] This provision captures the essence of the business rescue process. The business rescue process holds far more promise than the previous judicial management procedure, which was also aimed at the rehabilitation of a company but which was a dismal failure. The 2008 Act accordingly introduces an entirely new business rescue process, the purpose of which is to facilitate the rehabilitation or reorganisation of a company that is in financial distress. The merits of a proper business rescue regime are no longer open to doubt. It is accepted in most jurisdictions that business rescue offers a very useful alternative to the liquidation or winding-up of a company. [3] 'Rescue' may be defined as a major intervention necessary to avert the eventual failure of a company. [4]

By 'rescue' is meant simply a reorganisation of the company to restore it to a profitable entity and avoid liquidation. This is based on Chapter 11 of the US Bankruptcy Code, Bankruptcy Reform Act 1978, [5] which focuses on reorganising companies that are in financial difficulties and combines it with an automatic moratorium. The objective is to save companies - not put them under liquidation.

The effects of insolvency are not limited to the private interests of the insolvent debtor and his or her creditors. There are other groups in society that are vitally affected by the insolvency of the debtor. There are in general five groups of stakeholders affected by the financial distress of a company, viz shareholders, creditors, employees, directors and the local community. The interests of these stakeholders must be carefully balanced and proper weight given to the various competing interests. A good system of insolvency law should provide a means or a process for preserving viable commercial enterprises.

The Act attempts to make it easier for companies in financial difficulty to be rescued, to avoid insolvency and consequent winding-up, and to continue as

commercially viable entities. The fundamental purpose of a business rescue or reorganisation is to prevent a debtor from going into liquidation, with an attendant loss of jobs and possible misuse of economic resources. Business rescue is thus an alternative to the liquidation of a company. It is not by any means a preliminary step towards the liquidation of the company. Moreover, unlike the previous judicial management process, business rescue is not intended to apply only in exceptional circumstances.

The basic philosophy underlying much of the business rescue process is that a company in financial difficulties may be worth more as a going concern than if it is liquidated with its assets realised on a piecemeal basis. The underpinning approach is that as a general rule, it is better to rescue a company rather than to liquidate it or put it under winding-up. The 'going concern' value of a business will generally be greater than its liquidation or break-up value. Creditors would also, over time, receive a better return if the company survives as a 'going concern'.

The economy as a whole suffers when a company is shut down. But if a company is successfully rescued or turned around, creditors will receive payment, jobs will not be lost and the company will be able to pay taxes. When a company is placed under business rescue, it benefits from an automatic moratorium on the enforcement of remedies (see 20.5.1), which provides 'breathing space' while a business rescue plan is implemented by a business rescue practitioner or turnaround expert. However, not all companies are suitable for business rescue. Much depends on the cause of the company's financial distress. In some cases, a business rescue may be a prohibitively expensive process for a company to adopt. It may be that a straightforward sale of its business to an interested purchaser would be quicker, more effective and less expensive.

It should also be noted that business rescue does not necessarily entail a complete recovery of the company in the sense that after the procedure, the company will have regained its solvency, its business will have been restored and its creditors repaid. While this may be the ideal outcome, it is not always attainable. Sometimes the result of a business rescue process may be a management buy-out or a takeover of the distressed company. Alternatively, it could be that the company is restructured with the closure of some of its business activities, or that some parts of its business activities are sold off to others.

A final note of caution before turning to the provisions of the Act: when a company begins to experience financial difficulties, for example, when it struggles to pay its debts, or finds that its assets cannot readily be converted into cash for the payment of its obligations, it is only natural for the directors to continue trading in the hope of generating income to alleviate the company's financial difficulties. The directors must bear in mind the risk of being held liable for the fraudulent or reckless conduct of the company's business. (See further Chapter 14: The duties and the liability of directors.)

It is clear, from this brief introduction, that the business rescue provisions of the Act are bound to play an increasingly important role in our new corporate law regime. The business rescue provisions in ss 128 to 154 of Chapter 6 of the Act import many aspects of Chapter 11 of the US Bankruptcy Code that apply to companies in financial difficulties. The Act also borrows much from the United Kingdom Enterprise Act of 2002.

Despite its name, the business rescue provisions of the Act do not apply to unincorporated associations or entities such as sole traders, partnerships or a business trust. Even co-operatives have been excluded. Yet all these business structures are as much in need of the benefits of a business rescue process. The business rescue provisions of the Act do, however, apply to close corporations. [6]

20.2 The meaning of business rescue

The Act [7] defines a 'business rescue' as proceedings to facilitate the rehabilitation of a company that is financially distressed by providing for-

(i) the temporary supervision of the company, and of the management of its affairs, business and property;

(ii) a temporary moratorium on the rights of claimants against the company or in respect of property in its possession; and

(iii) the development and implementation, if approved, of a plan to rescue the company by restructuring its affairs, business, property, debt and other liabilities, and equity in a manner that maximises the likelihood of the company continuing in existence on a solvent basis or, if it is not possible for the company to so continue in existence, results in a better return for the company's creditors or shareholders than would result from the immediate liquidation of the company.

According to this provision, the object of business rescue is to save the company as a going concern or, if this is not possible, then as an alternative or secondary object, to restructure the company so as to produce a return for the company's creditors or shareholders that is better than the return that would have resulted from the immediate liquidation of the company. The secondary object imposes a less difficult duty on the business rescue practitioner than the primary object of saving the company as a going concern.

'Financial distress' is the trigger to the business rescue process. This gives rise to the basic and initial question of how to assess whether a company is financially distressed. A 'financially distressed company' is a company that appears to be reasonably unlikely to be able to pay all its debts as they become due and payable within the immediately ensuing six months *or* a company that appears to be reasonably likely to become insolvent within the immediately ensuing six months. [8] The gist of financial distress is a liquidity problem or an inability to meet current debts. The definition of a financially distressed company points to a probable failure in the near future of the business of the company. The company is not at this stage insolvent, either in the balance sheet sense (factual insolvency) or in the cash flow or liquidity sense (commercial insolvency). It is on the verge of insolvency or is experiencing liquidity problems. It frequently happens that the company is illiquid

rather than insolvent. There must, in addition, be a reasonable prospect of rescuing the company. [9] Thus, in broad [10] terms, the two prerequisites for business rescue proceedings are that the company must be financially distressed and there must be a reasonable prospect of rescuing the company. The requirement that there must be a reasonable prospect of rescuing the company ensures that companies that are not economically viable are not placed under business rescue but are instead liquidated. Financial distress is thus the trigger for business rescue proceedings. Financial distress is regarded as a step towards corporate failure, which puts the company in a position of 'near insolvency'.

20.3 The commencement of business rescue proceedings: two entry routes

Business rescue proceedings may be commenced in one of two ways:

(i) by a resolution of the board of directors of the company to begin business rescue proceedings voluntarily, if the board has reasonable grounds to believe that the company is financially distressed and there appears to be a reasonable prospect of rescuing the company; [11] or

(ii) by application to a court by an affected person at any time for an order placing the company under supervision and commencing business rescue proceedings. [12] Whatever the entry route, the object remains to rescue the company as a going concern or, failing this, to reorganise the company (or its business) in a manner than results in a better return for creditors or shareholders than the return that would have resulted from the immediate liquidation of the company.

These two possibilities are discussed below.

20.3.1 Commencement of business rescue by voluntary board resolution

The Act introduces a debtor-friendly business rescue process even though our insolvency law system is largely creditor-friendly.

According to the Act, [13] the board of directors of a company may resolve that the company voluntarily begins business rescue proceedings and that it be placed under supervision if the board has reasonable grounds for believing that two essential requirements are satisfied-

(i) the company is financially distressed (as discussed in 20.2); and

(ii) there *appears* [emphasis added] to be a reasonable prospect of rescuing the company. [14]

By 'rescuing' the company is meant achieving the goals of business rescue. [15] At this stage, recourse to a court of law is not necessary; nor is it necessary at this stage to file any supporting documentation.

This entry route is deliberately designed to be a low hurdle route. It should serve to encourage the directors of a financially distressed company to seek help at an early stage instead of waiting until it is too late.

This provision enables the board of directors to commence business rescue proceedings by resolution (majority vote). This accords with the new approach of the Act, which imposes a statutory duty on the board of directors to manage the business of the company. The directors are the persons best equipped to know whether the company is in financial difficulties. The shareholders of the company do not have the right to resolve that the company should be voluntarily placed under business rescue. The board of directors is under no legal duty to consult the shareholders in resolving to place the company under business rescue. A distinct advantage of authorising the board of directors to make the decision to place the company under business rescue is that it avoids unnecessary delay and costs. This procedure is meant to be swift and cost-effective. It is also in accord with a debtor-friendly business rescue system, and the underlying objective of a flexible business rescue regime that is uncomplicated and easy to implement. But, by the same token, it is the board of directors and not individual directors who may apply for voluntary business rescue. Individual directors may not do so. If however a director happens to be an employee or shareholder as well, he may as an 'affected person' (see 20.3.2) apply to court for an order to commence rescue proceedings. The problem with this entry route is that it allows management to trigger business rescue proceedings even though it may be their own ineptitude that is the cause of the company's financial problems.

Once the board resolves to place the company under business rescue, it becomes the duty of all the directors to implement it. This applies even to those directors who had voted against the resolution or had not taken part in the deliberations of the board.

There are two important restrictions on the board resolution to commence business rescue proceedings. [16] First, no such resolution may be adopted if liquidation proceedings have already been initiated by or against the company, and second, the board resolution to commence business rescue proceedings has no force or effect until it has been filed with the Companies and Intellectual Property Commission ('the Companies Commission'). The business rescue proceedings formally commence on the date of the filing of the board resolution. [17] Once the board has resolved to place the company under business rescue voluntarily, the company may not thereafter adopt a resolution to begin liquidation proceedings,

unless the resolution to commence business rescue proceedings has lapsed or until the business rescue proceedings have ended. [18]

Strict time limits are imposed for the publication of a notice of the resolution to place the company under business rescue and for the appointment of a business rescue practitioner. This is done to avoid unnecessary delay and abuse of the procedure. These time limits must be meticulously complied with, failing which the application for business rescue proceedings becomes a nullity. First, within five business days of the filing of the board resolution to commence business rescue, or such longer time as the Companies Commission on application by the company may allow, the company must 'publish' (ie publicise information by any means that can reasonably be expected to bring the information to the attention of the persons for whom it is intended) in the prescribed manner [19] a notice of the resolution and its effective date to every 'affected person'. [20] This must be accompanied by a sworn statement of the facts relevant to the grounds for the board resolution. [21] An 'affected person' means a shareholder or creditor of the company, a registered trade union representing employees of the company, and each of those employees not represented by a trade union or the representatives of such employees. [22] A single employee may thus be an affected person. This wide definition of an 'affected person' means that a very wide range of stakeholders are given certain rights in the business rescue process (as discussed in 20.3.1.1 and 20.8), particularly since it is each individual shareholder or creditor that is given these rights and not just shareholders or creditors as a general or collective body. This approach emphasises the consultative and inclusive nature of business rescue proceedings. The disadvantage is that it increases the risk of abuse of the business rescue procedure. In addition, there could easily be tension and conflict between creditors, employees and shareholders.

A copy of the notice of commencement of business rescue proceedings must also be conspicuously displayed at the registered office of the company, its principal place of conducting its business activities and workplace where employees are employed; on its website; or, if it is a listed company, on the electronic system of a relevant securities exchange such as the Securities Exchange News Service (SENS). [23]

Within the period referred to above (ie within five business days of the filing of the board resolution or such longer time as the Companies Commission may allow), the company must appoint a business rescue practitioner who is duly qualified as such and who has given his or her written acceptance of the appointment. [24] There is consequently a possible five-day period in which a company under business rescue is not under the control or supervision of a business rescue practitioner. It is thus within the contemplation of the Act that business rescue proceedings may be commenced without a business rescue practitioner. A business rescue practitioner is a person appointed, or two or more persons appointed jointly, to oversee the company during business rescue proceedings. [25] Within two business days after the appointment of the business rescue practitioner, a notice of his or her appointment must be filed, [26] and a copy of the notice of appointment must be sent to each affected person within five business days after the notice was filed. [27]

A failure to comply with the above provisions or their prescribed time periods would result in the lapse and the consequent nullity of the board resolution to commence business rescue proceedings. [28] For three months after the date of the adoption of the lapsed resolution the company may not file another resolution of this nature, unless the High Court approves the company filing a further resolution. [29]

A useful provision is that, if the board of directors does not adopt a resolution to place the company under business rescue even though the board has reasonable grounds to believe that the company is financially distressed, the board must [30] deliver a written notice to each affected person setting out which of the two criteria for financial distress as stated in s 128(1)*(f)* [31] applies to the company and the reasons for not adopting a resolution to commence business rescue proceedings. The rationale for this provision is that it enables an affected person to lodge an application to the court to commence business rescue proceedings (as discussed in 20.3.2).

It must be emphasised that for JSE-listed companies there are additional requirements for voluntary business rescue proceedings that arise from the need for listed companies to comply with the JSE Listings Requirements.

20.3.1.1 Objections to the business rescue resolution

At any time after the adoption of the resolution of the board of directors to commence business rescue proceedings and until the adoption of a business rescue plan, [32] an affected person may apply to a court [33] for an order setting aside the board resolution on the grounds that- [34]

(i) there is no reasonable basis for believing that the company is financially distressed;
(ii) there is no reasonable prospect for rescuing the company; or
(iii) the company has failed to satisfy the procedural requirements. [35]

In considering such an application, the court may set aside the resolution on any of these grounds or if it considers that it is otherwise just and equitable to do so (further discussed in 20.3.1.2).

The court may also give the business rescue practitioner sufficient time to form an opinion on whether or not the company appears to be financially distressed or whether or not there is a reasonable prospect of rescuing the company. [36] After receiving the practitioner's report, the court may set aside the resolution if it concludes that the company is not financially distressed or there is no reasonable prospect of rescuing the company. [37]

An affected person may lodge an objection, not only against the business rescue resolution, but also against the appointment of a business rescue practitioner on the grounds that the practitioner-

(i) is not properly qualified; [38] or
(ii) is not independent of the company or its management; or

(iii) lacks the necessary skills, given the company’s circumstances.

If an affected person lodges an application to have the appointment of the business rescue practitioner set aside, the court, in making such an order, must appoint an alternative practitioner who satisfies the requirements of a duly qualified business rescue practitioner. [39] This alternative practitioner must also be recommended or nominated by, or be acceptable to, ‘the holders of a majority of the independent creditors’ voting interests who were represented in the hearing before the court’. [40]

A copy of the application made by an affected person to set aside the board resolution to commence business rescue proceedings or the appointment of the business rescue practitioner, or to require him or her to provide security, must be served on the company and the Companies Commission. Each affected person must also be notified in the prescribed manner of the application. [41]

20.3.1.2 The powers of the court in relation to the objection

There is a conscious attempt to keep the role of the court in business rescue proceedings to a minimum. This would also help to keep the costs of the process down. The court is given wide powers in considering the application to set aside the company’s resolution to commence business rescue.

As stated above, the court may set aside the business rescue resolution on the basis of any one of the grounds on which the application was lodged, ie no reasonable basis for believing that the company is financially distressed, no reasonable prospect of rescuing the company, or failure to comply with the procedural requirements. In addition, the court may set aside the resolution simply on the ground that, having regard to all the evidence, it is just and equitable to do so. [42]

The court may give the business rescue practitioner additional or sufficient time to form an opinion on whether or not the company appears to be financially distressed, or whether there is a reasonable prospect of rescuing the company. After receiving the report on the matter from the practitioner, the court may set aside the resolution if it decides that the company is not financially distressed or there is no reasonable prospect of rescuing the company.

When a court makes an order to set aside the company’s resolution, it may make any further ‘necessary *and* [emphasis added] appropriate order’ including an order placing the company under liquidation. [43] There is thus a mechanism for the conversion of the business rescue proceedings into liquidation proceedings. But the liquidation proceedings would have to be a new legal process under the control of a liquidator and not a business rescue practitioner.

If the court sets aside the appointment of a business rescue practitioner, it must (as pointed out above) appoint an alternative practitioner recommended by or acceptable to the holders of a majority of the voting interests of independent creditors who were represented at the hearing. [44] The alternative practitioner may then have the duty to assess whether the company appears to be financially distressed or whether there is a reasonable prospect of rescuing the company.

20.3.2 Commencement of business rescue by order of court

The second entry route for commencing the business rescue process, one which imposes a higher hurdle, is that, provided the board has not passed a resolution to commence business rescue proceedings, any affected person may apply to a court *at any time* for an order to place the company under supervision and to commence business rescue proceedings. [45] This may be done even if the company is under liquidation proceedings. It follows that, when the board of directors is unable to place the company under business rescue proceedings because of the commencement of liquidation proceedings, an affected person, including a shareholder, may apply to a court to place the company under business rescue. This usefully also provides a mechanism for the conversion of liquidation proceedings into business rescue proceedings, and, as pointed out above (in 20.3.1.2) the converse applies too.

Since the application to commence business rescue proceedings must be approved by the court, frivolous or malicious applications intended to harass the company or other forms of abuse of process are deterred.

The applicant must serve a copy of the application on the company and the Companies Commission and notify (inform) each affected person of the application in the prescribed manner. [46] Each affected person has a right to participate in the hearing of the application without having to obtain the leave of court even though this may be desirable as a procedural requirement.

Where the application for a court order to commence business rescue proceedings is made after the commencement of liquidation proceedings, the liquidation proceedings will automatically be suspended until the court has adjudicated on the application. However, if the court makes the order to commence with the business rescue proceedings, the liquidation proceedings will be suspended until the business rescue proceedings have ended. To the extent that business rescue overrides liquidation proceedings, these provisions are in accord with the underpinning policy of preserving viable commercial enterprises rather than shutting them down by liquidation. It also emphasises the approach that business rescue is an alternative to liquidation of the company. Logically, therefore, liquidation proceedings should not be initiated until the business rescue proceedings have been terminated.

There are three grounds on which a court may make an order to place a company under supervision and to commence business rescue proceedings. These grounds or thresholds are wider than the grounds on which the board of directors may adopt a resolution to commence business rescue proceedings (as discussed in 20.3.1). The court must be satisfied that- [47]

(i) the company is financially distressed;
(ii) the company has failed to pay over *any* amount [emphasis added] in terms of an obligation under a public regulation [48] or contract in respect of employment-related matters; or
(iii) it is otherwise just and equitable to do so for financial reasons. [49]

These thresholds are important, otherwise creditors would be able to threaten to put the company under business rescue purely in order to pressurise a company. It should be noted that the second threshold above does not require a series of failures to pay - just one failure to pay suffices. This is unduly harsh, with an element of overkill. A technical default may often be renegotiated or remedied without the need for a business rescue procedure. In the case of each of the above grounds, the court must also be satisfied that there is a reasonable prospect of rescuing the company. Even if these grounds are satisfied, the court has a discretion to refuse to grant an order to place the company under supervision. The requirement that there must be a 'reasonable prospect' of rescuing the company ensures that companies that are not economically viable are not placed under business rescue. [50]

A court will clearly not grant an order to place a company under supervision if the application was not brought in good faith or constitutes an abuse of process. The business rescue process is not automatically granted by a court. The grounds for placing the company under business rescue must be properly established. There must also be a reasonable prospect of achieving the objects of a business rescue. No court would grant the application to place the company under business rescue if the application is devoid of any merit. [51] Business rescue proceedings must not be used for strategic purposes or to delay payment to creditors or delay an inevitable liquidation of the company. *Swart v Beagles Run Investments 25 (Pty) Ltd and Others* [52] illustrates this principle. In this case, the applicant, a sole director and shareholder of the respondent, sought an order placing the respondent under supervision on the grounds that the company was financially distressed. The application was successfully opposed by creditors on the grounds that it was an abuse of process and an attempt to postpone payment of the respondent's debts. There was no doubt, on the facts, that the respondent was hopelessly insolvent, with the result that there was no real prospect of rescuing the company or reorganising it to enable it to carry on business on a solvent basis; nor was there any basis for contending that creditors would be in a better position than they would be in a winding-up of the company. In rejecting the application, the court stated that where an application for business rescue entailed a weighing-up of the interests of creditors against those of the company, the interests of the creditors should prevail. Business rescue is not for a company that is beyond hope of a rescue or a turnaround. The rescue process is intended for ailing companies which, given time, will be rescued and become solvent. [53]

If the court decides to make an order for the commencement of business rescue proceedings, it may also make a further order appointing an interim business rescue practitioner who has been nominated by the affected person who applied for a court order for the commencement of business rescue proceedings, provided that the interim practitioner satisfies the prescribed qualifications of a practitioner. This appointment is subject to ratification by the holders of a majority of the voting interests of the independent creditors at the first meeting of creditors.

On the other hand, if the court dismisses the application, it may make any further necessary and appropriate order, including an order placing the company under liquidation. In any event, the High Court has the power as part of its inherent jurisdiction to make an order for costs in proceedings brought by an affected person.

A company that has been placed under business rescue by an order of court must notify each affected person within five business days after the date of the order of court. [54]

20.4 The duration of business rescue proceedings

20.4.1 The date of commencement

The commencement, the duration and the termination of business rescue proceedings are set out in the Act. [55] The date of commencement is of vital importance, because the moratorium and the restrictions and consequences of business rescue come into effect when business rescue proceedings formally commence.

As far as the commencement of business rescue proceedings is concerned, there are three possibilities. Business rescue proceedings begin-

(i) in the case of a commencement of business rescue by a board resolution, when the company files with the Companies Commission the resolution to place itself under supervision; or
(ii) in the case of a commencement of business rescue by court order, when an affected person applies to the court; or
(iii) when the court, during the course of liquidation proceedings or proceedings to enforce a security interest, makes an order placing the company under supervision.

20.4.2 The duration of business rescue and progress reports

The underpinning approach to the duration of business rescue proceedings is that the business rescue practitioner is expected to perform his or her functions swiftly, efficiently and cost-effectively. Business rescue proceedings must be conducted as expeditiously as possible. Underlying the strict time limits imposed by the Act is a degree of urgency. The quicker the process, the less the prejudice to creditors and employees and other third parties. Instead of an automatic termination provision, the Act implicitly contemplates that the business rescue process should end within 90 days, subject to an extension of time granted by the court.

In this regard, if the business rescue proceedings have not ended within three months, or such longer time as the court (on application by the business rescue practitioner) permits, the business rescue practitioner must prepare a report on the progress of the proceedings, and follow it up with updates at the end of each subsequent month until the termination of the business rescue proceedings. These reports must also be delivered to the court if the proceedings were the subject of a court order, or to the Companies Commission in any other case. [56]

20.4.3 The termination of business rescue proceedings: exit route

The exit routes provided by the Act do not distinguish between business rescue proceedings commenced by order of court and voluntary proceedings commenced by the board of directors: the rescue proceedings terminate in the same way, whether commenced by an order of court or by resolution of the board. There is also no need for a formal order of court to terminate the rescue process. The process for the termination of business rescue proceedings also provides the mechanism for the conversion of the proceedings into liquidation proceedings.

Business rescue proceedings terminate [57] when-

(i) the court sets aside the resolution or order that began those proceedings, or the court converts the business rescue proceedings to liquidation proceedings; or

(ii) the practitioner has filed with the Companies Commission a notice of the termination of the business rescue proceedings; or

(iii) a business rescue plan has been proposed and rejected, but no affected person has sought to extend the proceedings; [58] or alternatively, a business rescue plan has been adopted and the practitioner has subsequently filed a notice of 'substantial implementation' of that plan where the substantial purpose of the rescue process has been achieved. (See 20.9.2.)

20.5 The legal consequences of a business rescue order

The business rescue process is meant to facilitate the rescue of a company that is close to insolvency. This is achieved in two primary ways: first, by an automatic moratorium, and second, through the skill and guidance of the business rescue practitioner.

The Act provides [59] that, during business rescue proceedings, each director of the company must continue to exercise the functions of a director subject to the authority of the practitioner. The directors must also exercise any 'management functions' within the company in accordance with the express instructions or the directions of the practitioner, to the extent that it is reasonable to do so. (This is further discussed in 20.5.5.) An important safeguard that applies here is that the directors remain bound by their duty to disclose any personal financial interests which they or a related person may have. Provided that the directors do so, they are relieved of having to comply with the requirements of s 76 regarding the standards of directors' conduct and some, though not all, of the liabilities set out in s 77, but only to the extent that they comply with their duties to exercise management functions in accordance with the instructions or directions of the business rescue practitioner. [60]

20.5.1 The moratorium (or automatic stay)

The most important consequence of the commencement of business rescue proceedings is that there is an automatic moratorium, ie a freeze (or 'stay'), on legal proceedings or executions against the company, its property and its assets, and on the exercise of the rights of creditors of the company. In brief, there is a general moratorium on the enforcement of legal remedies against a company that is under business rescue. This suspension of legal proceedings against the company generally applies to all the company's creditors. The moratorium is effective until the business rescue process ends. [61] The rights of creditors are not substantially altered. They are instead frozen in the sense that creditors may not enforce their rights while the company is under the rescue process without the written consent of the business rescue practitioner or, in certain cases, the court. There are however some important exceptions to this general principle (discussed below).

The moratorium is of cardinal importance to business rescue, since it provides the crucial breathing space or a period of respite during which the company is given the opportunity to reorganise and reschedule its debts and liabilities.

During this period, the business rescue practitioner has the opportunity to formulate a business rescue plan designed to achieve the purpose of the rescue process. The moratorium applies to all creditors, even dissenting creditors and secured creditors. The moratorium enables the company to continue with its business and other operational activities. An incidental benefit is that it results in an orderly and perhaps more equitable treatment of the claims of creditors. Without the moratorium, the reorganisation of a financially distressed company would simply not be achievable.

20.5.1.1 Moratorium on legal proceedings

The company is given extensive protection against legal proceedings. The Act [62] provides that during business rescue proceedings, no legal proceeding against the

company, or in relation to any property belonging to the company, or lawfully in its possession, may be commenced except with the written consent of the practitioner, or with the leave of the court.

Proceedings by a regulatory authority are excluded from the moratorium. Likewise, criminal proceedings against the company or its officers are not subject to the moratorium. Legal proceedings are restricted as a general principle, since they may have a detrimental effect on the outcome of the business rescue process. However, criminal proceedings against the company or any of its directors or officers are not subject to the general moratorium.

