Acquisition of securities: Section 48 of the Companies Act 71 of 2008

by

Francois Claassens Wessels

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Acquisition of securities: Section 48 of the Companies Act 71 of 2008

Submitted in partial fulfillment of the degree LLM in Corporate Law by

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Summary

This work comprises a critical analysis of the section 48 acquisition of shares. Various predicaments inherent to such distributions are noted, and the financial, accounting, economic and statistical aspects pertaining to such distributions are used as yardstick in an effort to come to terms with the provisions of the Companies Act 71 of 2008. Initially, the section 48 distributions are analysed from a capital-related perspective in order to describe the application of the solvency and liquidity test, the fiction of beneficial interest in the current Act, as well as the effect of the exclusion of shareholder-specific distributions. Apart from capital rules, the internal actions' description extends to the *iusta causae* of and minority protection relating to the section 48 distributions. Specific attention is given to board resolutions, the capacity of management to effect such transactions, as well as the duties of directors that have been rendered ineffective due to a change in the role of principal in the principal-agency problem underlying companies. Shareholder protection (specifically the effect of substituting shareholder's resolutions with impractically phrased board resolutions) and creditor protection (specifically the cumbersome inclusion of "debt instruments" and its illogical nature) are discussed and, where possible, solutions are submitted. As a pragmatic step as an addition to director's duties, targeted share repurchases have also been discussed. Apart from discussing the common misperceptions inherent to some common terminology, an indication to the meaning of "acquisition of own shares" in section 48(2)(a) is sought, and the different forms that such distributions can take are briefly discussed (including the possibilities pertaining to introducing equity derivatives to create synthetic share repurchases). As for take-overs and fundamental transactions, the relevant scheme of arrangement provisions are taken note of, and themes underlying that topic – disclosure to shareholders, mandatory offers and share repurchases in order to deter take-overs – are included. The section 48(2)(b) subsidiaries' acquisition of shares in a holding company is not only compared to its version in the 1973 Act, but is also discussed from the perspective of the subsidiaries and of the holding company. Central to the latter is also the possibility of treasury shares and the liberal approach to financial assistance in the current Act.

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Introduction

The aim of this work is not only to submit a product that is good in law, but also one that is "good in corporate law". By stating the latter, the author refers to a regard for the inherent complexity of the subject at hand, as was stated by Coetzee DJP[1] and confirmed by Delport.[2]

A dissertation concerning section 48 of the Companies Act 71 of 2008 ("the Act") primarily pertains to two external corporate actions: Firstly, the acquisition of own shares[3] (commercially referred to as "share repurchases" or "share buy-backs")[4]; secondly, the subsidiary company's ("subsidiary") acquisition of shares in its holding company.[5] These aspects will be critically analysed in Chapter 3 and Chapter 4. The secondary aspects relating to section 48 pertain to internal corporate actions, as will be critically analysed in Chapter 1 and Chapter 2.

The reason for this backwards approach to the subject is due to the fact that is affronted by the said complexity – this is rather a case where "a word is worth a thousand pictures". Needless to say, the burocracy of companies supply the edifice of managing corporate capital, thereafter enabling one to come to terms with the wide-ranging implications of the application of section 48.

Section 48 is discussed here according to the themes that constantly run through company law: Director's duties, shareholder democracy, the group concept, take-overs, remedies, etc. Suffice to say that South Africa's Roman Dutch heritage has traditionally pointed towards a continental approach to the law in general, but that company law has been applied in South

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[1] *Ex Parte NBSA Centre Ltd* 1987 (2) SA 783 (T) at 787.
[2] (2011) v.
[3] s48(2)(a).
[4] Ch 3 par 2.
[5] s48(2)(b).

Africa according to English law principles,[6] even though neither the concept of a separate legal entity nor company law *per se* relate to Anglo-Saxon origins.[7]
The latter is the reason why a pure explanatory approach to section 48 would fail for the purpose at hand – the ability to make sense of it in the crossfire of two legal systems augments the intricacy and necessitates a critical examination. In order to do this, the author has made use of foreign law, positive law as common law, principles of civil law, principles of English law and legal interpretation. Furthermore, the section 48 corporate actions are exactly that: Actions taking place in the corporate sphere – whether viewed from an accounting, microeconomic, financial or statistical perspective – that are regulated by corporate law. Therefore, it would not be a pragmatic effort to analyse the law by disregarding quantitative or qualitative analysis at any level. This dissertation presupposes a certain minimum knowledge of corporate law and of finance, since terminology inherent to both systems has been liberally used.

