

SECTION 48 OF THE COMPANIES ACT 71 OF 2008

By

NAMALA TABARO

24236765

Submitted in partial fulfilment of the requirements
for the degree

LLM

CORPORATE LAW

In the faculty of Law

UNIVERSITY OF SOUTH AFRICA

SUPERVISOR: P.A DELPORT

(5 June 2012)

DECLARATION OF ORIGINALITY
UNIVERSITY OF PRETORIA

Full names of student:Namala Tabaro

Student number:.....24236765

Topic of work:.....Section 48 of The Companies Act 71 Of 2008

Declaration

1. I understand what plagiarism is and am aware of the University's policy in this regard.
2. I declare that this dissertation..... (eg essay, report, project, assignment, dissertation, thesis, etc) is my own original work. Where other people's work has been used (either from a printed source, Internet or any other source), this has been properly acknowledged and referenced in accordance with departmental requirements.
3. I have not used work previously produced by another student or any other person to hand in as my own.
4. I have not allowed, and will not allow, anyone to copy my work with the intention of passing it off as his or her own work.

SIGNATURE.....Namala Tabaro.....

Table of Contents

CHAPTER 1	5
INTRODUCTION	6
1. INTRODUCTION	6
2. THE DISSERTATION PROBLEM	7
3. THE DISSERTATION OBJECT	8
4. METHODOLOGY	8
5. SCOPE AND LIMITATION OF THE DISSERTATION	9
6. CHAPTER OVERVIEW.....	9
CHAPTER 2	12
THE CAPITAL MAINTENANCE	12
1. THE ORIGINS OF THE CAPITAL MAINTENANCE PRINCIPLE	12
2. THE PRESENT POSITION.....	14
3. SHARE REPURCHASES	15
3.1. <i>Capitex Bank Ltd v Qorus Holdings Ltd</i>	15
3.2. <i>The statutory provisions on share repurchases</i>	16
4. CONCLUSION.....	16
CHAPTER 3	18
ANALYSIS OF SECTION 48 OF COMPANIES ACT 2008	18
1. INTRODUCTION: BASIC ALLOWANCE	18
2. THE BREAKDOWN OF THE SUBSECTIONS OF SECTION 48.....	18
2.1. <i>Section 48(1): The Exception</i>	18
2.2. <i>Section 48(2): The Requirement of Section 46</i>	20
2.3. <i>Section 48(3): Instances where shares may not be acquired</i>	21
2.4. <i>Section 48(4): The Agreement for acquisition of own shares</i>	22
2.5. <i>Section 48(5): The Impossibility of the company to fulfil the agreement to acquire own shares</i>	22
2.6. <i>Section 48 (6): Irregular acquisition of own shares resulting in reversal of the acquisition</i>	22
2.7. <i>Section 48 (7): Directors Liability</i>	23
3. CONCLUSION	24
CHAPTER 4	25
ANALYSIS OF THE REQUIREMENTS OF SECTION 48	25
1. INTRODUCTION.....	25
2. DISTRIBUTION	26
3. DISTRIBUTION REQUIREMENT	27
3.1. <i>Section 46 (1)</i>	27
3.2. Breakdown of section 46 requirements.....	28
4. CONSEQUENCES OF NON-COMPLIANCE OF SECTION 46	29
5. CONCLUSION	30
CHAPTER 5	31



SOLVENCY AND LIQUIDITY	31
1. INTRODUCTION.....	31
2. THE LIQUIDITY AND SOLVENCY TEST	32
2.1. <i>Companies Act 61 of 1973</i>	32
2.2. <i>Companies Act 71 of 2008: Section 46</i>	32
3. ANALYSIS OF THE TEST	34
3.1. <i>The solvency element</i>	34
3.2. <i>The Liquidity element</i>	35
3.3. <i>When the test must be considered and satisfied?</i>	35
3.4. <i>Consequences of non compliance of solvency and liquidity test</i>	35
4. CONCLUSION	36
CHAPTER 6.....	37
PROTECTION OF THE CREDITORS AND SHAREHOLDERS	37
1. INTRODUCTION	37
2. PROTECTION OF CREDITORS.....	38
3. PROTECTION FOR SHAREHOLDERS	39
4. CONCLUSION	42
CHAPTER 7.....	44
CONCLUSION.....	44
1. SECTION 48	44
2. PROTECTION TO THE CREDITORS AND THE SHAREHOLDERS	46

ABBREVIATIONS

Companies Act 61 of 1973: The old Act; or the Companies Act 1973; or the 1973 Act.

The Companies Amendment Act 37 of 1999: The Amendment Act 1999; or the 1999 Act.

The Companies Act 71 of 2008: The new Act; or the Companies Act 2008; or the 2008 Act, the Act.

Article of association: Articles.

Memorandum of association: Memorandum.

CHAPTER 1

INTRODUCTION

Contents

Introduction
The dissertation problem
Object of the dissertation
Methodology
Scope and limitation of the dissertation
Chapter overview

1 Introduction

The Companies Act¹ was promulgated on the 9th of April 2009 and came into operation on the 1st of April 2011.² It has far reaching effects on the way in which a company is formed and operated under the South African company law. The Act provides for the procedure that must be followed by a company when acquiring its own shares. Schedule 5 of the 2008 Companies Act regulates the changeover from the previous regime under the old Act³ to that of the new regime under the new Act.

The old Act provided for two types of companies that may be incorporated under the South African law namely, a company having a share capital and a company not having a share capital.⁴ Issuing share capital enabled companies to acquire the necessary capital to conduct their business. The collected capital was once viewed as a safety net for creditors as they could recover their loans or satisfy their debts from the shared capital of the company.⁵ The courts followed the basic approach that

¹ Companies Act 71 of 2008.

² General Notice 421 *Government Gazette* 32121 (9 April 2009).

³ Companies Act 61 of 1973.

⁴ Cilliers *et al Corporate Law* (2000) 31.

⁵ Van der Linde "Par-value shares or no-par-value shares – is that the question?" 2007 *SA Merc LJ* 473; Van der Linde "The regulation of conflict situations relating to share capital" 2009 *SA Merc LJ* 33 at 35.

creditors should look to the contributed capital of the company for satisfaction of their claims against the company. This approach was established in the *Trevor v Whitworth*⁶ case where the court held that a company was prohibited from purchasing its own shares. The capital had to be maintained, assuring creditors that their debts would be satisfied.⁷

Therefore, in accordance with *Trevor v Whitworth*⁸, companies were not allowed to purchase their own shares so as to protect the paid-up capital. The prohibition remained part of our law until the 30th of June 1999, when the 1973 Companies Act was amended by the Companies Amendment Act.⁹ With the said amendment, the company law moved from relying on the capital maintenance rules to relying on the new system of solvency and liquidity.¹⁰

This dissertation is on section 48 of the new Companies Act concerning a company acquiring its own shares. The dissertation involves a discussion on the capital maintenance principle and how it has developed to affect the capital structure of a company, however, the main focus is on the solvency and liquidity principle and how the creditors and the shareholders of the company are affected by it.

Sections 48(2) and 48(3) of the 2008 Companies Act, governs acquisitions by a company of its own shares and shares of its holding company. This falls away from the capital maintenance principle which required that the capital of a company be maintained. According to the new Companies Act, a company may acquire its own shares provided that the decision to do so satisfies the requirements of section 46 which regulates distributions.¹¹

2 The dissertation problem

The dissertation subject is: Section 48 of the Companies Act 71 of 2008.

⁶ *Trevor v Whitworth* (1887)12 App Cas 409 (HL) at 416.

⁷ Pretorius *et al Hahlo's South African Company Law through the Cases* (1999) 123.

⁸ (1887)12 App Cas 409 (HL).

⁹ 37 of 1999.

¹⁰ Van der Linde (2007) *SA Merc LJ* 473 at 475

¹¹ S 46 of the 2008 Companies Act prescribes that "distributions", as defined in s 1, are subject to the liquidity and solvency test set out in s 4(1).

Initially, the capital maintenance rule was followed. The old Companies Act, after it was amended, incorporated the solvency and liquidity principle, which is now the prerequisite for any distribution by a company. However the Act held some remnants of the capital maintenance rule.

The new Companies Act came into operation in April 2011 and with it came many changes to the company law. The new Companies Act completely disregards the capital maintenance rule. A company may now acquire its own shares provided that the requirement of solvency and liquidity is complied with. The capital maintenance rule strove to protect company creditors and shareholders by forbidding the company from depleting its share capital. Strict rules were enforced for any distribution by the company and the shareholders had control of the company. The new regime of solvency and liquidity has brought in a lot of changes. The system is based on simpler and more precise rules, however, the question remains whether it offers more protection for the shareholders and creditors than the capital maintenance system ever did.