The effect of the moratorium is that legal proceedings against the company are automatically stayed. Execution or enforcement actions may not be initiated. If they have already commenced, they are frozen until the written consent of the business rescue practitioner or the leave of the court is obtained. The owners of property that is in the lawful possession of the company are also disabled from exercising their proprietary rights unless the business rescue practitioner or the court gives leave.

During business rescue proceedings, a guarantee or surety given by the company in favour of any other person may not be enforced against the company unless the court so permits and on such terms as it considers in the circumstances to be just and equitable. [63] This is a mandatory provision. The parties to the transaction may not agree otherwise in a contract or other similar agreement.

If any right to assert a claim or commence legal proceedings against the company is subject to a time limit, the measurement of that time is suspended during the company's business rescue proceedings. [64] This provision protects third parties in that the period during which the company is under business rescue is not counted when calculating the time limit to which the claim against the company is subject.

It should be noted that the Act does not as a general rule blankly prohibit the exercise of rights to commence legal proceedings or enforcement actions - it merely makes them subject to the written consent of the business rescue practitioner or the leave of the court.

It is unclear whether the moratorium extends to *quasi*-legal proceedings such as arbitration proceedings or tribunal proceedings. As stated above, proceedings by regulatory authorities are exempt from the moratorium on legal proceedings.

20.5.1.2 Moratorium on property interests

During the business rescue process a company may dispose of property or agree to dispose of property only if-

(i) it is in the ordinary course of its business; or

(ii) it is a *bona fide* transaction at arm's length for fair value, that has been approved in advance and in writing by the practitioner; or

(iii) it is in a transaction that is part of an approved business rescue plan. [65]

Thus, if the property is not disposed of in the ordinary course of the company's business, then it must be disposed of either in a *bona fide* arm's length transaction for fair value with the prior written approval of the practitioner, or it must have formed part of the implementation of an approved business rescue plan.

During the business rescue proceedings, despite any provision of an agreement to the contrary, no person may exercise any right in respect of any property in the lawful possession of the company (eg under a lease agreement) unless the practitioner consents in writing. The practitioner may not unreasonably withhold his or her consent, having regard to the purposes of business rescue under the Act, the circumstances of the company, and the nature of the property and the rights claimed in respect of it. [66]

Before a company disposes, during business rescue proceedings, of any property over which a third party has any security or title interest, it must obtain the prior consent of the third party, unless the proceeds of such disposal will be sufficient to fully discharge the amount of the third party's secured or protected claim. [67] Additionally, the proceeds of the disposal must be used promptly to pay to the third party the amount of the company's indebtedness to that party, or otherwise to provide security for the amount of those proceeds to the reasonable satisfaction of the third party. [68] To elaborate, the Act essentially provides that, if the company disposes of property over which a secured creditor holds security, it may dispense with the consent of the creditor, provided that the proceeds of the disposal are sufficient to pay the creditor in full and the company promptly so pays the creditor or, alternatively, the company provides security for the amount of those proceeds to the reasonable satisfaction of the creditor. [69] The effect of this provision is that the practitioner may simply pay the creditor in full and discharge the underlying transaction even before its maturity.

Where a third party is lawfully in possession of property owned by the company, under an agreement made in the ordinary course of the company's business before the commencement of business rescue proceedings, the third party may continue to exercise any right in respect of that property in accordance with the agreement. [70] However, this right is subject to the practitioner's discretion to suspend the agreement entirely, partially or conditionally, or to apply to court to cancel entirely, partially or conditionally any obligation of the company on terms that are just and equitable in the circumstances. [71] In this event, the third party's remedy is confined to a claim for damages only. [72] This is further discussed in 20.5.4.

20.5.2 Post-commencement finance

Post-commencement finance or new financing is one of the most important aspects of the business rescue proceedings. Like the moratorium, it is central to the business rescue process. Creditors, banks and financiers would obviously be reluctant to finance a company that is under business rescue proceedings. Yet additional new finance after the commencement of business rescue proceedings is often critical to the survival and the turnaround of the company's business. Not many companies that are placed under supervision have cash or assets that can easily be converted to cash to fund their business activities.

In order to encourage post-commencement finance, the Act creates a framework for super-priority post-commencement financing. [73] The Act provides that, during the business rescue proceedings, the company may obtain 'financing' that is unrelated to employment which-

(i) may be secured to the lender by utilising any unencumbered asset of the company; and
(ii) will be paid in the order of preference set out in s 135(3)*(b)*. [74]

The Act thus permits a company to use its unencumbered assets as security for 'financing' that is obtained by the company after the commencement of business rescue proceedings. Post-commencement finance obtained by the company will enjoy preference in the order in which it is incurred. [75] It will also enjoy priority over all unsecured claims against the company. It remains an important objective that the pre-existing rights and priorities of creditors are protected in so far as is reasonably practicable. A careful balance must be drawn here. Existing secured creditors must also have their rights protected. Both pre-existing secured and unsecured creditors would, of course, benefit albeit indirectly from new financing for the company if this results in a successful rescue for the company and its business.

The justification for the approach adopted by the Act is that pre-commencement unsecured creditors must submit to the preferential treatment of post-commencement creditors in order to facilitate the raising of finance for the company in the hope of full repayment of their claims in the event of a successful business rescue. Pre-commencement creditors thus concede priority over their claims to post-commencement creditors in order to facilitate new finance for the company.

The ranking of claims in respect of post-commencement finance [76] is:

(i) First, the practitioner's remuneration and expenses and other claims arising out of the costs of business rescue proceedings will be paid.
(ii) Second, all claims for post-commencement financing obligations that are related to employment will be paid. These claims enjoy super-

priority status. Employment-related post-commencement financing claims rank equally with each other, but enjoy priority over any other post-commencement financing claims, even if these are secured claims. These employment-related post-commencement financing claims also have priority over all unsecured claims against the company. [77] This includes vacation leave or payments in lieu of vacation leave. In this regard, all employment-related payments, including any remuneration, reimbursement for expenses or other amount of money relating to employment, that become due and payable to employees by the company during the course of the business rescue proceedings are regarded as post-commencement financing to the extent that they have not been paid. As such, they will rank for payment directly after the practitioner's remuneration and expenses and other claims arising out of the costs of the business rescue proceedings.

(iii) Third, all post-commencement finance (unrelated to employment) will be paid. These amounts will rank in the order in which they were incurred, evidently irrespective of whether the claims are secured or unsecured, and ahead of all unsecured claims against the company. These claims also enjoy super-priority status to the extent that they are paid before pre-commencement unsecured creditors.

(iv) Fourth, all unsecured pre-commencement claims against the company will be paid.

These preferences and ranking of claims will remain in force in the event that the business rescue proceedings are superseded by a liquidation order, except to the extent of claims arising out of the costs of liquidation. [78] The effect is that preference is still given even in the event of liquidation to unpaid post-rescue salaries and employment-related payments, as well as other post-commencement finance.

20.5.3 Effect of business rescue on employment contracts and employees

One of the primary goals of a good business rescue process is the fair and equitable treatment of employees of a financially distressed company. A proper balance must be drawn between the needs of a company's employees and the interests of its creditors. The employees of a company placed under business rescue may be affected in general by a change in their employment contracts or by changes as a result of the normal course of attrition or a change in a part of a business that is being sold as a going concern.

The Act [79] protects employees of the company by providing that, despite any provision of an agreement to the contrary, during a company's business rescue proceedings, employees of the company immediately before the commencement of business rescue continue to be employed on the same terms and conditions. This is subject to the following exceptions:

(i) changes that occur in the ordinary course of attrition; or
(ii) agreements between the employees and the company concerning different terms and conditions in accordance with applicable labour laws. [80]

Employees are given further rights under the Act, which are discussed in 20.8.1.

20.5.4 Effect of business rescue on contracts generally

Despite any provision of an agreement to the contrary, during business rescue proceedings the business rescue practitioner has the right to suspend, [81] whether entirely, partially or conditionally, any obligation that arises under an agreement to which the company is a party at the commencement of the business rescue process, and which will become due during the business rescue proceedings, The suspension of the contract or an obligation of the contract will endure only for the duration of the business rescue proceedings. This wide power significantly does not apply to an employment contract. [82]

The Act further provides that despite any agreement to the contrary, the business rescue practitioner may apply urgently to a court to cancel, whether entirely, partially or conditionally, on any terms that are just and reasonable in the circumstances, any obligation of the company under an agreement to which the company was a party at the commencement of the business rescue process and which would otherwise become due during the rescue process. [83] It thus seems that if a particular contract is impeding the business rescue proceedings, making it necessary or desirable to cancel the contract, the practitioner may cancel it but only with the consent of the court. While the section is not expressly limited to the cancellation of a contract that has become onerous to the company, or one that is impeding the rescue process, it is submitted that it is likely that this consideration will apply to the cancellation of such contracts in general. The consent of the court will provide the essential safeguard against abuse by the practitioner of his or her powers under the section. This right of cancellation does not apply to employment contracts or to an agreement to which s 35A or s 35B of the Insolvency Act of 1936 would have applied had the company been liquidated.

The other party to a contract that has been suspended or cancelled is not left without a remedy. Although he or she may not be entitled to a claim for specific performance of the contract, the Act confers a right to such a person to claim damages.

To sum up: while the practitioner may selectively suspend the terms of a contract, the power to cancel such terms is subject to the approval of the court. The cancellation must be just and reasonable in the circumstances. The other party to the contract has a right to claim damages only.

20.5.5 Effect of business rescue on shareholders and

directors

Shareholders are ‘affected persons’, and, as such, are entitled to receive notices of court proceedings, meetings and other relevant events concerning the business rescue proceedings. They are also entitled to participate formally in the process. [84] (This is discussed in 20.8 and 20.8.4.)

As regards directors, the directors of the company are not removed from office. The rationale of this approach is that the directors are the persons most familiar with

and best equipped to know the financial affairs of the company and the extent of its difficulties. They thus continue to exercise their functions as directors, but they are now subject to the authority of the business rescue practitioner. Directors must exercise any management function in accordance with the express instructions or directions of the practitioner, to the extent that it is reasonable to do so. [85] More importantly, each director must attend to the practitioner’s requests at all times and must provide the practitioner with any information about the company’s affairs that may reasonably be required. Co-operation between the business rescue practitioner and the directors is essential to a successful business rescue or turnaround. It is clearly of cardinal importance that incumbent management provides the practitioner with full and detailed information on the company’s business activities.

If a director has impeded or is impeding the practitioner in the performance of his or her functions and powers, in the management of the company, or in the development or the implementation of a business rescue plan, the director may, on the application of the practitioner, be removed from office by a court.

If, during a company’s business rescue proceedings the board of directors or one or more directors purport to take any action on behalf of the company that requires the approval of the practitioner, that action is void unless approved by the practitioner. Third parties dealing with the board of directors or with any one or more directors during the business rescue proceedings must exercise caution to ensure that the particular director that they are dealing with has the requisite approval or authority to act on behalf of the company.

As discussed in 20.5, although the directors of the company are subject to the authority and the directions of the practitioner, they are not relieved of all their statutory and fiduciary duties. [86] They must still disclose their personal financial interests or those of a related person in matters in which the company has an interest. While they may be relieved of some of the duties of directors, [87] and some of the liabilities of directors [88] to the extent that they are subject to and act in accordance with the instructions or directions of the practitioner, they are importantly not released from incurring liability for knowingly acquiescing in the fraudulent or reckless conduct of the company’s business. A second carveout is that the directors will also remain liable for loss sustained by the company if they were party to an act or omission by the company despite knowing that it was calculated to defraud a creditor, an employee or a shareholder of the company or had another fraudulent purpose. [89] Third, the directors remain liable to the company for knowingly acting on behalf of the company without authority to do so. [90]

20.6 The business rescue practitioner

20.6.1 Appointment

The business rescue practitioner has the most significant and pivotal task of overseeing the business rescue process and of turning the company around by developing a suitable business rescue plan. The Act confers on him or her a powerful position. He or she supervises and advises management, and has full managerial control of the company in substitution for the board of directors and pre-existing management. [91] The success of the business rescue process depends largely on the skill, expertise and the integrity of the business rescue practitioner. A high level of skill and expertise is required of the business rescue practitioner.

The practitioner may be appointed in various ways. First, he or she may be appointed by the board of directors if the business rescue proceedings are commenced by a resolution of the board. In that event, the practitioner must be appointed within five business days of the date that the resolution was filed with the Companies Commission. [92] Alternatively, in the event of an application to court for an order to place the company under business rescue, the court may appoint an interim practitioner, nominated by the affected person who made the application to the court. This is subject to ratification of the appointment by the holders of a majority of the independent creditors' voting interests, at the first meeting of creditors. [93] A third possibility is that the court must appoint an alternative practitioner when setting aside the appointment of a practitioner appointed by the company, as a result of an objection by an affected person. [94] The court will then appoint the practitioner who is recommended by or acceptable to the holders of a majority of the independent creditors' voting interests who were represented in the court hearing. [95]

Once appointed, the practitioner has extensive powers, including the power to manage the affairs of the company in substitution for the board of directors. The practitioner has the fundamentally important function of developing and implementing a business rescue plan. [96]

20.6.2 The qualifications of the practitioner

A proper business rescue process requires the services of a specialised professional. It is not only the personal qualities of integrity and impartiality that count - even more important are professional and practical experience.

The qualifications for appointment as the business rescue practitioner of a company are set out in the Act. [97] The prescribed qualifications are not however limited to turnaround expertise only. The Act provides that to be appointed as a business rescue practitioner a person-

(i) must be a member in good standing of a legal, accounting or business management profession accredited by the Companies Commission;
(ii) must be licensed by the Companies Commission (discussed below);
(iii) must not be subject to an order of probation; [98]
(iv) must not be disqualified from holding office as a director (ie the practitioner is subject to the same disqualifications as a director of a company);
(v) must not have any other relationship with the company such as would lead a reasonable and informed third party to conclude that the integrity, impartiality or objectivity of that person is compromised by that relationship; and
(vi) must not be related to a person who has a relationship contemplated in the preceding paragraph.

In addition, the practitioner, who may be an accountant or attorney and not necessarily a turnaround expert, must be suited to the particular circumstances of the company.

The Companies Commission may license a qualified person to practice as a business rescue practitioner. In considering an application for such a licence, the Companies Commission must be satisfied that the applicant is of good character and integrity and that his or her education and experience are sufficient to equip the applicant to perform the functions of a business rescue practitioner. [99]

The Companies Commission has the power not only to grant licences but also to revoke or suspend licences. An applicant whose licence has been refused, or who has been issued a conditional licence or whose licence has been suspended or revoked, has a right to apply to the Companies Tribunal to review the decision of the Companies Commission. [100]

The Companies Regulations [101] distinguish between large, medium and small companies in accordance with their public interest score and the type of company they are. The regulations provide that a junior practitioner, with no previous experience or experience in business turnaround or rescue practice of less than five years, may be appointed as a practitioner for a small company (ie a company, other than a state-owned company, with a public interest score below 100); an experienced practitioner, described as a practitioner with at least five years experience, may be appointed a practitioner for small and medium companies (ie a public company with a public interest score less than 500, or any other company other than a state-owned company with a public interest score between 100 and below 500 points); a senior practitioner, defined as a practitioner with at least ten years experience in a business turnaround practice or as a business rescue practitioner in terms of the Act, may be appointed a practitioner for any company, be it a small, medium or large company (ie a company, other than a state-owned company, with a public interest score of 500 or more). The public interest score of a company depends on the average number of employees during the financial year, its turnover, the number of shareholders or holders of the securities of the company, and the amount of the third party liability of the company. [102]

20.6.3 Removal and replacement of the practitioner

The Act ensures that the practitioner may be removed from office by means only of an order of court. This may be as a result of an objection to the appointment of the practitioner pursuant to a business rescue resolution [103] on the grounds that he or she is not qualified, is not independent, or lacks the necessary skills. The Act further provides [104] that a court may remove a practitioner on any one of six grounds:

- (i) incompetence or failure to perform the duties of a business rescue practitioner of the particular company;
- (ii) failure to exercise the proper degree of care;
- (iii) engaging in illegal acts or conduct;
- (iv) no longer satisfying the qualifications and requirements of a practitioner;
- (v) having a conflict of interest or a lack of independence; or
- (vi) being incapacitated and unable to perform the functions of his or her office without a likelihood of regaining that capacity within a reasonable time.

The court may remove a practitioner on these grounds either on its own motion or upon the request of an affected person.

If a practitioner dies, resigns or is removed from office, the company or the creditor who nominated that practitioner (as the case may be) must appoint a new practitioner. [105]

20.6.4 The remuneration of the practitioner

The basis of the remuneration of the business rescue practitioner is of great significance. It may have an effect on the impartiality and the independence of the practitioner. As a matter of principle, there are various ways in which the remuneration of a business rescue practitioner can be determined. For instance, the practitioner's remuneration can be determined by agreement between the practitioner and the company or a committee of creditors or by a resolution passed by the creditors, or it may be determined in accordance with a tariff laid down by statute. The basis of the practitioner's remuneration may be determined in accordance with the amount of time spent on performing the task, its complexity and the nature and the value of the property or assets involved. A time-based system of remuneration attempts to calculate the remuneration in accordance with the amount of work done by the practitioner.

Remuneration in principle should be commensurate with the tasks that the practitioner is required to perform and with the qualifications and the experience of the practitioner.

The Act provides [106] that the practitioner is entitled to charge an amount to the company for his or her remuneration and expenses in accordance with a tariff to be prescribed by the Minister.

The tariff of fees chargeable by a practitioner depends on whether the company is classified as a small, medium, large or state-owned company. The basic remuneration may not exceed R1 250 per hour, and is limited to a maximum of R15 625 per day (inclusive of VAT) in the case of a small company; R1 500 per hour, to a maximum of R18 750 per day (inclusive of VAT) in the case of a medium company; or R2 000 per hour, to a maximum of R25 000 per day (inclusive of VAT) in the case of a large company or a state-owned company. [107]

A practitioner is also entitled to be reimbursed for the actual cost of any disbursement made by the practitioner, or expenses incurred by him or her to the extent reasonably necessary to carry out the practitioner's functions and facilitate the conduct of the company's business rescue proceedings.

In addition to remuneration in accordance with this tariff, the Act permits the practitioner to propose an agreement with the company for the payment of an additional fee, to be calculated on the basis of a contingency. This contingency could be that the business rescue plan proposed by him or her is adopted, or that it is adopted within a particular period of time, or on the basis of the attainment of a particular result or combination of results relating to the business rescue process. For instance, the business rescue practitioner may undertake to move the company through all the stages of the business rescue process more quickly and expeditiously for an additional fee. The justification for permitting a contingency-based fee is that it provides the practitioner with an added incentive to implement a business rescue plan successfully. As a safeguard against abuse, the Act requires that such an agreement must be approved by the holders of a majority of the creditors' voting interests.

A further safeguard is that, even if the agreement is approved, a dissatisfied creditor or shareholder who voted against the agreement may apply to court, within ten business days after the date of voting on the proposal, for an order setting aside the agreement on the ground that the agreement is not just and equitable, or that the remuneration provided for in the agreement is unreasonable in view of the financial circumstances of the company.

It has already been pointed out in 20.5.2 that the practitioner's claim against the company for his or her remuneration and expenses will rank for payment in priority to all secured and unsecured creditors.

20.6.5 Powers and duties of the practitioner

Business rescue practitioners are given extensive powers to manage the company's business and to deal with its assets in order to rescue the company. In return, the Act imposes a great deal of responsibility on them. With greater power goes greater responsibility.

The success of the business rescue proceedings depends to a large extent on the competency, skill and experience of the business rescue practitioner. The practitioner has a large number of duties and functions to perform. For this purpose, he or she is given a wide range of powers, including the full managerial control of the company which he or she takes over from the company's incumbent board of directors and pre-existing management.

The Act permits the practitioner [108] to delegate any power or function to a person who has been a director of the company or part of its pre-existing management. By the same token, the practitioner has the power [109] to remove from office any person who has been part of the company's pre-existing management and to appoint any person to be a director of the company. [110]

The practitioner may also appoint persons as part of the management of the company, or as advisers to the company or the practitioner, provided that the approval of the court is obtained to appoint such a person where that person has a relationship with the company that would lead 'a reasonable and informed third party' to conclude that the integrity, impartiality or objectivity of that person is compromised, or is related to such a person.

It must be stressed that while the practitioner takes over the full management and control of the company, the pre-existing management is not completely displaced. It will continue to function during the process but under the authority of the practitioner. Existing management does not drive or control the business rescue proceedings. Since the practitioner is in control of the company, the powers of the company may not be exercised in a manner that interferes with the exercise of the powers of the business rescue practitioner, unless the practitioner so permits.

Significantly, the practitioner also has the duties, responsibilities and liabilities of a director of a company. This should deter a fraudulent, dishonest or a negligent practitioner who fails to attend to his or her duties. The practitioner must exercise reasonable care and skill in the performance of his or her duties. While the practitioner may not be liable for an act or omission in good faith in the course of the exercise of his or her powers, the practitioner may nevertheless be held liable for gross negligence.

An important safeguard is that if the business rescue process concludes with an order placing the company in liquidation, the business rescue practitioner may not be appointed a liquidator of the company. [111] This sensibly prevents the business rescue practitioner from benefiting by a second fee if he or she is appointed a liquidator of the company. Apart from this, the requisite skills of a liquidator are quite different from the expertise of a turnaround expert, and vice versa. A liquidator is a specialist in dismantling a company - not rescuing it. It is consequently commendable to preclude a business rescue practitioner from being appointed as a liquidator of the company. It also has the merit of preventing a conflict of interests.

The business rescue practitioner must, as soon as is practicable after having been appointed, investigate the company's affairs, its business, property and financial situation, evaluate how severe the company's financial difficulties are, and consider whether there is any reasonable prospect of rescuing the company. [112] Investigation of the company's financial situation is undoubtedly an important function of the practitioner. The practitioner must, as soon as is practicable after appointment, inform all relevant regulatory authorities that the company has been placed under business rescue proceedings.

The directors of the company are under a duty to co-operate with and to assist the practitioner. [113] The directors must deliver to the practitioner all books and records relating to the company that they may have in their possession. They must inform the practitioner of any other books and records of the company which are not in their possession but whose whereabouts are known to them.

Within five business days of the commencement of business rescue proceedings (or such longer period as the practitioner permits), the directors must provide the practitioner with a statement of affairs containing information (at a minimum) on the list of matters specified in the Act. [114] Some examples are-

(i) any material transactions involving the company or its assets that occurred within the 12 months immediately before the commencement of the business rescue proceedings;
(ii) any court, arbitration or administrative proceedings, including pending enforcement proceedings;
(iii) the assets and liabilities of the company and its income and disbursements within the previous 12 months;
(iv) the number of employees and any agreements relating to their rights;
(v) the debtors and creditors of the company and their respective obligations to the company; and
(vi) rights or claims against the company.

No person is entitled as against the practitioner to retain possession of any books or records of the company, or to claim or enforce a lien (or a right of retention) over such books or records, unless such books or records are in the lawful possession of such person and he or she has made copies available to the practitioner or has afforded the practitioner a reasonable opportunity to inspect the books or records. [115]

The practitioner must of course continue to monitor the company's financial situation regularly. If at any time during the business rescue process the practitioner decides that there is no reasonable prospect of a successful business rescue, he or she must apply to court to discontinue the process and instead place the company in liquidation. [116] If, on the other hand, the practitioner concludes that there are no longer reasonable grounds to believe that the company is in financial distress, he or she must have the business rescue process terminated.

More important, if the practitioner finds evidence of reckless trading, fraud or other contravention of any law relating to the company in the company's dealings before the rescue process began, he or she must forward the evidence to the appropriate authority for investigation and possible prosecution. In addition, the practitioner must direct the management to take any necessary steps to rectify the matter, including recovering any misappropriated assets. Rectification steps must also be taken if there is evidence of any voidable transactions or a failure by the company or a director to perform any material obligation relating to the company.

20.7 The business rescue plan

The most important function of the business rescue practitioner is to prepare and implement a business rescue plan for the company. The approval of the business rescue plan is the ultimate goal of the business rescue process. For these purposes, the practitioner must first consult with the creditors of the company, other affected persons and the management of the company. [117]

The business rescue plan must contain all the information reasonably required to help affected persons to decide whether to accept or reject the business rescue plan. [118] The business rescue plan sets out the history of the company, its financial background, its financial position and the practitioner's suggestions relating to the rescue of the company. The Act [119] requires the business rescue plan to be published within 25 business days after the date on which the practitioner was appointed, although this may be extended by the court.

According to the specific requirements of the Act, [120] the business rescue plan must be divided into three parts: Part A, dealing with the background; Part B, dealing with the proposals, and Part C, dealing with the assumptions and conditions.

Part A: Background

Part A must include at least-

(i) a complete list of all the material assets of the company, as well as an indication as to which assets were held as security by creditors when the business rescue proceedings began;

(ii) a complete list of creditors at the time the business rescue proceedings began, together with an indication as to which creditors would qualify as secured, statutory, preferent and concurrent

creditors, and an indication of which of the creditors have proved their claims;
(iii) an indication of the probable dividend that would be received by creditors, in their specific classes, if the company were to be placed in liquidation;
(iv) a complete list of the holders of the company's issued securities;
(v) a copy of the written agreement concerning the remuneration of the practitioner; and
(vi) a statement whether the business rescue plan includes any proposal made informally by a creditor of the company.

Part B: Proposals

Part B, concerning the proposed steps to be taken in order to resolve the company's difficulties, must specify at the least-
(i) the nature and duration of any moratorium for which the business rescue plan makes provision;
(ii) the extent to which the company is to be released from the payment of its debts, and the extent to which any debt is proposed to be converted to equity in the company, or another company;
(iii) the ongoing role of the company, and the treatment of any existing agreements;
(iv) the property of the company that is to be available to pay creditors' claims in terms of the business rescue plan;
(v) the order of preference in which the proceeds of property will be applied to pay creditors if the business rescue plan is adopted;
(vi) the benefits of adopting the business rescue plan as opposed to the benefits that would be received by creditors if the company were to be placed in liquidation; and
(vii) the effect that the business rescue plan will have on the holders of each class of the company's issued securities.

Part C: Assumptions and conditions

Part C sets out the assumptions and conditions that must be fulfilled for the implementation of the business rescue plan. This part must contain at least-
(i) a statement of the conditions that must be satisfied, if any, for the rescue plan to come into operation and to be fully implemented;
(ii) the effect of the plan on the number of employees, and their terms and conditions of employment;
(iii) the circumstances in which the rescue plan will end; and
(iv) a projected balance sheet for the company as well as a statement of income and expenses for the ensuing three years, prepared on the assumption that the proposed rescue plan is adopted. These must include a notice of any material assumptions on which the projections are based, and may include alternative projections based on varying assumptions and contingencies.

