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CAPITAL RULES in the COMPANIES ACT 71 of 2008
[With specific reference to sections 44 and 48.]

by

Cornelius Abraham Carstens

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I hereby declare that I have read and understood the regulations governing the submission of dissertations for the relevant degree, including those relating to length and plagiarism, as contained in the rules of the University, and that this dissertation conforms to those regulations.

_____________________________ _______________________
C Carstens. Date.

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FACULTY OF LAW

STATEMENT ON AUTHENTICITY

I, the undersigned,

Cornelius Abraham Carstens

Do hereby state as follows:

1. I am registered with the University of Pretoria for the degree of Master of Laws in the Corporate Law (04250102) field of study under Student No 29662754.
2. The dissertation, which I hereby submit for the degree of Master of Laws at the University of Pretoria, is my own work and has not previously been submitted by me for a degree at this or any other tertiary institution.

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C A Carstens

TABLE OF CONTENT

CHAPTER 1

INTRODUCTION

1. INTRODUCTION

This dissertation considers two of the statutory capital rules in the South African company law, and in particular the rule governing the prohibition of financial assistance by the company for the acquisition of its own shares, and the rule under which a company may acquire its own shares. This dissertation shall analyse the origin and development of these rules in the South African law, and how these two rules manifest in the Companies Act, 2008[1]. The said two rules are embodied in sections 44 and 48 of the Companies Act, 2008, respectively. This new Companies Act is not in operation yet.

2. THE DISSERTATION QUESTION AND RELEVANCE

The question that this dissertation will attempt to answer is, firstly, to ascertain what changes sections 44 and 48 of the Companies Act will bring about in company and corporate law in South Africa, and secondly, as to whether such changes will result in sound law. These two rules of the Companies act will play a very prominent role in the South African company law, as their forerunners[2] currently do. With the changes envisaged in the new Companies Act about to come into

[1] The Companies Act 71 of 2008 was promulgated and will come into operation on a date still to be determined. At the time of writing of this dissertation, the expected time when this new Act will come into operation is July 2010.
[2] Sections 38 and 85-89 of the present Companies Act 61 of 1973.

effect, it is essential to consider what changes such new law will bring about.

3. THE DISSERTATION OBJECTIVE

The objectives of this dissertation are to establish what changes, relative to sections 38 and 85-89 of the Companies Act, 1973, will be brought about in companies and corporate law by sections 44 and 48 of the Companies Act, 2008. I will also attempt to establish the effect that sections 44 and 48 will have on the current law, and whether the deficiencies in sections 38 and 85-89 were properly addressed in the said sections of the 2008 Act.

4. METHODOLOGY

The methodology that I will follow in this dissertation is to, firstly, give a brief synopsis of the development of the capital rules in order to serve as a background for the study. This background study will constitute chapter 2 of this dissertation. Secondly, I will analyse the company law of the Republic of Namibia in order to get an understanding of what the position in South African company law was approximately 30 years ago. The Republic of Namibia used the South African Company Act until 1978 when the administration of the Act was transferred to the then South West Africa. The position in the Namibian company law will be dealt with in chapter 3 of this dssertation. Thirdly, in chapter 4 of this dissertation, I will analyse the Companies Act 1973 to establish what further development of company law has taken place in South Africa up till now. Fourthly, in chapter 5, I will analyse the

Companies Act 2008 to see what changes will take effect when the Companies Act 2008 comes into effect. Chapter 6 will then contain my conclusion to the study. In order to achieve my objective, I will also make use of South African and Namibian case law and articles and handbooks by authorities and commentators on the subject matter.

5. LIMITATIONS

The capital rules that I will deal with in this dissertation forms only a portion of the capital rules that in general regulate the company law in South Africa. This dissertation is thus not a comprehensive study of the total of the capital rules and is only intended to deal with sections 44 and 48 of the Companies Act 2008.

CHAPTER 2

BACKGROUND TO THE CAPITAL RULES

BACKGROUND

1. The origin of the Capital Rules.

Capital rules developed from the necessity to protect the capital and in particular the share capital of a company, and *inter alia* gave rise to the capital maintenance doctrine. The doctrine of maintenance of capital should be seen against the background of the principles as formulated in the early English company law (which is the basis from which the South African company law developed) towards the end of the nineteenth century, where the following capital rules were developed and established:

- A company may not issue par value shares at a discount[3].
- Dividends may not be paid out of share capital[4].
- A company may not purchase its own shares[5].

The abovementioned development in the early English company law is comprehensively discussed by van der Linde in her Doctoral Thesis where she convincingly argues as follows; "*These principles were inferred from the existing legislation and the ultra vires rule. The legislation provided for disclosure of a company's authorised share capital and prescribed the procedure for the reduction of share capital,*

[3] Ooregum Gold Mining Co v Roper [1892] AC 125 (HL)
[4] Guinness v Land Corporation of Ireland [1883] 22 ChD 349 CA (356)
[5] Trevor v Whitworth [1887] 12 App Cas 409 (HL)

leading the courts to conclude that share capital could by implication not be returned to shareholders in other ways. The principle that the capital of a company should be devoted to the purpose for which the company was incorporated, confirmed that its return to shareholders would be ultra vires and void. This reasoning forms the basis of the capital maintenance doctrine applicable to companies[6]."

Van der Linde expresses her agreement with McGee in his assessment that the various capital maintenance rules were not designed in a coherent fashion, but that the following set of rational objectives can be inferred:

- "*Protecting existing shareholders from forced depletion of their interest in the company and by dilution of their interest by its devaluation.*
- *Protecting the company as an entity from being looted by unscrupulous shareholders or promoters.*
- *Protecting creditors from unjustified dilution of the value of the company*"[7].

2. Development of the Capital Rules in South Africa.

The capital rules based on the capital maintenance doctrine emanating from the early English legal system, were taken up in the original Companies Act 1973, and were steadily eroded since the 1973 act came into effect on 1 January 1974. These capital rules were subsequently transformed into capital rules based on the solvency and liquidity doctrine and taken up in

[6] See: van der Linde "Aspects of the Regulation of Share Capital" at 20.

[7] See: McGee *Share Capital*

the Companies Act 2008. This clear paradigm shift had and will have a major effect on the South African company law and, as will be shown later herein, significantly impacts on the powers, duties and responsibilities of directors.

Both of the capital rules under discussion emanated from the principle in the early English company law that a company could not acquire its own shares. Section 9 of the Companies Amendment act 37 of 1999 substituted section 85 of the Companies Act 1973, providing for the first time in South African law for a company to acquire its own shares under certain circumstances. This development was in line with a worldwide trend and pressure towards the view that companies should be able to reduce its capital by way of an acquisition of its own shares, provided that the maintenance of solvency and liquidity doctrine is complied with[8].

It is submitted that the timing of this paradigm in the South African company law was ideal in that, from a political point of view and in view of the great expectations of the Black Economic Empowerment drive at the time, it was necessary to put in place a practical mechanism by means of which Employee Share Schemes could be implemented, and which would enable the company to repurchase the shares of retiring employees on their ceasing to be employed by the company.

3. Criticism Against the Capital Maintenance Doctrine

[8] Schoeman *A Guide to the Companies Act* at 19-123

The popular theory is that share capital is nothing more than a notional liability in the accounts of a company, as the shareholders do not during the lifespan of the company have a legal claim to the return of the capital they contributed[9]. In modern (mostly unlisted) companies one would more than often find that the share capital of a company is rather nominal and does not in the majority of cases reflect on the size of the company or the value of the transactions that the company conducts. It is more feasible for companies (especially unlisted companies and in particular private companies), to rely on loan funding rather than to increase its share capital. Members of companies, for taxation purposes, very often prefer to fund the activities of the company by loan funding rather than by means of share capital. The creditors of a company very seldom rely on the share capital of a company as a measure for its credit worthiness, and in most cases do not even know or enquire what the company's share capital is. Several other measures are utilised to secure creditors, the most common of which is to bind the Directors as sureties and co-principal debtors for the obligations of the company.