Another important note on the text is that it takes an unapologetic stance of dematerialisation, all transactions are viewed as fill or kill orders, noise trading is taken into regard, and all companies referred to are public companies. Given the limited word count imposed on works of this nature, it is impossible to discuss all aspects pertaining to the section 48 acquisition of shares whilst maintaining a balance between substantive depth and width. Even though the rules of the Johannesburg Stock Exchange Ltd ("JSE") will apply to listed companies and will be mentioned in this work, the focus will be not on the latter. Furthermore, it is difficult to envisage a work on the acquisition of shares without the inclusion of works from think-tanks such as the RAND Institute, the CFA Institute, famous authors on the subject such as Bagwell and Vermaelen, and classic works on finance such as Graham and Dodd's *Security Analysis*. The author has aspired to include as much information from such sources as the inherent limitations permit.

It must be stated at the outset that, given the capital maintenance rule,[8] dividends constituted an "original" pay-out. In 1959, Gordon expressed the expected share price E at a specific moment for share price P (i.e. P_0) as the following dividend D_1 divided by the difference

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[6] Cilliers *et al* (2000) 19, 20.
[7] Pretorius JT *et al* (eds) (1999) 1, 9.
[8] Ch 1 par 3.

between shareholders' expected rate of return *k* and the long-term growth rate of dividends *g*.[9] This means that the expected share price as a function of P_0 would be a Bernoulli random variable[10] – an increase in D_1 would cause a decrease in *g* due to less funds reinvested in the company; therefore, the expected share price would either increase or decrease.[11] Furthermore, Lintner's model has proven successful in the United States of America ("USA") during the 20th century.[12] Lintner's model is hyperbolic, and expresses the direct proportionality of subsequent dividends Div_1 to the earnings per share ("EPS") for that subsequent period as EPS_1 if the company's target payout ratio remains a quantitative constant.[13]

To cut a long story short, it is disappointing to note that Lintner's model has proven to be less effective on the JSE than expected, given the fact that the data for research was subject to certain parameters rendering it the use of a pragmatically restricted sample in that study, rather than a population.[14]

The important question at hand can be deduced as follows: As the acquisition of own shares is now statutorily classified as a "distribution",[15] and the "original" distribution of dividends' effect on share prices in South Africa are somewhat unclear, and given that all distributions are subject to the solvency and liquidity test,[16] how much is known about the effect of section 48 actions in South African markets? The final deductive question could also be inversely expressed: Given financial uncertainty, how sound is the legislation? Therefore, it may be appropriate to commence this study with the same words as the six editions of Graham and Dodd's *Security Analysis* have commenced since 1934:[17]

> "Analysis connotes the careful study of available facts with the attempt to draw conclusions therefrom [*sic.*] based on established principles and sound logic. It is part of the scientific method. But in applying analysis to the field of securities we encounter the serious obstacle that investment is by

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[9] Wolmarans (2003) 11 *Meditari Accountancy Research* 243 at 244.
[10] *Ibid*.
[11] *Ibid*.
[12] *Id* at 245.
[13] *Id* at 247.
[14] *Id* at 251.
[15] Ch 1 par 4.
[16] Ch 1 par 5.
[17] Graham & Dodd (2009) 61.

nature not an exact science. The same is true, however, [*sic.*] of law and medicine, for here also both individual skill (art) and chance are important factors in determining success or failure. Nevertheless, in these professions analysis is not only useful but indispensable, so that the same should probably be true in the field of investment and possibly in that of speculation."

Chapter 1: Aspects relating to capital

1. Introduction

Both legislation[18] and authorities[19] primarily relate section 48 distributions to the corporate capital theme. Additional correlations include the scheme of arrangement procedure[20] as well as groups of companies; [21] however, the section 1 definition of distributions[22] and the provision of section 114(4)[23] categorise the acquisition of own shares and the subsidiary's acquisition of its holding company's shares as distributions, and subjects it to the solvency and liquidity test.[24]

The capital-specific development of section 48 distributions will briefly be put into context in this chapter – in relation to English law and previous legislation. Thereafter, the contemporary stance will be critically analysed from a legal perspective.