Therefore, the focus of this dissertation is on the system of solvency and liquidity test and its protection of shareholders and creditors of a company during an acquisition of its own shares as in terms of section 48 of the Companies Act 2008.

3. The dissertation object

The object of this dissertation is to analyse the provisions of section 48 of the new Act. In the process of understanding the section an attempt is made to show that section 48, which completely abolishes the capital maintenance principle, does not really provide better protect for the creditors and the shareholders.

4. Methodology

Qualitative research;

“A qualitative approach is one in which the inquirer often makes knowledge claims based primarily on constructivist perspectives (i.e. the multiple meanings of individual experiences, meanings socially and historically constructed, with an intent of

developing a theory or pattern) or advocacy/participatory perspectives (i.e. political, issue-oriented, collaborative or change oriented) or both”.¹²

A qualitative approach is used in this dissertation. Research will be based on the usage of literal works and comments made by various law experts, on section 48 and other sections referred by it.

The 2008 Companies Act will essentially be the foundation and the starting point of this research. Other Acts and where possible case law will be used as primary sources.

Secondary sources will also be referred to in the evaluation of the section such as writing, articles, journals and commentaries of South Africa law experts/authors. To be brief, the main method for my research will be on the literature.

5. Scope and limitation of the dissertation

My research is on section 48 of the Companies Act primarily on its solvency and liquidity requirement. A critical analysis of the section is be made, splitting the provisions for better understand of the intention and the purpose of the section. An attempt is also made at understanding the importance of the section to the creditors and the shareholder of the company which is involved in acquiring its own shares as in term of the section. Therefore, the research does not go further than the discussion of section 48 as it is provided by the Act and its effectiveness in the protection of the shareholders and the creditors of the company.

6. Chapter overview

Chapter 1

Chapter 1 is an introductory chapter (herein). The chapter introduces the topic of the dissertation, its object and scope.

Chapter 2

¹² Creswell *Research design: quantitative, and mixed method approaches* (2003)18.

Chapter 2 looks into the previous principle of capital maintenance and how it is now no longer followed. The discussion in this chapter starts with the history of the principle and how it was passed down from the *Trevor v Whitworth* case into the South African law. The principle was followed until it was amended by the Amendment Act 37 of 1999 and then entrenched in the previous/ old Companies Act. The present status of the principle and how it was replaced by the more effective solvency and liquidity principle as it is entrenched in the new Companies Act will be discussed.

Chapter 3

Chapter 3 will be analysing section 48 of the Companies Act 2008. The different subsections will be split and properly looked at for better understanding of the section.

Chapter 4

Chapter 4 of the dissertation focuses on the requirements of section 48. Focus in this chapter will be made on “distribution” as provided for in section 46 of the Act and as defined in section 1 of the Act. Section 48 makes reference to section 46 in that the requirements provided in the section must be complied with before a company can acquire its own shares. Section 46 provides for solvency and liquidity test being a prerequisite for any distributions made by a company. Therefore focus is also made on the two-element test as prescribed in section 4(1) of the Act.

Chapter 5

Chapter 5 discusses section 48 and its protection of the creditors and shareholders. A discussion is made on how the capital maintenance system tried to protect the shareholders and creditors of a company and how the Companies Acts, both Act 61 of 1973 and Act 71 of 2008, which is now in operation, continues to offer this protection with a different system. The question is whether the new system of ‘solvency and liquidity’ introduced by the Companies Act effectively protects the shareholders and the creditors better than the capital maintenance system. Primary focus will therefore be on the new Act, section 48 and its protection of companies’ shareholders and creditors.

Chapter 6

Chapter 6 is a conclusion chapter. This chapter summarises everything discussed.

CHAPTER 2

THE CAPITAL MAINTENANCE

Contents

The origins of the capital maintenance principle
The present position
Share repurchases
The statutory provisions on share repurchases
Conclusion

1. The origins of the capital maintenance principle

The common rule approach that was followed and then later entrenched in the Companies Act was the preservation or maintenance of the share capital of a limited company. The main purpose of the capital maintenance principle was to grant protection to creditors and also attempt to protect shareholders in the process. Creditors were to look to the company's paid-up capital to satisfy their claims.¹³ A company's capital was viewed to be fixed and certain, and as such creditors had definite protection as they were entitled to settle their debt from such capital.¹⁴ From the rule/principle, it could have been inferred that creditors would have been prejudiced if the company made any payments or attained funds from its capital. Therefore, a company could not acquire its own shares, pay dividends to the shareholders from its capital or even issue shares at a discount as the capital of the company had to be maintained.¹⁵

¹³ Cilliers (2000) 322.

¹⁴ *Ibid.*

¹⁵ *Ibid.*

The rule was established in *Trevor v Whitworth*¹⁶ where a former shareholder claimed from a company which had gone into liquidation the balance of the price of his shares which he had sold to the company before the liquidation and which was not wholly paid for. The shareholder's claim was dismissed. In the case Lord Watson also held that,

“Paid-up capital may be diminished or lost in the course of the company's trading: that is a fact which no legislation can prevent; but persons who deal with, and give credit to, a limited company, naturally rely upon the fact that the company is trading with a certain amount of capital already paid, as well as upon the responsibility of its members for the capital remaining at call; and they are entitled to assume that no part of the capital which has been paid into the coffers of the company has subsequently been paid out, except in the legitimate course of its business.”¹⁷

Therefore, it is evidenced from the extract that creditors will indeed be prejudiced if the capital is not maintained as it will mean shareholders can be paid dividends from the company's capital or the company can acquire their shares, depilating the company share capital.

In the abovementioned case the shareholders were entitled to look to the company's paid up capital for payment of their shares. This prejudiced the creditors. Any conduct by a company in respect of the company's share capital must not be *ultra vires* (for the shareholders protection) and must not prefer shareholders above the creditors.¹⁸

In the case of *The Ooregum Gold Mining Company of India Ltd v Roper*¹⁹ the judge stated that “the capital is fixed and certain, and every creditor of the company is entitled to look to that capital as his security”.

This was repeated in *Cohen NO v Segal*²⁰ where the court, in prohibiting the payment of a dividend out of share capital declared that,

“Whatever has been paid by a member cannot be returned to him and no part of the corpus of the company can be returned to a member so as to take away from the fund to which the creditors have a right to look as that out of which they are to be paid. The

¹⁶ *Trevor v Whitworth* (1887) 12 app cas 409 (HL) 416.

¹⁷ *Ibid.*

¹⁸ Cilliers (2000) 322, fn 2.

¹⁹ *The Ooregum Gold Mining Company of India Ltd v Roper* (1982) AC 125 at 133.

²⁰ *Cohen NO v Segal* (1970) SA 702 (W) at 705H.

capital may be spent or lost in carrying on the business of the company, but it cannot be reduced except in the manner and with the safeguards provided by the statute.”

2. The present position

The capital maintenance principle was later adopted in statutory provisions of the old Companies Act. Provisions such as section 81 and 82 of the old Companies Act prohibit a company from issuing its shares at a discount unless certain strict precautions have been complied with. Section 79 prohibits a company from paying interest on shares out of share capital unless this is authorised by the articles of association of the company or by a special resolution.²¹

However, the Amendment Act 1999 considerably changed the capital maintenance principle and hence the perceived protection it gave the creditors.²² The amendment adopted two primary international models being the English model “capital maintenance rule” and the American “solvency and liquidity test”. The Amendment Act played a part in removing the outdated capital maintenance rule and established a middle course between the two aforementioned models. As a result, all transactions such as companies acquiring their own shares or dividends being paid out of capital are now allowed subject to the basic requirement of the solvency and liquidity system.²³

As opposed to complying with the burdensome requirements of section 79, the amendment permits a company to simply make a payment, including dividend payments, in terms of section 90 whether out of capital or profits, to its shareholders provided that this is authorised by its articles of association and that it satisfies the tests of solvency and liquidity. A company may, if it so desires, prohibit in its articles of association such “payments”.

Section 90 abandoned the common law concept of capital maintenance and together with it the fundamental common law principle that dividends may only be paid out of distributable profits.

²¹ Companies Act 1973.

²² Cilliers (2000) 322.

²³ Jooste “The maintenance of capital and the Companies Bill 2007” 2007 *SALJ* 710-733.