The modern tendency for companies to have a nominal or small share capital has largely contributed to moving the emphasis from protection of share capital to a tendency of rather securing the solvency and liquidity of the company. The capital maintenance doctrine has in the process made way for the doctrine of solvency and liquidity and different measures are utilised to protect minority shareholders and

[9] Delport "Die Verkryging van Kapitaal" at 23.

the company against depletion, dilution or looting strategies by majority shareholders and directors[10].

With regard to the protection of creditors, it is also to be noted that in most ins tances the share capital of a company is tied up in illiquid assets which might erode in value or that might be written off over a period of time due to the limited lifespan of such assets. It is thus logical that creditors should be rather more concerned that the company shall remain solvent and liquid in order to maintain the ability to satisfy creditors in the normal course of business. It is impractical, costly and very difficult for creditors to monitor the available quantum of share capital of a company in order to assess the credit worthiness of a company over a period of time. It is much easier and more accurate for a creditor to assess and monitor the solvency and liquidity of a company from time to time by scrutinising the financial and management accounts of a company. A capital maintenance system is thus largely a theoretical system which does not by itself secure proper protection for a creditor. The move to a solvency and liquidity maintenance system is thus much more favourable to creditors.

In private companies, resulting from their usually small share capital, the share capital is mostly insufficient to serve as working capital and is accordingly only used by the shareholders as an allocation tool with regard to voting rights and profit sharing by means of dividend and distributions. In

[10] Maintenance of the company's solvency and liquidity, dissenting shareholders' appraisal rights and personal liability for breach of fiduciary duties by directors are more popular forms of protections in the modern company law. These mechanisms will by referred to later in this dissertation.

such instances, protection of the share capital plays a very insignificant role in the administration of the company.

CHAPTER 3

THE COMPANIES LAW IN NAMIBIA

1. Namibian Company Law as a Choice for a Comparative Study.

The Companies Act 1973 is the current company act of the Republic of South Africa at the time of writing of this dissertation. This act has shown significant development since it first came into operation On 1 January 1974. In order to show what the position in the earlier versions of the act was, prior to its development, I have chosen to do a comparison of the Companies Act 1973 and the Companies Act 2008 with the position in the Republic of Namibia.

The significance of the position in Namibia is that the territory of Namibia was administered by the Republic of South Africa until a transitional government was established prior to it gaining independence on 21 March 1990. The South African acts, common law and legal system were applicable in Namibia until the transitional government took over prior to its independence. As will be shown later herein, Namibia has till date hereof failed to implement a new companies act and is still using the version of the Companies Act 1973 as was applicable at the end of 1978. Namibia furthermore failed to further develop that early version of the 1973 act and a comparison with the present position in Namibia will thus effectively give an understanding of the position in the South African company law as in the late 1970's.

I am of the opinion that my choice of comparison as stated above will give the reader a proper understanding and perspective of the developments that gave rise to the said two capital rules as they appear in the Companies Act 2008.

2. FURTHER DEVELOPMENT OF THE COMPANY LAW IN NAMIBIA

As indicated earlier herein, the South African Companies Act 1973 as amended was applicable in Namibia (known as South West Africa until 1 March 1990) from its inception up to 1 October 1978.

The administration of the Companies Act 1973 was transferred to the transitional government of the then South West Africa in terms of South African Proclamation 234 of 22 September 1978 with effect from 1 October 1978.

South African Proclamation 234 of 22 September 1978 and the later South African Proclamation 23 of 1979 contained the last amendments to the Companies Act 1973 from South Africa that were to be applicable in the then South West Africa.

The Republic of Namibia gained independence on 1 March 1990. A new Companies Act 28 of 2004 was drafted and published post independence, but was never put into operation. From discussions that I had with Mr W Wohlers[11],

[11] The discussions occurred continuously during September 2009. Mr Wolf Wohlers is an eminent lawyer practicing commercial and corporate law in Windhoek under the

an eminent lawyer practicing commercial and corporate law in Windhoek, it would appear that the government of the Republic of Namibia has no desire to implement the Companies Act 2004, but would rather opt for a new act that would meet the modern social and economic requirements of the country.

3. NO FINANCIAL ASSISTANCE TO PURCHASE SHARES OF COMPANY OR HOLDING COMPANY (section 38)

The Prohibition.

Section 38 of the Namibian Companies Act 1973 *Inter Alia* provides as follows:

38. No financial assistance to purchase shares of company or holding company.-

(1) No company shall give, whether directly or indirectly, and whether by means of a loan, guarantee, the provision of security or otherwise, any financial assistance for the purpose of or in connection with a purchase or subscription made or to be made by any person of or for any shares of the company, or where the company is a subsidiary company, of its holding company.

Section 38(2) of the said act deals with certain exemptions to section 38(1), and section 38(3) deals with the effects of a contravention of the section.

Subsection (1) is clearly founded on the principles that a company may not purchase its own shares and that the resources of a company should not be applied to the prejudice

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name and style Lorentzangula Inc. Mr W Wohlers obtained the LLM degree (Banking and International Economic Law) from the University of South Africa during 2001.

or potential prejudice of its minority shareholders and creditors[12].

The provisions of s 38(1) are narrowly formulated and have been interpreted and implemented as such by the courts[13].

Miller JA has stated in the Lipschitz case as follows: *"The prohibition … comprises two main elements; one is the giving of financial assistance, and the other is the purpose for which it is given. The two elements are linked to form a single prohibition, but although so linked they are vitally different in concept"[14].*

Once it has been established that assistance as contemplated in section 38(1) was given, one should ask the question as to whether the assistance was or would be given for the purpose of purchasing shares in the company or its holding company. Only on confirmation of both these facts will there be a contravention of the said section.

It is significant to note that the prohibition only applies to the acquisition of shares by way of "purchase" or "subscription". In the case of Harrison v Harrison 1952 (3) SA 417 (N) it was ruled that an agreement for transfer of shares with a *causa* other than a "sale", would not be affected by the prohibition. The facts in the said case provided for the conversion of the relevant shares to redeemable preference shares and their redemption, whereupon it was ruled that it does not constitute a contravention of the said subsection.

[12] See Maskin *Henochsberg on the Companies Act* 4 ed at 61
[13] Lipschitz v UDC Bank Ltd 1979 (1) SA 789 (AD) at 798.
[14] Lipschitz v UDC Bank 1979 (1) SA 789 (AD) at 799.

In a number of cases a test, commonly known as the "impoverishment test", was applied in terms whereof the question was asked as to whether the company is or would be any poorer as a result of the alleged financial assistance[15]. This test does however not answer the decisive issue in the said section, but could assist in establishing as to whether both elements of the prohibition were present[16]. In the Lipschitz case (at 801), Miller JA said that while the impoverishment test might be a very helpful guide and often yield a clear and decisive answer to the question whether financial assistance had been given by the company, in other cases it might be not unhelpful, but entirely irrelevant.

By its very nature the "purpose" requirement might be very difficult to establish. It is has been submitted that the court might in some instances deduce the ostensible purpose as envisaged in terms of the said subsection by determining whether the transaction was outside the scope of the legitimate operations of the company or reasonable business practices[17].

When a company declares a substantial divided and the recipient of such dividend utilise the funds to purchase shares in the company, that would not automatically amount to a contravention of the subsection, provided however that the declaration would be in line with the principles governing the declarations of dividends in the company and that the dividend was not declared merely to assist the purchaser with

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15 See for instance Lomcord Agencies (Pty) Ltd v Amalgamated Construction Co (Pty) Ltd 1976 (3) SA 86 D); Evrard v Ross 1977 (2) SA 311 (D).
16 Maskin *Henochsberg on the Companies Act* 4 ed at 62.

17 See note 15.

the purchase of shares in the company. This is in line with the decision taken in the case of Novick v Comair Holdings Ltd 1979 (2) SA 116(W) at 135-137.

Several unsuccessful techniques were applied over the years to financially assist a purchaser with the purpose of purchasing shares in the company, the most common of which are for the company to take a mortgage against its property and make the funds available to a purchaser[18], and where the company then purchases property from the purchaser of shares with the sole purpose of putting the purchaser of shares in funds to pay for the shares[19].