2. Corporate reformation

It is peculiar that the Department of Trade and Industry's policy paper, entitled *South African Company Law for the 21st Century – Guidelines for Corporate Law Reform*,[25] contains abundant references to the capital maintenance rule. The same applies to Cassim, Davis and Geach.[26]

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[18] Ch 2 Part D of the Act, entitled "Capitalisation of profit companies".
[19] *Vide* Delport (2011) 53-62.
[20] Delport (2011) 129-131; *vide* ch 3 par 7.
[21] Delport (2011) 108; *vide* ch 4.
[22] *Vide* par 4.
[23] *Vide* ch 3 par 7.
[24] s46(1)(b) and s46(1)(c).
[25] (Notice No. 1183, 2004) *Government Gazette* 26493:468 June 23.
[26] Cassim F, Davis D & Geach W (eds) (2009) 53-56.

Probabilistic reasoning that it indicates the emphasis of replacing the English Rule with the American Rule[27] is weak induction, since section 9 of Act 37 of 1999 had already substituted section 85 of Act 61 of 1973.

Furthermore, if the purpose constituted a proposed alternative capital system from the decision in *Trevor v Whitworth*[28], the product fails in two regards. Firstly, from the viewpoint of control: If it was a question of creditor protection[29] the voting privileges provided for in section 43(3)(a) may render such a notion counter-inductive. From the viewpoint of economic *spei*:[30] The provision of debt instrument redemption in section 43(3)(b) is merely a legal justification of the call and refunding provisions[31] in the debt instrument's affirmative covenant and prepayment options.[32]

All things being equal, the rejection of the capital maintenance rule does not function as an "important feature" of the Act as stated by Cassim, Davis and Geach,[33] but rather as a continuation of the notion of section 9 of Act 37 of 1999. Neither does it constitute a "capital maintenance regime based on solvency and liquidity" as stated by the DTI.[34]

3. The capital maintenance rule

This capital maintenance doctrine was probably inherited from British charter corporations in excess of a century prior to the decision in the *Whitworth* case.[35] Furthermore, the case of *Lee v Neuchatel Asphalte Company Ltd* (1889) 41 ChD 1 (CA)[36] already provided a precedent indicating the demise of capital maintenance as a means of directing profit and loss for dividend determination within two years following the *Whitworth* case.[37]

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[27] Pretorius JT *et al* (eds) (1999) 121.
[28] (1887) 12 App Cas 409 (HL) 416-423.
[29] *Vide* Cilliers *et al* (2000) 324, 325; *vide* ch 3 par 5.
[30] *Vide* Van der Linde (2009) 3 *TSAR* 484 at 484.
[31] Fabozzi (2011) 331-335.
[32] *Ibid*.
[33] Cassim F, Davis D & Geach W (eds) (2009) 55.
[34] Van der Linde (2009) 2 *TSAR* 224 at 224.
[35] Aiken M (2005) An accounting history of capital maintenance: legal precedents for managerial autonomy in the United Kingdom <http://www.allbusiness.com/accounting/3581214-1.html> (accessed on 4 April 2011).
[36] *Ibid*.
[37] *Ibid*.

Nevertheless, Lord Watson's decision in the *Whitworth* case created the prohibition for companies' acquisition of own shares, partially as an extension of the *ultra vires* doctrine.[38] Suffice to say state that Aiken's statement, in paraphrasing Littleton, provides the solution in this regard:[39]

> "The maintenance of capital is indeed important, but maintenance is an objective of management policy…The proper matching of costs and revenues carries the relation of capital and income further than does the relation of principal and interest. The action of matching treats capital as a means, income as an end."

Corporate capital in the Act is based on the solvency and liquidity test,[40] i.e. the "American Rule".[41] The acquisition of own shares was first considered in and approved by the Supreme Court of New York in *Ex parte Holmes* 5 Cow. 426, 434-5 (N.Y. Sup. Ct. 1826)[42] and even though this matter was disapproved by the same court in *Barton v Port Jackson* 17 Barb. 397 (N.Y. Sup. Ct. 1854)[43] the matter was finally approved by the New York Court of Appeals in *City Bank of Columbia v Bruce & Fox* 17 N.Y. 507, 511 (1858)[44] due to the absence of a jurisprudential basis constituting a prohibition. Apart from diverse legislative positions by the mid-twentieth century, the majority of states recognised the acquisition of own shares by companies[45] out of surplus,[46] often on the condition of a liquidity test;[47] some states prohibited the acquisition of own shares,[48] whereas others required a "special resolution" by shareholders.[49]

4. Distributions

Given some measures,[50] the statutory substitution of the *Whitworth* case accommodated companies' acquisition of own shares and its current classification as a "distribution". The