The proposed business rescue plan must conclude with a certificate by the practitioner stating that any actual information provided appears to be accurate, complete and up to date, and that the projections provided are estimates made in good faith on the basis of factual information and assumptions as set out in the statements.

The consideration and adoption of a business rescue plan are discussed further in 20.9.

20.8 The rights of affected persons

Three groups of affected persons in particular must be taken into consideration, namely employees, creditors and the holders of the company's securities. They are the most important stakeholders in the business rescue of the company and are given certain specific rights, including the general rights of an affected person (as discussed in 20.3.1), such as the right to-

(i) apply for the commencement of business rescue proceedings;
(ii) lodge objections against such proceedings or the appointment of the practitioner;
(iii) receive notices of business rescue decisions;
(iv) participate in the business rescue process; and
(v) receive updates of the progress of the process in terms of s 132(3) *(b)*.

The basic approach is that all affected persons should have a fair say in the business rescue plan and its consequences. Shareholders are, however, given limited powers. The three main groups of affected persons are discussed below.

20.8.1 Employees

The rights of employees during the business rescue proceedings are specifically set out in the Act. [121] The Act provides that employees of a company who are represented by a registered trade union may exercise their rights collectively through their trade unions. [122] If employees are not represented by a registered trade union, they may elect to exercise any of their rights either directly or by proxy through an employee representative or organisation. [123]

It has already been pointed out above that employees are protected from loss of employment or a change in employment terms, subject to certain exceptions. The post-commencement employment-related payments and unpaid remuneration and their super-priority status have also been discussed in 20.5.2.

These provisions are further buttressed by the provision that any remuneration, reimbursement for expenses or other amount of money relating to employment that became due and payable *before* the commencement of business rescue proceedings (but was not paid to the employee immediately before the commencement of the rescue proceedings) would be treated as a preferred unsecured claim. The employee is thus a preferred unsecured creditor in respect of unpaid remuneration and employment-related payments. Such claims would consequently rank for payment before unsecured creditors, but after post-commencement finance.

Employees are entitled to-

(i) [receive] notice of each court proceeding, decision, meeting or other relevant event concerning the business rescue proceedings;
(ii) participate in any court proceedings arising during the business rescue proceedings;
(iii) form a committee of employees' representatives;
(iv) be consulted by the practitioner during the development of the business rescue plan, and [to be] afforded sufficient opportunity to review any such plan;
(v) be present and make a submission to the meeting of the holders of voting interests before a vote is taken on any proposed business rescue plan;
(vi) vote through a trade union or employee representative with creditors on a motion to approve a proposed business [rescue] plan, to the extent that the employee is a creditor; and
(vii) if the business rescue plan is rejected, to–
   (a) propose the development of an alternative plan; or
   (b) present an offer to acquire the interests of one or more affected persons.

Employees' representatives must also be given an opportunity to address a meeting that has been convened to consider the proposed business rescue plan, [124] and even to make an offer to purchase the voting interests of those opposed to the adoption of the (rejected) business rescue plan (further discussed in 20.9.1).

20.8.2 Employees' committees

Quite apart from the rights conferred on employees to be notified of and to participate in the business rescue proceedings, the Act provides that, within ten business days after his or her appointment, the business rescue practitioner must convene and preside over a first meeting of employees' representatives. At the meeting, the practitioner must inform the representatives whether he or she believes that there is a reasonable prospect of rescuing the company. The employees' representatives would also decide at the meeting whether to appoint an employees' committee, and, if so, may then appoint the members of such committee. [125]

The employees' committee may consult or discuss with the practitioner any matter relating to the rescue process, but without directing or instructing the practitioner. The committee may also receive and consider reports relating to the rescue process on behalf of the general body of employees. The committee must act independently of the practitioner to ensure fair and unbiased representation of the interests of employees.

Each member of a committee of creditors (see below) or employees (as the case may be) must be-

(i) an independent creditor or employee [126] of the company; or
(ii) authorised in writing by an independent creditor or employee to be a member of the committee; or
(iii) a proxy, an agent or attorney of an independent creditor or employee, acting under a general power of attorney. [127]

20.8.3 Creditors and creditors' committees

The underpinning approach of the statutory provisions relating to creditors of the company during the business rescue process is essentially that as a result of the

moratorium which freezes the rights of creditors, they should in return be formally given, as a *quid pro quo*, a right to influence the manner in which the affairs of the company are regulated and a right to vote on the business rescue plan. Creditors may furthermore participate informally in the business rescue proceedings by making proposals for a business rescue plan.

It must be borne in mind that even if the business rescue procedure may result in creditors incurring some losses, these losses may be less than if the company had gone into liquidation.

Creditors of the company are generally, apart from some exceptions, entitled to similar rights as employees of the company during the business rescue proceedings. Like the employees, creditors are entitled to-

(i) notice of each court proceeding, decision, meeting or other relevant event;
(ii) participate in any court proceedings;
(iii) formally participate in the rescue process to the extent provided for; and
(iv) informally participate by making proposals to the practitioner for a business rescue plan.

Creditors also have a right to vote on a proposed business rescue plan; and, if the proposed plan is rejected, they have a further right to propose the development of an alternative plan, or to make an offer to acquire the interests of any or all the other dissenting creditors of the company. [128]

Like the employees of the company, creditors may form a creditors' committee, which the business rescue practitioner would consult during the development of the business rescue plan. A creditors' committee is particularly useful in the case of a company with a large number of creditors. The committee may not, of course, give instructions to the business rescue practitioner. The committee does however, have a right to receive and consider reports relating to the business rescue process, and presumably to require the business rescue practitioner to provide the committee with information relating to the exercise of his or her functions. The members of the committee must consist of independent creditors only. [129] A creditors' committee may be appointed at the first meeting of creditors, if the creditors decide that such a committee should be appointed.

The voting interests of creditors are determined by the value of the amount owed by the company to the creditor, and by the status of the creditor. In this respect, the Act [130] provides that secured or unsecured creditors have a voting interest equal to the value of the amount owed to the creditor. Thus, in respect of any decision voted on by the creditors of the company, each creditor has a voting interest equal to the value of his or her claim against the company, irrespective of whether the creditor's claim is secured or unsecured.

At any meeting of creditors, all that is needed for a decision to be valid and binding is a decision supported by the holders of a simple majority of the independent creditors' voting interests voted on a matter. It must be stressed that this does not

apply to a meeting that is convened for the purpose of considering a proposed business rescue plan (discussed in 20.9.1).

20.8.4 The holders of the company's securities

The interests of shareholders or the holders of the company's securities are regarded as being subordinate to the interests of creditors and employees. Shareholders must be aware that if the company is liquidated their shares or investment in the company will be worthless. But if the company is successfully reorganised or restored to profitability, shareholders will benefit from an increase in the value of their shares. The holders of the company's securities or its shareholders are not given a vital role to play in the approval of the business rescue plan if their rights are not altered by the business rescue plan.

The holders of the company's securities are entitled to-

(i) notice of each court proceeding, decision, meeting or other relevant event concerning the business rescue proceedings;
(ii) participate in any court proceedings arising during the business rescue proceedings;
(iii) formally participate in a company's business rescue proceedings to the extent provided for in the Act;
(iv) vote to approve or reject a proposed business rescue plan if the plan would alter the rights associated with the class of securities held by that person; and
(v) if the business rescue plan is rejected, to–
    (i) propose the development of an alternative plan; or
    (ii) present an offer to acquire the interests of any or all of the creditors or other holders of the company's securities.

It must be emphasised that holders of a company's securities may not vote on the proposed business rescue plan unless the rights associated with their securities are to be altered by the rescue plan.

The holders of the securities of the company are entitled to make a binding offer to purchase the voting interests of persons who were opposed to the adoption of the rejected business rescue plan. [131] This is discussed further in 20.9.3.

The holders of the company's securities do not have the right given to creditors and employees to form a committee or to consult with the practitioner.

20.9 The consideration and adoption of the business rescue plan

20.9.1 Consideration of the plan

It has already been pointed out in 20.7 above that the business rescue practitioner must, after consulting the creditors, other affected persons, and notably the management of the company, prepare a business rescue plan. The company must publish the plan within 25 business days of the practitioner's appointment, or such longer time as may be allowed by the court (on application by the company or the holders of a majority of the creditors' voting interests).

The practitioner must convene and preside over a meeting of creditors and any other holders of a voting interest (including shareholders whose rights are affected), called for the purpose of considering the proposed plan, within ten business days after the publication of the plan. [132]

At the meeting, the practitioner must introduce the proposed business rescue plan for consideration by the creditors and, if applicable, by the shareholders. The practitioner must inform the meeting whether he or she continues to believe that there is a reasonable prospect of the company being rescued. The practitioner must also provide an opportunity for employee representatives to address the meeting.

To be approved on a preliminary basis, the proposed business rescue plan must be supported by the holders of more than 75 per cent of the creditors' voting interests that were voted and also by at least 50 per cent of the independent creditors' voting interests, if any, that were voted. [133] By an 'independent' creditor is meant a person who-

(i) is a creditor of the company, including an employee who is a creditor in respect of unpaid remuneration, reimbursement of expenses or other employment-related amount that became due and payable before the commencement of the business rescue process); and
(ii) is not related to the company, a director or the practitioner.

An employee is not related to the company solely as a result of membership of a trade union that holds shares (or securities) of the company. [134]

If the business rescue plan is supported by the prescribed majority voting interests of creditors, the plan is regarded as having been finally approved only if the rights of any class of shareholders or securities holders are not altered by the rescue plan.

If the business rescue plan is not approved by the creditors on a preliminary basis, the plan is regarded as having been rejected. However, the holders of voting interests who approve of the business rescue plan could perhaps buy out those who disapprove.

If the business rescue plan does alter the rights of any class of the company's securities, the practitioner must immediately convene a meeting of the relevant shareholders or securities holders, and call for a vote by them to approve the adoption of the proposed business rescue plan. In this event, the adoption of the plan by creditors is merely preliminary. Only if the relevant holders of the company's securities approve the plan, based on a majority of the voting rights that were exercised, would the rescue plan be treated as having been finally adopted. If, however, they oppose it, the plan is regarded as having been rejected.

Where the vote of the holders of the company's securities is not required, because the rescue plan does not alter their rights, the preliminary approval by the creditors

constitutes a final approval of the business rescue plan (subject to the satisfaction of any conditions on which that plan is contingent). [135]

20.9.2 The effect of the adoption of the plan

A business rescue plan that has been adopted is binding on the company, on each creditor and on every holder of securities of the company, whether or not that person was present at the meeting or voted in favour of adoption of the plan (or, in the case of creditors, had proven his or her claim against the company).

This, of course, is the well-known 'cramdown' [136] which is so essential to the successful implementation of the business rescue plan: it binds dissenting creditors and others. The 'cramdown' has the incidental effect of discouraging creditors from resisting or holding out for better treatment, and it enables a business rescue or reorganisation to proceed despite the objections of a few disgruntled creditors. It is clearly important that in order to 'cramdown' those creditors who object, the business rescue practitioner does not discriminate unfairly and that he or she is fair and equitable to all the creditors of the company.

If a business rescue plan has been approved and implemented, a creditor is not entitled to enforce a debt owed by the company immediately before the commencement of the business rescue process, except to the extent provided for in the business rescue plan. If the business rescue plan is approved, the practitioner must thereafter manage and conduct the affairs of the company in accordance with the business rescue plan. The approved business rescue forms the basis of the rescue process and if the practitioner arbitrarily deviates from it, he or she may find a creditor, an employee or a holder of the company's securities challenging him or her in an application to court.

When the business rescue plan has been substantially implemented, the practitioner must file a notice of the substantial implementation of the business rescue plan with the Companies Commission. [137] The filing of the notice formally brings the business rescue proceedings to an end.

20.9.3 Failure to adopt the plan

If the rescue plan is rejected by creditors or, where relevant, by the holders of the securities of the company, the practitioner may seek a vote of approval from the relevant holders of voting interests to prepare a revised plan. The alternative is for the practitioner to advise the meeting that the company will apply to the court to set aside the result of the vote on the grounds that it was inappropriate. A court may order that the vote on a business rescue plan be set aside if the court is satisfied that it is reasonable and just to do so, having regard to *(a)* the interests represented by the persons who voted against the rescue plan; *(b)* the provision, if any, made in the proposed rescue plan with respect to the interest of those persons; and *(c)* a fair and reasonable estimate of the return to those persons if the company were to be liquidated.

Alternatively, any affected person (or combination of affected persons), including holders of the company's securities [138] may make a binding offer to purchase the voting interests of any of those opposed to the adoption of the rescue plan. [139]

Failing this, the practitioner must promptly file a notice of the termination of the business rescue proceedings. [140]

If on the other hand, the practitioner has to prepare a revised plan, the plan must be published within ten business days, and the procedure for publishing and considering the new plan will apply afresh.

20.9.4 The termination of business rescue proceedings

The termination of business rescue proceedings has been discussed in 20.4.3.

20.10 Compromise with creditors

20.10.1 General

The Act deals also with compromises between the company and its creditors. It may be possible for a company to enter into a compromise with its creditors without going into liquidation or winding-up. A 'compromise' may be entered into between the company and its creditors as an alternative to business rescue proceedings. There is no barrier or entry requirement that the company must be in financial distress. The Act provides that a compromise may be entered into irrespective of whether the company is financially distressed, unless it is engaged in business rescue proceedings. A compromise would apply even if the company is in liquidation.

A ‘compromise’ is an agreement between a company and its creditors or a class of creditors that terminates a dispute over the rights of the parties which are to be compromised or their enforcement. A compromise is appropriate in cases where the normal mechanisms for reaching an agreement between the company and its creditors or class of creditors are not available. It is intended to provide the machinery for overcoming the practical difficulty that a company, and particularly a company with a large number of creditors, may experience in obtaining the individual consent of every creditor of the company to the settlement of their claims. It also prevents, in appropriate circumstances, a minority from impeding a beneficial scheme or from obtaining special advantages for themselves. A compromise does not entail a moratorium.

20.10.2 The proposal

The board of a company (or its liquidator, if it is being wound up) may propose an arrangement or a compromise of its financial obligations to all its creditors, or to all the members of any class of its creditors. It is only the board of directors or the liquidator of the company that has been given the right to propose a compromise or arrangement. This is done by delivering a copy of the proposal, and the notice of the meeting to consider it, to every creditor of the company or of the relevant class of creditors whose names and addresses are known to or can reasonably be obtained by the company. These documents must also be delivered to the Companies Commission.

The proposal put forward by the board of directors or the liquidator must contain all the information reasonably required to assist creditors in deciding whether to accept or reject the proposal. The proposal must be divided into three parts, consisting of the background to the proposal, the proposal itself and its assumptions and conditions. [141]

Part A: Background

Part A must contain at least the following:

(i) a complete list of all the material assets of the company, together with an indication of which assets are held as security by creditors as on the date of the proposal;

(ii) a complete list of the creditors of the company as on the date of the proposal and an indication of which creditors would qualify as secured, statutory preferent and concurrent creditors under the laws of insolvency (there must be an indication as to which of the creditors have proved their claims);

(iii) the probable dividend that would be received by creditors, in their specific classes, if the company were to be placed in liquidation;

(iv) the complete list of the holders of the securities issued by the company and the effect that the proposal would have on them, if any; and

(v) whether the proposal includes a proposal made informally by a creditor of the company.

Part B: Proposals

Part B must disclose at least the following:

(i) the nature and the duration of any proposed debt moratorium;

(ii) the extent to which the company is to be released from the payment of its debts, and the extent to which any debt is proposed to be converted to equity in the company, or another company;

(iii) the treatment of contracts and the ongoing role of the company;

(iv) the property of the company that is proposed to be available to pay the claims of creditors;

(v) the order of preference in which the proceeds of property of the company will be applied to pay the creditors if the proposal is adopted; and

(vi) the benefits of adopting the proposal as opposed to the benefits that would be received by creditors if the company were to be placed in liquidation.

Part C: Assumptions and conditions

Part C must include at least the following:

(i) a statement of the conditions that must be satisfied, if any, for the proposal both to come into operation and to be fully implemented;

(ii) the effect, if any, that the plan contemplates having on the company's employees, and their terms and conditions of employment; and

(iii) a projected balance sheet for the company and a projected statement of income and expenses for the ensuing three years, prepared on the assumption that the proposal is accepted.

The proposal must conclude with a certificate by an authorised director or prescribed officer stating that any factual information provided appears to be accurate, complete and up to date, and declaring that the projections provided are estimates made in good faith on the basis of factual information and assumptions as set out in the statement. [142]

20.10.3 Adoption of the proposal

To be adopted, the proposal for the compromise must be supported by a majority in number, representing at least 75 per cent in value of the creditors or relevant class of creditors (as the case may be) who are present and voting at a meeting called for that purpose. [143] According to this requirement, the proposal must be approved not only by a majority in number of the creditors, but by a majority holding at least 75 per cent in value of all the claims of creditors.

Upon adoption of the proposal, the company *may* apply to the court for an order approving the proposal. [144] The court may sanction the compromise as set out in the adopted proposal if it is just and equitable to do so. For these purposes the court will take account of the number of creditors of any affected class of creditors who were present or represented at the meeting, and who had voted in favour of the proposal.

For the compromise to be enforceable against all the parties concerned, it seems that it will have to be sanctioned by the court.

The final step in the process is that the company must file a copy of the court order sanctioning a compromise with the Companies Commission within five business days. It must also be attached to each copy of the company's memorandum of incorporation that is kept at the company's registered office or elsewhere. From the date on which it is filed, the court order sanctioning an arrangement or compromise becomes final and binding on all the company's creditors or on all members of the relevant class of creditors, as the case may be.

Questions

1. Due to a severe economic recession, ABC Property Investment CC is experiencing severe cash flow problems. It finds itself increasingly unable to pay its debts in the ordinary course of business. The close corporation has liabilities of R10 million and its assets, consisting mainly of investments in property

   development, have fallen to R5 million as a result of the depressed economy. The financial statements of the close corporation show that the close corporation is in fact hopelessly insolvent. The court has granted a provisional order for the liquidation of the close corporation. The managing members of the close corporation decide to put the close corporation under immediate business rescue. They are of the view that the general moratorium which would result from the business rescue process would give the close corporation an opportunity to sell some of its assets in the hope that this would restore the solvency of the entity. Some creditors of the close corporation have threatened to object to any attempt to place the close corporation under business rescue.

   Advise the members of ABC Property Investment CC of the legal requirements that they would have to comply with in order to place the close corporation under business rescue and whether on the facts a court is likely to make a business rescue order. In the course of your answer, advise the members whether they would be able to place the close corporation under a voluntary business rescue process.
2. Discuss and explain the requirements and the formalities that must be complied with in order for an affected person to obtain a court order to place a company under the business rescue process.

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[*] I acknowledge funding received from the South African National Research Foundation, which was used for research assistance.

[1] The Department of Trade and Industry policy paper entitled 'South African company law for the 21st century: Guidelines for corporate law reform' GN 1183 in *GG* 26493 of 23 June 2004, para 4.6.2.

[2] Section 7*(k)*.

[3] See Farouk HI Cassim 'Business rescue and compromises' *South African Corporate Business Administration* chapter 14 (Revision Service 18, 2011).

[4] A Belcher *Corporate Rescue: A Conceptual Approach to Insolvency Law* (1997) 4.

[5] 11 USC 1978.

[6] See item 6, Schedule 3 to the Act.

[7] Section 128(1)*(b)*.

[8] Section 128(1)*(f)*.

[9] Sections 129(1)*(b)* and 131(4).

[10] 'Broad', because the prerequisites for court-ordered rescue are slightly different.

[11] Section 129(1)*(a)* and *(b)*.

[12] Section 131(1).

[13] Section 129(1).

[14] There must be factual details of the source, nature and extent of the resources that are likely to be available to the company. Mere speculative suggestions would not suffice (*Southern Palace Investments 265 (Pty) Ltd v Midnight Storm Investments 386 Ltd* 2012 (2) SA 423 (WCC)). There must be facts which would enable a court to assess whether there is a reasonable prospect of successfully rescuing the company.

[15] As set out in s 128(1)*(b)*, discussed in 20.2.

[16] Section 129(2)*(a)* and *(b)*.

[17] Section 132(1). The difficulty with this provision is that it is uncertain when exactly a resolution is 'filed' with the Companies Commission.

[18] Section 129(6).

[19] The Act (s 6(10) and (11)) permits notice to be given or published electronically provided that the notice can conveniently be printed by the recipient within a reasonable time and at a reasonable cost. Alternatively, a notice of the availability of the document, summarising its content and satisfying any prescribed requirements, may be delivered to each intended recipient together with instructions for receiving the complete document. More specifically, a notice or document to be delivered for any purpose contemplated in the Act may be delivered in any of the following ways:

- by fax;
- by electronic mail;
- by registered post to the person's last known address;
- by any other means authorised by the High Court;
- by any other method allowed for that person in terms of the Companies Regulations (Table CR3 Annexure 3; see further reg 123(2)).

In *Cape Point Vineyards (Pty) Ltd v Pinnacle Point Group Ltd, Companies and Intellectual Property Commission and Advantage Projects Managers* 2011 (5) SA 600 (WCC), the court accepted that notification by email is one of the permitted methods of notification. Thus sending the application to commence business rescue proceedings by email to creditors of the company is in accordance with the requirements of the Act.

[20] Notices must be filed on CoR 123.1 together with a copy of a board resolution to commence business rescue proceedings (Companies Regulations GN 34239 *GG* 9526 of 26 April 2011).

[21] Section 129(3)*(a)*.

[22] Section 128(1)*(a)*(i) to (iii).

[23] In the case of a company with a large number of shareholders, physical delivery of the application to all the shareholders may not be practicable. In the case of a listed company an announcement on SENS is one of the prescribed methods of bringing corporate information to the attention of its shareholders, in addition to individual notification. If SENS is to be used as a substitute for personal notification, in order to cover a wider field this ought to be coupled with publication in a national newspaper, because not all shareholders are likely to have access to SENS announcements. See *Cape Point Vineyards (Pty) Ltd* (n 19).

[24] Section 129(3)*(b)*.

[25] Section 128(1)*(d)*.

[26] This must be done on form CoR 123.2. There is no prescribed fee payable for filing this form.

[27] Section 129(4)*(a)* and *(b)*.

[28] Section 129(5)*(a)*.

[29] Section 129(5)*(b)*.

[30] In terms of s 129(7).

[31] For ease of reference, s 128(1)*(f)* provides as follows:

' 'financially distressed', in reference to a particular company at any particular time, means that-

(i) it appears to be reasonably unlikely that the company will be able to pay all of its debts as they fall due and payable within the immediately ensuing six months; or

(ii) it appears to be reasonably likely that the company will become insolvent within the immediately ensuing six months.'

[32] In terms of s 152.

[33] By a 'court' is meant the High Court that has jurisdiction over the matter or a designated or assigned judge of the High Court that has jurisdiction over the matter (s 128(1)*(e)* and (3)). It must of course be a court and not, for instance, the Companies Tribunal or other regulatory body.

[34] Section 130(1)*(a)*(i)-(iii).

[35] Set out in s 129, as discussed in 20.3.1.

[36] Section 130(5)*(b)*(i) and (ii).

[37] Section 130(5)*(b)*.

[38] Ie is not properly qualified in terms of the requirements and qualifications set out in s 138(1)*(a)* to *(f)* for a business rescue practitioner.

[39] Section 130(6).

[40] By an 'independent creditor' is meant a creditor of the company, including an employee who is a creditor, who is not related to the company, or to a director or the business rescue practitioner (s 128(1)*(g)*). For these purposes, an employee is not related to the company solely as a result of being a member of a trade union that holds securities of that company

[41] Section 130(3)*(b)*. See reg 124 read with reg 7. A copy of the court application must be delivered to each affected person known to the applicant. See further 20.3.1.

[42] See further 20.3.1.1.

[43] Section 130(5)*(c)*(i).

[44] Section 130(6)*(a)*.

[45] Section 131(1).

[46] Section 131(2)*(a)* and *(b)*. In accordance with reg 124 read with reg 7 and Table CR3 in Annexure 3, the notice may be faxed, sent electronically or by registered post or any other means authorised by the High Court, or by any other method allowed for that person in terms of Table CR3. Perhaps reg 124 goes too far in requiring a copy of the court application to be delivered to each affected person. The regulation requires service of the whole application to court. This is often not practicable as the documentation could be voluminous. A possible solution is that in terms of s 6(11)*(b)*(ii) notice of the availability of the document or the application to court may be given together with instructions for receiving the complete document.

[47] In terms of s 131(4)*(a)*.

[48] 'Public regulation' is defined very widely in s 1 of the Act to mean 'any national, provincial or local government legislation or subordinate legislation, or any licence, tariff, directive or similar authorisation issued by a regulatory authority or pursuant to any statutory authority'. Thus a failure to pay income tax deducted from employees or contributions to the Unemployment Insurance Fund or to make payments to a medical aid falls within the ambit of s 131(4)*(a)*(ii).

[49] For this ground to apply, the company must not itself be responsible for causing the grounds for which it would be just and equitable to place the company under business rescue. In considering this ground, a court must take into account the financial interests of all stakeholders, such as creditors, employees, holders of the company's shares or securities and the company itself.

[50] 'Reasonable prospect' means that something less than a reasonable probability is required. It seems that a reasonable possibility of the company being successfully rescued may

suffice. The applicant should give reasons why the business rescue process (and plan) will have a reasonable prospect of success. A mere bald assertion is not enough.

[51] *Southern Palace Investments 265 (Pty) Ltd v Midnight Storm Investments 386 Ltd* 2012 (2) SA 423 (WCC).

[52] 2011 (5) SA 422 (GNP).

[53] *Antonio Welman v Marcelle Props 193cc and Others* Case Number 33958/2011 (CSP).

[54] Section 131(8)*(b)*.

[55] Section 132.

[56] Section 132(3).

[57] Section 132(2)*(a)*-*(c)*.

[58] As contemplated in s 153.

[59] Section 137(2)*(a)*.

[60] Section 137(1)*(d)*. These duties and liabilities are discussed in Chapter 14: The duties and the liability of directors.

[61] Section 133(1).

[62] Section 133(1)*(a)* and *(b)*.