In the event of a contravention of subsection 38(1), the transaction for the purchase of the shares would be void and unenforceable[20]. This principle flows from the fact that both the seller and the purchaser acted *Mala Fide* and in contravention of the law. Where the company however make a loan to a third party (someone other than the seller or the purchaser of the shares) in terms of which a purchaser, other than the third party taking up the loan, indirectly obtains funds to finance the transaction to purchase shares in the company, then such transaction would not be void, provided the purchaser was not aware of the *Male Fide* intentions of the company or the third party[21]. Any intentional scheme or simulated transaction to avoid the effect of a contravention of subsection 38(1) will however result in the transaction being void. If a transaction for the purchase of shares contravenes subsection 38(1), but is severable from the rest of the

[18] Karoo Auctions (Pty) Ltd v Hersman 1951 (2) SA 33 (E) at 37.
[19] S v Hepker 1973(1) SA 472 (W) at 479.
[20] See Lipschitz case supra.
[21] Saambou Nasionale Bouvereniging v Ligatex (Pty) Ltd 1976 (1) SA 868 (E).

transaction, the rest of the transaction will not automatically be void merely because of the said contravention.

Directors of a company who cause it to contravene section 38(1) would under the common law be in breach of their fiduciary duties towards the company and would be liable to the company for any loss or damage suffered by it[22].

The Exemptions.

Subsection 2(a) provides for an exemption from subsection 38(1) where the main business of the company is the lending of money and the loan has been made in the ordinary course of its business. By necessary implication the terms and conditions of the loan should be consistant with the ordinary business practices of the company and similar to the terms and conditions that would apply to a person lending money from the company for a purpose other than to purchase shares in the company.

The exemption contained in subsection 2(b) relates to the provision by a company, in accordance with any scheme for the time being in force, of money for the subscription for or purchase of shares of the company or its holding company by trustees to be held by or for the benefit of employees of the company, including any director holding a salaried employment or office in the company. This exemption is clearly aimed at providing for Employee Share Schemes which became popular under pressure by the workers' unions during

[22] Jacobson v Liquidator M Bulkin & Co Ltd 1976 (3) SA 781 (T) at 787-788; Wallersteiner v Moir[1974] 3 All ER 217 (CA) at 239; Maskin *Henochsberg on the Companies Act* 4 ed at 64.

the latter half of the 20th century. Significantly a director of a company having an employment contract or holding office is also considered an employee of the company to qualify under this exemption.

Subsection 2(c) provides for an exemption relating to loans to *Bona Fide* employees of the company, excluding persons that are directors and wishing to take up loans from the company, for the purpose of purchasing shares in the company for their own benefit, and thus become members of the company. It is submitted in *Henochsberg* that for a person to qualify under this exemption, the person must already be in employment of the company at the time of the loan and the employment must be genuine and not merely a scheme in order to qualify such person for a loan to acquire shares[23].

The Sanctions for Contravening Section 38

Subsection (3) of section 38 sets out the sanctions for the contravention of section 38.

The contravention of the provisions of section 38 constitutes an offence by the company, each director or officer of it and each former director if he was a director at the time when the contravention occurred. The said persons, excluding the company, would however be entitled to the defence that they did not have knowledge of the contravention or did not participate in the conduct that gave rise to the contravention.

[23] Maskin *Henochsberg on the Companies Act* 4 ed at 64.

Present status of Company Law in Namibia

The above is a synopsis of the current law in the Republic of Namibia relating to the capital rule against the providing of financial assistance by a company to persons for the acquisition of shares in the company. The position set out above was also the position in the South African law as at October 1978.

3 THE ACQUISITION BY A COMPANY OF ITS OWN SHARES

Sections 9-13 of the (South African) Companies Amendment Act, 1999[24], substituted sections 85-89 of the current (South African) Companies Act 1973 and for the first time made provision for a company incorporated in South Africa to acquire its own shares.

At the time of this enactment in South Africa, Namibia was an independent state already and the South African enactment did not affect the position in Namibia. The Republic of Namibia ceased to be affected by the changes in the South African company law by October 1978. The Companies amendment Act, 1999, came into operation in South Africa on 30 June 1999.

Namibia thus continued with the capital rule that a company may not acquire its own shares and the capital maintenance rule is to this extent still intact in Namibian company law. The Republic of Namibia has not as to date put into operation any act that would authorise a company to acquire its own shares.

[24] The Companies Amendment Act 37/1999.

The further development brought about by the Companies Amendment Act, 1999, thus only occurred in South Africa and will be discussed in the next chapter.

CHAPTER 4

SECTIONS 38 AND 85 OF THE COMPANIES ACT, 1973.

1. INTRODUCTION.

The position in the Republic of Namibia as set out in chapter 3 reflects the position in South Africa as at October 1978. In this chapter I will indicate the amendments to the Companies Act, 1973, that occurred subsequent to October 1978, relating to sections 38 and 85-89 in particular.

It should become clear from the development of the capital rules as discussed in this chapter, that South Africa moved away from the capital maintenance principle and, under pressure from the rest of the developed world, adopted instead the maintenance of liquidity and solvency as a principle of its company law.

2. THE NEED FOR THE FURTHER DEVELOMENT OF THE COMPANIES ACT, 1973.

The present Companies Act, 1973, is largely based on the Companies act, 1926, which in turn was based on early English law.

The Companies Act, 1973, was written at a time when the capital maintenance rule was still intact and entrenched in the South African company law. As the capital maintenance doctrine in South Africa became more and more eroded, the overall structure and basis of the Companies Act became outdated and problematic.

As indicated prior in this dissertation[25], the approach to true share capital was re-thought and the significance of the maintenance thereof was eroded. Par value shares resulted in companies having a very low share capital and it became more important to secure the solvency and liquidity of companies in order to protect the interests of creditors and shareholders.

As the company law in South Africa developed, it became apparent that the capital maintenance doctrine, stemming from the early English capital rules and aimed at, *inter alia,* prohibiting companies from making distributions to its shareholders out of capital, giving financial assistance for the acquisition of its shares and acquiring its own shares, must make way for a new set of rules.

The logical route to go with the required development in the South African law, was to follow the more sophisticated jurisdictions with the approach that a company must essentially be liquid in order to conduct its business and pay its creditors, and must maintain solvency in order to protect its creditors and members.

The required development of the Companies Act however took place not in a holistic manner, but rather on an *ad hoc* basis as was required from time to time.

I will now proceed to discuss some of the major developments that took place with regard to the capital rules

[25] See Paragraph 3 Chapter 2.

on which the act was based and in particular with special reference to the present sections 38 and 85-89.

3. AMENDMENT OF SECTION 38 OF THE COMPANIES ACT, 1973, BY SECTION 3 OF THE COMPANIES AMENDMENT ACT 1999.

Section 3 of the Companies amendment act, 1999, amended section 38 of the companies Act, 1973, by the insertion of section (2)(d) to provide for a further exemption to the prohibition.

Section 38(2)(d) provides that the provision of financial assistance for the acquisition of shares in a company, by the company or its subsidiary, in accordance with the provisions of section 85 for the acquisition of such shares, shall not constitute a contravention of section 38(1).

This was an essential provision as the same amendment act, by a substitution of sections 85 to 89, also for the first time provided for a company to acquire its own shares.

The said amendment of section 38 was the start of a paradigm shift that was taking place in the South African company law at the time.

In view of the simultaneous amendment of sections 85-89 and 90 of the act, it was clear that, on the basis that investor and creditor protection is covered by solvency measures, the preclusion of financial assistance, which remains extant in section 38, appeared unnecessary[26].

[26] See: Weiner "The Companies Act Changes" at 133

Wainer[27] expressed the view that, having regard to the harsh consequences of a breach of section 38 and the commercial realities, the continued existence of this section of the Act undermines the new philosophy and is restrictive of the encouragement of commercial activity[28].

The impact of this amendment will only be fully appreciated when read in conjunction with the other major amendments that the Companies Amendment act, 1999, brought about and which will be discussed below.