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[38] Cilliers *et al* (2000) 322 n2.
[39] Aiken *supra* n18.
[40] Delport (2011) 53.
[41] Pretorius JT *et al* (eds) (1999) 121.
[42] As quoted in Dodd (1941) 89 *U. Pa. L. Rev. & Am. L. Reg.* 697 at 698.
[43] *Id* at 699.
[44] *Id* at 699 n7.
[45] *Id* at 704-705 ("and by inference the management, untrammelled discretion"); *cf* chapter 2 par 3.
[46] *Id* at 705.
[47] *Ibid*.
[48] *Ibid*.
[49] *Ibid*; *cf* ch 2 par 3.
[50] Specifically shareholder and creditor protection.

latter derivation is binary:[51] Firstly, section 48(2)(a) provides that a decisions for the acquisition of own shares is subject to section 46, entitled "Distributions must be authorised by board"; secondly, section 1 classifies acquisition of own shares within the ambit of "distribution" at paragraph (a)(iii)(aa) of the definition of distribution. In addition, the group concept encapsulated in the section 1 definition of "distribution" at paragraph (a)(iii)(bb) deductively includes the section 48(2)(b) acquisition of a company's shares by its subsidiary.

4.1. The Companies Act 61 of 1973

Even though the employment of the conjunctive term "corporate distribution" dates back to the early 20th century,[52] the term "distribution" was not defined in Act 61 of 1973. Therefore, wider acceptance of the term "dividend" is evident in publications such as *Cilliers and Benade's Corporate Law*, although it is a colloquial term for "distribution".[53]

Dividend allocation was regulated by section 90 of the 1973 Act, and was categorized within the inclusive definition of "payment".[54] Section 90(3) expressly excluded *inter alia* the acquisition of own shares (regulated by section 85) and the redemption of redeemable preference shares (regulated by section 98). Even though the acquisition of shares by a subsidiary in its holding company[55] was to be executed *mutatis mutandis* in accordance with *inter alia* the provisions regulating the acquisition of own shares,[56] it is doubtful whether the section 89 acquisition could have classified as a section 90 "payment".

4.2. The Companies Act 71 of 2008

Prima facie, the definition of "distribution" in section 1 is not only a linguistic adaptation of the inclusive definition of "payment" *supra* (which was already considered by Pretorius *et al* (eds) as "extremely wide"),[57] but also an expansion of its content. Apart from the fact that the acquisition of own shares (primarily regulated by section 48) and redemption (which will be

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[51] *Contra* Jooste (2009) 126 *SALJ* 627 at 634.
[52] *Vide* e.g. Magill R (1936) 36 *Columbia L. Rev.* 519 and Katz WG (1941) 16 *Account Rev* 244.
[53] Delport (2011) 58 n28.
[54] s90(3) of Act 61 of 1973.
[55] s89 of Act 61 of 1973.
[56] s85 of Act 61 of 1973.
[57] Pretorius JT *et al* (eds) (1999) 122.

discussed later)[58] have been included, the uncertainty regarding the subsidiary's acquisition of its holding company's shares, as indicated *supra*,[59] is cleared through its inclusion.

A distribution means, *inter alia*:[60]

> "a direct or indirect–
>
> (a) transfer by a company of money or other property of the company, other than its own shares, to or for the benefit of one or more holders of any shares, or to the holder of a beneficial interest in any such shares, of that company or of another company within the same group of companies, whether–
>
> (iii) as consideration for the acquisition–
>
> (aa) by the company of any of its shares, as contemplated in section 48; or
>
> (bb) by any company within the same group of companies, of any shares of a company within that group of companies; or
>
> (iv) otherwise in respect of any of the shares of that company or of another company within the same group of companies, subject to section 164(19);"

In *Bond v Barrow Haematite Steel Co*[61] it was confirmed that the "shareholder has no right to any payment until the corporate body has determined that the money can be properly paid away".[62] Van der Linde confirms that distributions legally constitute gratuitous payments.[63] However, this legal reality often contradicts real commercial practices, since several companies have a culture of dividend distribution that is principally founded on historical consistency.[64] All things being equal, the definition *supra*, as well as the Act *in toto*,[65] presents various predicaments relating to the company or a subsidiary acquiring shares in the company.