Section 83 and section 84 of Companies Act 1973, which regulated reductions of share capital, have been repealed by section 8 of the Companies Amendment Act 37 of 1999. The repeal resulted in an end to statutory procedure for the reduction of a company's share capital, except in accordance with section 90 of the Companies Act 1973.

Therefore, as discussed above, a total shift has been made towards solvency and liquidity principle, in that companies can now acquire own shares provided that such transactions comply with the solvency and the liquidity rule.

3. Share repurchases

The important part of the change of the capital maintenance concept is the right conferred by section 85 of the Companies Act 1973 (as amended by section 9 of the Amendment Act 1999), enabling companies to purchase their own shares.

While the capital maintenance concept has been abandoned to some extent, it still remains essential to protect not only the creditors from potential abuse of the share repurchase power but also shareholders, since they are at risk if the share repurchase power is used by a company to discriminate against them.²⁴ The question of whether the common law prohibition on the repurchase by a company of its own shares has been abolished entirely was discussed in *Capitex Bank Ltd v Qorus Holdings*.²⁵

3.1. *Capitex Bank Ltd v Qorus Holdings Ltd*

According to *Capitex Bank Ltd v Qorus Holdings Ltd*,²⁶ “the first case dealing with the statutory provisions relating to share repurchases, the court, correctly with respect, ruled that while the statutory provisions have dramatically changed the capital maintenance rule and the perceived protection it afforded to shareholders, the rule continued to have some residual function in South African law in that it remains an

²⁴ *The Capital Maintenance Concept and Share Repurchases in South African Law - By F.H.I Cassim and Rehana Cassim* <<http://www.bowman.co.za/LawArticles/Law-Article~id~-639353216.asp>>

²⁵ *Capitex Bank Ltd v Qorus Holdings Ltd and Others* 2003 (3) SA 302 (W) at 3081-J; Meskin Henoschsberg on the Companies Act (1989) 179.

²⁶ 2003 (3) SA 302 (W).

important guideline to protect creditors and shareholders against abuse of the power of a company to repurchase its own shares.”

3.2. The statutory provisions on share repurchases

3.2.1. Section 85(1) of the Companies Act 1973, as amended²⁷

Section 85(1) enabled a company to acquire its own shares provided that it was authorised to do so by its articles of association and the share repurchases had been approved by a special resolution concluded by the members of the company. Such approval could have been either a general approval which was valid until the next annual general meeting unless varied or revoked earlier²⁸ or it could have been a specific approval for a particular acquisition.²⁹

3.2.2. Section 48 of the Companies Act 2008

The new Act is wholly based on the solvency and liquidity principle and any remains of the capital maintenance system on which the Companies Act 1973, as amended by the Amendment Act 1999, was based are now removed.³⁰ Section 48 makes provision for a company to acquire its own shares subject to compliance of the approved requirements provided.

4. Conclusion

According to the capital maintenance concept, the share capital of a company is seen as a guarantee fund or a fixed fund intended for the payment of the company's creditors' claims. For this reason the issued share capital of a company may not be reduced, nor may it be returned to shareholders except where the Companies Act or the common law allows. The capital maintenance rule was adopted by the 1973 Companies Act which was then amended by the Amendment Act 1999. The amendment introduced the solvency and liquidity rule, but still had some remains of the capital maintenance rule. The new Companies Act eliminates all remaining ideas

²⁷ Amendment Act 1999.

²⁸ Section 85(2) and (3) of companies Act 1973.

²⁹ Section 85(2) of companies Act 1973.

³⁰ Delpont *New Companies Act Manual* (2009) 31.

of the capital maintenance rule and as the result, the Act is solely based on the solvency and liquidity principle.

CHAPTER 3

ANALYSIS OF SECTION 48 OF COMPANIES ACT 2008

Contents

Introduction: Basic allowance
The breakdown of the subsections of section 48
Conclusion

1. Introduction: Basic allowance

Section 48 of the Companies Act 2008 is the main operative section of this research. The section makes allowance for companies to acquire their own shares or for subsidiaries to acquire shares from their holding companies. This certainly as discussed above³¹ is a clear shift from the capital maintenance principle/rule used prior to 1999³². For protection of shareholders and creditors the Act also provides for exceptions where the company or its subsidiaries may not acquire the company's shares. In this chapter focus is made on this provision and an attempt is made to explain it in detail for better understanding.

2. The breakdown of the subsections of section 48

2.1. Section 48(1): The Exception

This section does not apply to—

(a) “The making of a demand, tendering of shares and payment by a company to a shareholder in terms of a shareholder’s appraisal rights set out in section 164”; or

³¹ Ch 2 of this dissertation.

³² Companies Act amended.

(b) “the redemption by the company of any redeemable securities in accordance with the terms and conditions of those securities”.

According to section 48(1)(a), this section will not apply where section 164 is in operation, meaning that where there is a demand in terms of section 164 of the new Act in respect of appraisal rights of the shareholders.

Section 164 of the Act will come into operation where a company, except under a business rescue plan, chooses to amend the company’s memorandum of incorporation, changing preferences, rights, limitations and any other terms of its share that will materially affect the interest of the holders.³³ It may also come into operation where the company chooses to enter into transactions such as disposal of all or greater part of assets or undertakings³⁴ or proposal for merger or amalgamation³⁵ or proposal for a scheme of arrangement³⁶. The company must notify the shareholders of such resolutions or transactions and also include a statement in the notice informing them of their appraisal rights in terms of section 164.³⁷ A shareholder can therefore make a demand to the company to buy his/her shares provided that the shareholder had sent the company a notice of objection, objecting to a resolution to amend the Memorandum of Association and the company nevertheless adopts the resolution and as a result of the adoption, the holder’s shares are materially and adversely affected by the amendment of the Memorandum of Association. The shareholder must have been present at the meeting, must have voted against the resolution and must have complied with the procedural requirement of section 164.³⁸

Therefore, any payment made in respect of section 164 of the Act, the company will not be required to comply with the requirement of section 48 as it will not constitute the acquisition of own share as in terms of section 48 of the Act.

³³ Note: s37(8) of the Act requires for a shareholder’s shares to be materially and adversely affected by the amendment of the memorandum before s/he can rely on the relief offered by section 164.

³⁴ S112.

³⁵ S113.

³⁶ S114.

³⁷ Delport (2009) 118.

³⁸ S164(5) Companies Act 2008.

Furthermore, according to Section 48(1)(b) where a company is buying back redeemable securities in accordance to those securities' terms and conditions, the requirements provided in section 48 of the Act will not apply.

2.2. Section 48(2): The requirement of section 46

The authority of the company to acquire its own shares or of a subsidiary acquiring shares of its holding company is derived from section 48(2). Section 48(2) of the Act provides that, subject to subsections (3) and (8) (which will be discussed below), and if the decision to do so satisfies the requirements of section 46 of the Act, the board of a company may decide that the company acquire some of its shares; and also the board of a subsidiary company may decide to acquire shares of its holding company. However, subsidiaries may not acquire more than ten percent (10%) in total of the number of issued shares of a holding company and no voting rights attached to such shares may be exercised for as long as they are held by the subsidiaries.

The reason for section 48(2)(a) seems unclear. It is argued that the provision is superfluous for the reason being, a buy-back is included in the definition of a distribution, therefore the requirements of section 46 will apply anyway and there is no need to stipulate such in section 48.³⁹

Section 46 makes provision for the distribution of company funds. Before a company can make any distribution such as a payment for consideration for purchase of shares, the requirements so provided in the section must be complied with.⁴⁰ The requirements provided are; a resolution by the board authorising the distribution; and it must reasonably appear that the company will be solvent and liquid after the proposed transaction/distribution and the board must by way of resolution acknowledge that the solvency and liquidity test was applied and it reasonably concluded that the company will be solvent and liquid immediately after the transaction/distribution. Therefore according to section 48 of the Act, a company must comply with section 46 before it can acquire its shares.

³⁹ Jooste "Financial assistance - a new approach" 2009 *SALJ* 566 at 638.

⁴⁰ *Ibid.*

It is clear that although section 48 authorises the purchase of the company shares, it does not directly inform us what the status of the shares is after they have been acquired by the company. However section 35(5) seems to provide a clear status for the shares. According to section 35(5), shares that have been issued and subsequently required by that company as in terms of section 48, or surrendered to that company in terms of shareholder exercising appraisal rights,⁴¹ the shares will have the same status as shares that have been authorised, but not issued.