It must be pointed out that a debate developed between eminent academic commentators as to the exact meaning of the wording used in the said subsection 2(d). It would appear as if the debate has not been settled fully. Cassim makes the submission that there might be a compelling reason for the wording of section 38(2)(d), because the words "financial assistance" in section 38(1) are not defined and because the section is couched in such wide terms, it may strictly be possible for a company to give "financial assistance" to itself for the purchase of its own shares[29]. Cassim further more argues that since the word "person" in section 38 includes a legal person, the section does apply to a company purchasing its own shares.

I am of the opinion that in the present act and after the implementation of the Corporate Law Amendment Act, 2006, the role of section 38(2)(d) is merely to avoid any arguments that an acquisition of its shares by a company may possibly

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[27] H E Wainer B Acc (Witwatersrand) CA (SA) is a visiting Professor of Accounting, University of the Witwatersrand.
[28] See note 25 above.
[29] Cassim "Unravelling the Obscurities" at 493.

be considered as a contravention of section 38(1). If ever there is doubt as to whether an acquisition of its shares by a company might constitute a contravention of section 38(1), the said subsection has removed all such doubt.

What must also be borne in mind is the common law fiduciary duty of the directors to act in the best interest of the company and for a proper purpose. When for instance the company takes up a loan to obtain funds for the acquisition of its shares, it might trigger an argument that the directors are not using their powers for a proper purpose and in the best interest of the company.

4. AMENDMENT OF SECTION 38 OF THE COMPANIES ACT, 1973, BY SECTION 9 OF THE CORPORATE LAWS AMENDMENT ACT 2006

Section 9 of the Corporate Laws Amendment Act 24 of 2006 amended section 38 of the Companies act by the insertion of subsections 2(A) and 2(B).

Subsection 2(A) provides that section 38(1) does not prohibit a company from giving financial assistance for the purchase of or subscription for shares of that company or its holding company, if the company's board is satisfied that subsequent to the transaction, the consolidated assets of the company fairly valued will be more than its consolidated liabilities; and subsequent to providing the assistance, and for the duration of the transaction, the company will be able to pay its debts as they become due in the ordinary course of business; and the terms upon which the assistance is to be given is sanctioned by a special resolution by its members.

This legislation has now clearly done away with the sharp edge of the prohibition in section 38(1), provided the company is solvent and liquid and the transaction has been sanctioned by the members of the company by way of a special resolution.

Section 38(2)(A) has now, to a certain extent, eroded the importance of section 38(2)(d) and section 38(2)(d) might be of more academic value.

What is however of significant importance is that section 38(2)(A) has now done away with the capital maintenance doctrine as far as the issue of financial assistance is concerned and has placed the focus on the solvency and liquidity tests.

With regard to the wording used by the legislator in section 38(2)(A), it is interesting to take note of the argument put forward by Yeats during 2006[30].He commented on the Bill prior to the enactment thereof and pointed out that while direct or indirect financial assistance (including loans, guarantees, security or financial assistance otherwise provided) for the purpose of or in connection with a purchase or subscription of shares in a company or its holding company is patently prohibited, it appears, in terms of the amendment in the then Bill, that only financial assistance for the purchase of or the subscription of shares in a company or its holding company may properly be executed or permitted[31]. This discrepancy has to the best of my knowledge not yet been addressed in the case law and remains open for debate. It is not clear as to whether this was an intentional deviation from

30 Yeats "The drafter's Dilema"
31 Yeats "The drafter's Dilema" at 609.

the wording used in section 38(1) or whether it came about only by an inaccurate choice of words.

In my view these statutory provisions render sufficient and proper protection for creditors and shareholders by requiring authorisation in the company's articles of association[32], of approval by special resolution[33] and compliance with the liquidity and solvency tests[34]. In the last few decades prior to the relevant amendment, it was clear that the capital maintenance rules contributed very little, if anything at all, to protect the interests of the creditors of a company. One of the factors that contributed to the failure of the capital rules to offer effective protection to creditors, is the failure of the Companies Act to prescribe a minimum capital for either public or private companies. The term "capital maintenance" which was so sacredly enshrined in the company law is actually a misnomer as a company is not required to keep its capital intact as the term would suggest. The capital maintenance rule can not be an adequate safeguard for creditors if the capital that in protects in the first instance is not adequate to satisfy creditors.

5. AMENDMENT OF SECTIONS 85-89 OF THE COMPANIES ACT, 1973, BY SECTIONS 9-13 OF THE COMPANIES AMENDMENT ACT 1999.

Sections 9-13 of the Companies Amendment Act, 1999, that took effect on 30 June 1999, repealed sections 83 and 84, and substituted sections 85-90 of the Companies act, 1973.

[32] S 85(1) of the Companies Act.
[33] See note 29 above.
[34] S 85(4) of the Companies Act.

This amounted to a paradigm shift in the approach to the capital maintenance doctrine in the South African company law and marked a deliberate shift towards a doctrine of maintenance of solvency and liquidity instead. For the first time in South Africa it became possible for a company to acquire its own shares.

- Section 85 provides for the acquisition, under certain circumstances, by a company of shares issued by it.
- Section 86 vests liability in shareholders and directors under certain circumstances.
- Section 87 prescribes the procedure of acquisition of certain shares by a company.
- Section 88 provides for the enforceability of contracts for the acquisition by a company of certain shares.
- Section 89 makes provision that subsidiaries may acquire certain shares in a holding company.
- Section 90 regulates new rules for payments to shareholders.

In 2001, after the Companies Amendment Act, 1999, took effect, Wainer expressed the view that the repeal of sections 83 and 84 of the Companies Act and the promulgation of the new sections 85-90 indicated the apparent death of the capital-maintenance concept as a principle underlying company law in South Africa, and a shift to factual and commercial solvency measures as the protection for investors and creditors[35]. He however went on to state that despite the apparent abandonment of the capital maintenance concept, there were several relics of its existence still lurking in the

[35] See note 25 above.

Companies Act, and that amendments promulgated simultaneously with the introduction of the new sections 85-90 appear, curiously, to reinforce certain elements of the capital maintenance philosophy[36].

6. AN ANALYSIS OF THE SOLVENCY TEST IN TERMS OF SUBSECTION 85(4)(a)

The liquidity and solvency tests in subsection 85(4)(a) and (b) provide that a company shall not make any payment in whatsoever form to acquire any share issued by the company if there are reasonable grounds for believing that the company is, or would after the payment be, unable to pay its debts as they become due in the ordinary course of business, or that the consolidated assets of the company fairly valued would after the payment be less than the consolidated liabilities of the company.

The liquidity test in subsection 85(4)(a) contains certain deficiencies that are discussed below.

The said liquidity test requires that directors have reasonable grounds to believe that a company is at the time of the transaction and at the time of payment liquid and able to pay its debts as they become due in the ordinary course of business. It is not specifically required to prove that the company is in fact liquid and would remain liquid for a reasonable time. The directors are obviously required to do an assessment of the solvency and liquidity of the company, taking into account the liabilities and creditor payment schedules of the company. Any negligent contravention of

[36] See note 25 above.

subsection 85(4) would render a director liable in terms of section 86 of the Act.

Subsection 85(4) does not stipulate for what period after the transaction the company must remain solvent and liquid. In my view the section should have provided for a period of at least one year in order to properly protect creditors and shareholders.

There is also no provision in the act that describes the method as to how the purchase price for the shares is to be determined. In companies where the shares are not traded, it is sometimes difficult to determine the fair value of shares. The solvency and liquidity of the company will have an impact on the share price. The directors are in the best position to assess the value of the shares and the shareholder selling shares to the company might be in a disadvantaged position with regard to information. In my view the information used by the directors to assess the solvency and liquidity of the company should be disclosed to the shareholders in order for them to verify the fairness of the price paid by the company. This might be necessary to avoid the danger of insider trading, which is dealt with in paragraph 10 of chapter 4 below.

7. THE REQUIREMENTS FOR A ACQUISITION OF ITS SHRARES BY A COMPANY

When a company wishes to acquire its shares under the Companies Act, 1973, the Act provides for certain statutory rules and prescribes certain statutory procedure that must be complied with, in order for the company to legally and validly acquire issued shares. The most important of those will be discussed below.