[63] In *Investec Bank v Andre Bruyns* (Case No 19449/11; 14 November 2011) the court ruled that the statutory moratorium afforded to a company under the business rescue process is a defence *in personam*. The moratorium consequently does not apply to a person who has signed as surety for debts of the company.

[64] Section 133(3).

[65] Section 134, subject to s 134(2) and (3).

[66] Section 134(2).

[67] Section 134(3)*(a)*.

[68] Section 134(3)*(b)*.

[69] Section 134(3).

[70] Section 134(1)*(b)*.

[71] Section 136.

[72] Section 136(3).

[73] See G McCormack 'Super-priority new financing and corporate rescue' 2007 *Journal of Business Law* 701.

[74] Section 135.

[75] Section 135(3)*(b)*.

[76] As set out in s 135(3)*(a)* and *(b)*.

[77] Section 135(3)*(a)*(i) and (ii).

[78] Section 135(4).

[79] Section 136(1)*(a)*.

[80] Any retrenchments of employees of the company contemplated in the business rescue plan are subject to ss 189 and 189A of the Labour Relations Act 66 of 1995 and other applicable employment-related legislation.

[81] Section 136(2).

[82] It is also subject to s 35A and s 35B of the Insolvency Act 24 of 1936.

[83] Section 136(2)*(b)*.

[84] Section 146.

[85] Section 137(2)*(b)*.

[86] Section 137(2).

[87] As set out in s 76.

[88] As set out in s 77.

[89] Section 77(3)*(c)*.

[90] See Chapter 14: The duties and the liability of directors.

[91] Section 140(1)*(a)*.

[92] Section 129(3).

[93] Sections 131(5) and 147(1).

[94] Section 130(6)*(a)*; see 20.3.1.2 above.

[95] Section 130(6)*(a)*.
[96] Section 140(1)*(d)*.
[97] Section 138(1)*(a)*-*(f)*.
[98] See Chapter 12: Governance and the board of directors.
[99] Companies Regulation 126(4). The application for a practitioner's licence must be on prescribed form CoR 126.1. A filing fee of R500 for the application is payable.
[100] Regulation 126(8).
[101] Regulation 127.
[102] Regulation 26(2).
[103] In terms of s 130, as discussed in 20.3.1.
[104] Section 139(2)*(a)*-*(f)*.
[105] Section 139(3). This is subject to the right of an affected person to bring a fresh application to set aside the new appointment (ie on the grounds that the appointed person does not satisfy the requirements of a practitioner, is not independent, or lacks the necessary skills).
[106] Section 143(1).
[107] Regulation 128. See 20.6.2 for the criteria distinguishing small, medium and large companies.
[108] Section 140(1)*(b)*.
[109] Under s 140(1)*(c)*.
[110] For this purpose the practitioner does not need the consent of court.
[111] Section 140(4).
[112] Section 141(1).
[113] Section 142.
[114] Section 142(3)*(a)*-*(f)*.
[115] Section 142(4).
[116] Section 141(2)*(a)*.
[117] Section 150(1).
[118] Section 150(2).
[119] Section 150(5).
[120] Section 150(2).
[121] Section 144.
[122] Section 144(1)*(a)* and *(b)*.
[123] Section 144(1)*(b)*.
[124] Section 152(1)*(c)*.
[125] Section 148(1)*(a)* and *(b)*.
[126] That is, must not be related to the company, its directors or the practitioner (s 128(1)*(g)*). An employee (who is a creditor in terms of s 144(2)) is not related solely because he or she is a member of a trade union that holds securities of that company.
[127] Section 149(2)*(a)*-*(c)*.
[128] In accordance with the provisions of s 153.
[129] That is, a creditor who is not related to the company, a director or the business rescue practitioner.
[130] Section 145(4).
[131] Section 153(1)*(b)*(ii).
[132] At least five business days before this meeting, the practitioner must deliver a notice of the meeting to all affected persons containing the date, time and place of the meeting; its agenda; and a summary of the rights of affected persons to participate in and to vote at the meeting (s 151(2)).
[133] Section 152(2).
[134] Section 128(1)*(g)* and (2).
[135] Section 152(3)*(b)*.
[136] By a 'cramdown' is meant the process by which creditors are forced to accept a reorganisation or business rescue plan, even against their wishes.
[137] Section 152(8). This must be done on prescribed form CoR 125.3.

[138] Section 146*(e)*(ii).

[139] Section 153(1)*(b)*(ii).

[140] Section 153(5). This must be done on prescribed form CoR 125.2, which must be published in the same manner as that required for the publication of a notice of substantial implementation of the business rescue plan (discussed in 20.9.1 and 20.9.2).

[141] Section 155(3).

[142] Section 155(5).

[143] Section 155(6).

[144] Section 155(7)*(a)*. Although s 155(7)*(a)* is drafted in terms that appear to be permissive, in effect its terms are practically mandatory.

Chapter 21
Winding-up

Jacqueline Yeats

21.1 Introduction

The winding-up of a company is the legal process in which its financial and administrative affairs are 'wound up', ie finalised equitably and in an orderly, regulated fashion by a liquidator, and culminates in the termination of the company's legal existence. Companies may be wound up for a variety of reasons. However, a convenient and currently appropriate distinction may be made between the winding-up of a solvent company and the winding-up of an insolvent company.

The winding-up of South African companies is governed by two separate pieces of legislation. The winding-up of solvent companies is regulated in terms of the Companies Act 71 of 2008 ('the Act'). [1] The winding-up of insolvent companies, however, is currently still regulated in terms of Chapter XIV of the previous Companies Act. [2] There is a legislative process under way that is intended to reform the law of insolvency generally and that will result in a new, unified Insolvency Act. When this process is complete and alternative legislation has been brought into force that adequately provides for the winding-up and liquidation of insolvent companies, Chapter XIV will no longer apply.

21.2 Winding-up of solvent companies

A solvent company may be dissolved by-

(i) a voluntary winding-up initiated by the company and conducted either by the company itself or by its creditors; or

(ii) winding-up and liquidation by court order.

21.2.1 Voluntary winding-up of solvent companies

A company may be wound up voluntarily if it has adopted a special resolution to do so. [3] The special resolution may provide for the winding-up to be by the company or by its creditors. The resolution together with the prescribed notice must be filed with the Companies and Intellectual Property Commission ('the Companies Commission'). However, prior to such a filing, the company must-

(i) arrange for security satisfactory to the Master [4] for payment of the company's debts within a maximum of 12 months after the commencement of the winding-up; [5] or

(ii) obtain consent from the Master to dispense with security.

A liquidator appointed in a voluntary winding-up may exercise all powers given by the Act to a liquidator in a winding-up by the court without requiring a specific order or sanction of the court, subject to any directions given by the shareholders (in the case of a winding-up by the company) or the creditors (in the case of a winding-up by the creditors). [6]

The company remains a juristic person and retains all its powers as such while it is being wound up. However, from the beginning of the company's winding-up it must cease carrying on its business except to the extent required for the beneficial winding-up of the company. In addition, all the directors' powers cease except to the extent that they are specifically authorised to act by the liquidator or the shareholders in general meeting (in the case of a winding-up by the company) or the liquidator or creditors (in the case of a winding-up by creditors).

21.2.2 Winding-up of solvent companies by court order

The circumstances under which the court may wind up a solvent company are many and varied. The court has a discretion as to whether to grant a winding-up order, and is therefore not obliged to grant the order merely because the resolution has been passed or one of the other grounds for winding-up has been established. Section 81 provides that a court may order a solvent company to be wound up if-

(a) the company has-

(i) resolved, by special resolution, that it be wound up by the court; or

(ii) applied to the court to have its voluntary winding-up continued by the court;

(b) the practitioner of a company appointed during business rescue proceedings has applied for liquidation in terms of section 141(2)*(a)*, on the grounds that there is no reasonable prospect of the company being rescued; or

(c) one or more of the company's creditors have applied to the court for an order to wind up the company on the grounds that-

(i) the company's business rescue proceedings have ended in the manner contemplated in section 132(2)*(b)* or *(c)*(i) and it appears to the court that it is just and equitable in the circumstances for the company to be wound up; or

(ii) it is otherwise just and equitable for the company to be wound up;

(d) the company, one or more directors or one or more shareholders have applied to the court for an order to wind up the company on the grounds that-

(i) the directors are deadlocked in the management of the company, and the shareholders are unable to break the deadlock; and-

(aa) irreparable injury to the company is resulting, or may result, from the deadlock; or

(bb) the company's business cannot be conducted to the advantage of shareholders generally, as a result of the deadlock;

(ii) the shareholders are deadlocked in voting power, and have failed for a period that includes at least two consecutive annual general meeting dates, to elect successors to directors whose terms have expired; or

(iii) it is otherwise just and equitable for the company to be wound up;

(e) a shareholder has applied, with leave of the court, for an order to wind up the company on the grounds that-

(i) the directors, prescribed officers or other persons in control of the company are acting in a manner that is fraudulent or otherwise illegal; or

(ii) the company's assets are being misapplied or wasted; or

(f) the Commission or Panel has applied to the court for an order to wind up the company on the grounds that-

(i) the company, its directors or prescribed officers or other persons in control of the company are acting or have acted in a manner that is fraudulent or otherwise illegal, the Commission or Panel, as the case may be, has issued a compliance notice in respect of that conduct, and the company has failed to comply with that compliance notice; and

(ii) within the previous five years, enforcement procedures in terms of this Act or the Close Corporations Act 69 or 1984 were taken against the company, its directors or prescribed officers, or other persons in control of the company for substantially the same conduct, resulting in an administrative fine, or conviction for an offence.

Although the grounds for the winding-up of a solvent company by the court under the Act are quite different from the grounds on which a court could previously wind up a company under the 1973 Act, where the same words or phrases are used as those which applied under the previous Act, it is likely that the court may be guided or even bound by existing case law in this regard. To illustrate, the 1973 Act contained a section providing that the court may wind up a company if 'it appears to the court that it is just and equitable that the company should be wound up'. [7] The Act, in s 81(1)*(c)* (application by creditors) and s 81(1)*(d)*(iii) (application by company, directors or shareholders), also uses the 'just and equitable' ground as part of these

subsections. In *Apco Africa (Pty) Ltd v Apco Worldwide Inc* [8] the Supreme Court of Appeal made the following points in relation to the 'just and equitable' ground as a basis for winding-up:

(i) This type of consideration postulates not facts, but only a broad conclusion of law, justice and equity as a ground for winding-up.

(ii) It is well settled that the power given to the court to wind up on a just and equitable ground is not confined to cases where there are grounds analogous to those mentioned in other parts of the section.

(iii) No general rule can be laid down as to which circumstances have to be borne in mind in considering whether a case comes within the phrase.

(iv) The cases show that the application of the 'just and equitable' provision is not to be limited to cases where the substratum of the company has disappeared or where there has been a complete deadlock.

The final observation above flows from the fact that the courts have developed guidelines for the exercise of their discretion on the 'just and equitable ground'. These principles (which do not constitute a closed list of recognised categories for winding-up on just and equitable grounds) are-

(i) the disappearance of the company's substratum (which makes it impossible for a company to pursue its objects);
(ii) illegality of objects and fraudulent purpose (the company's objects are or become illegal or the company was promoted for the purpose of perpetrating a fraud);
(iii) a deadlock in the company's administration (which renders the company incapable of carrying on its business); and
(iv) irretrievable destruction of the relationships in a domestic company ('or *quasi*-partnership').

Judgments such as this should prove useful in assisting with the interpretation of the new provisions dealing with the winding-up of solvent companies.

21.3 Winding-up of insolvent companies

As pointed out previously, this area of law continues to be regulated by the provisions of the 1973 Act until such time as it has been replaced by other appropriate legislation. It is not possible to discuss the substantive and procedural requirements for winding up an insolvent company in detail in this chapter. These requirements are complex and lengthy and are supported by case law spanning nearly a century. However, for the sake of completeness, a brief overview of the main facets of the winding-up of an insolvent company is included.

The term 'insolvency' describes the situation where a company is unable to pay its debts and is governed by s 345 of the 1973 Act. In terms of this section a company is deemed to be unable to pay its debts (and is therefore insolvent and liable to beliquidated) if-

(i) a creditor that is owed [9] at least R100 by the company has served a demand for payment [10] and the amount has not been paid within three weeks; or
(ii) the sheriff has issued a *nulla bona* return to a warrant of execution; [11] or
(iii) it is proved to the satisfaction of the court that the company is unable to pay its debts. [12]

In making the determination whether a company is unable to pay its debts the court must also take into account the contingent and prospective liabilities of the company. [13] A company is unable to pay its debts within the meaning of s 345(1)*(c)* when it is 'commercially insolvent', ie when it is unable to pay its debts as they fall due in the ordinary course of business. The question is therefore not whether the company is factually solvent in the sense that its assets exceed its liabilities, but whether it can meet its obligations and thereafter continue trading. This may be proved in any manner that satisfies the court.

The power of the court to grant a winding-up order is a discretionary one [14] but the 1973 Act places restrictions on the discretionary power of the court in hearing the application for winding-up. In addition, certain guidelines and principles have evolved through the cases to aid the courts in exercising this rather wide discretion. For example, where the application for a winding-up amounts to an abuse of process because its aim is not only to place the company in liquidation to achieve a fair and equitable distribution of its assets, but instead is motivated by bad faith, the court will not grant a winding-up order. Similarly, when winding-up proceedings are used in an attempt to enforce payment of a debt which is disputed by the company on reasonable and substantial grounds, the court will dismiss the application.

21.4 The winding-up process

An application to court for the winding-up of a company may be made by-

(i) the company itself; [15] or
(ii) one or more of the company's creditors (contingent or prospective creditors included); [16] or
(iii) one or more of the company's members or the executor, administrator, trustee, curator or guardian in respect of the estate of a deceased member or one whose estate has been sequestrated or who is otherwise under disability, or the liquidator of a body corporate in the course of being wound up which is a member of the company; [17] or
(iv) jointly by any or all of the above parties. [18]

The application takes the form of a notice of motion together with an affidavit supporting the facts on which the applicant relies for relief, ie the grounds for winding-up. The purpose of the application is to place before the court, the company, the creditors and the shareholders, a statement of the material facts upon which the winding-up order is claimed and to provide information to the Master, the sheriff, the liquidator and other interested parties. [19] Every application must be accompanied by a certificate by the Master to the effect that sufficient security has been given. Unless the application is brought by the company itself, notice of the application should be served on the company except in matters of urgency. The court may grant or dismiss an application for winding-up or adjourn the hearing thereof or make an interim order or any other order which it deems just. [20]

21.5 The liquidator

A liquidator appointed in a voluntary winding-up may, upon appointment, exercise all the powers given in law to a liquidator in a winding-up by a court. The exercise of his or her powers does not require the specific order or sanction of the court, but is subject to any directions given by the shareholders in general meeting (in the case of a winding-up by the company) or the creditors (in the case of a winding-up by creditors). [21]

The Master appoints the liquidator once a winding-up order has been made. The Master may appoint any suitable person as the provisional liquidator and has the power to remove a liquidator from his or her office on a number of grounds, including on the basis that the liquidator has failed to perform his or her duties satisfactorily. [22] Liquidators are entitled to reasonable remuneration for their services [23] and, once they have performed all their duties and complied with the Master's requirements, they may apply to the Master for a certificate of completion of duties and a cancellation of the security initially given by them. [24]

21.5.1 Powers of the liquidator

The powers of the liquidator are the same for the winding-up of solvent and insolvent companies. The liquidator has wide general powers, [25] as well as the power (granted by the court, creditors or members of the company, as the case may be) [26] to, among other things, bring or defend legal proceedings; agree to settlements with debtors of the company; compromise or admit claims against the company; make arrangements with creditors; submit disputes to arbitration; carry on or discontinue the business of

the company; sell the property of the company; and approach the court for leave to perform any act or exercise any other power.

21.5.2 Duties of the liquidator

The general duties of the liquidator are to recover all the assets and property of the company, to sell these to satisfy the costs of the winding-up and the claims of creditors as far as possible, and ultimately to distribute the balance of the insolvent estate (the free residue) to those persons legally entitled to it. In the course of the performance of this general duty, the liquidator naturally has to perform a number of specific duties. [27] The liquidation and distribution process is conducted through a series of prescribed meetings of creditors and members to ascertain their wishes. The process eventually culminates in the lodging of a liquidation and distribution account by the liquidator. [28] The assets of the estate are distributed in accordance with the liquidation and distribution account once this account has been confirmed.

21.6 Dissolution of companies and removal from register

When the affairs of a company have been completely wound up and a court order of final liquidation has been made, the Master must promptly file a certificate of the winding-up of the company together with a copy of the court order, with the Companies Commission [29] which must, in turn, record the dissolution and remove the company's name from the companies register. [30]

21.7 Deregistration of companies

In addition to the duty to deregister a company described above, the Companies Commission may otherwise remove a company from the companies register only in the limited circumstances set out in section 82(3). If the Companies Commission deregisters a company in these circumstances, any interested person may apply to the Companies Commission to reinstate the registration of the company. [31] The court has the power to restore the company's registration.

21.8 Effect of removal of company from register

A company is dissolved as of the date on which its name is removed from the companies register. [32] This does not affect the liability of any former director or shareholder of the company (or any other person) in respect of any act or omission that took place before the company was removed from the register. [33] To the contrary, any liability continues and can be enforced as if the company had not been removed from the register. [34] The property of a company becomes *bona vacantia* upon its deregistration and vests in the State. [35]

At any time after a company has been dissolved-

(i) the liquidator of the company, or other person with an interest in the company, may apply to a court for an order declaring the dissolution to have been void, or any other order that is just and equitable in the circumstances; and

(ii) if the court declares the dissolution to have been void, any proceedings may be taken against the company as might have been taken if the company had not been dissolved. [36]

The court thus has the power upon application by the liquidator or other interested party to set aside a dissolution in terms of a voiding order. The purpose of setting aside a dissolution is usually to complete unfinished business or to rectify an oversight in relation to a winding-up, such as the distribution of one or more of the company's assets that had been overlooked in the final process.

Questions

1. Briefly explain how a liquidator is appointed, what his duties are, and how the Act ensures that he properly fulfils these duties.
2. Vengeco (Pty) Ltd is a solvent company. As a result of a personal feud which has been raging for a long time, the only two members

of the company, John and Vusi, are no longer on speaking terms. Each time a company decision needs to be made they purposely vote differently and this results in a deadlock in the voting. As a result the company cannot move forward. John wants to liquidate the company but Vusi says that this is impossible because the company has assets with a total value of R2 000 000 and has liabilities of only R500 000. Comment on this statement and discuss their legal position.

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[1] Sections 79-81.

[2] Act 61 of 1973.

[3] Section 80(1).

[4] The Master is the person who holds the office of Master of the High Court.

[5] Section 80(6) determines that a voluntary winding-up begins when the resolution of the company has been filed in terms of s 80(2).

[6] Section 80(5).

[7] Section 344*(h)* of the 1973 Act.

[8] 2008 (5) SA 615 (SCA).

[9] The debt must be due and payable.

[10] As required in terms of s 345(1)*(a)* of the 1973 Act.

[11] This means that the sheriff or messenger of the court has indicated by an endorsement on his or her return of service that he or she has not found sufficient property to satisfy the judgment, decree or court order or, alternatively, that any disposable property found did not upon sale satisfy the process.

[12] 'Debt' in this context means an amount of money that is due and owing.

[13] Section 345(2) of the 1973 Act.

[14] This also applies to the winding-up of solvent companies.

[15] Section 346(1)*(a)* of the 1973 Act.

[16] Section 346(1)*(b)* of the 1973 Act.

[17] Section 346 (1)*(c)* read with s 103(3) of the 1973 Act.

[18] Section 346(1)*(d)* of the 1973 Act.

[19] *Breetveldt v Van Zyl* 1972 (1) SA 304 (T) 314.

[20] Section 347(1) of the 1973 Act.

[21] Section 80(5).

[22] Sections 379 and 381 of the 1973 Act.

[23] Section 384 of the 1973 Act.

[24] Section 385 of the 1973 Act.

[25] Section 386 of the 1973 Act.

[26] Section 386(3) of the 1973 Act.

[27] Sections 391-411 of the 1973 Act.

[28] Sections 412-16 and 403-5 of the 1973 Act.

[29] Section 82.

[30] Section 82(2).

[31] Section 83(4).

[32] Section 83(1).

[33] Section 83(1).

[34] Section 83(2).

[35] *Ex parte Sprawson: In re Hebron Diamond Mining Syndicate* Ltd 1914 TPD 458.

[36] Section 83(4).

Chapter 22
Insider Trading and Market Manipulation

Richard Jooste and Rehana Cassim [*]

22.1 Insider trading

22.1.1 General

The use of the terms 'insider trading' and 'insider dealing' is misleading these days. The terms are used to refer to the sale and purchase of a company's securities by persons associated with the company, known as 'insiders', who are in possession of 'price-sensitive' information not generally available and gained as a result of that association. The law relating to insider trading used to be an aspect of the law that governed the conduct of the directors and officers of companies. Today, however, the approach is to regulate all trading on 'inside information', not only by 'insiders', but also by persons to whom insiders have passed on insider information, known as 'secondary insiders' or 'tippees', and persons who have otherwise wrongfully gained possession of such information. There is thus both 'primary' insider trading and 'secondary' insider trading. It is therefore now more correct to speak, not of 'insider trading', but of 'trading on inside information'. [1] However, for the sake of brevity we will refer to 'insider trading' in this chapter.

There are various arguments in favour of outlawing insider trading.

First, it is argued that insiders are in a position of trust. They should therefore not be permitted to abuse that position to benefit themselves, especially at the cost of the beneficiaries of that trust, namely, the shareholders. It is argued that today 'commercial morality' rejects the contention that the use of such information for personal gain is a normal benefit of those closely associated with a company.

A second argument against insider trading is that-

> insider trading is harmful to the company. It is an incentive to managers to manipulate prices (eg by the timing of releases or withholding of information); it diverts managers from performing their duties to the company; and it enables managers to minimise their losses at times of stress for the company and, consequently, their incentive to avoid 'flops' by the company is lessened. What is more, insider trading undermines the company's reputation of integrity, which is, among other things, essential to its ability to raise capital. [2]

A third argument is that-

> although there are uncertainties and undoubted elements of chance inherent in the buying and selling of shares, the insider (or person with insider information) ought not to be in a position of ascendancy over the outsider, for his ascendancy is not attributable to any industry or merit that might otherwise justify it. Fairness, it is argued, requires equality of opportunity and the inherent unfairness of the practice is reason for outlawing it. [3] A fourth argument is the argument that trading on inside information deters investors. It is, in fact, now generally accepted that the reason for prohibiting insider trading is the inherent unfairness of the practice, with the consequent knock that it has on confidence in the market in shares.

Some have argued that insider dealing ought not to be outlawed. In broad terms, the proponents of insider trading argue that insider trading improves market efficiency. They argue that insider trading speeds up the accurate pricing of securities, thus enhancing the economy's allocation of capital investment and minimising the volatility of security prices. They also argue that insider trading is a justifiable and efficient way of remunerating managers for having unearthed the inside information. The contention is that allowing insider trading benefits the firm and therefore society because of the incentive it creates to be innovative. [4]

The law governing insider trading is to be found in the common law and in legislation. Insider trading is by its nature difficult to police and the common law is particularly inadequate in this regard.

22.1.2 Common law

If directors use confidential information for their own purposes, this is a breach of their fiduciary duty [5] and makes them liable to account to their company for any profits they may have made. Thus, if a director uses confidential price-sensitive information to buy or sell his or her company's shares, the director, it appears, will be liable to the company for any profit he or she has made. This is so even though the company may not have suffered any loss.

The company can also claim profits from the 'tippees' of a director if the 'tippees' knew of the director's breach of duty. The director and the tippee will be jointly liable to the company. It would seem, however, that the company has no action against the director for the profits made by the tippee.

For a long time it has been accepted that directors do not owe fiduciary duties to the shareholders of their companies and accordingly, in the event of insider trading involving a shareholder and a director, there would be no liability of the director to the shareholder on the basis of such duty. [6] There are, however, indications that the law may be changing in this regard. [7]

22.1.3 Legislation

Legislation aimed at insider trading is to be found in the Securities Services Act 36 of 2004. Prior to this legislation, there were various legislative attempts to regulate insider trading but they all proved to be inadequate. The Securities Services Act will soon be history when the Financial Markets Bill, 2012, is made law. The Bill is intended to align South African legislation and regulatory framework with developments and standards in other countries to facilitate integration and to make the market open and user-friendly to local and foreign market players.

The Financial Markets Bill introduces new offences and defences relating to insider trading and removes others. The defence that a person may deal with inside information because it was in pursuit of an affected transaction has been removed, as well as the defence available to a public sector body in pursuit of monetary policy. A person who implements an offending transaction on behalf of another person, suspecting or having a reason to suspect that the person was an insider, can be found liable. A new defence has been included for a good faith commercial transaction among insiders that is not designed to benefit from the price sensitive information. The defence available to an authorised user who is an insider, but who acted on specific instructions from a client, has been extended to require the authorised user not to execute such a transaction if he or she has reason to suspect that the client is also an insider.

Apart from these changes, the Financial Markets Bill generally retains the insider trading provisions of the Securities Services Act.

22.1.4 The Securities Services Act 36 of 2004

22.1.4.1 General

The Securities Services Act was motivated by South Africa's reintegration into the international financial markets and the government's desire to create an environment conducive to foreign investment.

The provisions of the Securities Services Act considerably broaden the scope of offences related to insider trading by prohibiting three kinds of conduct:

(i) dealing;
(ii) encouraging or discouraging dealing; and
(iii) improper disclosure or 'tipping'.

It is not necessary for the prosecution to show that the alleged offender had dealt on the basis of unpublished price-sensitive information. It need simply be proved that the offender had known that he or she was in possession of 'inside information' [8] and that he or she had dealt in the relevant securities. Various defences are available.

Both criminal and civil liability are possible and can be incurred not only by natural persons but also by juristic persons as well as partnerships and trusts.

One of the objectives of the insider trading legislation is to include an effective civil remedy. The Securities Services Act provides for a 'derivative' civil action which may be instituted by the Financial Services Board (FSB) against persons involved in a contravention of the insider trading provisions. Money awarded to the FSB as a result of such a civil action will be distributed to those individuals affected by the insider trading.

22.1.4.2 'Inside information' and 'insider'

Of great importance is what is meant by 'inside information' in the legislation. To qualify as inside information, the information in question-

(i) must be 'specific or precise';
(ii) must not have been made public;
(iii) must be 'obtained or learned as an insider'; and
(iv) if it were made public would be likely to have a material effect on the price or value of any security listed on a regulated market.