2.3. Section 48(3): Instances where shares may not be acquired

According to section 48(3), a company cannot acquire its own shares or a subsidiary cannot acquire shares of its holding company if after the acquisition the only issued shares remaining are those held by the company's subsidiaries or are convertible or redeemable shares.⁴² Therefore, this section limits the authorisation of section 48, meaning that even though the company can acquire its own shares, it cannot do so under these circumstances.

“The rationale for the requirement that a buy-back must not result in a company being left with only redeemable shares is presumably to prevent a situation arising where the company, as a result of a redemption of the redeemable shares, has no shares.”⁴³ It can also be argued that the rationale behind the fact that a company cannot acquire its own shares if it will only be left with convertible shares is to prevent a situation where the company is left with no voting shares.⁴⁴

The exception in respect of shares held by the subsidiaries seems irrelevant given the general restriction that the aggregate shares acquired by the subsidiaries from the holding company must not exceed ten percent (10%).⁴⁵

⁴¹ S164.

⁴² Delpont (2009) 35.

⁴³ Jooste 2009 SALJ 566 at 640.

⁴⁴ *Ibid.* Jooste argues that it is possible for a company to have convertible voting shares and that when they are converted the company could be left with shares that have no voting rights.

⁴⁵ Delpont (2009) 35, fn 24.

2.4. Section 48(4): The agreement for acquisition of own shares

Section 48(4) provides for the enforcement of the agreement concluded by the company to acquire the shares of a shareholder.

“An agreement with a company providing for the acquisition by the company of shares issued by it is enforceable against the company, subject to subsections (2) and (3).”

Therefore, according to this section, an agreement between the company and any shareholders to pay the holder for their shares is valid and enforceable against the company.

2.5. Section 48(5): The impossibility of the company to fulfil the agreement to acquire own shares

Section 48(5) provides that, where a company claims that it cannot make payment in respect of the acquisition of its shares from the shareholders for the reason being that in doing so it will not comply with subsection (2) or (3), the company must make an application to the court declaring such. The company must satisfy the court that it cannot make the payment in fulfilment of its obligation as doing so will result in the company being in breach of the relevant subsections. If the court is satisfied that the company is prevented from making any payment, it may make an order that is just and equitable and also ensure that the person, to whom the company is obligated to, receives the payment as soon as the company can satisfy its obligations as they fall due.

2.6. Section 48(6): Irregular acquisition of own shares resulting in reversal of the acquisition

According to section 48(6), any transaction which is contrary to section 46, must be reversed in no more than two years after the acquisition. Therefore, any acquisition of shares which does not comply with the distribution requirements must be reversed by the company in order to rectify the fault. According to the section, the company may approach the court for an order to reverse such acquisition and for the court to order the involved person from whom the shares were acquired to return the amount or any other consideration paid by the company. The company must then issue such person

an equivalent number of shares from the same class as those acquired by the company.

According to the Act, primarily section 46 dealing with distribution, a contravention of such a section, where a transaction is made without fully complying with the requirement provided by the section may not necessarily mean that such a transaction is irregular, however, the payment of the transaction will be unlawful. Therefore, an acquisition of shares from a shareholder, provided he is a *bona fide* seller, is legal even though it does not comply with the section. However, a payment of such acquisition which does not comply with distribution requirements in terms of section 46 is illegal. In such instances, the company must reverse the transaction and the *bona fide* seller may rely on the common law and section 48(7) for relief. In terms of the common law and the effect of section 48(7) of the Act, it seems as though a *bona fide* seller may have a claim for damages from the company where he/she has suffered damages as a result of a compulsory reversal of an acquisition.

2.7. Section 48 (7): Directors liability

Section 48(7) deals with directors' liability for non compliance of the requirements provided by section 48. According to section 48(7) read with section 77(3)(e)(vii), where a director was present at a meeting when the board of the company approved an acquisition of shares as in terms of section 48 and he/she participated in the making of such decision⁴⁶ or failed to vote against the decision to acquire the shares despite knowing that such acquisition is contrary to section 46 or 48, he/she will be held personally liable. One should view the definition of "knowing" as provided by the Act in section 1.

The term "knowing", as defined by section 1 of the new Act, is widely formulated in that it will prove difficult for a director to prove that he had acted without knowing that the transaction was in contravention of section 46 or section 48 of the Act. The director will be accountable to the company. In some instances however, the court may order the company to indemnify the directors involved.

⁴⁶ S74 of Companies Act 2008.

“If the board of a company has made a decision contrary to s 46 or s 48 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.⁴⁷The court may make an order setting aside the decision in whole or in part, absolutely or conditionally, and any further order that is just and equitable in the circumstances, including an order; to rectify the decision, reverse any transaction, or restore any consideration paid or benefit received by any person in terms of the decision of the board (s 77(5)(ab)(ii)(bb); and requiring the company to indemnify any director who has been or may be held liable in terms of this section, including indemnification for the costs of the proceedings under this subsection (s 77(5)(b)(ii)(bb)).”⁴⁸

The Act states that the director will be liable if he/she had knowledge at the time of the voting that the resolution is in contravention of section 46 and section 48. Therefore, it does not make sense that the directors need to be indemnified in any way.⁴⁹ If they are at fault, they must be held accountable.

3. Conclusion

Section 48 of the Companies Act allows companies to acquire their own shares or for the subsidiaries to acquire shares from their holding companies. The requirements of section 48 as well as the requirements of section 46 which deal with distribution, have to be met. A company buying its own shares falls into the scope of distribution as the company will be required to make payment for the purchase of the shares. Therefore, for a proper acquisition of shares from the shareholders, the Act requires a resolution by the board of the company favouring the acquisition of such shares and the solvency and liquidity test requirement to be met.

⁴⁷ S77(5)(a).

⁴⁸ Jooste 2009 SALJ 566 at 648-9.

⁴⁹ *Ibid.*

CHAPTER 4

ANALYSIS OF THE REQUIREMENTS OF SECTION 48

Contents

Introduction
Distribution
Distribution requirement
Consequences of non-compliance of section 46
Conclusion

1. Introduction

The Act does not have separate rules for different kinds of distribution. Any kind of distribution is dealt with by section 46 of the new Companies Act. Section 48 of the Act only deals with company acquisitions of its own shares from its shareholders and does not provide for distribution requirements. Section 48 makes reference to section 46 of the Act as one of its requirement which has to be complied with for a proper acquisition of its shares.

According to section 48(2) of the new Act, before any acquisition can take place, the requirements of a distribution as provided for in section 46 of the Act must be complied with. This chapter explores the distribution requirement as provided by section 46.

2. Distribution

All kinds of distribution must be regulated so as to protect companies' minority shareholders and their creditors.⁵⁰ "Company law regulates distributions in order to ensure firstly that the rights of creditors are not endangered and secondly that shareholders are not disadvantaged by disproportionate payments either within a single class of shareholders or among different classes."⁵¹ Previously, the shareholders and creditors were protected by the capital maintenance system which was later embedded in the Companies Act 1973 until it was amended by the Amendment Act 1999. The Amendment Act abolished the capital maintenance principle to an extent, giving companies permission to acquire their own shares and also pay dividends to their shareholders out of the companies' capitals. The new Companies Act completely removed all the remains of the capital maintenance system and is solely based on the solvency and liquidity principle. The principle/ rule of solvency and liquidity as set out in section 4 of the Act must be complied with whenever there is a distribution.⁵²

Section 1 of the Act, defines a distribution in three parts. Firstly, it is a transfer of money or property of a company by the company to or for the benefit of a shareholder/s or holder/s of a beneficial interest in any shares of the company or shares of another company in the same group: Secondly, it is the incurrance of a debt or obligation by a company for the benefit of a shareholder/s of the company or another company in the same group: Thirdly, it is a forgiveness or waiver of a debt or obligation owed to a company by a shareholder/s of the company or another company of the same group of companies.⁵³ Therefore, whenever any of these actions occur, whether directly or indirectly, in that there's a transfer of money or property or incurrance of a debt by a company or forgiveness of a debt, a distribution is made and the requirement of solvency and liquidity must be complied with.⁵⁴

⁵⁰ Jooste "Issues relating to the regulation of 'distributions' by the 2008 Companies Act" 2009 *SALJ* 627

⁵¹ Van der Linde "The regulation of distributions to shareholders in the Companies Act 2008" 2009 *TSAR* 484 at 627.

⁵² Van der Linde 2009 *TSAR* 484.

⁵³ Van der Linde 2009 *TSAR* 484-486.

⁵⁴ Van der Linde 2009 *TSAR* 484 at 486.