7.1 **The Statutory Rules**

Section 85(1) provides that the company may approve the acquisition of shares issued by it, by way of special resolution, if authorised thereto by its articles of association.

The approval by special resolution may be a general approval or a specific approval for a particular acquisition[37]. In my opinion, the two types of special resolution is of great significance as it determines the procedure that has to be followed[38], and it determines whether the company must make an offer to all shareholders or whether the company may acquire only the shares of a specific shareholder[39].

A general approval shall only be valid until the next annual general meeting, but it may be revoked or varied by special resolution by a general meeting of the company at any time prior to such annual general meeting[40].

Section 85(4) contains the required solvency and liquidity tests discussed in paragraph 6 above. It is important to note that, unless there has been strict compliance with these two tests, no valid acquisition of issued shares by the company is possible. In the matter of Capitex Bank Ltd v Qorus Holdings Ltd & others [2003] JOL 12125 (W) Malan J held that as a result of section 85(1) of the Companies Act, 1973, an agreement relating to the acquisition by a company of its own shares is no longer, in itself, illegal or unlawful, but that a payment made in contravention of the liquidity and solvency

[37] See section 85(2) of the Companies Act, 1973.
[38] See paragraph 7.2 below on statutory procedure.
[39] See paragraph 7.3 below.
[40] Section 85(3) of the Companies Act, 1973.

tests as embodied in section 85(4)(a) and (b) would result in the illegality of the share repurchase agreement. This is also the view expressed by F H I Cassim and Rehana Cassim in their article *The Capital Maintenance Concept and Share Repurchases in South African Law*[41].

Against the acquisition of par value shares, the issued capital of the company shall be reduced by an amount equal to the par value of the shares acquired[42]. The Acquisition of shares in terms of section 85 has thus the effect of reducing the issued share capital of the company.

Against the acquisition of no par value shares, the stated capital of the class of share so acquired shall be reduced by an amount equal to the number of shares acquires, multiplied by the calculated value of such shares[43]. The method of calculation of the value of the shares whereby the stated capital is to be reduced, is provided for in section 85(6), as multiplying the number of shares of that class so acquired with the amount arrived at by dividing the stated capital contributed by issued shares of that class by the number of issued shares of that class. The result of the acquisition is thus again the reduction of the stated capital of the company.

Section 85(7) provides that in the event of par value shares being acquired at a premium over the par value; such premium may be paid out of reserves, including statutory non-distributable reserves.

Any shares issued by a company and acquired in terms of section 85 of the Companies Act, 1973, shall be cancelled as

41 Cassim & Cassim "The Capital Maintenance Concept" at 188-191.
42 Section 85(5) of the companies Act, 1973.
43 Section 85(6) of the Companies Act, 1973.

issued shares and be restored to the status of authorised share capital[44].

Section 85(9) contains the prohibition that shares in a company may not be acquired under section 85, if, as a result of such acquisition, there would no longer be shares in issue other than convertible or redeemable shares.

7.2 **The Statutory Procedures**

Section 87 of the Companies Act, 1973, sets out the statutory procedure that has to be followed at the repurchase of issued shares by a company

Section 87(1) provides that a company proposing to acquire shares issued by it, shall, firstly, deliver or mail a copy of the written offering circular in the prescribed form to each registered shareholder on record as at the date of the offer in such manner as may be provided in the articles of the company for the sending of any notice of a meeting of shareholders, stating the number and class or kind of its issued shares which the company proposes to acquire, and specifying the terms and reasons for the offer. Secondly, the company must lodge a copy of the offering circular with the Registrar of Companies within 15 days of the date that it is delivered or mailed to the shareholders of the company.

It is however specifically provided for in section 87(2) that the procedure of dispatching an offer circular to shareholders and filing same with the registrar need not be complied with in the following two instances:

When the shares are acquired by special resolution passed in terms of section 85(1) and the approval by such special

[44] Section 85(8) of the Companies Act, 1973.

resolution is a specific approval contemplated in section 85(2)[45].

In the case of a company whose shares are listed on a stock exchange within the Republic, to the acquisition by that company of shares in terms of transactions effected on such stock exchange in accordance with the rules and listing requirements of that exchange[46].

Sections 160-163 of the Act contain provisions relating to untrue statements in prospectuses and the liability of directors and experts in relation thereof. Section 87(3) specifically provides that these provisions of sections 160-163 shall apply *mutatis mutandis* to all documents issued in terms of section 87(1).

Where, in response to any offer to acquire shares, the shareholders propose to dispose of a greater number of shares than the company offered to acquire, the company shall acquire from all of the shareholders who offered to sell, *pro rata* as nearly as possible disregarding fractions; Provided that this shall not apply to the acquisition of shares in terms of transactions effected on a stock exchange within the Republic[47].

When acquiring shares issued by it, the company must notify the Registrar of Companies within 30 days of the date of the acquisition in the prescribed form of the date, number and class of shares that it has acquired[48].

Section 87(6) provides that a stock exchange within the Republic of South Africa may, in addition to the requirements

[45] Section 87(2)(a) of the Companies Act, 1973.
[46] Section 87(2)(b) of the Companies Act, 1973.
[47] Section 87(4) of the Companies Act, 1973.
[48] Section 87(5) of the Companies Act, 1973.

contained in the Act, determine further requirements with which the company whose shares are listed on such exchange, must comply prior to it acquiring its own shares.

Save for the above procedural requirements, it must be noted that in terms of section 203 of the Act, a special resolution passed by a company shall not take effect until it has been registered by the Registrar of Companies in terms of section 200 of the Act. It is thus necessary for a company to first register the special resolution in terms of section 200 of the Act prior to it doing the transaction for acquisition of the shares issued by it. Furthermore, on the issue of registration of the special resolution, the special resolution will, unless the court otherwise directs, lapse and be void if not lodged and registered within six months after date of passing of the resolution[49].

8. POSSIBILITY OF SECONDARY TAX ON COMPANIES RESULTING FROM AN ACQUISITION BY A COMPANY OF ITS ISSUED SHARES

With effect from 30 June 1999, amendments to section 1 of the Income Tax Act have had the result that where a company acquires its own shares, so much of the consideration paid therefore which represents profits of the company available for distribution, will be treated as a dividend to the shareholder who is disposing of those shares and the company will be liable for Secondary Tax on Companies (STC) thereon[50].

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[49] Section 202 of the Companies Act, 1973.
[50] Maskin *Henochsberg on the Companies Act* (2009) at 180.

9. ACQUISITION OF ITS SHARES RESULTING IN AN AFFECTED TRANSACTION

In the definitions in section 440A(1) of the Companies Act, 1973, an "affected transaction" is defined as a transaction, (including a transaction which forms part of a series of transactions) or scheme, whatever form it may take, which:

- Taking into account any securities held before such transaction or scheme, has or will have the effect of:
- Vesting control of any company in any person, or two or more persons acting in concert, in whom control did not vest prior to such transaction or scheme; or
- Any person, or two or more persons acting in concert, acquiring, or becoming the sole holder or holders of, all the securities, or all the securities of a particular class, of any company; or
- Involves the acquisition by any person, or two or more persons acting in concert, in whom control of a company vests in or after the date of commencement of section 1(1) of the Companies Second Amendment Act, 1990, of further securities of that company in excess of the limits prescribed in the rules.

When a company acquires some of its issued shares, and in particular when it acquires all the shares of one or more shareholders, it might have the effect of one particular shareholder on his own, or acting in concert with other, will gain control of the company and the transaction or scheme in terms of which the acquisition occurred, then becoming an affected transaction in terms of the said section 440A. This means that the acquisition transaction itself may be an affected transaction. In the event of an affected transaction, Chapter XVA of the Companies Act, 1973, and the Securities Regulation Code on Take-overs and Mergers need to be complied with.

10. COMPANY ACQUIRING ITS OWN SHARES – THE ISSUE OF INSIDER TRADING

In terms of the definitions in section 72 of the Securities Services Act, 2004, an "insider" is defined as "... *a person who has inside information* ..."