4.2.1 Proprietary fiction and spoliation abuse

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[58] Ch 3 par 6.
[59] Par 4.1.; *vide* par 4 *supra* on group concept.
[60] s1.
[61] [1902] 1 Ch 353 at 362, as quoted in Pretorius JT *et al* (eds) (1999) 141.
[62] *Ibid*; *contra Burland v Earle* [1902] AC 83 (PC) at 95 (as quoted in Pretorius JT *et al* (eds) (1999) 138) where Lord Davey correctly assumed that dividends, in both distribution and quantity distributed, are a matter of internal management, yet erroneously stated that the powers in this regard are vested in the shareholders.
[63] Van der Linde (2009) 3 *TSAR* 484 at 484.
[64] Skinner (2008) 87 *J Financ Econ* 582 at 583; an example of the effect of such historical consistency was apparent when Anglo American PLC suspended dividends in 2009 – Lourens C (2009) Anglo suspends dividends for first time since WWII (Update 4) <https://www.bloomberg.com/apps/news?pid=newsarchive&sid=aBPkQKqf6kZc> (accessed 2 November 2011); *vide* ch 3 par 4.
[65] Delport (2011) v.

The word "other" in paragraph (a) of the section 1 definition of distribution assimilates shares with property – akin to the description in section 35(1). There is a discrepancy in the legal rationalisation of a "share" in common and civil law.[66] Whereas several courts have accepted shares as *jura in personam*,[67] the legislation has always been fixated on a common law proprietary classification,[68] even though the latter is a fiction in South African civil law[69] - based not on contradiction but on misconstruction,[70] and used to circumvent detracting from the efficacy of some convenient notions.[71] Therefore, the word "other" is nonsensical. Furthermore, since the classification of shares as movable property in section 35(1) is modified by the section 37(9) provisions relating to register-keeping, share-trading is rendered comparable to the trade of immovable property.[72]

Proprietorship aside, the misclassification facilitates the employment of a spoliation order – rather than specific performance – to circumvent the onus of proving the existence of a valid contract to attain possession of shares in cases of section 48(2)(a).[73] As an example of active arbitrage in a liquid market, the spoliation order may be used by a growth investor in cases of exotic share repurchases[74] where a company fails to perform the transfer compliant with section 37(9).[75] However, this would hardly occur in cases envisaged in section 48(2)(b) in the primary market due to section 40(5)(b)(ii) statutorily excluding the possibility of the *exceptio non adimpleti contractus*. It must be noted that the grey market is not discussed in this work.

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[66] *Vide* Fox (2009) 4 *TSAR* 638.
[67] E.g. *Standard Bank of SA Ltd v Ocean Commodities Inc* 1983 (1) SA 276 (A) at 288-289; Cilliers *et al* (2000) 224.
[68] *Vide* definition of "share" in s1 of Act 71 of 2008 and s91 of Act 61 of 1973; Pretorius JT *et al* (eds) (1999) 148.
[69] *Oakland Nominees (Pty) Ltd v Gelria Mining & Investment Co (Pty) Ltd* 1976 (1) SA 441 (A), as quoted in Cilliers *et al* (2000) 243 n23 and n27.
[70] Fox (2009) 4 *TSAR* 638 at 640: "Confusion may arise because there is some overlap in the terminology that each system uses, which may lead a reader to think that the same principles were being applied in the two systems. This is not necessarily so. The objects of 'property' in the English sense are not necessarily the 'things' of South African law. 'Proprietary interest' in the English sense are not confined to the 'real rights' of South African law."; it is submitted that, in accordance with this asymmetry, Trollip JA's decision in *Utopia Vakansie-Oorde Bpk v Du Plessis* 1974 (3) SA 148 (A) at 181, as quoted in Pretorius JT *et al* (eds) (1999) 160-161, that "belange is 'n woord van breë betekenis…dit [beteken] iets anders as 'regte'" is a correct observation based on an incorrect principle.
[71] *Supra* n53.
[72] Delport P (2010) *Lecture for LLR 801* 4 August 2010.
[73] Christie *et al* (2006) 460.
[74] *Vide* Conclusion.
[75] *Vide* s35(1).

4.2.2. Beneficial interest – a failure of "effectual and purposeful legislation"[76]

Based on the misperceptions pertaining to "interests" in company law,[77] the term "beneficial interest" is rendered a misnomer. However, if this proves to be an incorrect deduction it is still not clear how the transfer to or for the benefit of a shareholder differs from a transfer to the holder of a beneficial interest in a share. According to Delport a share is defined by the substance of its assigned rights,[78] and it is transferred in common law upon rescinding these rights.[79] Therefore, since the benefit of a holder of shares may overlap with as the holder of a beneficial interest, any reference to "benefit" in this definition, following the *eiusdem generis* rule, is of no effect. Furthermore, the provision relating to register-keeping that renders share-trading similar to the trade of immovable property[80] nullifies the concept of "beneficial interest" in the Act.