The definition expressly excludes any of these actions if taken when a company is in final liquidation. When a company is being liquidated, any remaining assets are distributed to the shareholders only when all the company's debts have been paid, therefore there is no need to protect the creditors.⁵⁵

There seems to be a loop hole in the definition of distribution.⁵⁶ Section 1 of the Act, part (a), defines a distribution as a transfer of money or property and so on and then it gives examples of actions (I) to (IV) which constitutes a distribution. According to part (a), the money or property is transferred to shareholders as dividends, or as payment for capitalization of shares, or as consideration for the acquisition of shares, and in respect of share as in terms of section 164(19). What is not clear is whether or not these examples also apply to parts (b) and (c) of the definition. If they don't fall into parts (b) and (c) a loophole is present. A company, for example, can incur debt for its shareholder or forgive its shareholder the debt owed as a consideration for the acquisition of the company shares. As the definition does not properly provide for such an act, it does not constitute a distribution and the company escapes complying with the solvency and liquidity test. It is argued that the section/definition should be more clear whether or not the sub-parts (I) to (iv) of part (a) also apply to parts (b) and (c) or otherwise have them removed from the section completely.⁵⁷

According to the definition, the transfer of money or property to a shareholder of the company or another company within the same group of companies, as a consideration for the acquisition of its own shares is a distribution. Section 46 of the Act regulates distribution and all its requirements must be complied with.

3. Distribution requirement

3.1. Section 46 (1)

“A company must not make any proposed distribution unless—
(a) the distribution—

⁵⁵ *Ibid.*

⁵⁶ Jooste 2009 SALJ 627 at 634.

⁵⁷ *Ibid.*

- (i) is pursuant to an existing legal obligation of the company, or a court order; or (ii) the board of the company, by resolution, has authorised the distribution;
- (b) it reasonably appears that the company will satisfy the solvency and liquidity test immediately after completing the proposed distribution; and
- (c) the board of the company, by resolution, has acknowledged that it has applied the solvency and liquidity test, as set out in section 4, and reasonably concluded that the company will satisfy the solvency and liquidity test immediately after completing the proposed distribution.”

According to section 46 of the Act, a company can make a distribution only if the distribution is in pursuant to an existing legal obligation of the company or a court order or that the distribution is authorised by the board of the company. It must also reasonably appears that the company will satisfy the solvency and liquidity tests immediately after the distribution. The board, by way of a resolution, must acknowledge that the solvency and liquidity test was applied and that it reasonably concluded that the company will satisfy the test.

Therefore, for a company to acquire its own shares or for a subsidiary to acquire shares from its holding company, the solvency and the liquidity test as required by section 46 must be complied with. A company’s assets must be more than its liabilities and it must be able to pay its debts as they fall due in the course of business after the acquisition.⁵⁸

3.2. Breakdown of section 46 requirements

- The distribution must be pursuant to a legal obligation or a court order, or
- It must be authorised by the board by way of a resolution.⁵⁹ Before the board can resolve, it must reasonably appear that the company will satisfy the solvency and liquidity test immediately after it acquires the shares. The board must also acknowledge by a resolution that the solvency and liquidity test was applied and it reasonably concluded that the company will satisfy the test after the acquisition.

⁵⁸ S4 of Companies Act 2008.

⁵⁹ S46 of the Companies Act 2008.

Therefore, not only must it reasonably appear that the company will satisfy the test immediately after the distribution, but the board must also confirm that the test was applied. These two seem to be in conflict with each other. It is uncertain why section 46(1)(b) is required for compliance of the section if the board is required to prove that the test was applied. A mere appearance should not really be a requirement.⁶⁰

4. Consequences of non-compliance of section 46

The Companies Act 2008 holds directors liable for unlawful distributions, however, the liabilities of shareholders who receive the unlawful distribution is not regulated and will have to be determined by the common law rules.⁶¹

A distribution in contravention of section 46 is not void unless a court declares it void.⁶² Therefore, if the court does not declare it void, the distribution/acquisition which does not comply with section 46 (the solvency and liquidity test) will be valid but voidable. However a director may be held liable.

According to section 46(6), directors can be held liable for any loss, damages, or cost suffered by a company, if as provided in section 77(3)(e)(vi) of the Companies Act 2008, the director was present at the meeting where the board approved of the distribution which is in contravention with section 46 or participated in the making of such decision and had failed to vote against the distribution, despite knowing it is contrary to section 46. Directors can only be held liable for any loss, damages, or cost suffered by a company.⁶³ It can be concluded from this section that liability will still follow even if the resolution for the transaction has not been declared void.⁶⁴

The liability of a director who failed to vote against the aforementioned resolution will only rise if immediately after the distribution, the company does not meet the solvency and liquidity test and if it was unreasonable to conclude that the company will satisfy such test after the distribution.

⁶⁰ Van der Linde 2009 *TSAR* 484-501.

⁶¹ Van der Linde 2009 *TSAR* 484 at 499.

⁶² S218.

⁶³ Delport (2009).

⁶⁴ Delport (2009) 34, fn 20.

According to section 77(4), “the quantity of the liability is the maximum of the differences between the values by which the distribution exceeded the amount that would have been distributed without causing the company to fail to satisfy the solvency and liquidity test and the amount, if any, recovered by the company from the persons to whom the distribution was made”.⁶⁵

Therefore, there is the requirement that the section 46 must be complied with, however, non-compliance will not render the transaction void unless it is declared void by the court as in terms of section 218 of the new Act. Whether or not it is declared void, liability will fall upon a director who was present at the meeting and did not vote against the distribution, despite knowing it is contrary to section 46 of the Act. For a proper distribution, the board must always authorise it and the solvency and liquidity test must be complied with.

5. Conclusion

Section 48 of the Act makes a cross-reference to section 46. According to the Act, before section 48 can be complied with the requirements provided in section 46 must be satisfied. The following chapter discusses in detail the requirements of solvency and liquidity as provided by section 46.

⁶⁵ Delport (2009) 35.

CHAPTER 5

SOLVENCY AND LIQUIDITY

Contents

Introduction
The liquidity and solvency test
Analysis of the test
Conclusion

1. Introduction

“The solvency and liquidity test is set out in section 4 of the new Act. The test comprises of a solvency element and a liquidity element, both of which must be satisfied.”⁶⁶

Essentially, liquidity refers to a company having or being able to easily access cash which it can use to pay its debts as they fall due. Merely having assets is not enough, the company has to be able to satisfy its debts as they fall due, without having to look to the assets for the cash. Solvency on the other hand means at some point or at any given time the company’s assets are greater than its liabilities. If the company’s liabilities are greater than its assets, it will be referred to as insolvent as in accordance to section 4 of the Companies Act 2008.

It is possible to be liquid and insolvent at the same time. This can happen where a company can still pay its debts as they fall due whilst its balance sheet shows that its liabilities are greater than its assets.⁶⁷

⁶⁶ Van der Linde “The Solvency and Liquidity approach in the Companies Act 2008” 2009 *TSAR* 224 at 225.

⁶⁷ Roodt inc *The solvency and liquidity test - what it means and when it applies* sourced at

Vice versa is also possible. For example, a company may have/own assets, of which it has fully paid for, but at the same time it cannot pay its debts as they fall due meaning the company has no cash to make any payments unless it sells its assets. The company is therefore solvent but not liquid.⁶⁸

2. The liquidity and solvency test

2.1. Companies Act 61 of 1973

The old Companies Act (as amended by the Amendment Act 1999) introduced the solvency and liquidity system. The authority is primarily entrenched in section 85(4)(a) and (b) of the Act. The section states that,

“a company shall not make any payment in any form for the acquisition of its shares if there are reasonable grounds for believing: (a) the company is, or would after the payment be, unable to pay its debts as they become due in the ordinary course of business (liquidity test) or (b) the consolidated assets of the company fairly valued would after the payment be less than the consolidated liabilities of the company (solvency test).”⁶⁹

Therefore, according to the section, a company is prohibited from acquiring its own shares if it is insolvent or illiquid or it will become insolvent or illiquid after the acquisition.

2.2. Companies Act 71 of 2008: Section 46

“(1) For any purpose of this 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—

- (a) the assets of the company, as fairly valued, equal or exceed the liabilities of the company, as fairly valued; and
- (b) 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—

<http://www.roodtinc.com/newsletter45.asp> (November 2011).

⁶⁸ *Ibid.*

⁶⁹ S85(4)(a)and(b) of Companies Act 1973.