In terms of the Insider Trading Act, 1998, which was repealed by the Securities Services Act, 2004, an insider was not defined as a person, but rather as an "individual".

From the above it is clear that under the Insider trading Act, 1998, only a natural person could have been an insider. A company could not have been an insider.

In terms of the Securities Services Act, 2004, however, any person (which includes *inter alia* a company, a partnership and any trust) could be an insider. Insider trading applies to securities listed on a regulated market only.

When the concept of a company purchasing its own shares was introduced into the South African law in 1999, it was impossible that a company could be regarded as an insider.

Since 1 February 2005, when the Securities Services Act, 2004, took effect, it however became possible for a company to be an insider in terms of the chapter VIII of the said Act, which relates to market abuse.

In terms of chapter VIII of the Securities Services Act, 2004, insider trading is an offence and also results in civil liability.

It is my view that, on a proper interpretation of the Securities Services Act, 2004, a company acquiring its own shares in terms of section 85 of the Companies Act, 1973, could be considered to be conducting insider trading under certain circumstances. The same might also applies to a director acting for and on behalf of the company. This view is also expressed in the company law of New Zeeland, Australia and Canada where a company is treated as an insider when it acquires its own shares. This interpretation should compel listed companies to make public any material non-public information prior to a repurchase of its shares.

11. ACQUISITION BY COMPANY OF OWN SHARES IN A MANNER OTHER THAN IN TERMS OF SECTION 85

P A Delport in his article *Company Groups and the Acquisition of Shares* published in the *South African Law Journal* (2001) at 128, discussed a peculiar situation that may arise and in terms of which a company shall acquire its own shares in a manner other than in terms of section 85 of the Companies Act, 1973. For purposes of this study I will summarise the scenario sketched by Delport, and the questions posed by him, as follows.

A subsidiary owns 10% of the issued share capital in a holding company, which it is entitled to do in terms of section 89 of the Act, subject obviously to the restriction in section 39 of the Act.

The subsidiary declares a dividend *in specie* of the shares held in the holding company, resulting in the holding company acquiring shares in it.

Section 85(8), which determines the status of the shares acquired in terms of section 85(1) by a company, cannot apply as the acquisition did not occur in terms of section 85.

If the acquired shares cannot be dealt with in terms of section 85(8), the question arises as to what the status of those shares will be.

The Act does not provide for such scenario and logically one will have to look at the common law for guidance.

In terms of the common law remnants of the capital maintenance rules, the company cannot own shares in it with the result that the shares are extinguished. The shares being a bundle of rights and obligations, it is impossible for the shares to continue to exist, as the company cannot have rights and obligations towards itself.

Delport contended that the situation is clouded in controversy and suggested that it be properly provided for in legislation.

My view is that the shares that the company holds in the subsidiary is obviously an asset in the hands of the company and at least partially determines the value of its shares. If the subsidiary declares a dividend *in specie* of the company shares that it holds, the asset value of the subsidiary obviously reduces and subsequently the asset value of the company reduces *pro rata* to its shareholding in the subsidiary. The shares that the company is to receive in terms of the dividend declaration are in terms of Delport's contention extinguished and the company thus receive no counter value for the reduction in its asset value. The company controls the subsidiary and consequently it is in the interest of the company that the subsidiary does not declare a dividend *in specie* of the company's shares. If the directors of the company allow such declaration of dividends, supports it or vote in favour of such dividend declaration, it might even be argued that it constitutes a breach of their fiduciary duty towards the company. It would be in the interest of the company that the subsidiary rather sells the shares that it holds in the company.

CHAPTER 5

SECTION 44 AND 48 IN THE COMPANIS ACT 2008

1. INTRODUCTION

This chapter shall deal with the two capital rules relating to financial assistance by a company for the acquisition of its shares and the repurchase by a company of its shares as they appear in sections 44 and 48 of the Companies Act, 2008, respectively.

A proper understanding of the previous discussions of the position in the Namibian company law (which at this stage merely represents an older version of the South African company law) and the position in terms of the current company law in South Africa, regulated in terms of the Companies Act, 1973, is acutely relevant to a discussion of the position under the Companies Act, 2008.

With regard to the said two capital rules, the companies Act, 2008, has shown a dramatic further development. This dissertation shall attempt to analyse some of the more important differences brought about by such further development, and how they will impact on the South African company law when the 2008 Act comes into operation.

An important aspect that must be borne in mind when analysing the effect that the 2008 Act will have on the South African company law, is the fact that the South African courts have not been in a position to make rulings and interpretations on the new act. At this stage, great reliance will have to be put on the similarities found in the current act, its historical development and the current available case law thereon.

The historical background and the current position relating to the aspects, on which this dissertation focuses, have been analysed quite extensively in the previous chapters. In order to avoid unnecessary repetition, references will frequently be made to the previous discussions. New aspects that were not mentioned before or that have not been discussed in full will however be dealt with in this chapter.

2. BASIS OF REGULATION OF CAPITAL IN THE COMPANIES ACT, 2008

As mentioned earlier in this dissertation, the South African company law has originally embraced the capital maintenance doctrine as inherited from the earlier English law, but has gradually developed away from the archaic capital maintenance rules into a regime which is based on the maintenance of solvency and liquidity.

The new 2008 Act has now completely done away with the remnants of the capital maintenance doctrine currently still noticeable in the 1973 Act, and is now wholly based on the principles of the maintenance of solvency and liquidity[51].

3. FINANCIAL ASSISTANCE FOR ACQUIRING OF COMPANY'S SHARES – SECTION 44.

[51] Delport *The New Companies Act Manual* at 31.

Section 44 of the Companies Act, 2008, authorises a company to give financial assistance for the purpose of and in connection with the acquisition of its shares, whether by way of subscription or purchase.

- Section 44(2) is the operative section in terms whereof the authorisation is granted.
- An exemption as to the meaning of financial assistance is contained in section 44(1).
- Sections 44(3) and (4) set out requirements that that must be complied with prior to the Board of a company being entitled to authorise the rendering of financial assistance.
- Section 44(5) provides for circumstances under which a decision of a board to provide such financial assistance or an agreement to provide the assistance will be void, and section 44(6) describes the liability of directors resulting from the said voidness.

4. THE OPERATIVE SECTION – SECTION 44(2)

Section 44(2) provides as follows:

(2) To the extent that the Memorandum of Incorporation of a company provides otherwise, 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, subject to subsections (3) and (4).

The subsection makes provision for a Memorandum of Incorporation to specifically take this authorisation away from the board. My submission is, in the event of such authorisation having been taken away from the board in the Memorandum of Incorporation, that the general meeting of the company, by way of a special resolution, will have the power to authorise the directors to render such financial assistance in a specific instance. The other alternative obviously is that the company in general meeting and by way of a special resolution, amends the Memorandum of Incorporation to make provision for such authorisation.

The wording used in the subsection that "... *the board may authorise the company to provide*..." is very peculiar in that the board is in fact the executive body of the company. The effect of the wording used is that the board effectively authorises itself to render financial assistance. If an authorisation was deemed necessary by the legislator, one would have expected that the company in general meeting and not the board itself would have had to authorise the board.

The subsection is now much wider than its forerunner, section 38(1) of the Companies Act, 1973, in that it also regulates the assisting in financing of the subscription for or purchase of shares in a related or inter-related company. A related or inter-related company is defined in section 2 of the Companies Act, 2008.

Section 2(1)(c) provides that a company is related to another company if either of them directly or indirectly controls the other, or the business of the other, or either is a subsidiary of the other, or a person directly or indirectly controls each of them, or the business of each of them.

The "control" that is referred to in section 2(1)(c) is defined at length in section 2(2) of the Act. The essence of the description of "control", however, is that a company (the first person) controls another (the second person) or its business, if, the second person is a subsidiary [as determined in terms of section 3(1)(a)] of the first person, or, the first person together with any related or inter-related person is directly or indirectly able to exercise or control the exercise of the majority of the voting rights associated with securities of that company, whether pursuant to a shareholders 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; or that first person has the ability to materially influence the policy of the second person in a manner comparable to a person who, in ordinary commercial practice, would be able to exercise a certain element of control referred to above.