(i) Specific or precise information

To qualify as 'inside information' the information must be 'specific or precise'. It has been said, regarding this restriction, that-

> the crucial effect of this restriction is that it should relieve directors and senior managers of the company and analysts who have made a special study of the company from falling foul of the legislation simply because they have generalised informational advantages over other investors, arising from their position in the one case and the effort they have exerted on the other. Having a better sense of how well or badly the company is likely to respond to a particular publicly known development does not amount to the possession of precise or specific information. [9]

(ii) Which has not been made public

'Inside information' is information 'which has not been made public'. In an attempt to introduce a measure of certainty in this regard, the legislation, without limiting the circumstances in which information may be regarded as having been made public, stipulates alternative situations where the information shall be regarded as having been made public, and also lists circumstances where information may still be treated as having been made public despite the circumstances.

Information is to be regarded as having been made public in circumstances which include, but are not limited to, the following:

(a) when the information has been published in accordance with the rules of the relevant regulated market for the purpose of informing clients and their professional advisers;
(b) when the information is contained in records which by virtue of any enactment are open to inspection by the public;
(c) when the information can be readily acquired by those likely to deal in any listed

securities-

- to which the information relates; or
- of an issuer to which the information relates; or
- when the information is derived from information which has been made public.

The legislation then lists three circumstances where, despite the fact that one or more of these circumstances might *prima facie* suggest that the information has not been made public, the information may still be regarded as public:

(a) it can be acquired only by persons exercising diligence or observation, or
(b) it is communicated only on payment of a fee; or
(c) it is published only outside the Republic.

Although some certainty regarding publication has been created by these provisions, questions still abound. What about information published in a financial journal? Will some financial journals suffice but not others, for example, those freely available on the news-stands, but not those sold on subscription only? Is publication in any one of the official languages sufficient? What about publication on the radio or television (and what if it is late at night)?

(iii) Obtained or learned as an insider

The definition of 'inside information' is 'obtained or learned as an insider'.

'Insider' means a person who has inside information-

(a) through being a director, employee or shareholder of an issuer of securities listed on a regulated market to which the inside information relates; or
(b) through having access to such information by virtue of employment, office or profession; or
(c) where such person knows that the direct or indirect source of the information was a person contemplated in *(a)* and *(b)* above.

(iv) If it were made public would be likely to have a material effect on the price or value of any security listed on a regulated market

It is important to note that materiality is essential.

22.1.4.3 'Person'

The insider trading violations can be committed by any 'person'. 'Person' includes a corporate or other legal entity.

The imposition of liability for insider dealing on bodies corporate contrasts with the King Task Group's view:

> In view of the lack of development in our law of the jurisprudence concerning the efficacy of the Chinese wall, the Task Group decided that both the criminal offence of insider trading and the civil remedy set out in the proposed legislation should be limited to conduct by an individual. [10]

The problem alluded to by the King Task Group is the one that arises where, for example, the corporate advisory department of a company has inside information relating to the shares in another company and the investment department of the company, which does not have the inside information, deals in the shares. Has the company dealt on the strength of the inside information? Unless some 'Chinese wall' defence is available to the company it appears that it may be liable.

A 'Chinese wall' is essentially an information barrier. It is created by putting together administrative and organisational arrangements and structures that stop information from flowing from one part of a business to another.

The definition of 'person' includes a partnership and a trust, which means that the insider trading violations can be committed by a partnership or a trust, neither of which has legal personality in terms of the common law.

22.1.4.4 'Securities' and 'regulated market'

The insider trading violations relate to 'securities' traded on a 'regulated market'. 'Securities' are defined very widely, and include, for example, bonds, debentures and derivative instruments. Money market instruments are, however, excluded as well as any securities specified by the registrar.

For securities to qualify they must be listed on a 'regulated market'. Section 72 of the Securities Services Act provides that "regulated market" means any market, whether domestic or foreign, which is regulated in terms of the laws of the country in which that market conducts business as a market for dealing in securities on that market'. Thus insider trading in regard to unlisted securities, even those of a company which is a subsidiary of a listed company, is not prohibited by the Securities Services Act.

The definition of 'securities' makes it clear that the prohibitions embrace all securities and financial instruments listed on a regulated market in South Africa or internationally. Instruments and securities issued by public sector bodies are included.

Although only listed securities fall within the ambit of the Securities Services Act, insider trading in these securities is prohibited, whether such dealing occurs on a regulated market or OTC (over the counter).

22.1.4.5 Criminal liability

The Securities Services Act prohibits four types of conduct on the part of an 'insider' who has 'inside information': dealing on one's own account, dealing on behalf of someone else, improper disclosure or 'tipping' and encouraging or discouraging dealing.

(i) The 'dealing' offence

Section 73(1)*(a)* of the Securities Services Act describes the offence that is committed when an insider deals for his or her own account on the strength of inside information. It provides:

> An insider who knows that he or she has inside information and who deals directly or indirectly or through an agent for his or her own account in the securities listed on a regulated market to which the inside information relates or which are likely to be affected by it commits an offence.

The offence is, however, not committed in the circumstances envisaged in s 73(1)*(b)*, namely if such insider-

(a) proves on a balance of probabilities that he or she was acting

in pursuit of the completion of an affected transaction as defined in the Companies Act; or

(b) only became an insider after he or she had given the instruction to deal to an authorised user and the instruction was not changed in any manner after he or she became an insider.

It is not a requirement of the offence that the accused made a profit or avoided a loss. This is odd. Say, for example, an insider sells his or her shares for R100 (the current market price) when he or she has inside information which, if known, would cause the price to rise (and when known did cause the price to rise) to R200. Surely, that ought not to be an offence?

There is no exhaustive definition of 'dealing' in the Securities Services Act. It appears that 'dealing' means buying or selling or a transaction akin thereto such as bartering, but just how far the meaning goes is unclear.

It is not clear whether 'dealing' includes 'subscribing' for shares. Clarification that it is included is called for as there appears to be no basis for its exclusion. For example, Mr X, an employee of Company Y, knows he has inside information which, when made public, will cause the price of Company Y's shares to rise, and he subscribes for shares in Company Y. Company Y does not have the inside information. Surely this is as unacceptable as purchasing shares in Company Y?

It is submitted that where a company acquires its own shares, it is 'dealing' even though it is not able to 'deal' with them thereafter.

Abstaining from dealing is not an offence and does not give rise to any criminal or civil liability. Thus it is not an offence if a person retains securities he or she would otherwise have sold because he or she has acquired inside information that they will increase in value. This exclusion is no doubt based on the severe evidential problems that a prosecution would face in such a case.

The Securities Services Act expressly renders insiders liable - both criminally and civilly - if they deal 'directly or indirectly or through an agent'.

The 'dealing' offence requires knowledge on the part of the insider that he or she has inside information, although there is no need to establish that possession of inside information prompted the decision to deal. [11]

(ii) The offence of dealing on behalf of someone else

Section 73(2)*(a)* of the Securities Services Act makes it an offence to deal on the basis of inside information on behalf of someone else. It provides:

> An insider who knows that he or she has inside information and who deals, directly or indirectly, for any other person in the securities listed on a regulated market to which the inside information relates or which are likely to be affected by it commits an offence.

The offence is not committed, however, if such insider proves on a balance of probabilities that he or she-

(a) is an authorised user and was acting on specific instructions from a client, save where the inside information was disclosed to him or her by that client;

(b) was acting on behalf of a public sector body in pursuit of monetary policy, policies in respect of exchange rates, the management of public debt or external exchange reserves;

(c) was acting in pursuit of the completion of an affected transaction as defined in the Companies Act [61 of 1973]; or

(d) only became an insider after he or she had given the instruction to deal to an authorised user and the instruction was not changed in any manner after he or she became an insider. [12]

(iii) The 'disclosure' offence

The 'disclosure' or 'tipping' offence is to be found in s 73(3)*(a)*, which provides:

> An insider who knows that he or she has inside information and who discloses the inside information to another person commits an offence.

The offence is not committed, however, if such insider proves on a balance of probabilities that he or she disclosed the inside information because it was necessary to do so for the purpose of the proper performance of the functions of his or her employment, office or profession in circumstances unrelated to dealing in any security listed on a regulated market and that he or she at the same time disclosed that the information was inside information. [13]

It is a requirement, as for the other offences, that the offender understood the quality and the source of the information at the time of disclosure, in other words, he or she knew he or she was an insider and that he or she had inside information. It does not have to be shown that the offender intended to bring about a particular result as a consequence of his or her disclosure. It does not have to be shown, for example, that he or she intended or ought to have realised that the recipient would use the information to advise others to deal in the affected securities or financial instruments.

Liability for the disclosure offence is not contingent on the insider being remunerated in some way for the disclosure.

(iv) The 'encouraging' or 'discouraging' offence

In terms of s 73(4) of the Securities Services Act a person is guilty of the 'encouraging' or 'discouraging' [14] offence if he or she-

(a) knowing that he or she has inside information;

(b) encourages or causes another person to deal or discourages or stops another person from dealing;

(c) in the securities listed on a regulated market to which such information relates or which are likely to be affected by it.

The essence of the offence is the imparting of advice to deal or not to deal in specified securities or financial instruments as opposed to substantive disclosure of the information that has led the person to give that advice. If the recipient did in fact receive inside information when encouraged or discouraged, the individual divulging that information may also have committed the disclosure offence. It is not necessary that the 'encouraging' or 'discouraging' be successful, nor is it relevant whether the advice was offered gratuitously or for personal gain.

It is to be noted that if a person is encouraged to deal without receiving any inside information, he or she is not guilty of the offence of insider dealing if he or she deals. The dealing offence requires possession of inside information on the part of the dealer. So if Mr X says to Mr Y: 'I have inside information about Company A. I will not disclose the information but I strongly advise you to buy its shares,' and Mr Y deals, he is not guilty of insider dealing. It is unclear why Mr Y should escape liability. Why should liability only arise if the inside information is passed on to Mr Y? This anomaly represents a serious flaw in the legislature's attempt to combat insider trading.

The offender must 'know' that he or she has 'inside information', as defined. However, the offence is committed without the recipient having known that the offender had the benefit of price-sensitive information when he or she was encouraged or discouraged to trade or not to trade. Nor does it have to be shown that the recipient actually heeded the advice given.

The existence of this offence is likely to curb overzealousness on the part of company representatives when making presentations to meetings of large shareholders or analysts.

Liability is not contingent on the insider being remunerated in some way for the encouragement or discouragement.

There are no defences for the 'encouraging' or 'discouraging' offence in the Securities Services Act, which appears to be harsh.

(v) Penalty

The maximum penalty for committing any of the offences created by the Securities Services Act is a fine of R50 million or imprisonment of ten years, or both such fine and imprisonment. [15] In the assessment of any penalty, the court must take into account any civil liability award made in terms of the Securities Services Act that arises from the same cause.

22.1.4.6 Civil liability

(i) The rationale for civil liability under the Securities Services Act

Despite the fact that a person who deals with the benefit of unpublished price-sensitive information will be financially advantaged and that other parties who contra-deal in the same instrument without that information will be financially disadvantaged, our common-law remedies have not developed, whether in contract or in delict, to protect the victims. This is largely because of the anonymity of the stock market and the possible problems of proof of causation although harm is foreseen. A legislated derivative-type civil remedy accordingly provides a more effective form of discouragement and of redress.

A fundamental principle of our criminal law is that a person is deemed to be innocent until proven guilty. The onus to prove that guilt must be discharged by the State beyond a reasonable doubt. Consequently there is a dire need for legislated derivative-type civil remedy.

In attempting to provide such a derivative-type civil remedy, the Securities Services Act provides for a civil action to be brought by the Directorate of Market Abuse (a committee of the FSB) against insider dealers, 'encouragers' and 'disclosers'. The action is for the recovery of the profit made or loss avoided by the insider dealer, plus a penalty. The amount recovered is to be paid into a fund to be distributed among persons who dealt in the securities in question at a certain time in relation to the insider dealing. The FSB can recover its costs plus a fee before any distribution is made.

Any amount recovered by the Directorate must be deposited by the Directorate directly into a specially designated trust account. As a first charge against this trust account, the Directorate is entitled to be reimbursed for all expenses that it has reasonably incurred in bringing such proceedings and in administering the distributions made to claimants. In addition, it is entitled to a sum equal to 10 per cent of the gross amount recovered less any amount of costs actually recovered from the other party before the finalisation of the distribution account.

Section 77(8) of the Securities Services Act provides that the balance of the amount referred to 'must be distributed to all claimants' who-

(a) submit claims to the directorate within 90 days from the date of publication of a notice in two national newspapers inviting persons who are affected by the dealings to submit their claims; and

(b) prove to the reasonable satisfaction of the claims officer that-
  - (i) they were affected by the dealings; and
  - (ii) in the case where the inside information was made public within five trading days from the time the insider or the other person dealt, they dealt in the same securities at the same time or any time after the insider or other person so dealt and before the inside information was made public; or
  - (iii) in every other case, they dealt in the same securities at the same time or any time thereafter on the same day, as the insider or other person.

The period of five days is arbitrary, but an element of arbitrariness is inevitable once one moves away from requiring a direct causal link between the insider dealing and the claimant's loss. The chosen approach is to disregard causation and to compensate claimants who dealt around the same time as the insider dealer.

The arbitrary approach has been borrowed from the USA and signifies a move away from the debate about the need to establish privity between insider and outsider. The insider, it is said, is effectively deemed to owe a duty of disclosure to contemporaneous traders for any transactions undertaken on the basis of inside information in the relevant securities.

By trading on the inside information, the insider is effectively deemed to have breached that duty. The theory presupposes that, since the information on which the insider trades is material, these investors would have relied on it and would have altered their conduct accordingly had the information been disclosed. The causal link between the insider and the loss sustained is presumed and the loss is deemed to be sufficiently proximate; the need for privity is thus abolished. [16] The difficulty of draconian liability arising because of a duty owed to all contemporaneous traders is averted by limiting the damages. The approach is artificial and leads to fortuitous plaintiffs and windfall recoveries which are not, as a general rule, to be encouraged. However, it is thought to be justifiable where the primary purpose is not compensation, but to further the socially beneficial goal of deterring insider dealing.

The arbitrary approach can thus be defended.

(ii) Amount the claimant is entitled to

A claimant is entitled to an amount-

(a) equal to the difference between the price at which the claimant dealt and the price, determined by the court or a settlement, that the claimant would have dealt at if the inside information had been published at the time of dealing; or

(b) equal to the pro rata portion calculated according to the relationship which the amount contemplated in para *(a)* bears to all amounts proved by claimants, whichever is the lesser, unless the claims officer in his or her discretion determines that the claimant should receive a lesser or no amount.

(iii) Protection of common-law rights

A claimant's common-law rights to claim any amount from the defendant are preserved, save to the extent that any portion of such amount has been recovered under the Securities Services Act. An amount awarded in proceedings under the Securities Services Act must be reduced by any amount recovered under the common law.

(iv) Criminal penalty taken into account

In the assessment of any civil award the court must take into account any criminal penalty which arises from the same cause and that has been previously imposed.

22.2 Market manipulation [17]

22.2.1 Introduction

Market manipulation refers to the attempt to interfere with the operation of the stock market. Stock markets operate on the principle of a free market, according to which supply and demand regulate the price of securities so that the price of a security reflects its true value. [18] Any interference with this process of price determination amounts to market manipulation. Market manipulation thus creates an artificial picture that obscures the true value of the securities being manipulated. 'Market abuse' is described in the Securities Services Act as constituting three offences:

(i) insider trading;
(ii) engaging in a prohibited trading practice; and
(iii) the making or publishing of false, misleading or deceptive statements, promises and forecasts.

The latter two offences constitute market manipulation and are the focus of this section.

22.2.2 Objective of market manipulation

The objective of manipulating the market is to make money dishonestly, either directly through transactions or by other means. A number of factors may cause a person to manipulate the market. For example, market manipulators would attempt to influence the price of a security so that they could buy the securities at a lower price, sell them at a profit, combat competitive transactions, or influence takeover bids or other large transactions. The manipulative manoeuvres are complex and are generally secretly executed and skillfully disguised by the market manipulator. It is sometimes difficult to distinguish a genuine market fluctuation from an artificial price inflation.

One reason for the regulation of market manipulation is to maintain an open and free market where the price of a security is determined by the natural forces of supply and demand. Other reasons why market manipulation is regulated are to achieve investor confidence in the integrity of the financial markets and to protect investors from market manipulation. At the same time, overregulation of market manipulation must be guarded against so as not inadvertently to inhibit legitimate market activity.

22.2.3 The regulation of market manipulation at common law

Market manipulation is prohibited in South Africa at common law, where it is known as the crime of 'rigging the market'. A 'rig' is essentially a fictitious operation. It involves the rigger offloading shares to the public which he or she cannot offload other than by the creation of a fictitious market for those shares.

Significantly, the statutory prohibition against market manipulation applies only to listed securities, whereas the common-law offence of rigging the market applies to both listed and unlisted securities. It is important to note that the Securities Services Act does not repeal the common-law crime of rigging the market. Consequently, if an act falls outside the scope of the statutory prohibition of market manipulation in the Securities Services Act, the common-law crime of rigging the market (or other common-law remedies) could still apply.

22.2.4 Market manipulation under the Securities Services

Act

22.2.4.1 Prohibited trading practices

Section 75(1) of the Securities Services Act prohibits trade-based market manipulation. Trade-based manipulative practices typically comprise the buying or selling of a security by a person that misleads or deceives others about the trading volume or the price of that security. Section 75(1) provides as follows:

> 75.(1) No person may-
>
> *(a)* either for such person's own account or on behalf of another person, directly or indirectly use or knowingly participate in the use of any manipulative, improper, false or deceptive practice of trading in a security listed on a regulated market, which practice creates or might create-
>
> (i) a false or deceptive appearance of the trading activity in connection with; or
>
> (ii) an artificial price for,
>
> that security;
>
> *(b)* place an order to buy or sell listed securities which, to his or her knowledge will, if executed, have the effect contemplated in paragraph *(a)*.

Broadly speaking, there are two types of trade-based market manipulation practices that are prohibited:

(i) creating a false or deceptive appearance of the trading activity in connection with a listed security; and

(ii) creating an artificial price for a listed security.

In addition, the placing of an order to buy or sell listed securities which, if executed, would create a false or deceptive appearance of the trading activity in connection with that security, or an artificial price for that security, is also prohibited.

Some noteworthy points about trade-based market manipulation are as follows:

(i) The trading practice must be 'manipulative, improper, false or deceptive'. The Securities Services Act does not define these terms. 'Manipulative' connotes intentional or wilful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities.

(ii) A person may not circumvent the prohibition of market manipulation by employing another person to engage in it, as the offence would be committed even if a person commits the offence indirectly. The intermediary may also be guilty of market manipulation if he or she had the necessary intention to

commit this offence. If an intermediary merely carries out a customer's order and honestly does not know that the instruction would result in market manipulation, he or she would not be guilty of having knowingly participated in the manipulative trading practice.

(iii) Should a secondary actor, such as an investment banker, an accountant, a lawyer or an underwriter, give some degree of assistance to a market manipulator, he or she would be guilty of participating in a manipulative trading practice, provided he or she had the necessary intention at the time of such assistance. Examples of these practices include advising a client on a business transaction or drafting documents related to a business structure that has questionable business or accounting practices.

(iv) Various factors may be used to determine whether or not a person's behaviour amounts to creating an artificial price for a security. These factors include the extent to which price, rate or option volatility movements for the security in question are outside their normal daily, weekly or monthly range, and whether a person has successively and consistently increased or decreased his or her bid, offer or the price he or she has paid for a security.

(v) It may be difficult to obtain direct evidence in the form of documents or testimony that a person has used or has knowingly participated in a prohibited trading practice. It is more likely that proof of market manipulation would be based on circumstantial or indirect evidence and on inferences based on such evidence, such as patterns of conduct, the fact that the alleged offender has a monetary interest in a security, or by analysing the trading patterns and any irregularities which may emerge from the trading data.

(vi) The market manipulation provisions of the Securities Services Act are far-reaching in that they apply to securities listed on a foreign market, even if there is no territorial link to South Africa.

22.2.4.2 Deemed prohibited trading practices

Section 75(3) of the Securities Services Act deems certain trading practices to be manipulative, improper, false or deceptive. If an activity meets the requirements of a deemed manipulative trading practice, that activity will be deemed to have contravened s 75(1) of the Securities Services Act. If an activity does not meet the requirements of a deemed manipulative trading practice, it may still be prohibited if it infringes the general prohibition contained in s 75(1) of the Securities Services Act. Some examples of practices which are deemed by s 75(3) to be manipulative, improper, false or deceptive are as follows:

(i) Wash sales

This practice involves approving or entering on a regulated market an order to buy or sell a listed security which involves no change in the beneficial ownership of that security. This is known as a 'wash sale' and involves a person (either directly or indirectly) being both the purchaser and the seller of securities in the same transaction. A wash sale creates a false or deceptive appearance of trading activity in connection with a security. The manipulator undertaking a wash sale usually undertakes frequent trades in the security in the hope that other investors would be attracted by the increased turnover of the security. The object of this practice is to gain financially by creating a small price differential between the buy and sell rates of the security in question.

(ii) Marking the close

This practice entails approving or entering on a regulated market an order at or near the close of the market, the primary purpose of which is to change or maintain the closing price of a listed security. This practice is known as 'marking the close'. The aim of buying or selling the securities at the close of the market is to alter the closing price of the securities and thereby to mislead persons acting on the basis of the closing prices. This might be done to support a flagging price or to affect artificially the valuation of a portfolio (known as 'window dressing'). In order for this offence to be committed the *primary* purpose of the activity must be to change or maintain the closing price of the security.

(iii) Market corner

A 'market corner' arises where a person, or group of persons acting in concert, buys up a substantial volume of a security, knowing that other market participants would be forced to buy from him or her at a higher price. A similar practice is known as an 'abusive squeeze', which arises where a person has a dominant position in the market and then seeks to use his or her control or influence to cause a shortage and thereby to create artificial prices. Having a substantial influence over supply and extracting elevated profits thereby is not of itself abusive - the abuse lies in cornering the market and then using it to distort the market. [19]

Further deeming provisions are set out in s 75(3) of the Securities Services Act.

22.2.4.3 False, misleading or deceptive statements, promises and forecasts

Section 76(1) of the Securities Services Act prohibits disclosure-based market manipulation, which entails a person making or publishing false or misleading information to the market which materially affects the price of securities. Spreading false rumours has been said to be one of the most common manipulative devices in this regard. Section 76(1) provides as follows:

> 76.(1) No person may, directly or indirectly, make or publish in respect of listed securities, or in respect of the past or future performance of a public company-
>
> *(a)* any statement, promise or forecast which is, at the time and in the light of the circumstances in which it is made, false or misleading or deceptive in respect of any material fact and which the person knows, or ought reasonably to know, is false, misleading or deceptive; or
>
> *(b)* any statement, promise or forecast which is, by reason of the omission of a material fact, rendered false, misleading or deceptive and which the person knows, or ought reasonably to know, is rendered false, misleading or deceptive by reason of the omission of that fact.

Some noteworthy points about this offence are as follows:

(i) Section 76(1) of the Securities Services Act prohibits not only the making of false, misleading or deceptive statements, promises or forecasts, but also the

omission or concealment of a material fact that renders a statement, promise or forecast false, misleading or deceptive.

(ii) It is an offence directly or indirectly to make false, misleading or deceptive statements, promises or forecasts.

(iii) The statement in question must be false, misleading or deceptive in respect of a *material* fact, or must be rendered false, misleading or deceptive by reason of the omission of a *material* fact. The role of a materiality requirement is to filter out essentially useless information that a reasonable investor would not consider significant.

(iv) Not only the making or publishing of false statements in respect of listed securities is prohibited, but so too is the making of false statements in respect of the past or future performance of a public company.

(v) The motive for making the false, misleading or deceptive statement is not relevant. It is also not a prerequisite for the offence to be committed that the false, misleading or deceptive statement induced a third party to buy or sell listed securities – the mere making of the false, misleading or deceptive statement, promise or forecast constitutes an offence.

(vi) The offence is committed where the fault element is either intention or negligence. Thus a person may be guilty of committing the offence even if he or she ought reasonably to know that a statement was false, misleading or deceptive.

(vii) Developments in technology, most notably the internet, have considerably increased the potential for disclosure-based market manipulation. It is imperative that the publication and the dissemination of false information on the internet be stringently regulated in South Africa because the price of a security may be influenced within minutes of posting information on the internet. While s 76(1) of the Securities Services Act does not specifically prohibit the dissemination of information on the internet, it is arguable that the word 'publish' in s 76(1) would include publication on the internet.

22.2.5 Defences

The deeming provisions in s 75(3) of the Securities Services Act are subject to the proviso that the use of price-stabilising mechanisms regulated in terms of the rules or listing requirements of an exchange would not constitute a prohibited trading practice. Price stabilisation usually involves trading by issuers, underwriters or those participating in the offer of securities to prevent the offer from failing. The stabilisation is only allowed to be used to prevent or slow down a decline in the price of securities, but not to raise the price. While stabilisation creates the impression that there is a demand for the securities at a particular price and while it may artificially affect the share price or create a false or misleading appearance with respect to trading in the offered shares, it would not be manipulative if it were disclosed to the public, since investors would have been forewarned that stabilisation may occur. The main purpose of price-stabilising mechanisms is to establish an orderly secondary market for securities following an offer of securities. These mechanisms are

legitimate, because they help to promote investor confidence in the market for a new issue of shares, and the general opinion is that this enhanced confidence is of benefit to the market.

Chapter 5 of the JSE Listings Requirements sets out the requirements that must be complied with before embarking on price stabilisation. The most important requirement is that adequate disclosure must have been made in all communications issued by the issuer or the stabilising manager to prospective investors in the securities that stabilisation may take place in relation to the relevant offer. [20] A further important requirement is that the stabilisation may take place only during the stabilisation period, which is limited to a maximum of 30 calendar days. [21]

Apart from the price-stabilisation defence, s 75 of the Securities Services Act does not make provision for any other defence to a charge of market manipulation and s 76 does not make provision for any defence at all.