4.2.3. Uncertainty and redundancy

Certain actions have been statutorily excluded from the ambit of section 48. Firstly, the omission of redemption of securities has thrusted the latter into obscurity. This is discussed in Chapter 3 at par 6. Though not discussed at breadth in this work, the reference to section 164 in section 48(1)(a) is redundant, since the section 1 definition of "distribution" already provides for the exclusion of section 164(19) at paragraph (a)(iv).

4.2.4. The capacity of shareholding

Even though the Act amalgamates the earlier concepts of shareholding and membership into, loosely stated,[81] "shareholding",[82] the definition of distribution does not render distribution reception in the capacity of "shareholding"[83] as was the case in section 90(3) of the 1973 Act. The section 90(3) capacity-proviso was not encapsulated in section 85 or section 89 of the 1973 Act.

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[76] Botha (2005) 74-76.
[77] Par 4.2.1. *supra*.
[78] Delport P (2010) *Lecture for LLR 801* 4 August 2010; *contra Smuts v Booyens* 2001(4) SA 15 (SCA).
[79] *Botha v Fick* 1995 (2) SA 750 (A) at 762-764.
[80] s37(9).
[81] *Vide* reference to "beneficial interest" in s1 definition of "distribution".
[82] *Vide* s1 definitions of "shareholder", "securities" and "distributions"; *vide* Delport (2011) 71 n 2.
[83] Delport (2011) 59 n33.

Firstly, it is imperative to note the uncertainty regarding a *numerus clauses* of "distributions", rather than "pay-outs". Van der Linde refers to the new Act as containing a "single definition of 'distribution'",[84] since the list of examples prove to be an exhaustive list. While the waiver of repayment on section 44 financial assistance will constitute a "distribution" in terms of the section 1 definition of "distribution" at paragraph (c), section 45 loans or financial assistance that have subsequently rendered the applicable director in *mora debitoris* will not be automatically considered a section 1 "distribution", since paragraph (c) refers only to holders of shares in the company[85] or in another company within that group of companies. Therefore, there could be a cornucopia of cases where companies relinquish capital *sans* the classification of "distribution". More subject-specific, the exclusion of the "shareholder" capacity could pertain to loan agreements by the company[86] to a shareholder in order to purchase shares in that company; therefore, constituting section 44 financial assistance but not a section 48(2)(b) distribution.[87]

According to Jooste, the inclusion of subparagraphs (i) – (iv) in paragraph (a) of the section 1 definition of "distribution" creates an ambiguity that is left unresolved by the exclusion of such information in paragraphs (b) and (c).[88] The author agrees with Jooste given the conjunctive of "or" in the definition.

5. Solvency and liquidity approach

Given the classification of section 48(2)(a) and section 48(2)(b) actions as "distributions",[89] these actions will necessarily be subjected to the solvency and liquidity requirements.[90] The solvency and liquidity tests, as set out in section 4, are merely yardsticks for the short and long-term financial condition of a company[91] – whereas the solvency test is an objective test[92] that will be satisfied where assets exceed liabilities[93] on a company's balance sheet and may

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[84] Van der Linde (2009) 3 *TSAR* 484 at 485.
[85] As per Delport (2011) 59 n30, it remains uncertain whether a section 1 "shareholder" correlates with the common law "holder of shares".
[86] Delport (2011) 59 n33.
[87] *Vide* ch 4 par 6.
[88] Jooste (2009) 126 *SALJ* 627 at 634.
[89] Par 4 *supra*.
[90] s46(1)(b).
[91] Broihahn *et al* (2011) 7.
[92] Delport (2011) 54.
[93] Van der Linde (2009) 2 *TSAR* 224 at 225.

relate to working capital management,[94] the liquidity approach, as a subjective test,[95] entails a cash flow analysis.[96]

A company may not implement a section 48 distribution, unless the following is apparent: [97]

> "(b) it reasonably appear 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"

The solvency test in section 4(1)(a) roughly corresponds to the solvency test in section 85(4)(b) of the 1973 Act, and the liquidity test in section 4(1)(b) roughly corresponds to section 85(4)(a) of the 1973 Act.