In the description of "control" above, reference is made to the instance where the second person is a subsidiary of the first person. Section 3 of the Act deals with subsidiary relationships between companies and define when a company is a subsidiary of another. The subsidiary relationship is once again determined by the control of the majority of the general voting rights associated with issued securities of the company, whether pursuant to a shareholders agreement or otherwise, and the appointment or election of the majority of directors who control a majority of the voting rights on the board.

5. THE EXCEPTION – SECTION 44(1)

Section 44(1) contains the exception from the application of the section. The exception provides that for purposes of the said section, "financial assistance" shall not include the lending of money in the ordinary course of business by a company whose ordinary business is the lending of money. This is a very logical exception to the rule, as persons wishing to subscribe for or purchase shares in a company whose primary business is the lending of money, would probably target such company for a loan. The company is in the business of granting loans and it would be the in the best position to evaluate the security of the investment to be made by the person wishing to take up the loan. Such company would most probably not refuse the loan as a result of assessing the investment as a security risk, as that would dissuade the public from investing in the company.

6. REQUIREMENTS FOR A BOARD TO APPROVE FINANCIAL ASSISTANCE – SECTIONS 44(3) AND (4)

Section 44(3) provides that despite any provision of a company's Memorandum of Incorporation to the contrary, the board may not authorise any financial assistance contemplated in subsection (2) unless :

The particular provision of financial assistance is pursuant to an employment share scheme that satisfies the requirements of section 97 of the Act, 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 general for a category of recipients, and the specific recipient falls within that category[52].

The board is satisfied that immediately after providing the financial assistance the company would satisfy the solvency and liquidity test and the terms under which the financial assistance is proposed to be given are fair and reasonable to the company[53].

Again it is noticeable that the legislator chose to embrace the solvency and liquidity tests which form the basis of the regulation of capital under the new Act. The onus of assessing the desirability of extending the loan to the borrower is also on the board, which has to act in the best interest of the company and not just grant the loan to attract capital regardless of the risk and profitability of the transaction. The proper purpose rule can also be detected in this requirement.

Whereas the company's Memorandum of Incorporation may prohibit the granting of financial assistance as envisaged in section 44(2), section 44(4) clearly states that the board must ensure that any conditions or restrictions respecting the granting of financial assistance contained in the company's Memorandum of Incorporation has been satisfied.

[52] See section 44(3)(a) of the companies Act, 2008.
[53] See section 44(3)(b) of the companies Act, 2008.

7. VOIDNESS AND LIABILITY OF DIRECTORS – SECTIONS 44(5) AND (6)

A decision by the board to provide financial assistance contemplated in section 44(2), or any agreement with respect to the provision of financial assistance in conflict with the provisions of section 44 or contrary to any prohibition, condition or requirement contained in the company's memorandum of Incorporation is void in terms of the provisions of section 44(5). This provision does not take proper account of section 218 of the Act, which provides that nothing in the Act renders void an agreement, resolution or provision of an agreement, resolution, Memorandum of Incorporation or rules of a company that is prohibited, void, voidable or may be declared unlawful in terms of the Act, unless a court declares that agreement, resolution or provision to be void. It would thus be arguable that a breach of section 44(5) would render the action therein contemplated as voidable and not void as stated in the section. Voidness will only follow once a court has made a ruling for voidness as envisaged in section 218. Until a court has declared the action void in terms of section 218, the action will at best be voidable.

In terms of section 44(6) a director of a company is liable to the extent set out in section 77(3)(e)(iv) (this section makes the director liable for any loss, damages or costs) in circumstances where an agreement has been declared void by a court in terms of section 44(5) read with section 218 of the

Act. This liability will only follow when a director was present at the meeting when the board approved the resolution or agreement, or participated in the making of such a decision in terms of section 74[54] (section 74 provides for the passing of a resolution by written consent by a majority of directors without having had a formal meeting), and, failed to vote against the resolution or agreement, despite knowing that the provision of financial assistance was inconsistent with section 44 or a prohibition, condition or requirement contained in the Memorandum of Incorporation of the company[55].

Section 44(6) refers to section 218 which supports my view that the voidness in terms of section 44(5) should have been subject to a court declaring the action void in terms of section 218.

When evaluating an action in terms of section 44(6)(b), one should take cognisance of the very widely formulated definition of "knowing" as contained in section 1 of the Act. In my view it would be very difficult for a director to prove that he did not act "knowingly" as contemplated in the said definition.

8. COMPANY OR SUBSIDIARY ACQUIRING COMPANY'S SHARES – SECTION 48

Section 48 of the new companies Act, 2008, regulates the acquisition of a company's shares by the company or a subsidiary.

[54] See section 44(6)(a) of the Companies Act, 2008.
[55] See section 44(6)(b) of the Companies Act, 2008.

The right of a company to acquire its own shares has been present in the South African company law since 1999. This right was introduced as sections 85-89 of the Companies Act, 1973. In the 1973 Act the process and rules relating thereto were quite elaborate in contrast with the rather simple procedure authorised in section 48 of the 2008 Act.

In order to explain the relevant law envisaged in section 48 of the 2008 Act, I will now proceed to discuss section 48 in more detail.

9. THE EXCEPTION – SECTION 48(1)

Section 48(1) provides that 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 do not constitute an acquisition of its own shares within the meaning of section 48.

Section 164(2)(a) and (b) set out he following the following categories of resolutions that a company might propose to adopt at a meeting:

- The amendment of its Memorandum of Incorporation by the altering of the preferences, rights, limitations or other terms of any class of its shares in any manner materially adverse to the rights or interests of holders of that class of shares, as contemplated in section 37(8) of the Act.
- To enter into a transaction contemplated in sections 112, 113, or 114. Sections 112, 113 and 114 refer to proposals to dispose of the greater part of asset or

undertaking of a company; for an amalgamation or merger; and for a scheme of arrangement respectively.

The gist of section 164 is that in the event of a company a company giving notice to its shareholders of a meeting to consider any of the issues referred to in 9.2.1 and 9.2.2 above, a shareholder (as a dissenting shareholder) might give notice to the company, prior to the voting on the meeting, that he objects to the resolution.

Should the resolution however be passed, the company must then within 10 days give notice to the dissenting shareholders who gave notice of objection and has neither withdrawn the objection notice or voted in support of the resolution.

The result of the process described above is that a dissenting shareholder may then demand that the company pay the shareholder the fair value for all of the shares of the company held by that person, if:

- The shareholder sent the objection notice and in the case of an amendment to the company's Memorandum of Incorporation, holds shares of a class that is materially and adversely affected by the amendment.
- The company has adopted the resolution against which the shareholder objected.
- The shareholder voted against that resolution and has complied with all of the procedural requirements of section 164.

10. RELEVANCE OF THE DISTRIBUTION SECTION – SECTION 46

Section 48(2)(a) grants the authority to a company to acquire its own shares if the decision to do so satisfies the requirements of section 46.

Section 46 sets out the requirements for a distribution. In order to gain perspective on the mechanics of section 46, one must take cognisance of the definition of "distribution" as contained in section 1 of the Act.

In terms of the definition of distribution as contained in section 1 of the Act, a distribution also includes consideration for the acquisition by the company of any of its shares as contemplated in section 48, or by any company within the same group of companies, of any shares of a company within that group of companies.

Section 46(1) contains the relevant requirements for the making of a distribution (the payment of consideration for the purchase of shares). The relevant requirement are a resolution by the board authorising the distribution, that it reasonably appears that the company will satisfy the solvency and liquidity test immediately after completing the proposed distribution, and that 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.

From the above it is clear that a company may only pay for the purchase of its shares after full compliance with the requirements set out in section 46(1), as referred to in paragraph 10.4 above.