- (i) 12 months after the date on which the test is considered; or
- (ii) in the case of a distribution contemplated in paragraph (a) of the definition of distribution in section 1, 12 months following that distribution.”

Therefore, the solvency and liquidity test is a prerequisite to any distribution made by a company as in terms of section 46 of the Act. The test set out in section 4 of the new Act is more precise and different from the old Act. The solvency and liquidity test plays an important role in company law dealing with distributions, share repurchases, financing assistance by a company for the purchase of own share, financing assistance given to the company directors and to mergers and amalgamation.⁷⁰

There are several circumstances in the new Act that require the solvency and liquidity test application such as;

- I. Section 22 of the Companies Act which prohibits a company from trading in insolvent circumstances,
- II. Section 44 dealing with provision of financial assistance to third parties so that they may acquire the company shares,
- III. Section 45 dealing with loans and other financial assistance to related parties, including directors, subsidiary companies and holding companies,
- IV. Section 46 dealing with dividend or other distributions to shareholders as defined in section 1 of the Act,
- V. Section 47 dealing with issues of capitalisation of shares where the receiver may choose whether to receive shares or cash, and
- VI. Section 48, dealing with share-buy backs or when a company buys back its own shares to be exact.

The solvency and liquidity test must be satisfied in each of these circumstances. The Act imposes a duty on companies' directors to question whether the test has been met. In terms of the Act, section 4, the board must question whether “considering all reasonable, foreseeable financial circumstances of the company at the time”⁷¹ the company will pass the solvency and liquidity test after a transaction/distribution.⁷²

⁷⁰ Cassim *The practitioner's guide to the Companies Act 71 of 2008* (2011) 119.

⁷¹ S4(1) of Companies Act 2008.

⁷² Roodt Inc (2011).

Therefore, according to the Act, for the solvency and liquidity test to be satisfied with, at the time the decision was taken, the assets of the company as fairly valued must equal or exceed the liabilities of the company as fairly valued. It must also appear that the company will be able to pay its debts as they become due in the ordinary course of business for the following period of twelve months after the test is considered or if it is a distribution, then twelve months after the distribution.⁷³

In applying the solvency and liquidity test, only accounting records that comply with section 28 and financial statements complying with section 29 and any fair valuation of the company's assets and liabilities, or other valuation that is reasonable in the circumstances, are used in the computation.⁷⁴

The test as provided by the Act is subjective, in that the board must be satisfied that the company is actually insolvent and that it reasonably appears that it will be able to pay its debts after the transaction for the following twelve months. If a company becomes insolvent and/or illiquid after the board has been satisfied, the validity of the transaction will not be affected and the directors will not be held liable.⁷⁵

3. Analysis of the test

3.1. The solvency element

The solvency element requires that, at a particular time “considering all reasonably foreseeable financial circumstances of the company at the time”⁷⁶ the fairly valued assets of the company must be equal or exceed the fair value of the liabilities of the company.⁷⁷ Rather than relying on the actual financial position of the company, the element relies on or has its basis on a prediction of the position of the company immediately after the distribution or transaction. The board, therefore, does predict that the assets of the company will be more than its liabilities after the transaction or distribution.⁷⁸

⁷³ S4(1) of Companies Act 2008.

⁷⁴ Delpont (2009) 32; s(4)-(2) of the Companies Act 2008.

⁷⁵ Delpont (2009) 32.

⁷⁶ S4(1).

⁷⁷ Van der Linde 2009 TSAR 224 at 227.

⁷⁸ *Ibid.*

3.2. The Liquidity element

The liquidity element requires that at a particular time “considering all reasonably foreseeable financial circumstances of the company at the time”⁷⁹, it appears that company will be able to pay its debts as they become due in the ordinary course of business.⁸⁰ The element only applies to individual companies and not a group, unlike the solvency element.⁸¹ However, like the solvency element, the liquidity test also involves prediction. The board must predict whether or not the company will be able to pay its debts when they fall due after a transaction/distribution. If the prediction was reasonable the test will still have been satisfied even though at a later stage the prediction appears to be wrong, meaning that the company ends up being unable to pay its debts. In such instances, the transaction’s validity will also not be affected.⁸²

3.3. When must the test be considered and satisfied?

According to the Act, the test must be considered when the company intends to make a proposed distribution.⁸³ “The effect of the distribution must be determined with reference to the time when it is authorised by the board and not when the debt or obligation is satisfied.”⁸⁴

3.4. Consequences of non-compliance of the solvency and liquidity test

It is argued that the solvency and liquidity test is a subjective test because the board must apply its mind to the test and be satisfied that the company is actually solvent and reasonably predict that it will be able to meet its debts as they fall due in the ordinary course of business for the following twelve months.⁸⁵ Therefore, if the board was indeed satisfied, and later after the transaction it is found that the company is insolvent and/or illiquid, the transaction will not be affected and the directors will not be held liable.⁸⁶

⁷⁹ S4(1).

⁸⁰ Van der Linde 2009 *TSAR* 224 at 225.

⁸¹ Van der Linde 2009 *TSAR* 224 at 229.

⁸² Van der Linde 2009 *TSAR* 224 at 236.

⁸³ Van der Linde 2009 *TSAR* 224 at 233.

⁸⁴ Van der Linde 2009 *TSAR* 224 at 234.

⁸⁵ Delpport (2009) 32.

⁸⁶ *Ibid.*

According to section 46 of the new Act, a director will be personally liable if he or she was present at the meeting and/or participated and did not vote against a resolution knowing it was contrary to section 46.

4. Conclusion

Therefore, before a company can acquire its own shares or before a subsidiary acquires shares from its holding company, the solvency and liquidity test, in accordance to section 46, must be complied with. The directors are required to consider the solvency and liquidity of the company at the meeting, before making a resolution. The board has to reasonably predict that the company's assets will exceed its liabilities and that it will be able to meet its debts as they fall due. Failing to do so, the Act will hold the directors who were present at the meeting and did not vote against the resolution, knowing it was contrary to the solvency and liquidity requirement, personally liable. The issue that has yet to be answered in this dissertation is whether or not the solvency and liquidity principle provides sufficient protection for the shareholders and the creditors of a company.

CHAPTER 6

PROTECTION OF THE CREDITORS AND SHAREHOLDERS

Contents

Introduction
Protection of creditors
Protection for shareholders
Conclusion

1. Introduction

Initially companies were prevented from acquiring their own shares.⁸⁷ Until the Companies Act was amended, this rule was embedded in the old Companies Act which prohibited a company from buying its own shares even if the transaction was authorised in the company's articles of association (hereinafter articles).⁸⁸ The Amendment Act 1999 changed the old Companies Act, ending the common law principle of capital maintenance.⁸⁹ A company could then acquire its own shares, finance others to buy the company shares, make payments to shareholders in their capacities as shareholders and pay out dividends from the company's capital,⁹⁰ all provided that the articles of the company authorised it. There must also be reasonable grounds for believing that after the transaction/distribution, the company will be able to pay its debts as they fall due and that after the payment, its consolidated assets will exceed its consolidated liabilities.⁹¹ The new Companies Act is wholly based on solvency and liquidity unlike its predecessor. The new Act removes all the remnants of the capital maintenance system.

⁸⁷ Trevor v Whitworth.

⁸⁸ Cilliers (2000) 351.

⁸⁹ Cilliers (2000) 351.

⁹⁰ Cassim (2011) 115.

⁹¹ Cilliers (2000) 351.

The main purpose for the capital maintenance system was to protect shareholders and creditors, but mostly to ensure the creditors. According to the system, as explained in detail above,⁹² a company was not to touch its share capital. The creditors of the company were expected to look to the company's capital to satisfy their debts, so the demand for a company to maintain its capital is primarily for the creditors' assurance and protection. It was argued however that the system did not truly protect the creditors and that its regulations which applied the principle were not precise.⁹³ It was also argued that it left the companies vulnerable to share prices manipulation.⁹⁴ The Companies Acts were introduced based on a different principle eliminating the system of capital maintenance. The new system introduced was of solvency and liquidity⁹⁵. This chapter discusses how this new system, unlike the capital maintenance system, better protects companies' creditors and shareholders.