5.1. Defining the scope of information for analysis prior to a section 48 distribution

Section 4(1) subjects the use of the solvency and liquidity test to "all reasonably foreseeable financial circumstances", the latter presumably being "financial information" according to the provisions of section 28[98] and section 29.[99] However, "financial information" has a more limited meaning than "all reasonably foreseeable financial circumstances";[100] therefore, it is submitted that Van der Linde is correct in stating that the latter wider term should be dominant.[101] In the first instance, the fundamental analysis that underpins sections 28 and 29 is rather ignorant of the fact that share prices and volumes are driven by erudite market participants trading on all their knowledge,[102] since "the market reduces to a bloodless verdict all knowledge bearing on finance, both domestic and foreign."[103] Secondly, it remains a

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[94] DeFusco *et al* (2011) 312.
[95] Van der Linde (2009) 2 *TSAR* 224 at 225; Broihahn *et al* (2011) 7.
[96] Van der Linde (2009) 2 *TSAR* 224 at 226.
[97] s46(1).
[98] s4(2)(a)(i).
[99] s4(2)(a)(ii).
[100] Van der Linde (2009) 2 *TSAR* 224 at 230.
[101] *Ibid*.
[102] *Vide* Sine & Strong (2011) 647.
[103] *Ibid*.

realistic and radical verity that the instantaneous consequence of trades on share prices and volumes often forecasts fundamental development.[104]

Furthermore, the palpable inadequacy of the solvency and liquidity test pertains to its focus on company records *per se* and not also to microeconomic predictions. A classic justification of section 48(2)(a) is the re-issue of undervalued shares in favourable market conditions in the future. This practice of "signaling" constitutes a circumstance of asymmetric information between parties.[105] Of equal validity is the "handicap principle".[106] Such corporate decisions are naturally subject to various random variables that may influence the volatility of share prices. A valid selection for analysis would be the employment of Monte Carlo simulations in order to observe the probability of certain future market conditions based on various observations.[107] It is odd to contemplate that the analytical techniques employed by investors would not reciprocally be employed by the companies in which such investors invest, if only for purposes of competitive intelligence.

5.2. An impractical resolution

The non-correlative wording between section 46(1)[108] and section 46(1)(a)[109] is still subject to the principle that no word or sentence may be regarded as superfluous in legal interpretation.[110] By implication section 46(1)(b), containing an objective test, [111] is applied when the distribution is proposed,[112] in juxtaposition to the moment of board authorisation.[113] The board resolution, as a subjective test, must concede the acknowledgement of application at the time of the resolution. This can be proved by the synonymous use of "resolution" and "acknowledgement" in section 46(3), constituting a circumstance of *noscitur a sociis*. The

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[104] *Ibid*.
[105] Polak B "Assymetric information: silence, signaling and suffering education" <http://academicearth.org/lectures/assymetric-information> (accessed on 14 November 2011); *vide* ch 3 par 4.
[106] E.g. Krings A, Sheldon FT & Zhanshan SM "The handicap principle, strategic information warfare and the paradox of asymmetry" <http://info.ornl.gov/sites/publications/files/Pub24036.pdf> (accessed on 14 November 2011).

[107] DeFusco *et al* (2011) 528 *et seq*.
[108] Reference to "proposed distribution".
[109] Reference to "distribution".
[110] Botha (2005) 70.
[111] Van der Linde (2009) 2 *TSAR* 224 at 235.
[112] This information may be contained in the minutes of the meeting – s88(2)(d).
[113] Van der Linde (2009) 2 *TSAR* 224 at 233.

effect of this is that the 120 day time constraint[114] is not applicable to the actual performance of the solvency and liquidity test, but rather to the resolution/acknowledgement. It is submitted that this is an impractical measure that dilutes the efficiency of the solvency and liquidity test, given the assumption that that which is regarded as "reasonable" may be a variable over an elongated period of time.

5.3. Counter-performance in share repurchases

The doctrine of valuable consideration is enshrined in the provisions of section 40(1)(a) as "adequate consideration" for the issue of shares.[115] Frankly, the same principle is to be found in section 424(2)(b) of the Companies Act 61 of 1973, section 126A(5)(b) of the National Credit Act 34 of 2005, section 24(1) of the Insolvency Act 24 of 1936, section 45 of the Long-term Insurance Act 52 of 1998, section 44 of the Short-term Insurance Act 53 of 1998, and even in the decision of *Reynolds v Est. A Findlay and J Hulston*[116] on Law 19 of 1893.

The scheme of arrangement procedure[117] allows for an independent expert to undertake a valuation of applicable securities,[118] as it applies to a company's acquisition of its own shares.[119] Apart from the obvious pragmatic critique pertaining to exactly how the independent expert will cause the report to be circulated to all relevant securities holders,[120] the Act supplies no indication as to the method according to which the consideration will be estimated for the acquisition of own shares of 5% and less.