An interesting aspect, that links up with the principle that a payment for the acquisition of shares is a distribution to shareholders, is that since 30 June 1999, amendments to section 1 of the Income Tax Act have had the effect that where a company acquires its own shares, so much of the consideration paid therefore which represents profits of the company available for distribution will be treated as a dividend to the shareholder who is disposing of those shares and the company will be liable for Secondary Tax on Companies (STC) thereon[56].

In my view the most important consequences in respect of an acquisition of shares in terms of section 48 that flow from section 46, is firstly that the directors must authorise the payment of the consideration and secondly that there must be compliance with the solvency and liquidity test.

11. THE OPERATIVE SECTION – SECTION 48(2)

The authority of a company to acquire its own shares is derived from section 48(2) of the Act. In terms of the section and subject to subsection (3) [which will be discussed below] a company may acquire its own shares, if the decision to do so satisfies the requirements of section 46, and, any subsidiary of a company may acquire shares of that company,

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56 Meskin *Henochsberg on the Companies Act* (2009) at 180.

but, 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, and no voting right attached to those shares may be exercised while the shares are held by the subsidiary, and it remains a subsidiary of the company whose shares it holds.

The stripping of voting rights from the shares held by a subsidiary in a holding company has certain ramifications on the other shareholders in the holding company. This issue was pointed out by Delport in a recent publication where he used the following example to explain the problem: "... *if A holds 10 shares out of 100 issued shares and a subsidiary acquires 10 of the remaining shares, A will now have 11% of the votes instead of the previous 10%.*"[57]

Section 48 does not directly address the status of the shares acquired by the company. I am however of the view that the shares acquired by the company will derive their status from section 35(5), which provides that shares of a company that have been issued and subsequently acquired by that company in terms of section 48, or surrendered to that company in the exercise of appraisal rights in terms of section 164, have the same status as shares that have been authorised, but not issued.

The question discussed in paragraph 11 of chapter 4 above, also need to be re-mentioned her. If a subsidiary holds shares in a holding company and declare a dividend *in specie* of such share, the holding company will receive its

[57] Delport *The New Companies Act Manual* at 35.

shares in a manner otherwise than in terms of section 48 (also not in terms of section 164). Section 35(5) would then not apply and the status of the shares so received by the holding company will have to be ascertained in terms of the common law. The same arguments as in paragraph 11 of chapter would also apply under the 2008 Act.

12. PROHIBITION WHEN NO ISSUED SHARES OR ONLY SHARES OF CERTAIN CLASSES REMAIN IN ISSUE. – SECTION 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 that company in issue other than shares held by one or more subsidiaries of that company, or, convertible or redeemable shares.

Delport commented that it is not clear why convertible and redeemable shares are singled out[58]. Delport also cannot see what a redeemable share will be in terms of the 2008 Act[59]. He is further of the opinion that the exception in respect of shares held by subsidiaries is superfluous, given the general restriction that the aggregate of shares acquired by subsidiaries must not exceed 10%[60].

58 Delport *The New Companies Act Manual* at 35 in footnote 24.
59 See footnote 58 above.
60 See footnote 58 above.

13. ENFORCEABILITY OF AGREEMENT FOR ACQUISITION OF OWN SHARES BY COMPANY – SECTION 48(4)

In terms of section 48(4) 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).

14. IMPOSSIBILITY OF COMPANY TO PERFORM UNDER AGREEMENT TO ACQUIRE OWN SHARES – SECTION 48(5)

Section 48(5) regulates the situation where a company cannot perform its obligations under an agreement to acquire its own shares as a result of the operation of sections 48(2) and (3).

In circumstances referred to in paragraph 14.1 above, the company must bring an application to court[61] and carries the burden of proof that fulfilment of its obligations would put it in breach of subsections (2) or (3)[62].

If the court is satisfied that the company is prevented from fulfilling its obligations pursuant to the agreement, the court may make an order that is just and equitable, having regard to the financial circumstances of the company, and ensures that the person to whom the company is required to make a payment in terms of the agreement is paid at the earliest

[61] Section 48(5)(a) of the Companies Act, 2008.
[62] Section 48(5)(b) of the Companies Act, 2008.

possible date compatible with the company fulfilling its other obligations as they fall due and payable[63].

My submission is that the procedure described above is only applicable when the seller of the shares wishes to enforce the transaction for the sale of shares to the company. Should the person however elect to cancel the transaction with the company due to breach on the part of the company, he would be entitled to do so, and might also succeed with a claim for damages that he might have suffered as a result of the said breach. There is nothing in the said subsection that would suggest that such rights are not available to a seller.

15. REVERSING OF ACQUISITION OF SHARES BY COMPANY – SECTION 48(6)

Section 48(6) provides for the reversal of a transaction within two years of the transaction in the event of a company acquiring its own shares contrary to section 46.

The said subsection provides further that in circumstances set out above, the company may apply to 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.

It is my submission that section 46 deals with the "distribution" which is the payment of the consideration for the transaction. A contravention of section 46 might not mean

[63] Section 48(5)(c) of the Companies Act, 2008.

that the transaction as such has been irregular, but merely that the payment of the consideration was done in contravention of the Act. If that is so, the transaction would not necessarily be an illegal transaction, but the payment made in terms of the transaction would have been illegal. I submit that in such circumstances a *bona fide* seller (which is not a director of the company) might be entitled to (in terms of the common law) claim damages from the company suffered by him as a result of such compulsory reversal of the transaction. Nothing in the said subsection rules out the common law rights of a *bona fide* seller to claim damages. This view is supported by the liability of directors imposed in terms of section 48(7) discussed below.

16. LIABILITY OF DIRECTORS – SECTION 48(7)

Section 48(7) renders liable a director to the extent set out in section 77(3)(e)(vii) [loss, damage and costs], if the director was present at the meeting when the board approved an acquisition of shares contemplated in section 48, or participated in the making of such a decision in terms of section 74, and failed to vote against the acquisition of shares, despite knowing that the acquisition was contrary to section 48 or section 46.

When evaluating the knowledge a director in terms of section 48(7)(b), one should take cognisance of the very widely formulated definition of "knowing" as contained in section 1 of the Act. In my view it would be very difficult for a director to prove that he did not act “knowingly” as contemplated in the said definition.

CHAPTER 6
CONCLUSION

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1. INTRODUCTION

The conclusions drawn in this chapter are obviously untested in the sense that I did not have the privilege of seeing how the courts might interpret the relevant sections of the Companies Act, 2008. I have noticed some difference of opinion and interpretation with the academic commentators. Finality on the interpretation of certain issues will only come when the courts have the opportunity to do the required interpretations. The present uncertainty that exist with regard to the correctness of certain interpretations, certainly inhibit the will to express comprehensive and final conclusions.

2. CONCLUSIONS ON SECTION 44 OF THE COMPANIES ACT, 2008

The solvency and liquidity tests on which section 44 is based, renders adequate protection for creditors and shareholders of a company. The doctrine of maintenance of solvency and liquidity renders better protection for interested parties than doctrines previously used as for instance the capital maintenance rule.

The approval of financial assistance in the hands of the board is more appropriate than what it would be in the hands of shareholders in general meeting who are not necessarily informed enough to make decisions in the best interest of the company. The board carries the risk of liability and is subject to the fiduciary duties towards the company and should be in the best position to act in the best interest of the company.

The shareholders in general meeting (by special resolution) can limit or restrict the powers of the board by way of prohibitions or conditions in the Memorandum of Incorporation. This renders sufficient control in the hands of the majority which is consistent with the principle of majority rule.

Section 44 of the Companies Act, 2008, is an improvement on section 38 of the Companies Act, 1973.

3. CONCLUSIONS ON SECTION 48 OF THE COMPANIES ACT, 2008

It would bring more certainty into the company law if a comprehensive and proper definition for “acquisition” is inserted into the Act. As shown in the body of this dissertation, there are instances where a company “acquires” its own shares without the transaction falling within the ambit of section 48. The common law does not solve this problematic area comprehensively.

The solvency and liquidity tests on which section 48 (read with section 46) is based, renders adequate protection for interested parties.

Section 48 of the Companies Act, 2008, is an improvement on sections 85-89 of the Companies Act, 1973.

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