22.2.6 Penalties

A person who contravenes ss 75 or 76 of the Securities Services Act is liable on conviction to a fine not exceeding R50 million or to imprisonment for a period not exceeding ten years, or to both such fine and imprisonment. [22]

22.2.7 The Financial Markets Bill, 2012

The Financial Markets Bill, 2012 [23] ('the Financial Markets Bill') is intended to repeal and replace the Securities Services Act when it comes into force. In light of the developments in the local and international financial markets it was necessary to review the Securities Services Act in order to assess its effectiveness and feasibility. It was decided, due to the magnitude and complexity of the amendments to be made to the Securities Services Act and in the interests of simplicity and legal certainty, to replace the Securities Services Act with a new Bill instead of proposing a complex amendment Bill.

Chapter X of the Financial Markets Bill prohibits market abuse and deals with the functions of the Directorate of Market Abuse in dealing with market abuse-related offences. Chapter X of the Bill amends and tightens up some of the provisions of the Securities Services Act relating to the market abuse offences. For instance, with regard to the market manipulation offence, the Bill now prohibits a person who has reason to suspect that he or she is participating in a manipulative, false or deceptive trading practice from participating in such a practice. [24] The Bill further introduces a new requirement that a person who has made a false, misleading or deceptive statement, promise or forecast and was unaware that the statement was false, misleading or deceptive and who later becomes aware of this fact must, without delay, publish a full and frank correction with regard to such statement. [25] Failure to do so constitutes an offence. [26] Also noteworthy is that under the Bill the defence of price stabilisation is no longer a lawful defence to insider trading but it is a defence to market manipulation. [27]

Questions

1. Explain why making a company subject to the insider trading provisions of the Securities Services Act is of such concern to large companies with various divisions.
2. Outline what the state would have to prove to establish that the crime of insider trading has been committed.
3. A barman, Tom, at a company function, overhears two directors of the company discussing the wonderful financial results of the company which are to be published in a week's time. The next day, on the basis of this information, Tom purchases shares in the company. He also informs his friend Joe of what he heard and Joe then also independently purchases shares in the company. Joe encourages his son to purchase them as well; he does not, however, say why. Joe's son does not purchase any shares.

   Explain whether Tom and/or Joe have committed any criminal offence(s) in terms of the Securities Services Act.
4. Illustrate with an example the workings of the civil liability provisions of the Securities Services Act relating to insider trading.
5. Mr Dodgem, the chief executive officer of XYZ Ltd, a company listed on the JSE, informed the public that in the following year XYZ Ltd would have its best financial year yet. This was not true, as XYZ Ltd had just made a series of poor investments, which would result in it suffering a huge financial loss. Mr Dodgem is aware of these poor investments but does not inform the public of such investments. Mr Dodgem also advises his stockbroker to purchase large quantities of shares of XYZ Ltd, for a period of two weeks, just before the close of the market.
   - *(a)* Discuss whether Mr Dodgem has committed any form of market manipulation.
   - *(b)* Explain whether Mr Dodgem's stockbroker has committed any form of market manipulation.

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[*] Para 22.1 was written by Richard Jooste and para 22.2 was written by Rehana Cassim.

[1] See SM Luiz 'Prohibition against trading on insider information: The saga continues' (1990) 2 *SA Merc LJ* 328 at 330. Also see MS Blackman et al *Commentary on the Companies Act* (2002) (Revision Service 8, 2011) 5-376.

[2] Blackman et al (n 1) 5-377.

[3] Blackman et al (n 1) 5-378. Thus in *SEC v Texas Gulf Sulphur Co* 401 F 2d 833 (1968) 851-2, Waterman J said: 'All investors should have equal access to the rewards of participation in securities transactions [and] all members of the investing public should be subject to identical

market risks.'

[4] See HG Manne *Insider Trading on the Stock Market* (1966); and for a discussion of Manne's views, see WH Painter *The Federal Securities Code and Corporate Disclosure* (1979); see also BAK Rider 'Should insider trading be regulated? Some initial considerations' (1978) 95 *SALJ* 79; JAC Hetherington 'Insider trading and the logic of law' (1967) *Wis LR* 720; RA Schotland 'Unsafe at any Price: A reply to Manne, insider trading and the stock market' (1967) 53 *Va LR* 1425.

[5] See Chapter 14: The duties and the liability of directors.

[6] *Percival v Wright* [1902] 2 Ch 421 (ChD).

[7] Blackman et al (n 1) 5-389.

[8] As defined in s 72 of the Securities Services Act.

[9] P Davies *Gower's Principles of Modern Company Law* 6 ed (1997) 461.

[10] See 'Final Report by the King Task Group into Insider Trading Legislation', October 1997, para 3.1.2. For an excellent discussion of Chinese walls, see R Cassim 'Some aspects of insider trading - has the Securities Services Act 36 of 2004 gone too far?' 2007 SA *Merc LJ* 44.

[11] The accused may of course have one of the defences provided by s 73(1)*(b)* of the Securities Services Act.

[12] Section 73(2)*(b)* of the Securities Services Act.

[13] Section 73(3)*(b)* of the Securities Services Act.

[14] The terms 'encourage' and 'discourage' are not defined, which was also the case with these words in the Insider Trading Act. 'Presumably encouraging or discouraging another person from dealing could take place by words or by conduct. The more subtle the encouragement or discouragement, the more difficult it would be to prove.' (R Cassim (n 10) at 65, who refers to S Luiz 'Insider dealing in the United Kingdom: Some comments and some comparisons' (1995) 7 *SA Merc LJ* 204 at 208.)

[15] Section 115*(a)* of the Securities Services Act.

[16] H McVea 'Fashioning a system of civil penalties for insider dealing: sections 61 and 62 of the Financial Services Act 1986' 1996 *Journal of Business Law* 344.

[17] This section on market manipulation relies on the following two articles: R Cassim 'An analysis of market manipulation under the Securities Services Act 36 of 2004 (Part 1)' (2008) 20(1) *SA Merc LJ* 33, and R Cassim 'An analysis of market manipulation under the Securities Services Act 36 of 2004 (Part 2)' (2008) 20(2) *SA Merc LJ* 177.

[18] JJ Henning & S du Toit 'High-pressure selling of securities: From rigging the market to false trading, market manipulation and insider dealing' (2000) 21 *The Company Lawyer* 257 at 257.

[19] A Alcock 'Market abuse' (2002) 23 *The Company Lawyer* 142 at 145.

[20] Rules 5.104 and 5.110 of the JSE Listings Requirements.

[21] Rules 5.104 and 5.105 of the JSE Listings Requirements.

[22] Section 115 of the Securities Services Act.

[23] B12-2012.

[24] Clause 82(1) of the Financial Markets Bill, 2012.

[25] Clause 83(2) of the Financial Markets Bill, 2012.

[26] Clause 83(3) of the Financial Markets Bill, 2012.

[27] Clause 82(3) of the Financial Markets Bill, 2012.

Chapter 23
Transitional Arrangements

Maleka Femida Cassim and Farouk HI Cassim

23.1 Introduction

The Companies Act 71 of 2008 ('the Act' or the 'new Act' for the purpose of comparison) was signed into law on 8 April 2009. It was subject to a waiting period of one year during which it could not come into operation. Over two years later, the Act came into operation on 1 May 2011. This is the 'general effective date' of the Act. [1]

The Transitional Arrangements of the Act [2] deal with the arrangements for the transition of 'pre-existing' companies as at the date on which the Act came into operation. In wide terms, 'pre-existing companies' are juristic persons that (immediately before 1 May 2011) were registered in terms of the Companies Act 61 of 1973 ('the 1973 Act'). Pre-existing companies continue to exist as companies in terms of the Act. As a broad general principle, the Act applies to both to pre-existing companies and companies incorporated under the Act.

This chapter discusses only the most important Transitional Arrangements.

23.2 Continuation of pre-existing companies

The Transitional Arrangements state that every pre-existing company that, immediately before 1 May 2011, was incorporated or registered under the 1973 Act continues to exist as a company as if it had been incorporated and registered in terms of the new Act. [3] It also bears the same name and the same registration number that had been previously assigned to it.

23.3 Pending matters

No company may convert to a close corporation, although a close corporation may convert into a company at any time. This has applied since the new Act came into force, ie since 1 May 2011. [4] However, pending conversions of companies into close corporations, that had already been filed with the Registrar by 1 May 2011 and that had not been fully concluded at that time, must be concluded by the Registrar in terms of the Close Corporations Act 69 of 1984.

23.4 Types of companies and names

Pre-existing companies are generally *deemed* to have changed their names in order to comply with the provisions of the Act regarding the concluding expressions in company names, as appropriate for the relevant category of company (eg Inc., NPC). [5]

Pre-existing section 21 companies (that were incorporated under s 21 of the 1973 Act) are recognised as non-profit companies under the new Act. Such companies are deemed to have amended their Memorandums of Incorporation as at 1 May 2011 (the general effective date) to state that they are non-profit companies, and to have changed the concluding expressions of their company names to 'NPC'. Pre-existing companies do not have a Memorandum of Incorporation; they have instead a memorandum of association and articles of association. The reference to 'Memorandum of Incorporation' in this context must therefore be understood to refer to both the memorandum of association and articles of association of the pre-existing company.

Similarly, every pre-existing section 53*(b)* company [6] is deemed to have amended its Memorandum of Incorporation as at 1 May 2011 to expressly state that it is a personal liability company, and to have changed the concluding expression of its name to 'Inc.' or 'Incorporated'.

Pre-existing companies that fall within the definition of a state-owned company under the Act are deemed to have amended their Memorandums of Incorporation as at 1 May 2011, and to have changed the concluding expressions of their names to ‘SOC Ltd.’.

The company limited by guarantee, as classified by the 1973 Act, has no equivalent or counterpart under the new Act. It has been discarded. An entity that was incorporated under the 1973 Act as a company limited by guarantee could choose to become a profit company under the new Act (whether a public or a private company) by filing a notice to that effect and changing the concluding expression of its name to correctly reflect the type of company that it would be. The notice had to be filed within 20 business days after the general effective date of the Act (ie 1 May 2011). If a company limited by guarantee failed to file such a notice, it is deemed to have amended its Memorandum of Incorporation to state expressly that it is a non-profit company, and to have changed its name as appropriate, with effect from 1 May 2011.

23.5 Memorandum of Incorporation

A pre-existing company may file, without charge, an amendment to its Memorandum of Incorporation to bring it in harmony with the requirements of the Act. This may be done at any time within two years of 1 May 2011. This would result in a useful savings in costs. The reference to the ‘Memorandum of Incorporation’ of a pre-existing company is taken to mean the memorandum of association and articles of association of a pre-existing company.

During this two-year transitional period, if there is a conflict between a provision of the Act and a provision of a pre-existing company’s Memorandum of Incorporation, the latter provision will prevail (except to the extent that the Transitional Arrangements to the Act provide otherwise). [7] However, once the company has amended its Memorandum of Incorporation to harmonise it with the Act or once the two-year transitional period has elapsed (whichever occurs earlier), a compliance notice may be issued to the company [8] whenever necessary, requiring it to comply with the Act.

A pre-existing company may similarly alter its name in so far as is necessary to meet the requirements of the Act, by filing a notice of name change together with a copy of the relevant special resolution, without any charge or fee, within the two-year period after 1 May 2011.

23.6 Rules

The Transitional Arrangements preserve any binding provisions that are comparable in purpose and in effect to the rules of a company [9] (regardless of the style or the title of those provisions) that were adopted by a pre-existing company before 1 May 2011. The binding force and effect of such provisions is similar to that of pre-existing shareholder agreements (see below).

23.7 Shareholder agreements

A shareholder agreement, entered into by the shareholders of a pre-existing company before 1 May 2011, continues to have the same force and effect for a period

of two years after 1 May 2011, or until amended by the shareholders who are parties to the agreement. After the two-year transitional period, the shareholder agreement will have force and effect only to the extent that it is consistent with the Act and the company's Memorandum of Incorporation.

During the transitional period, the shareholder agreement prevails in the event of a conflict with the Act or with the company's Memorandum of Incorporation. [10] Furthermore, during the two-year period after 1 May 2011, a compliance notice may not be issued to the company in respect of conduct that is inconsistent with the Act but that is consistent with the shareholder agreement, until such time as the company has filed an amendment to its Memorandum of Incorporation to bring it in harmony with the Act. It is noteworthy that practical problems may arise in the event that a company's shareholder agreement is not altered at the same time that its Memorandum of Incorporation is amended to harmonise it with the Act.

23.8 Pre-incorporation contracts

The provisions of the Act on pre-incorporation contracts do not apply to pre-existing companies. [11] This is because companies that are already incorporated would clearly not enter into a pre-incorporation contract.

23.9 Par value shares

Section 35(2) of the Act is an important provision, which states that shares do not have a nominal value or par value under the Act, subject to the Transitional Arrangements. Under the 1973 Act the share capital of a company could be divided into shares having a par value or no par value. The new Act abolishes the concept of par value shares for new companies formed under the Act.

However, despite the repeal of the 1973 Act, par value shares and other shares issued by a pre-existing company (and held by a shareholder immediately before 1 May 2011) will generally continue to have all the rights associated with the shares. Par value shares issued by a pre-existing company will continue in existence, subject to regulations made by the Minister for their transitional status and their *optional* conversion into no par value shares.

In this regard, the Companies Regulations [12] provide that a pre-existing company may not, after 1 May 2011, authorise any new par value shares or shares having a nominal value. If, before 1 May 2011, a company had any authorised class of par value shares from which it had *not* issued any shares before 1 May 2011, then the company must not issue any shares of that class unless it has first converted that class of authorised shares into no par value shares. This is done by way of a board resolution and the filing (without charge) of a notice of the resolution.

If, on the other hand, before 1 May 2011 the company had any authorised class of par value or nominal value shares from which any shares were issued (and remained

issued) before 1 May 2011, then the company may continue to issue further shares of that class at any time *after* 1 May 2011, and may do so until it has published a proposal to the shareholders to convert that class of par value shares into no par value shares. In order to convert such a class of issued par value shares, an amendment to the company's Memorandum of Incorporation is required. This must be adopted in accordance with the specified procedure and the requirements set out in regulation 31. [13]

Banks for now are exempt from s 35(2) and the conversion of par value shares until a date to be declared by the Minister, after consulting with the member of Cabinet responsible for national financial matters.

23.10 Company finance and governance

Despite anything to the contrary in a company's Memorandum of Incorporation, the following provisions of the Act apply to all pre-existing companies with immediate effect as from 1 May 2011:

- (i) the duties, conduct and liability of directors;
- (ii) the rights of shareholders to receive any notice or to have access to any information;
- (iii) meetings of shareholders or directors, and adoption of resolutions; and
- (iv) Chapter 5 of the Act, which regulates fundamental transactions, takeovers and offers (except to the extent that they are exempted by that Chapter).

Despite anything to the contrary in a company's Memorandum of Incorporation, the approval of any distribution, financial assistance, insider share issues or options is subject to the Act, even if any such action had been approved by a company's shareholders before 1 May 2011. This provision is intended to apply to distributions, financial assistance, insider share issues or options that had been approved but had not been implemented before 1 May 2011. In this event, the approval of these transactions must comply with the new and additional requirements of the Act.

23.11 Office of director, company secretary, auditor and prescribed officer

The Transitional Arrangements provide for the continuity of the office of directors, prescribed officers, company secretaries and auditors of pre-existing companies. These persons continue to hold office after 1 May 2011, subject to the company's Memorandum of Incorporation and the Act. However, any person who, in terms of the Act, is ineligible to be or is disqualified from being a director, an alternate director, a prescribed officer, a company secretary or an auditor is regarded as having resigned that office as from 1 May 2011.

A vacancy in the office of director, company secretary or auditor of a pre-existing company as from the effective date (1 May 2011) is to be filled in accordance with the Act.

Regarding the rotation of auditors, the Act states that the same individual may not serve as the auditor or designated auditor of a company for more than five

consecutive years. This period, in respect of pre-existing companies, is calculated from the date of commencement of the new Act (1 May 2011).

23.12 Right to seek remedy

Any person has a right to seek a remedy in terms of the Act, even with respect to conduct pertaining to a pre-existing company and occurring *before* the effective date, ie before 1 May 2011. However this does not apply where the aggrieved party, before 1 May 2011, had already commenced proceedings in a court of law in respect of the same conduct.

23.13 Company records

If a pre-existing company fails to maintain any company record for the duration of the period prescribed by the Act (namely for a period of seven years or any longer period specified by any other applicable public regulation), it will not be in contravention of the Act if it had disposed of that record before the effective date, and at a time at which it was not required by any public regulation to continue to maintain that record.

23.14 Restrictive conditions and prohibitions on the amendment of the Memorandum of Incorporation

Any prohibitions on the amendment of provisions of a pre-existing company's Memorandum of Incorporation and any restrictive conditions (with additional requirements for their amendment) [14] continue to have the same validity as they had under the 1973 Act, despite a failure by the pre-existing company to have drawn attention to the provision in its Notice of Incorporation (as required by the new Act). This provision is logical, since the 1973 Act did not require a statement in the company's constitution or anywhere else drawing attention to such provisions.

23.15 Company names and name reservations

The Transitional Arrangements generally enable names that were reserved or were registered as defensive names under the 1973 Act to continue to be so reserved or registered under the new Act. Such a reserved name must, however, satisfy the criteria for company names in terms of the new Act. [15] The Transitional Arrangements also set out the procedure to be followed if the Companies and Intellectual Property Commission believes that a reserved name does not satisfy these criteria.

23.16 Continued application of the 1973 Act to winding-up and liquidation

Despite the general repeal of the 1973 Act, Chapter XIV of that Act continues to apply with respect to the winding-up and liquidation of companies under the new company law regime.

However, an exception is created in respect of solvent companies. Certain sections of Chapter XIV of the 1973 Act [16] do not apply to the winding-up of a solvent company. [17]

Chapter XIV of the 1973 Act will apply to the winding-up and liquidation of companies until alternative legislation has been brought into force which adequately provides for the winding-up and liquidation of insolvent companies. This means that s 424 of the 1973 Act, which deals with the liability of directors for the fraudulent or reckless conduct of the company’s business, may continue to apply to companies that are in winding-up and liquidation.

23.17 Preservation and continuation of court proceedings and orders; rights, duties, notices and other instruments; investigation and enforcement

The Transitional Arrangements provide for the preservation and continuation of court proceedings and court orders in terms of the 1973 Act. From 1 May 2011, when the Act came into effect, any proceedings in any court in terms of the 1973 Act are to continue in terms of the 1973 Act as if it had not been repealed.

The Transitional Arrangements generally preserve rights and duties in terms of the 1973 Act; notices given, and documents served or filed in terms of the 1973 Act; and other instruments.

Furthermore, the Transitional Arrangements provide for the continued investigation and enforcement of the 1973 Act. Provision is made for continued investigations by regulatory agencies. Despite the repeal of the 1973 Act, for a period of three years after the effective date (1 May 2011) a court is empowered to make any order that could have been made in the circumstances by a court acting in terms of the 1973 Act.

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[1] However, the provisions of the Act relating to the use of symbols as part of company names only come into operation three years from the date of commencement of the Act, ie 1 May 2014 (s 225; s 11).

[2] The Transitional Arrangements are contained in Schedule 5 to the Act.

[3] A similar provision applies to external companies.

[4] See further Chapter 24: Close corporations.

[5] See further Chapter 6: Formation of companies and the company constitution.

[6] That is, a company that was incorporated under the 1973 Act with a constitution that imposed personal liability jointly and severally on the directors and past directors in terms of s 53*(b)* of that Act.

[7] See further below; and see particularly 23.10-23.14.

[8] With respect to conduct that is consistent with the company's Memorandum of Incorporation but inconsistent with the Act.

[9] See Chapter 6: Formation of companies and the company constitution.

[10] Except to the extent that the agreement or the company's constitution provides otherwise.

[11] See Chapter 6: Formation of companies and the company constitution.

[12] Regulation 31 of the Companies Regulations GNR 351 *GG* 34239 of 26 April 2011 ('the Regulations').

[13] See further reg 31(6)-(11).

[14] Over and above the requirements of s 16; see Chapter 6: Formation of companies and the company constitution.

[15] See Chapter 6: Formation of companies and the company constitution.

[16] That is, ss 343, 344, 346, and 348 to 352 of the 1973 Act.

[17] Except to the extent necessary to give effect to the provisions of Part G of Chapter 2 of the new Act dealing with the winding-up of solvent companies and deregistration.

Chapter 24
Close Corporations

Richard Jooste and Joanne Shev [*]

24.1 Introduction

Close Corporations ('CCs') are governed by the Close Corporations Act 69 of 1984. The close corporation was introduced in order to provide a business vehicle suitable for the small entrepreneur or small groups of entrepreneurs. The need was felt for a business structure less complicated, less formal and less expensive than a company, but at the same time providing the advantages of operating as a company. The main advantages in question are separate legal personality, simplicity, limited liability and perpetual succession.

The new Companies Act 71 of 2008 is expected, with its intention to promote procedural simplicity and flexibility, to cater for the needs of the small entrepreneur to an extent that is likely to render the close corporation redundant. As a result, as from 1 May 2011, when the Companies Act of 2008 came into force, no new close corporations can be registered nor are any new conversions from companies to close corporations possible. However, existing close corporations are to continue in existence until such time as they are de-registered or wound up.

An examination of the Close Corporations Act reveals that a CC is a hybrid form of business structure that borrows principles from company law and partnership law, while at the same time introducing principles foreign to both companies and partnerships.

24.2 Features of a close corporation

24.2.1 Legal personality

A CC is a juristic person, ie it is a separate legal person like a company and unlike a partnership, which is not a legal person. A CC therefore is capable of having its own rights (both real and personal rights) and its own liabilities. These rights (for example, ownership of assets) and liabilities thus vest in the CC and not in its members.

The fact that a CC is a separate legal person means that the CC can sue and be sued in its own name.

24.2.2 Members not liable for close corporation's debts

Flowing from the fact that a CC is a separate legal person capable of having its own rights and obligations, the members of a CC are generally not liable for the debts of the CC. In exceptional circumstances the members may become so liable for all or some of the debts.

Being shielded from creditors is also a benefit enjoyed by the shareholders of a company, but not by partners of a partnership.

24.2.3 Perpetual succession

Also flowing from its legal personality, a CC has, like a company, the attribute of perpetual succession. This means that if the membership of the CC changes, the change has no effect on the continued existence of the CC. A partnership does not have this feature.

24.2.4 Limited membership

In the pursuit of simplicity-

(i) a CC is limited to natural persons. So a company or a CC cannot be a member of a CC;

(ii) the number of members of a CC is limited to ten. A CC may have only one member.

24.2.5 Management and internal relations

Unlike shareholders of a company, each member of a CC is entitled to participate in the carrying on of the business of the CC. [1] The association agreement (see 24.9) may, however, provide otherwise. The members of a CC accordingly are in a similar position to partners in a partnership. A CC does not have directors.

A CC may have an 'association agreement', which is similar to the

Memorandum of Incorporation and the rules of a company, or a partnership agreement, which governs the internal affairs of the CC. An association agreement is not compulsory and in its absence s 46 of the Close Corporations Act will govern the CC's internal relations.

24.2.6 Interests of members

Another respect in which a CC differs from a company is that members of a CC hold interests in the CC and not shares. The interests are expressed as a percentage as in a partnership and must always add up to one hundred.

24.2.7 Simplicity

The hallmark of a close corporation is its simplicity. It is easy to form and is not burdened with unnecessary legal formalities.

24.3 Formation and conversion of a close corporation

24.3.1 Formation

As CCs can from 1 April 2008 no longer be formed, the formation thereof is not dealt with in this chapter.

It should be noted, however, that when a CC was formed it lodged with the Companies and Intellectual Property Commission ('the Companies Commission') a founding statement, which is the constitution of the CC. The 'founding statement' contains the following:

(i) the name of the corporation;
(ii) the principal business of the corporation;
(iii) the postal and registered address of the corporation;
(iv) the date of the end of the financial year;
(v) the accounting officer;
(vi) particulars of each member of the corporation;
(vii) particulars of each member's contribution;
(viii) the percentage size of each member's interest in the corporation.

If there is a change in any of the particulars in the founding statement, for example, admission of a new member, an amended founding statement must be lodged with the Companies Commission in the prescribed form. It must be signed by each member of the CC and lodged within 28 days of the change. A fee is payable if the change is in respect of the name of the CC, the description of its principal business or the CC's financial year-end. The change is effected by the Commissioner issuing a statement in the prescribed form.

Registration of the CC by the Companies Commission gives the CC corporate status and legal personality.

24.3.2 Conversion of a close corporation to a company

A company cannot convert to a CC, but a CC can convert to a company.

To do so the corporation files a notice of conversion in the prescribed manner and form, at any time. The notice of conversion must be accompanied by-

(i) a written statement of consent approving the conversion of the close corporation signed by members of the corporation holding, in aggregate, at least 75 per cent of the members' interest in the corporation;
(ii) a Memorandum of Incorporation consistent with the requirements of the Companies Act;
(iii) the prescribed filing fee.

Upon conversion of a close corporation the Companies Commission must-

(i) cancel the registration of that close corporation in terms of the Close Corporations Act;
(ii) give notice in the *Gazette* of the conversion of the close corporation into a company; and
(iii) enable the Registrar of Deeds to effect the necessary changes resulting from conversions and name changes.

Every member of a close corporation converted is entitled to become a shareholder of the company resulting from that conversion. However, the shares to be held in the company by the shareholders individually need not necessarily be in proportion to the members' interests as stated in the founding statement of the close corporation concerned.

The registration of a company converted from a close corporation has the following consequences:

(i) the juristic person that existed as a close corporation before the conversion continues to exist as a juristic person, but in the form of a company;
(ii) all the assets, liabilities, rights and obligations of the close corporation vest in the company;
(iii) any legal proceedings instituted before the registration by or against the corporation may be continued by or against the company, and any other thing done by or in respect of the close corporation, is deemed to have been done by or in respect of the company;
(iv) any enforcement measures that could have been commenced with respect to the close corporation in terms of the Close Corporations Act, 1984, for conduct occurring before the date of registration may be brought against the company on the same basis, as if the conversion had not occurred; and
(v) any liability of a member of the corporation for the corporation's debts that had arisen in terms of the Close Corporations Act, and existed immediately before the date of registration, survives the conversion and continues as a liability of that person, as if the conversion had not occurred.

24.4 Membership of a close corporation

24.4.1 Restrictions on membership

There is no limit on who may be a shareholder of a company or how many shareholders a company may have. However, the same is not the case with a CC.