2. Protection of creditors

As companies are now allowed to acquire their own shares, the companies' share capital is now affected. However, this will not prejudice the creditors based on the fact that the system of solvency and liquidity is in operation. According to this system, a company may only acquire its own shares and a subsidiary may acquire shares from its holding company if it reasonably appears that immediately after the acquisition the company will be able to pay its debts as they became due (liquidity test) and that its total assets exceed its total liabilities immediately after the payment (solvency test).⁹⁶

According to the companies Act, if this requirement is not complied with, in that a company acquires shares contrary to section 48 (governing share acquisition) and section 46 (governing distribution), it has to apply to court in no more than two (2) years, for an order commanding the shareholder or ex-shareholder to return the amount paid to him or her by the company for the shares and for the company to issue the person an equivalent number of shares of the same class as the ones

⁹² Ch 2 of this dissertation.

⁹³ Cilliers (2000) 322.

⁹⁴ *Ibid.*

⁹⁵ Ch 4 of this dissertation.

⁹⁶ S48 the companies Act 2008 read with section 46 of the Companies Act 2008.

he/she had. The court may make any other order it thinks fit.⁹⁷ The previous Act allowed a company's creditor to apply to court for such orders.⁹⁸ This gave the creditors assurance that if the company was illiquid or insolvent, no share repurchases/acquisition could take place⁹⁹ and if it did, he/she could approach a court for a reversal of the transaction. However, unlike the old Act, the new Act does not provide creditors with such a specific remedy in similar circumstances.

“If a company acquires its own shares or shares in its holding company contrary to s 46, it is the company that is given the right to apply to court in terms of s 48(6). Section 48(6) does not give such right to a shareholder or creditor of the company. By contrast, s 86(3), read with s 89 of the current Act, gives both shareholders and creditors the right to apply to court for repayment of the amount paid for the acquisition.”¹⁰⁰

The Act also provides for liability against the directors of the company if they are party to such acquisition. They will be liable for any loss, damages or cost sustained by the company as a result of the contravention of section 46 and 48 of the Act. According to section 48 of the Act, a director will be held liable if he/she was present at the meeting and did not vote against it despite knowing that it was contrary to section 48 or 46 of the Act.¹⁰¹ This regulation ensures that the directors act cautiously so as not to incur liability upon themselves. The directors are aware that in the event of any careless conduct by them resulting in the company becoming illiquid and/or insolvent, they will be held personally accountable hence giving the creditors further protection from directors' negligence.

3. Protection for shareholders

The shareholders were at first protected by section 85(1) of the old Act. According to the section the shareholders were protected, in the sense that before any repurchase of shares, a special resolution had to be attained. If a company wanted

⁹⁷ Cassim *Contemporary Company Law* (2011) 279.

⁹⁸ Cilliers (2000) 324.

⁹⁹ Cassim *Contemporary Company Law* (2011) 118.

¹⁰⁰ Jooste “Issues relating to the regulation of ‘distributions’ by the 2008 Companies Act” 2009 *SALJ* 627 at 647. He compares the old Act's protection with the new Act's which is now the Act in operation.

¹⁰¹ S48(7) of the Companies Act.

to acquire its own shares, it had to distribute an offering circular to all shareholders holding shares of the class about to be repurchased, explaining the proposal and all the merits and demerits of the proposed acquisition. The shareholders could then make informed decisions. However, the new Act has changed all this.

Section 48 of the Act provides that the requirements of section 46 for a distribution must be met for a permissible acquisition of own shares by a company. Section 46 of the Act, as previously explained in detail,¹⁰² provides that a distribution must be authorised by the board's resolution. Therefore, the board of the company and not the shareholders authorise the acquisition of company shares.¹⁰³ The shareholders are therefore excluded from the decision making. The directors may resolve to acquire company shares from its shareholders without informing the shareholders, unless it is in relation to section 48(8) of the Act. It does not make sense that the shareholders are excluded from the decision making as the repurchase/acquisition of the shares may highly affect them. It is argued:

“A share repurchase entails a change in the ownership of the company's shares, and . . . may thus be used to change control of a company or, for that matter, to prevent a change of control; or it may be used to manipulate the market price of the company's shares. Share repurchases clearly have a . . . potential for unequal treatment of shareholders. In short, the share repurchase power may be abused and it may, unless safeguards are provided, enable one group of shareholders to obtain an unfair advantage over other shareholders. . . . It is not enough to protect creditors — shareholders and the investing public must also be protected.”¹⁰⁴

Therefore, not enough protection is put in place for the shareholders. Directors or some shareholders may abuse the repurchase power so as to gain power over the company and remove a shareholder/s from the company. Creditors are protected but clearly the shareholders are not sufficiently protected.¹⁰⁵

¹⁰² Ch 3.

¹⁰³ Jooste 2009 *SALJ* 627 at 637.

¹⁰⁴ Cassim “The reform of company law and the capital maintenance concept” (2005) 122 *SALJ* 283 at 287- 8.

¹⁰⁵ *Ibid.*

The shareholders are not told of the merits and the demerits of the acquisition, no circulars in a prescribed form have to be sent to all shareholders as required in the Companies Act 1973. The new Act also does not provide for a distinction between general and selective offers,¹⁰⁶ hence inviting mischief and abuse of repurchase power.¹⁰⁷ Even though the previous Act seemed to have better protection, it is argued that,

“the safeguard provided by our companies Act are not only inadequate; there are clearly rudimentary, and require further thought and analysis. The provisions of the Act relating to selective share repurchases leave too much scope for mischief. Specific statutory safeguards must be provided to guard against a very real danger of abuse here. It is not a sufficient safeguard that at common law the directors have a fiduciary duty to act *bona fide* in the best interest of the company with the primary motive of perpetuating themselves in office”.¹⁰⁸

Share-repurchase, specifically selective repurchase, encourages abuse of power.¹⁰⁹ A company may have various motives for wanting to acquire its shares back, such as to accommodate a shareholder who wants to retire or to leave the company for some reason or the company may want to re-purchase its shares so as to shift control of the company or even get rid of a shareholder.¹¹⁰ Hereunder is an example where such abuse or manipulation may take place.

“In a going private transaction a company’s management or controllers could use a share repurchase as a way of increasing their own shareholding to a level where they are able to freeze out the remaining shareholders by compulsorily acquiring their shares. Similarly, in an empowerment transaction the idea may be to repurchase shares from shareholders other than black investors so that the resultant stake of the black investors is increased.”¹¹¹

¹⁰⁶ Unlike s87 of Companies Act 2008.

¹⁰⁷ Cassim *Contemporary Company Law* (2011) 276.

¹⁰⁸ *Ibid.*

¹⁰⁹ Van der Linde “Share repurchases and the protection of Shareholders” 2010 *TSAR* 288 at 289.

¹¹⁰ Van der Linde 2010 *TSAR* 288 at 289.

¹¹¹ *Ibid.*

The company can achieve such objectives by offering selective repurchase whereby they repurchase shares selectively, making sure its offer is directed to specific shareholders.

Section 48 of the new Act, however, has a provision which provides for some amount of protection to the shareholders. According to Section 48(8) of the Act, a special resolution will be required if the company is to repurchase shares from a director or a prescribed officer, or to a person related to either of them. Therefore, in such instances, the board's resolution will not be enough. This requirement was introduced to prevent directors from benefiting themselves by abusing their positions.¹¹²

The shareholders may also rely on the fiduciary duties of the directors of the company. The directors are required to exercise their powers for a proper purpose. However, it seems this protection is not concise or predicate. A precise protection needs to be developed and made predictable for the protection of the shareholders.¹¹³

4. Conclusion

Therefore, it appears that section 46 and 48 of the new Act, governing distribution and acquisition, do not sufficiently protect the shareholders and creditors as its predecessor did. In terms of the new Act, the board of the directors have almost all the power. The creditors and the shareholders are protected by the solvency and liquidity system, to an extent, by the fact that there cannot be a transaction/acquisition until the test is satisfied. As the Act requires a company to be solvent and liquid before any distribution is made and that it must remain solvent and liquid after the acquisition, the creditors are assured that their debts will be satisfied when they are due.

The shareholders are not as assured as the creditors. They are excluded in the decision making of whether or not to acquire company shares. The shareholders are not given the chance to decide if the acquisition will be good or bad even though the

¹¹² Cassim *Contemporary Company law* (2011) 277.

¹¹³ Van der Linde 2010 *TSAR* 288 at 299.

transaction might affect their interests adversely. This may encourage abuse of the power of re-purchase/acquisition and some shareholders may engage in mischief so as to gain or shift control of the company. The directors have absolute power in this matter and the shareholders are left to rely on the fact that the directors have to act in good faith and for the best interest of the company or else be held accountable. The creditors and the shareholders can also rely on the fact that the Act places liability on directors if the transactions/acquisitions are in contravention of section 46 and 48 and they did not vote against it.