Only natural persons [2] may be members of a CC and the number of members is limited to ten. [3]

A juristic person (a company or CC) cannot hold an interest in a CC directly or indirectly through a nominee (an agent). [4]

Although persons with legal disability such as minors and insolvent persons may be

members of a CC, they must be represented by their legal representatives (guardians, trustees etc). A person under legal disability may not participate in the management of a CC. [5]

The following natural or juristic persons (eg a company) may be a member of a CC in their representative capacity:

(i) an executor, trustee, administrator or curator of an insolvent, deceased or mentally disabled person;

(ii) a trustee of a testamentary trust or an *inter vivos* trust, provided that–

- a juristic person is not a beneficiary of the trust;
- the total number of members, including the beneficiaries of the trust, does not exceed ten.

It will be deduced from the above that a CC may be a shareholder of a company and may in fact be the 'holding company' at the apex of a group of companies. The reverse is, however, not true as a company cannot be a member of a CC.

It is to be noted that where a person holds membership in a position of trust, the CC deals with the trustee of the trust as if the trustee is the member and does not have to concern itself with the fact that membership is held in trust. [6]

24.4.2 Acquisition of membership

Membership of a CC is acquired through the acquisition of an interest in the CC either from an existing member or from the CC itself. [7] In both cases an amended founding statement is required. Where it is acquired from the CC itself, the new member must make a contribution (see 24.5). [8]

24.4.3 Nature of a member's interest

A member's interest in a CC is expressed as a percentage and the total interests held by members of the CC must always equal one hundred. [9] Two or more persons cannot hold an interest jointly. [10]

The size of a member's interest is determined by agreement with the existing members. The size does not have to be in proportion to his or her contribution. If there is a change in membership, the percentage of each member's interest must accordingly be changed to maintain the 100 per cent total. If the CC acquires a member's interest (see 24.7), the percentage interest of the other members must be increased proportionally.

An interest in a CC is regarded as moveable property [11] even though it is not tangible.

An interest in a CC is a bundle of rights and obligations. The rights relate to distributions by the CC and voting. Obligations include, for example, fiduciary duties and the duty to act with due care and skill. An interest in a CC is the equivalent of a share in a company.

A member is entitled to a certificate reflecting the percentage of such member's interest in the CC. [12] The certificate must be signed by all the members of the CC.

24.4.4 Commencement of membership

As rights and obligations flow from membership in a CC, it is important to know when membership commences. It commences when the founding statement or amended founding statement, as the case may be, is registered. [13] The names of members and the interests held by them are particulars that must appear in the founding statement.

24.4.5 Disposal of a member's interest (section 36)

Generally, the disposal of a member's interest must be made according to the association agreement (which is an agreement setting out the internal workings/rules of the CC - see 24.9), if there is one, or with the consent of all members. It makes sense for disposals to be dealt with in an association agreement to avoid inconvenience, disputes and court proceedings. It is common for an association agreement to give other members of a CC a right of first purchase (also referred to as a pre-emption right) where a member wishes to dispose of his or her interest. This gives the other members the opportunity to purchase the interest. The disposition can be to another person, who can be a member or to the CC itself. If it is to the CC itself, the CC must have one or more other members.

If a member of a CC goes insolvent, his or her interest in the CC will fall into his or her insolvent estate. The trustee of the insolvent estate must sell the interest in order to satisfy the debt of the insolvent. However, the other members and the CC have a right of first purchase (pre-emption right).

If a member of a CC dies, the association agreement, if there is one, may determine what is to happen to the member's interest. Otherwise, the interest can pass to an heir or legatee of the deceased estate with the consent of all the existing members of the CC. If such consent is not forthcoming, the executor of the estate may sell the interest, but subject to the same right of first purchase available to the members and the CC that they have in the case of a member going insolvent.

24.4.6 Using a member's interest as security

A member may use his or her interest as security for a debt. This is done by way of a cession. A cession is the transfer of a right. This can be done in two ways:

(i) the shareholder can pledge his or her rights to the cessionary (the creditor); or
(ii) the shareholder can cede them out-and-out to the cessionary (the creditor) subject to the condition that they will be ceded back to him or her on repayment of the debt (a cession *in securitatem debiti*).

Although the pledge itself would not require the consent of all members (not being a disposal of the interest), the problem with the pledge is that if the interest is to be disposed of in terms of the pledge (ie because the debt that has been secured by the pledge is not paid), the consent of all members will be required.

The out-and-out cession (cession *in securitatem debiti*) is a disposal of the interest and therefore requires the consent of all the other members.

In respect of both the pledge and the cession *in securitatem debiti* it must be remembered that a juristic person (a company or CC) cannot be a member of a CC, and therefore a member cannot use his or her interest to secure a debt owing to a juristic person.

It will be gathered from the above that a member's interest does not readily lend itself to the provision of security.

24.5 Contributions (section 24)

Every person who is to become a member of a CC upon its registration must make an initial contribution to the CC. The contribution can be of money, of other property (whether corporeal or incorporeal), or of services rendered in connection with the formation of the corporation. Particulars of such contribution must be stated in the founding statement of the corporation.

The amount of the members' contributions, or of any one or more members, may from time to time by agreement among all the members be increased by additional contributions. The amount may also be reduced. An amended founding statement must be lodged where contributions are increased or reduced. Contributions must be made within a period of 90 days after the date of registration of the corporation, in the case of an initial contribution, or after the date of the registration of an amended founding statement in the case of any additional contribution. Failure to comply with this requirement could result in personal liability being imposed on the member.

24.6 Cessation of membership by order of court

It is possible in terms of two different provisions of the Close Corporations Act (ss 36 and 49) for the court to bring a member's interest in a CC to an end. Any member of a CC can apply to court for such an order.

Section 36 provides the following grounds on which such an order may be granted:

(i) the member is permanently incapable, because of unsound mind or for any other reason, of performing his or her part in the carrying on of the business of the corporation;
(ii) the member has been guilty of conduct which is likely to have a prejudicial effect on the carrying on of the business of the CC;
(iii) the member so conducts him- or herself in matters relating to the corporation's business that it is not reasonably practicable for the other member or members to carry on the business of the corporation with him or her; or
(iv) circumstances have arisen which render it just and equitable that such member should cease to be a member of the corporation.

A court granting such an order may make further orders in regard to-

(i) the acquisition of the member's interest concerned by the corporation or by other members; or
(ii) the amounts (if any) to be paid in respect of the member's interest concerned or the claims against the corporation of that member, the manner and times of such payments and the persons to whom they shall be made.

In terms of s 49, if any member of a corporation who alleges that any particular act or omission of the CC or of one or more other members is unfairly prejudicial, unjust or inequitable to him or her, or to some members including him or her, or that the affairs of the CC are being conducted in a manner unfairly prejudicial, unjust or inequitable to him or her, or to some members including him or her, he or she may apply to court for relief.

The court may, if it considers it just and equitable, make such order as it thinks fit, whether for regulating the future conduct of the affairs of the corporation or for the purchase of the interest of any member of the corporation by other members thereof or by the corporation.

24.7 Acquisition by a close corporation of an interest in itself

A CC may acquire a member's interest itself. It cannot, however, hold the interest. The interest acquired must be added to the respective interests of the other members in proportion to their existing interests or as they may otherwise agree. In order to protect the members and the creditors of the CC acquiring the interest, the Close Corporations Act [14] lays down certain requirements for such an acquisition. They are that the acquisition can only be made-

(i) with the previously obtained written consent of every member of the CC, other than the member whose interest is acquired;

(ii) if, after the payment for the interest is made, the CC's assets, fairly valued, exceed all its liabilities (this is known as the solvency test);

(iii) if the CC is able to pay its debts as they become due in the ordinary course of its business (this is known as the liquidity test); and

(iv) if such payment will in the particular circumstances not in fact render the CC unable to pay its debts as they become due in the ordinary course of its business.

24.8 Financial assistance by a corporation in respect of acquisition of members' interests

A corporation may give financial assistance (whether directly or indirectly and whether by means of a loan, guarantee, the provision of security or otherwise) for the purpose of, or in connection with, any acquisition of a member's interest in that corporation by any person.

In order to protect the members and the creditors of the CC, however, such assistance can only be provided if the following requirements are satisfied. The assistance can only be given-

(i) with the previously obtained written consent of every member of the corporation for the specific assistance;

(ii) if, after such assistance is given, the corporation's assets, fairly valued, exceed all its liabilities (the solvency test); and

(iii) if such assistance will in the particular circumstances not in fact render the corporation unable to pay its debts as they become due in the ordinary course of its business (the liquidity test).

24.9 Association agreements and internal relations

An association agreement is an agreement, described as such, between the members of a CC and the CC, and between each other, which governs the relationship between the members and the CC and between the members themselves. It is optional. An association agreement is, of course, advisable.

An association agreement is signed by, or on behalf of, each member. A new member is automatically bound by the provisions of an existing association agreement. Changes to an association agreement must be signed by all members, including the new members.

Any other agreements between the members of a CC will be valid as long as they do not conflict with the association agreement and the unalterable provisions of the Close Corporations Act. Such agreements will only be binding on the parties to the agreement. Care must be taken to identify the association agreement as the association agreement.

The association agreement, unlike the founding statement, is not filed with the Companies Commission. Members of the public do not have the right to inspect the agreement. Matters that are usually governed by an association agreement are participation in management of the CC; procedures at meetings; voting at meetings; business financing; contributions; the disposal of a member's interest in the CC; and resolution of internal disputes.

Rules which will apply in the absence of an association agreement to the contrary are: every member has the right to participate in management and to represent the CC; equal say in decision making; differences are to be decided by a majority vote; a member's vote corresponds with his or her percentage interest; members are to be indemnified for business expenditure; and distributions to members are to be in proportion to respective interests.

There are certain unalterable provisions, ie matters that cannot be altered by an association agreement. They relate to the right of a member to call a meeting; disqualification from participation in management (see below); excusing a member's breach of duties; and the disposal of an insolvent member's interest.

There are certain matters that require the written consent of members holding at least 75 per cent of the interests in the CC. They are the acquisition or disposal of immovable property; the disposal of the greater part of the assets; the disposal of a substantial part or the whole of undertaking; and change in principal business.

In certain instances the written consent of each member is required. They are-

(i) acquisition of a member's interest;
(ii) financial assistance to acquire a member's interest;
(iii) granting loans to and provision of security on behalf of a member;
(iv) ratification of a pre-incorporation contract;
(v) excusing of a member's breach of duty;
(vi) appointment of an accounting officer;
(vii) voluntary winding-up; and
(viii) deregistration of the CC by the CC.

No matter what the association agreement of a CC may say, certain persons are disqualified from taking part in the management of the CC. They are-

(i) any person under legal disability, except a minor who has attained at least the age of 18 years and whose guardian has lodged with the corporation a written consent to the minor's participation in the management of the business of the CC;
(ii) a person who has been placed under probation by a court in terms of s 62 of the Companies Act;
(iii) an unrehabilitated insolvent;

(iv) a person who is prohibited in terms of any public regulation to be a director of the company;

(v) a person who has been removed from an office of trust, on the ground of misconduct involving dishonesty;

(vi) a person who 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 involving fraud, misrepresentation or dishonesty; or

(vii) any person who is disqualified from being a director of a company in terms of ss 69(8) to (11) of the Companies Act, subject to sub-s (1B).

In certain circumstances the disqualification may be lifted.

24.10 Meetings of members

Any member of a CC may by notice to every other member, and every other person entitled to attend a meeting of members, call a meeting of members for any purpose disclosed in the notice. [15]

Unless an association agreement provides otherwise, the notice must fix a reasonable date and time, and a venue which is reasonably suitable for all persons entitled to attend the particular meeting. Three-fourths of the members present in person at the meeting shall constitute a quorum. Only members present in person at the meeting may vote at that meeting.

Unless an association agreement provides otherwise, a meeting at which a quorum is not present within half an hour after the time appointed for the meeting shall be adjourned to a day not earlier than seven days and not later than 21 days after the date of that meeting. If at such adjourned meeting a quorum is not present within half an hour after the time appointed for the meeting, the members present in person shall constitute a quorum.

A CC must keep minutes of all meetings.

A resolution in writing, signed by all the members and entered into the minute book, is as valid and effective as if it were passed at a meeting of the members duly convened and held. This is often referred to as a 'round-robin resolution'.

24.11 Payments to members

If 'payments' are made by a CC to its members, this could prejudice creditors of the CC. The payments could result in the CC being unable to pay the creditors.

Accordingly, to protect creditors, the Close Corporations Act [16] provides that payments can only be made to members if the following requirements are met. A payment can only be made-

(i) if, after such payment is made, the CC's assets, fairly valued, exceed all its liabilities (the solvency test); and
(ii) if such payment will not render the CC unable to pay its debts as they become due in the ordinary course of its business (the liquidity test).

These requirements encompass what is known as the 'solvency and liquidity test' which, as has been seen and will be seen, become relevant in other part of the Act as well.

It is important to note that a 'payment' to which these requirements applies is a payment to a member in his or her capacity as a member. The Act includes within the meaning of a 'payment' a distribution, or a repayment of any contribution, or part thereof, but excludes any payment to a member in his or her capacity as a creditor of the relevant corporation and, in particular, a payment as remuneration for services rendered as an employee or officer of the corporation, a repayment of a loan or of interest thereon or a payment of rental.

A member is liable to a CC for any payment received contrary to the requirements above.

In winding up a CC unable to pay its debts, any such payment made to a member within a period of two years before the commencement of the winding-up of the CC shall be repaid to the CC by the member, unless such member can prove that the CC was solvent and liquid after such payment was made. [17]

A 'payment' includes the delivery or transfer of any property and not only cash.

24.12 Loans to and the provision of security on behalf of members

If a CC makes loans to or provides security on behalf of its members, minority interest-holders in the CC may be prejudiced. Accordingly, such a loan or provision of security requires the prior written consent of all the members of the CC. [18] To

prevent attempts to avoid this requirement, such consent is also required if the recipient is-

(i) any other corporation in which one or more of its members together hold more than a 50 per cent interest; or
(ii) any company or other juristic person controlled by one or more members of the corporation.

Any member of a CC who authorises or permits or is a party to the making of any loan or the provision of any security contrary to this requirement-

(i) shall be liable to indemnify the CC, and any other person who had no actual knowledge of the contravention, against any loss directly resulting from the invalidity of such loan or security; and

(ii) shall be guilty of an offence.

It is to be noted that 'loan' here includes-

(i) a loan of any property; and
(ii) any credit extended by a CC where the debt concerned is not payable or is not being paid in accordance with normal business practice in respect of the payment of debts of the same kind, for example, where the CC normally grants 30 days' credit and in this instance grants six months' credit.

A loan or provision of security made without the prior written consent of all members is void and cannot be ratified. [19] The members who are responsible for such breach are liable to the CC for any loss suffered as a result.

24.13 Duties of members

24.13.1 Fiduciary duties

The members of a CC are in a position of trust in relation to the CC. To put this differently, they are in a fiduciary position in relation to the CC. The position is therefore unlike that in a partnership, where the partners are only in a fiduciary relationship with each other.

From this fiduciary position flow certain duties, known as fiduciary duties. If they are breached and the CC suffers loss, the members in breach are liable for such loss.

Section 42 of the Close Corporations Act sets out certain fiduciary duties which are based on the common law as developed by the courts in relation to directors of a company. The Act does not seek to codify the fiduciary duties of members. It is clear that the courts will seek guidance from the common law in regard to fiduciary duties other than those specified in the Act, and will also look to the common law in interpreting the duties in the Act. There are a myriad of reported cases dealing with the fiduciary duties of directors.

The fiduciary duties prescribed in the Act are:

(i) A member must, in relation to the CC, act honestly and in good faith, and in particular–
   - a member must exercise such powers as he or she may have to manage or represent the CC in the interest and for the benefit of the CC;
   - a member shall not act without power or exceed his or her powers.
(ii) A member must avoid any material conflict between his or her own interests and those of the CC.
(iii) A member must not derive any personal economic benefit to which he or she is not entitled by reason of his or her membership of or service to the CC, from the CC or from any other person in circumstances where that benefit is obtained in conflict with the

interests of the CC.

(iv) A member must notify every other member, at the earliest opportunity practicable in the circumstances, of the nature and extent of any direct or indirect material interest which he or she may have in any contract of the CC.

(v) A member must not compete in any way with the CC in its business activities.

A member of a CC who breaches any duty arising from his or her fiduciary relationship shall be liable to the CC for any loss suffered as a result thereof by the CC, or any economic benefit derived by the member by reason thereof.

Where a member fails to disclose an interest in a contract of the CC, the contract in question is, at the option of the CC, voidable. However, where the CC chooses not to be bound, a court may, on application by any interested person, order that such contract shall nevertheless be binding on the parties, give an order to that effect, and make any further order in respect thereof which it may deem fit.

Any particular conduct of a member shall not constitute a breach of a duty arising from his or her fiduciary relationship to the CC, if such conduct was preceded or followed by the written approval of all the members. Such members must be aware of all the material facts.

24.13.2 Duty to act with due care and skill

In addition to fiduciary duties, a member must act with the degree of care and skill that may reasonably be expected from a person of his or her knowledge and experience. Failure to comply with this duty can lead to liability for any loss caused to the CC by the breach. The test is not purely objective. The member's knowledge and experience are taken into account in determining if there has been a breach.

A member who is in breach of such duty is liable for any loss suffered by the CC as a result.

24.14 Members' remedies

In certain circumstances members need remedies where they have been wronged. The Act thus provides two remedies, namely, a personal action and a derivative action.

24.14.1 Personal action

The personal action is provided by s 49 of the Close Corporations Act. This is an action instituted by a member in his or her personal capacity against the CC or another member. The ground for the action is that the conduct of the CC or other member is unfairly prejudicial, unjust or inequitable to the member.

The court has a wide discretion in this regard. It may make such order as it thinks fit, including regulating the future conduct of the affairs of the CC. It can also order that a member's interest be purchased by the CC or by another member of the CC.

24.14.2 Derivative action

The derivative action is provided by s 50.

This is an action brought by a member or members of a CC against another member where the CC has been wronged in a certain way and the CC has failed to take action against the perpetrator. So the action is brought by a member on behalf of the CC.

The circumstances in which such an action can be brought are where the member has-

(i) failed to make his or her contribution;
(ii) acted in breach of a fiduciary duty;
(iii) acted in breach of the duty of care and skill.

24.15 Capacity, authority and contracts of a close corporation

When one talks about the 'capacity' of a CC one is usually referring to what it can and cannot do. Section 2(4) of the Close Corporations Act provides that a CC has the capacity and powers, legally, of a natural person of full capacity in so far as a juristic person is capable of having such capacity or exercising such powers. Obviously, a CC cannot, for example, get married.

When one talks about 'authority' in relation to a CC one is usually talking about the authority or power of a member to bind the CC to a contract with a third person, in other words, the power to represent the CC. Section 54(1) of the Act provides that any member of a CC shall, in relation to a person who is not a member and is dealing with the CC, be an agent of the CC.

When a CC contracts with a third party it will be recognised from the above that the capacity of the CC is irrelevant in determining whether the CC is bound by the contract.

As far as authority of a member to enter into the contract is concerned, s 54(2) provides that the contract will be binding on the CC even if the member had no authority to act on the CC's behalf. This will not be the case, however, if the third person with whom the member deals has, or ought reasonably to have, knowledge of the fact that the member had no such authority. It is important to note that the contract is binding on the CC whether or not the contract is within the usual scope of the CC's business. In addition, whether or not the act of entering into the contract was performed for the carrying on of the business of the CC is irrelevant.

It is important to note in regard to a third person dealing with a CC that such person is not deemed to have knowledge of any particulars merely because such particulars are stated, or referred to, in any founding statement regarding a corporation registered by the Registrar, or kept at the registered office of a corporation in accordance with the provisions of the Close Corporations Act. So if, for example, a CC's founding statement says that the CC cannot enter into a contract

for the purchase of a race horse, a third person who sells a race horse to the CC is not regarded as knowing about this limitation, even though the founding statement is a public document, ie open to inspection by the public. If the third person was deemed to know this, it would mean that a doctrine known as the doctrine of constructive notice would be applicable. This doctrine does not apply. It follows that the CC cannot argue that it is not bound by the contract because of the limitation in the founding statement.

Where a member acts beyond his or her authority when entering into a contract, the member may be liable to the CC for any loss suffered by the CC. This is because the member is in breach of his or her fiduciary duty to the CC.

24.16 Pre-incorporation contracts [20]

It often happens that one seeks, for example, to acquire a business, or premises, or a licence on behalf of a company to be formed. However, in terms of the common law, one cannot enter into a contract with a person not yet in existence. Section 53, however, allows a CC to ratify a pre-incorporation contract concluded by an agent, if certain requirements are met.

Section 53 provides that a corporation can ratify or adopt a written contract entered into by someone purporting to act as the corporation's agent or trustee before its incorporation, as if the corporation had been duly incorporated at the time the contract was entered into. The following requirements must be complied with:

(i) the contract must be made in writing;
(ii) it must have been entered into by a person who professed to act as agent or trustee of a corporation not yet incorporated; and
(iii) the corporation must duly ratify or adopt the contract after its incorporation.

It is possible, in various ways, to achieve what s 53 achieves without complying with s 53:

(i) One could use a contract for the benefit of a third person (a *stipulatio alteri*).
(ii) One could enter into the contract in one's personal capacity and then on incorporation of the CC cede one's rights in terms of the contract to the CC.
(iii) One could personally acquire a transferable option to acquire what it is sought to acquire, and then on incorporation of the CC cede the option to the CC.

24.17 Liability of members for A close corporation’s debts

One way of attempting to enforce the provisions of the Act is to provide that a contravention of the Act is a criminal offence and then to impose a penalty. The Act, however, does not do this. Instead it provides that in certain instances a contravention will lead to a member or members being ordered by the court to pay all or some of the debts of the CC.

Members’ liability for debts of their CC arises in the following instances: [21]

(i) Where the name of the CC is in any way used without the required abbreviation, any member of the CC who is responsible for, or who authorised or knowingly permitted the omission of such abbreviation, shall be so liable to any person who enters into any transaction with the CC from which a debt accrues for the CC while that person, in consequence of such omission, is not aware that the person is dealing with a CC.

(ii) Where any member fails to make a required contribution, that member shall be liable for every debt of the CC incurred from the date of registration of the founding statement in which particulars of the contribution concerned are stated to the date of the actual making of the contribution.

(iii) Where a juristic person or a trustee of a trust *inter vivos* in that capacity purports invalidly to hold a member’s interest in the CC, such juristic person or trustee shall be liable for every debt of the CC incurred during the time the contravention continues.

(iv) Where a CC makes an unlawful payment in respect of the acquisition of a member’s interest, every person who is a member at the time of such payment, including a member or a former member who receives or who received such payment, shall be liable for every debt of the CC incurred prior to the making of such payment unless, in the case of a member who is so aware, he or she proves that she took all reasonable steps to prevent the payment.

(v) Where the CC unlawfully gives financial assistance for the purpose of or in connection with any acquisition of a member’s interest, every person who is a member at the time of the giving of such assistance and who is aware of the giving of such assistance, and the person who receives such assistance, shall be liable for every debt of the CC incurred prior to the giving of such assistance unless, in the case of a member who is so aware, that member proves that he or she took all reasonable steps to prevent the payment.

(vi) Where a person takes part in the management of the business of the CC while disqualified from doing so, that person shall be liable for every debt of the CC which it incurs as a result of his or her participation in the management of the CC.

(vii) Where the office of accounting officer of the CC is vacant for a period of six months, any person who at any time during that period was a member and aware of the vacancy, and who at the expiration of that period is still a member, shall be so liable for every debt of the CC incurred during such existence of the vacancy and for every such debt thereafter incurred while the vacancy continues and he or she is still a member.

It must be noted that in the above instances not all members of the CC are necessarily liable, and those that are liable are not necessarily liable for all the debts of the CC.

The members who are liable are jointly and severally liable. This means that if there are, for example, four members liable, the debts for which they are liable can all be recovered from one member. That member can in turn recover the other three members' proportionate share of the debts from those members.

24.18 Liability for reckless or fraudulent carrying on of the business of a close corporation

If any business of a CC is carried on recklessly, with gross negligence or with intent to defraud any person, a court may declare that any person who was knowingly a party to the carrying on of the business in any such manner shall be personally liable for all or any of such debts or other liabilities of the CC as the court may direct. The court may also give such further orders as it considers proper for the purpose of giving effect to the declaration and enforcing that liability. [22]

Conducting the business of a CC in such a way is also a criminal offence.

24.19 Gross abuse of the juristic personality of a close corporation

Where there has been what the Act [23] calls a 'gross abuse of the juristic personality of a CC', the persons (members or non-members) responsible for such abuse can be declared by a court to be liable for such debts of the CC as the court determines. The court can also make such other orders as it sees fit to enforce that liability.

What is effectively being done here is what the common law relating to companies calls 'piercing' the 'corporate veil'. The court is disregarding the separate legal personality of the CC and imposing liability for debts of the CC on other persons.

24.20 Winding-up of a close corporation

The winding-up (also referred to as liquidation) of a CC is governed by the provisions in the Companies Act governing the winding-up of a company, [24] except for a few provisions in the Close Corporations Act, namely, ss 69, 73-79 and 81.

When a CC has been completely wound up, the Master must file a certificate to that effect. The Companies Commission must record the dissolution of the CC and remove the CC's name from the close corporation register (s 26).

24.21 Repayments by members on winding-up

A member of a CC is in the winding-up of the CC liable for the repayment of any payment made by the CC to him or her by reason only of his or her membership, unless that member can show that at the time of the payment the solvency and liquidity test was satisfied. [25] This liability for repayment only applies to payments made within the two years preceding the commencement of the winding-up. [26]

A person who ceased to be a member of the CC within this preceding period of two years is also liable for any repayment if, and to the extent that, repayments by present members, together with all other available assets, are insufficient for paying all the debts of the CC. [27]

A certificate given by the Master as to the amount payable by any member or former member may be forwarded by the liquidator to the clerk of the magistrate's court and the certificate will have the effect of a civil judgment of that magistrate's court against the member or former member. [28]

The court may, however, on application by the member or former member, make any order that it deems fit in regard to the certificate. [29]

24.22 Repayment of salary or remuneration by members on winding-up

If a CC is wound up and is unable to pay its debts, any remuneration paid by the CC within a period of two years before the commencement of its winding-up to a member in his or her capacity as an officer or employee of the CC is repayable if the Master so directs. [30] The Master must only do so, however, if he or she is satisfied that the remuneration was not paid in good faith or was unreasonable. [31]

A person who, within the two-year period, ceased to be a member of the CC may also be directed by the Master to make a repayment of remuneration if, and to the extent that, any such repayments by present members are, together with all other available assets, insufficient for paying all the debts of the CC. [32]

24.23 Repayments, payments of damages and restoration of property by members and other on winding-up

In certain circumstances set out in s 73 the court may order members, former members, officers, accounting officers, or former officers and accounting officers, to pay compensation to a CC on its winding-up. The court may do this if it appears that any such person has taken part in the formation of the CC or has misapplied or retained or become liable or accountable for any money or property of the CC, or has been guilty of any breach of trust in relation to the CC. The court may order such person to repay or restore the money or property, or any part thereof, with interest at such rate as the court considers just, or to contribute such sum to the assets of the CC by way of compensation or damages in respect of the misapplication, retention or breach of trust, as the court considers just.