CHAPTER 7

CONCLUSION

Contents

Section 48
Protection to the creditors and the shareholders

1. Section 48

A company needs capital to exist and be able to carry out its operations. In order to protect companies' capital, various capital rules were adopted to restrict companies from concluding transactions that will adversely affect the capital of the company. Creditors of the company were expected to look to the company funds/capital for satisfaction of their debts, therefore, any payments made by a company from its capital, reducing its capital, will adversely prejudice the creditors. South Africa introduced the capital maintenance system into its law so as to better protect the creditors and shareholders. The system/principle was confirmed in the case of *Trevor v Whitworth*, where the court declared that a company may not buy back its own shares, pay dividends out of capital and issue shares at a discount.

The question of whether or not the common law prohibition on the purchase by a company of its own shares has been abolished entirely was discussed in *Capitex Bank Ltd v Qorus Holdings*. According to this case, the court declared that even though the capital maintenance principle and the supposed protection it afforded companies' creditors, had been abolished by the Companies Amendment Act, it continued to have residual application in the South African law. The court also held that the rule laid down in the *Trevor v Whitworth* case, that a company could not acquire its own shares, was repealed by the Amendment Act of 1999. Section 85(1) of the Companies Act of 1973 allowed companies to acquire their own shares and

that only payments of consideration in contravention of the solvency and liquidity tests will result in the transaction being voidable.

The new Companies Act has finally removed all remnants of the capital maintenance principle and replaced it completely with a system based on solvency and liquidity. The system provides companies with more flexibility, however, like any other system, it has its share of uncertainties and criticisms.

The main purpose of the capital maintenance rule is to protect companies' creditors, however, it has received harsh criticisms. The rule has been criticised for being imprecise, uncertain, and overly rigid. It has also been claimed to be unnecessarily complicated and to not truly protect the creditors.¹¹⁴

In terms of new Act, section 48, a company may acquire shares issued by it with a board resolution. The shares so acquired according to section 37 must be cancelled and restored to the status of authorised but unissued shares. However the company may only go on with the acquisition if there is a reasonable ground to believe that the company will be solvent and liquid after the said transaction as in terms of section 46 of the new Act.

According to the new Companies Act,¹¹⁵ a company satisfies the solvency and liquidity test at a particular time if, considering all reasonable financial circumstances of the company at the time, the fairly valued assets of the company are equal to or exceed the fairly valued liabilities of the company 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 either twelve months after the date on which the test is applied, or in the case of a distribution, twelve months following that distribution.

Section 1 of the new Companies Act defines a distribution as being a, direct or indirect transfer of money or other property by a company, to or for the benefit of the shareholders of the company or of another company, in the same group of companies as consideration for the acquisition of its own shares or shares of another

¹¹⁴ Van der Linde 2009 *SA Merc LJ* 33 at 37; Cilliers (2000) 322.

¹¹⁵ S46.

company within the same group of companies.¹¹⁶ Therefore the payment for the acquisition of shares is a distribution, as defined and is thus subject to all the requirements pertaining to distributions as previously discussed.

Where shares are acquired in contravention of the solvency and liquidity requirement, the directors will be held liable¹¹⁷ provided that they were present at the meeting or participated in the decision making and did not vote against the resolution while knowing of its contravention of the Act.

An acquisition in contravention of the relevant section¹¹⁸ will also result in the reversal of the acquisition. A shareholder or a creditor at the time of the acquisition may apply to the court for an order that the shareholder/ former shareholder repay the consideration for the shares acquired to the company and for the company to reissue as equivalent number of shares to him/her.

2. Protection to the creditors and the shareholders

The new Act provides that the company must be solvent and liquid before it does any kind of distribution, including share acquisition. The Act holds directors who were involved in a resolution which is in contravention with sections 46 and 48, mainly with regards to solvent and liquidity requirement, liable.

Companies' shareholders are protected to an extent. Section 85 of the previous Act required authorisation by the company's constitution and that a special resolution from its shareholders must be obtained. However, because there was no voting restriction, controlling shareholders could manipulate the system. For example; they may vote that their shares be acquired at an excessive price.¹¹⁹

The solvency test protects the creditors, especially during the dissolution of the company while the liquidity test ensures creditors' debts are paid on time.¹²⁰ Both the creditors and the shareholders can also find relief in the personal liability bestowed

¹¹⁶ S1 of Companies Act 2008.

¹¹⁷ S48(7) of Companies Act 2008.

¹¹⁸ S46 of Companies Act 2008.

¹¹⁹ Van der Linde 2010 *TSAR* 288 at 299.

¹²⁰ *Ibid.*

on the directors who act negligently and do not satisfy themselves that the company can afford a share acquisition. A director who acts in contravention of section 46 and section 48 of the Act will be held liable for any loss, damages or costs sustained by the company as the result of the acquisition.

Section 48 of the Act requires that the solvency and liquidity must be complied with and failure may lead to personal liability. The creditors are assured that their investment will be protected as the company is required to always be solvent. The creditors are also assured that their debts will be paid as they fall due in satisfaction of the company's liquidity requirement. Shareholders, even though they have no say in the making of the decision to repurchase company shares, can rely on the fact that the directors are demanded to be sure that the company can afford the transaction and it will be able to pay its debts as they fall due.

The solvency and liquidity tests as set out in section 4 of the new Act seem to provide some protection to both company's creditors and shareholders, however, the capital maintenance system seems to provide more protection. With the capital maintenance system, the capital of the company was not touched; no acquisition of shares could be made by the company and so the creditors' debts were guaranteed to be satisfied and there was no chance for shareholders to abuse the system. The capital maintenance was stricter and focused on protecting the company's creditors and shareholders.

WORD COUNT: 12,350

BIBLIOGRAPHY

Journals

Cassim F “The new statutory provisions on company share repurchases: A critical analysis” (1999) 116 *South African Law Journal* 760.

Cassim F (2005) “The reform of company law and the capital maintenance concept” 122 *South African Law Journal* 283.

Jooste R “The maintenance of capital and the Companies Bill 2007: note” (2007) 124 *South African Law Journal* 710.

Jooste R “Financial assistance - a new approach” (2009) 126 *South African Law Journal* 566.

Jooste R “Issues relating to the regulation of ‘distributions’ by the 2008 Companies Act” (2009) 126 *South African Law Journal* 627.

Van der Linde K “Par-value shares or no-par-value shares – is that the question?” (2007) 19 *South African Mercantile Law Journal* 473.

Van der Linde K “The regulation of distributions to shareholders in the Companies Act 2008” (2009) *TSAR* 484.

Van der Linde K “The regulation of conflict situations relating to share capital” (2009) 21 *South African Mercantile Law Journal* 33.

Van der Linde K “The solvency and liquidity approach in the Companies Act 2008” (2009) 2 *TSAR* 224.

Van der Linde K “Share repurchases and the protection of shareholders” (2010) *TSAR/Journal of South African Law* 288.

Books

Cilliers HS *et al* (2000) *Corporate Law* 3rd edition Durban : LexisNexis Butterworths.

Cassim F *et al* (2011) *Contemporary Company law* Claremont : Juta & CO LTD.

Cassim F *et al* (2011) *The practitioner's guide to the Companies Act 71 of 2008*
Cape Town: Juta.

Creswell J W (2003) *Research design: quantitative, and mixed method approaches*
2nd edition : Sage Publications Inc

Delport P A (2009) *New Companies Act manual* Durban : Lexis Nexis.

Henochsberg E & Meskin P (1989), *Henochsberg on the Companies Act Volume 2*
4th edition South Africa: Lexis publishing.

Pretorius J T *et al* (1999) *Hahlo's South African Company law through the Cases*
6th edition [S.1] : Juta & company.

Cases

Capitex Bank Ltd v Qorus Holdings Ltd and Others 2003 (3) SA 302 (W).

Cohen NO v Segal (1970) SA 702 (W).

The Ooregum Gold Mining Company of India Ltd v Roper (1982) AC 125.

Trevor v Whitworth (1887) 12 App Cas 409.

Legislation

The Companies Act, 61 of 1973.

The Companies Act Amendment Act, 37 of 1999.

The Companies Act, 61 of 2008.

Internet

The solvency and liquidity test - what it means and when it applies
<http://www.roodtinc.com/newsletter45.asp> (November 2011)

*The Capital Maintenance Concept and Share Repurchases in South African Law -
By F.H.I Cassim and Rehana Cassim <<http://www.bowman.co.za/LawArticles/Law-Article~id~-639353216.asp>> (January 2012)*