24.24 Composition

If a CC is being wound up because it is unable to pay its debts, someone (the offeror) may be prepared to offer the creditors of the CC a compromise (referred to as a 'composition' in the Close Corporations Act). [33] The offeror may be prepared to offer them a certain number of cents in the rand (eg 30 cents) in satisfaction of their claims. This offer may be attractive because if the winding-up of the CC, with its substantial cost, can be avoided, the creditors may get more than they would get on a winding-up of the CC.

Such a composition is possible in terms of s 72 of the Act.

Section 72 basically provides that if two-thirds in value and number of the creditors vote in favour of the composition at a special meeting of creditors called for this purpose, the composition will be binding on all creditors (even those not in favour of the composition or not present at the meeting). Secured or preferent creditors are not bound.

If the composition is accepted by the required number of creditors, the offeror may apply to court to have the winding-up order set aside. [34]

24.25 Deregistration of a close corporation

In addition to deregistration on a winding-up of a CC, a CC may also be deregistered in the following circumstances: [35]

(i) the CC has transferred its registration to a foreign jurisdiction; or
(ii) the CC has failed to file an annual return for two or more years in succession; and, on demand by the Companies Commission, has failed to give satisfactory reasons for the failure to file the required annual returns, or to show satisfactory cause for the CC to remain registered; or
(iii) the Companies Commission has determined that the CC appears to have been inactive for at least seven years, and no person has demonstrated a reasonable interest in, or reason for, its continued existence; or

(iv) the Companies Commission has received a request for deregistration and has determined that the company has ceased to carry on business; and has no assets or, because of the inadequacy of its assets, there is no reasonable probability of the CC being liquidated.

A CC is dissolved as of the date its name is removed from the close corporation register unless the reason for the removal is that the CC's registration has been transferred to a foreign jurisdiction.

The removal of a CC's name from the close oorporation register does not affect the liability of any former member of the CC or any other person in respect of any act or omission that took place before the CC was removed from the register. Such liability continues and may be enforced as if the CC had not been removed from the register.

At any time after a CC has been dissolved, the liquidator of the CC, or any other person with an interest in the CC, may apply to a court for an order declaring the dissolution to have been void, or any other order that is just and equitable in the circumstances. If the court declares the dissolution to have been void, any proceedings may be taken against the CC that might have been taken if the CC had not been dissolved.

The reason for having a dissolution set aside is usually to complete unfinished business or to rectify an oversight in relation to the winding-up.

24.26 Business rescue

The business rescue procedure aimed at reviving companies governed by Chapter 6 of the Companies Act is equally applicable to CCs. [36]

24.27 Accounting records

A CC must maintain accounting records in one of the official languages of South Africa at its place of business or its registered office. [37] The term 'accounting records' is defined as accounts, deeds, writings and other documents as may be prescribed. [38] At a minimum, these accounting records must include the information necessary to fairly present the state of affairs and business of the CC, and to explain the transactions and financial position of the CC's business. [39]

The accounting records of a CC must include- [40]

(i) records of its assets, liabilities, undrawn profits and revaluations of fixed assets;
(ii) records of members' contributions and amounts of loans to and from members with sufficient detail of individual transactions to identify the nature and purpose thereof;
(iii) a fixed asset register reflecting–
  - acquisition costs;
  - revaluation amounts;
  - any consideration received upon disposal; and

- the respective dates of acquisitions, revaluations and disposals;

(iv) detailed records of all cash and credit transactions with sufficient information to determine the nature of the transactions and, other than in the case of cash sales, the names of the parties to the transactions;

(v) inventory records incorporating data from the annual inventory count and any other information required to determine the inventory value at the financial year end; and

(vi) vouchers supporting entries in the accounting records.

In addition, any accounting records relating to payments to members must contain sufficient detail of individual transactions to identify the nature and purpose of such payments. [41]

Precautions must be taken to avoid falsification and to facilitate the discovery of falsification of the accounting records. [42]

Any CC which fails to comply with the provisions of the Close Corporations Act relating to the accounting records, and every CC member who is party to such failure or who fails to take all reasonable steps to secure compliance with these provisions,

shall be guilty of an offence. However, a member shall have a valid defence if-

(i) that member had reasonable grounds to believe that a competent and reliable person was responsible for overseeing the compliance with these provisions;

(ii) that person was in a position to discharge that responsibility; and

(iii) the member had no reason to believe that such person had in any way failed to discharge that responsibility. [43]

24.28 Financial year

The financial year of a CC is its annual accounting period. [44] The first financial year of a CC commences on its date of registration and must extend for not less than three months nor more than 15 months. [45] A CC's founding statement must include the date of the financial year end. [46] The duration of a financial year is generally 12 months. However, the duration may increase or decrease subject to a change in the date of the financial year end. [47] A CC may change the date of its financial year end by lodging an amended founding statement for registration provided that the date is changed only once in a financial year and the financial year extends not less than three months nor more than 18 months. [48]

24.29 Annual financial statements, transparency and accountability

The members of a CC must ensure the preparation of annual financial statements that are internally or independently compiled for each financial year, within six months after the end of that financial year, in one of the official languages of South Africa. [49] The annual financial statements must be in agreement with the accounting records, which must be summarised in a manner that allows the accounting officer to report to the CC on the annual financial statements without referring to any subsidiary accounting records and vouchers supporting the entries in the accounting records. This does not preclude an accounting officer from inspecting such records and vouchers. [50]

A CC must, in accordance with generally accepted accounting practice appropriate to its business, fairly present the state of affairs of the CC as at the end of the respective financial year, and the results of its operations for that year, in its financial statements. The annual financial statements of a CC should consist of - [51]

(i) a statement of financial position and any notes thereto;
(ii) an income statement or any similar financial statement, eg a statement of comprehensive income, and any notes thereto;
(iii) the accounting officer's report; and
(iv) a statement of changes in net investment of members, being a reconciliation between the opening and closing balances of members' contributions, undrawn profits, other reserves and loans to or from members.

Although not required by the legislation, it is generally accepted that the annual financial statements of a CC will also include a cash flow statement.

If a CC is required by the Companies Regulations to have its annual financial statements audited, those annual financial statements must- [52]

(i) include an auditor's report;
(ii) include a report by the members with respect to the state of affairs, the business and profit or loss of the CC, or of the group, if the CC is part of a group, including any matter material for the members to appreciate the CC's affairs; and any prescribed information;
(iii) be approved and signed by or on behalf of a member, or members, holding members' interests of at least 51 per cent in the CC; and
(iv) be presented to the first meeting of the members after the statements have been approved.

The audited annual financial statements must also disclose the remuneration and benefits received or receivable by a member or prescribed officer of the CC or attributable to the rendering of services to the CC, or a company within the same group. [53]

See further Chapter 15: The auditor, financial records and reporting.

24.30 Audit and independent review of close corporations

For financial years beginning prior to 1 May 2011, the financial statements of a CC were not subject to an audit or independent review. An accounting officer was required to report on the financial statements of a CC, which were compiled using an accounting framework selected by the CC.

For financial years beginning on or after 1 May 2011 (ending on or after 30 April 2012), CCs may be subject to an audit or independent review and will be required to prepare financial statements in accordance with prescribed financial reporting standards. [54] Various financial reporting standards are available, the most rigorous being the International Financial Reporting Standards (IFRS). The South African Standards of Generally Accepted Accounting Practice (SA GAAP) are similar to IFRS, but due to their withdrawal, SA GAAP will not be applicable to financial years beginning on or after 1 December 2012. Another financial framework that is prescribed in certain cases is IFRS for Small and Medium Enterprises (IFRS for SMEs), which is less rigorous and was developed to reduce the costs and complexities of compliance for smaller entities. Nothing precludes a CC from using more rigorous financial reporting standards than those prescribed.

Read with the changes required by the context- [55]

(i) regulations made in terms of ss 30(7), 29(4) and (5) of the Companies Act apply to a CC; and
(ii) section 30(2)*(b)* of the Act applies to a CC that is required by the regulations made in terms of s 30(7) to have its financial statements audited.

These provisions of the Act and Regulations determine the financial reporting standards applicable for the preparation of a CC's financial statements, whether those financial statements are subject to audit or independent review and the persons eligible to perform any such independent review.

If an audit or independent review is not required in terms of any other laws or an agreement, s 30(2A) of the Act exempts a CC's financial statements from the audit or independent review requirement, provided that-

(i) every person who has a beneficial interest in the CC is also a director of the CC; and
(ii) it is not deemed desirable in terms of the Regulations, in the public interest, for the annual financial statements to be audited.

This exemption is significant for CCs, owing to members of a CC both holding a beneficial interest in the CC and being responsible for the management of the CC.

An accounting officer must report on the CC's financial statements if they are exempt from audit and independent review. In this case, the accounting officer does not perform an audit or independent review and must merely report on the appropriateness of the accounting policies applied by the CC in the preparation of its financial statements and whether the CC's annual financial statements are in agreement with its accounting records. [56] It is important that a distinction is drawn between such a report and the report of an auditor or independent reviewer. The report of the accounting officer should therefore state that neither an audit nor an independent review has been performed.

See further Chapter 15: The auditor, financial records and reporting.

24.31 Reportable irregularities

The individual auditor responsible for an audit or the independent reviewer of a CC's financial statements is responsible for reporting any reportable irregularity that he or she identifies in respect of that CC. [57]

For the purposes of an auditor, a 'reportable irregularity' is defined in s 1 of the Auditing Profession Act 26 of 2005 ('the Auditing Profession Act') as-

> any unlawful act or omission committed by any person responsible for the management of the entity, which-
>
> *(a)* has caused or is likely to cause material financial loss to the entity or to any partner, member, shareholder, creditor or investor of the entity in respect of his, her or its dealings with that entity; or
> *(b)* is fraudulent or amounts to theft; or
> *(c)* represents a material breach of any fiduciary duty owed by such person to the entity or any partner, member, shareholder, creditor or investor of the entity under any law applying to the entity or the conduct or management thereof'.

For the purposes of independent review, 'reportable irregularity' is defined in the Regulations as-

> any act or omission committed by any person responsible for the management of a CC, which-
>
> (i) unlawfully has caused or is likely to cause material financial loss to the CC or to any member, creditor or investor of the CC in respect of his, her or its dealings with that entity; or
> (ii) is fraudulent or amounts to theft; or
> (iii) causes or has caused the CC to trade under insolvent circumstances. [58]

The reporting responsibilities with respect to a reportable irregularity are outlined in the Auditing Profession Act for the purposes of the auditor, whereas the Regulations deal with them for the purposes of an independent review. [59]

See further Chapter 15: The auditor, financial records and reporting.

24.32 The auditor

A CC that is required to have its annual financial statements audited in terms of the Companies Act or Regulations must apply the enhanced accountability and transparency provisions in the Act relevant to auditors. However, a CC that opts in its Memorandum of Incorporation to have its financial statements audited and to appoint an auditor is only required, to the extent elected therein, to comply with the enhanced accountability and transparency provisions of the Act dealing with the-

(i) appointment of the auditor;
(ii) resignation or removal of auditors and vacancies;

(iii) rotation of auditors; and
(iv) rights and restricted functions of auditors. [60]

These provisions must be read with the changes required by the context for the purposes of a CC.

See further Chapter 15: The auditor, financial records and reporting.

24.33 Accounting officer

24.33.1 Appointment, resignation and removal

Every CC that is not subject to audit or independent review must appoint an accounting officer. [61] The details of the first accounting officer, who has given written consent for appointment and whose appointment takes effect on the CC's date of registration, are recorded in the founding statement. [62]

If a vacancy occurs in the office of accounting officer, the CC must appoint another accounting officer and lodge an amended founding statement for registration within

28 days. [63] In the case of removal of an accounting officer by a CC, written notice must be given to the accounting officer by the CC. [64] If an accounting officer believes that he or she was removed from office for improper reasons, he or she should send a letter informing the Commissioner of this. A copy of this letter must be sent to every member of the CC. [65]

An accounting officer who resigns, or is removed, from office is required to inform every member of the CC thereof in writing and to send a copy of this notice to the registered office of the CC. In addition, the accounting officer must inform the Commissioner, in writing, of-

(i) his or her resignation or removal from office;
(ii) the date of his or her resignation or removal from office;
(iii) the date up to which he or she performed the duties of accounting officer; and
(iv) his or her awareness, at the time of resignation or removal, of any matters in the financial affairs of the CC which are in contravention of the provisions of the Close Corporations Act; the full particulars of which must be provided in writing to the Companies Commission. [66]

24.33.2 Qualifications of an accounting officer

To qualify for the position of accounting officer, a person must be a member of a recognised profession which-

(i) requires its members to have passed examinations in accounting and related fields of study which are approved by the Minister;
(ii) has the power to exclude from membership any persons found guilty of negligently performing their duties or of conduct which may bring their profession into disrepute; and
(iii) has been named by notice in the Government Gazette as a

profession whose members are qualified to perform the duties of an accounting officer of a CC. [67]

Some of the professions whose members qualify to perform the duties of an accounting officer are-

(i) the South African Institute of Chartered Accountants;
(ii) the Independent Regulatory Board for Auditors;
(iii) the South African Institute of Professional Accountants;
(iv) the South African Institute of Government Auditors;
(v) the South African Institute of Chartered Secretaries and Administrators; and
(vi) the Institute of Cost and Management Accountants.

A firm also qualifies for appointment as accounting officer if it is- [68]

(i) a partnership of which all the partners are registered auditors; or
(ii) a company–
- with a share capital, and its Memorandum of Incorporation provides that its

  directors and past directors shall be liable jointly and severally, together with the company, for its debts and liabilities contracted during their periods of office;
- whose shareholders are all registered auditors; and
- whose shareholders are all directors and whose directors are all shareholders.

In addition, any other firm or CC qualifies to be appointed as an accounting officer if each partner or member in the firm or CC, respectively, qualifies to be so appointed. [69] The liability of a partner or member of such a firm or CC, respectively, in respect of debts or liabilities incurred by the firm or CC in the discharge of its duties, during the partner's or member's term as partner or member, may not be excluded by law or in any other way. [70]

It must be noted that a CC qualifies for appointment as accounting officer only if each member of the CC is qualified to be so appointed and a CC may appoint a member or employee of that CC, or a firm whose partner or employee is a member or employee of that CC, only if all of the CC's members consent to the appointment in writing. [71] The purpose of this provision is to prevent the objectivity of the accounting officer being compromised, due to an interest in the CC or its business, without the recognition and acceptance of this by all of the members. CIPRO [72] Practice Note 1 of 2006 provides the following guidance with respect to sole proprietors:

> [I]t is evidently clear that for a firm to be appointed as an accounting officer it must either be a common-law partnership or a firm of accountants and auditors ... A sole proprietor conducting his or her business under a business name (ie a name other than the name of its proprietor), therefore, cannot be appointed as a firm but will have to be appointed in his or her personal capacity under paragraph (i) of section 60 (4)*(a)*. In the past this distinction was not clearly drawn and a number of appointments of firms as accounting officers were allowed where the 'firm' was in fact a sole proprietor that had to be appointed in a personal capacity. These appointments will be regarded as appointment in a personal capacity of the person whose particulars appeared in the relevant letter of consent and any reference to the

firm will be deemed to be a reference to the relevant person. No re-appointment will be required but such accounting officers must ensure that all future acts performed by them as accounting officers under the Close Corporations Act, 1984, or any other law must be performed in their personal capacities and not by or on behalf of a 'firm'. Of particular importance in this regard is the use of the correct letterhead by accounting officers who are deemed to be or are appointed in their personal capacities - such a letterhead should reflect the personal particulars of the appointed accounting officer and not that of a firm.

24.33.3 Right of access to accounting records and documents

The accounting officer of a CC has a right of access at all times to all the CC's accounting records, books and documents, and to require from members such information as considered necessary by him or her for the performance of his or her duties as accounting officer. [73]

24.33.4 Remuneration of an accounting officer

The remuneration of an accounting officer is determined in agreement with the CC. [74] As an accounting officer must be a member of a recognised profession, this determination should take into consideration the guidance provided by any relevant code of professional conduct.

24.33.5 Duties of an accounting officer

The accounting officer of a CC must, not later than three months after completion of the annual financial statements- [75]

(i) determine whether those annual financial statements are in agreement with the accounting records of the CC;

(ii) review the appropriateness of the accounting policies applied by the CC in the preparation of the annual financial statements; and

(iii) report thereon to the CC.

If an accounting officer becomes aware, during the performance of his or her duties, of any contravention of the Close Corporations Act, he or she must describe the nature of such contravention in his or her report. In addition, an accounting officer who is a member or employee of a CC, or is a firm of which a partner or employee is a member or employee of the CC, must state this fact in his or her report. [76]

An accounting officer must report in writing to the Commissioner if he or she- [77]

(i) knows or has reason to believe that the CC is not carrying on business or is not in operation and has no intention of resuming operations in the foreseeable future; or

(ii) during the performance of his or her duties discovers that–
   - any change with respect to any particulars mentioned in the founding statement, during a relevant financial year, has not been registered;
   - the financial statements indicate that the CC's liabilities exceed its assets at the end of the financial year concerned; or
   - the annual financial statements incorrectly indicate that the

assets of the CC exceed its liabilities as at the financial year end, or has reason to believe that such an incorrect indication has been given.

If, after reporting to the Commissioner, an accounting officer discovers that any subsequent financial statements of the CC indicate that the situation has changed or

has been rectified and that the assets then exceed the liabilities, or that they no longer incorrectly indicate that the assets exceed the liabilities, or the accounting officer no longer has reason to believe that such an indication is given, he or she may report to the Commissioner accordingly. [78]

24.34 Audit committee and company secretary

Any CC that opts in its Memorandum of Incorporation to appoint an audit committee or a company secretary must, to the extent elected therein, comply with the enhanced accountability and transparency provisions of the Companies Act dealing with the audit committee or company secretary, respectively. These provisions must be read with the changes required by the context for the purposes of a CC. [79]

See further Chapter 15: The auditor, financial records and reporting.

24.35 Annual return

Every CC must lodge an annual return with the Commissioner. A copy of this return must be kept at the registered office of the CC and must be available for inspection.

The annual return of a CC must include-

(i) the financial year end;
(ii) the name of the accounting officer;
(iii) the registration number of the accounting officer if it is a firm as defined in s 1 of the Auditing Profession Act, 2005, or a CC;
(iv) the postal address of the accounting officer;
(v) the profession of the accounting officer; and
(vi) the practice number or membership number of the accounting officer. [80]

See further Chapter 15: The auditor, financial records and reporting.

Questions

1. You are the auditor of Panache CC, a close corporation, whose sole business is the manufacture and engraving of tombstones. At the beginning of the year ending December 2012 Panache CC had three members, Tom, Dick and Harry. During the course of your audit for the year you come across the following transactions which are unrelated:
    - On 1 June 2012 there were two changes in membership.

    - Dick, who had held a 20 per cent interest, sold half of his interest to a trust he had created. The trustees and the beneficiaries of the trust were all natural persons.
    - Dig and Drop, a partnership, made a contribution of R10 000 and was allocated an interest of 8 per cent. The partners are all natural persons.
- On 1 July 2012 an agreement was reached between Panache CC and its chief competitor, Supertombs (Pty) Ltd, of which Tom is a shareholder. In terms of the agreement Panache undertook not to trade in a particular area and received a payment of R30 000 in return.
- On 1 August 2012 Panache made an interest-free loan (which was repayable on demand) to Zoot CC. The favourable terms of the loan were due to the fact that Harry held a 40 per cent interest in Zoot CC.
- On 1 July 2012 Harry sold his interest in Panache CC to Dem Stones CC, a close corporation which Harry had formed and of which he was the sole member. In terms of the sale agreement Panache undertook not to trade in a particular type of tombstone which Panache had been particularly successful in marketing. Panache received no consideration for this undertaking.
- On 1 August 2012 Panache CC repaid 50 per cent of each member's contribution.

State whether you are satisfied with each transaction. If not, give reasons for your dissatisfaction. If you would be satisfied provided certain requirements laid down by the Close Corporations Act have been complied with, state those requirements.

2. In certain of the circumstances set out in question 1 certain persons could, if there is a failure to comply with the Close Corporations Act, become liable for the debts of the close corporation.

   State for each of the five situations in question 1:

   (a) Which persons would become liable?

   (b) For which debts, if any, would such persons become liable?

3. Mr Ego wishes to acquire an interest in a CC. Should Mr Ego acquire the interest, the effective date of commencement of his membership will be 30 June 2012. The four existing members have insisted that in order to acquire the 15 per cent interest, Mr Ego will have to:
   - make a contribution of R35 000;
   - grant a loan of R10 000 to the CC at an interest rate of approximately 10 per cent.

   Mr Ego wishes to have advice on the following particular points:

   (a) Why should he make a contribution of R35 000 if he is getting only a 15 per cent interest?

   (b) What right do he or any of the other members have to withdraw their contributions?

(c) What right does he have to any of the undrawn profits of the CC?
(d) What right would he have to get his loan repaid to him?
(e) What 'voting power' does he have in the CC?

4. List all of the components to be included as part of a CC's annual financial statements that are subject to an audit.

5. You are the auditor responsible for the audit of Constructor CC, a CC operating in the engineering industry. The CC has a public interest score in excess of 350, which has resulted in its financial statements being subject to an audit.

   While performing the audit, one of the audit team members discovered that the consulting fees of R800 000 reflected on the income statement for the year were paid to Mary Trapper, the wife of John Trapper. John is the most senior member responsible for the management of the close corporation. When you met with John to plan the audit, you also noticed that he was driving a new luxury car and that he was excited to tell you about his recent extravagant overseas holiday. This made you suspect that a reportable irregularity may exist.

   When you investigated the situation further, you discovered that Mary prepares the management accounts at home for Constructor CC. This is the only service that Mary provides to the close corporation and she spends no more than ten hours a week on this task. The market value of the services provided by Mary is R8 000 per month.

   (a) Discuss whether this matter would constitute a reportable irregularity in terms of the Auditing Profession Act.
   (b) Discuss whether the annual financial statements of Constructor CC would be subject to an audit or an independent review if the public interest score was only 235.
   (c) Comment on whether you would have a duty to report a reportable irregularity if Constructor CC's annual financial statements were subject to an independent review rather than an audit.

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[*] Richard Jooste wrote paras 24.1 to 24.26, and Joanne Shev wrote paras 24.27 to 24.35.
[1] Section 46*(a)* of the Close Corporations Act.
[2] Section 29.
[3] Section 28.
[4] Section 28.
[5] Section 47.
[6] Section 29(4).
[7] Section 33.
[8] Section 33.
[9] Section 30.
[10] Section 30.
[11] Section 30.
[12] Section 3.

[13] Section 15.
[14] Section 39.
[15] Section 48.
[16] Section 51.
[17] Section 70.
[18] Section 52.
[19] *Hanekom v Builders Market Klerksdorp (Pty) Ltd* 2007 (3) SA 95 (SCA).
[20] This chapter must be read subject to the fact that close corporations can no longer be formed.
[21] Sections 63 and 64.
[22] Section 64.
[23] Section 65.
[24] Section 66.
[25] Section 70(1).
[26] Section 70(2).
[27] Section 70(3).
[28] Section 70(4).
[29] Section 70(5).
[30] Section 71.
[31] Section 71.
[32] Section 71(2).
[33] Section 72.
[34] Section 72(11).
[35] Section 82 of the Companies Act.
[36] Section 66(1A) of the Close Corporations Act. See Chapter 20: Business rescue and compromises.
[37] Section 56(1) and (4).
[38] Section 1.
[39] Section 56(1).
[40] Section 56(1) and (2).
[41] Section 56(2).
[42] Section 56(3).
[43] Section 56(5).
[44] Section 57(1).
[45] Section 57(4)*(a)*.
[46] Section 12*(g)*.
[47] Section 57(3).
[48] Section 57(2) and (4)*(b)*.
[49] Section 58(1) and reg 27(1) of the Companies Regulations GNR 351 *GG* 34239 of 26 April 2011.
[50] Section 58(2)*(d)* of the Close Corporations Act.
[51] Section 58(2) and (3).
[52] Section 58(2A) and s 30(3) of the Companies Act.
[53] Sections 58(2A) of the Close Corporations Act and 30(4)-(6) of the Companies Act.
[54] Section 10(3) of the Close Corporations Act.
[55] Sections 10(3) and 58(2A).
[56] Section 62(1).
[57] Regulation 29(6)*(a)* of the Companies Regulations and s 45 of the Auditing Profession Act.
[58] Regulation 29(1)*(b)* of the Companies Regulations.
[59] Regulation 29 and s 45 of the Auditing Profession Act.
[60] Section 62A of the Close Corporations Act and s 84(1)*(c)* of the Companies Act.
[61] Sections 59(1) and 62A of the Close Corporations Act.
[62] Sections 59(2) and 12*(g)*.

[63] Sections 59(3) and 15(2).
[64] Section 59(4).
[65] Section 59(5)*(b)*.
[66] Section 59(5)*(a)*.
[67] Section 60(1) and (2).
[68] Section 60(4)*(a)* of the Close Corporation Act and ss 1 and 38 of the Auditing Profession Act.
[69] Section 60(4)*(a)* of the Close Corporations Act.
[70] Section 60(4)*(b)* and *(c)*.
[71] Section 60(3).
[72] Companies and Intellectual Property Registration Office (CIPRO), which was replaced by the Companies and Intellectual Property Commission.
[73] Section 61(1) of the Close Corporations Act.
[74] Section 61(2).
[75] Section 62(1).
[76] Section 62(2).
[77] Section 62(3).
[78] Section 62(4).
[79] Sections 62A and 84(1)*(c)* of the Companies Act.
[80] Section 15A of the Close Corporations Act and regulation 16A of the Close Corporations Administrative Regulations, 1984.

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