Analogous interpretation on the topic of valuation would not be possible here, given that there are cases where the court has taken it upon itself to establish the fairness of a valuation[121] and where it took the advice of an independent expert into account.[122]

6. Conclusion

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[114] s46(3).
[115] Delport (2009) 21 n40.
[116] (1908) 29 NLR 32.
[117] s114.
[118] s114(2)(a)(i)(cc).
[119] s114(1)(e) read with s114(4).
[120] *Vide* s114(3).
[121] *Vide* e.g. *Ex parte Macey's Stores Ltd* 1983 (2) SA 657 (ZH).
[122] *Vide* e.g. *Ex parte Garlick Ltd* 1990 (4) SA 324 (C).

The section 48 acquisition of shares is once more a legitimate corporate pay-out subject to a solvency of liquidity test. However, as Jooste has shown, not all cases of acquisition of shares are necessarily distributions and regulated in the Act,[123] just as this chapter has proven that the solvency and liquidity test falls short of constituting an effective financial analysis. The financial analysis is further diluted by provisions constituting impractical resolutions. In the latter regard, the Act's section 7(d) purpose of achieving economic benefits is rendered a wildcard, just as the cumulative effect renders section 7(e) somewhat tempered in this regard.

[123] Jooste (2009) 126 *SALJ* 627 at 634.

Chapter 2: Corporate Governance & Minority Protection

1. Introduction

This chapter is primarily concerned with the role of those with control and those with "ownership" in the section 48 acquisition of shares, commencing with the legal causes of such distributions. It must be noted that the financial causes of such transactions are referred to throughout this dissertation. As for management, the duties of directors and the nature of their decisions are discussed as it pertains to section 48 distributions. Thereafter, the role of the shareholders is discussed.

2. *Iusta Causae*

The acquisition by a company or subsidiary of the company's shares requires a *iusta causa*, the latter being either an existing legal obligation or a court order[124], or through authorisation by the board of the company.[125]

2.1. Existing legal obligation

The ambit of "existing legal obligation" is indistinct, but may either refer to obligations (commonly referred to as "bargains")[126] that existed before or after the Act came into operation.[127]

If the former applies, the transitional arrangements of the Act will apply. A person has the right to seek a remedy in terms of the Act with respect to the conduct of an existing company and occurring prior to the operative date of the Act, unless the case was rendered *litis contestatio* before that date.[128] This is in accordance with section 12(2)(b) of the Interpretation Act 33 of 1957. The nature of the remedies sought is discussed in Chapter 3 and Chapter 4.

[124] s46(1)(a)(i).
[125] s46(1)(a)(ii).
[126] "A term used interchangeably with the term 'a contract to buy/sell shares' ." – Arnold (2010) 494.
[127] Delport (2011) 59 n33.
[128] Item 7(7) of Schedule 5.

If the latter applies, there are two possible interpretations.[129] The first possibility would be that economic rights, such as cumulativeness, are excluded from the ambit of section 46, with the effect that it is uncertain how this would be regulated.[130] Given paragraph 4.2.4. in Chapter 1, it may refer to distributions to shareholders based on separate obligations, such as a loan agreement, beyond the ambit of section 46.[131]

2.2. Board authorisation

The "board" refers to "the board of directors of a company",[132] whereas "director" refers to a member of the former, as provided for in section 66, or an alternate director of a company, including any person occupying the position of a director or alternate director, by whatever designation.[133] Previously, the legal position of a director could not be "determined *a priori* by reference to a single stereotyped legal relationship".[134] Whether section 15(6)(c) of the Act indicates a contractual relationship between the company and the directors is not clear,[135] but in the light of the fact that a superimposed relationship did not influence the nature of the office previously,[136] a contractual relationship in terms of the new Act may not necessarily constitute a problem.[137]

In addition, the statutory denotative phrasing of "director" – "and includes any person occupying the position of a director or alternate director, by whatever name designated"[138] – will include *de facto* directors.[139] Subject to the MOI, the board of a company may delegate their authority in terms of section 46 to a company committee.[140] However, delegation of

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[129] Delport (2011) 59 n33.
[130] *Ibid*.
[131] *Ibid*.
[132] s1.
[133] s1. The statutory definition of "director" in the new Act differs from the inclusive definition of "director" in s1 of Act 61 of 1973.
[134] Cilliers *et al* (2000) 118.
[135] Delport (2011) 21 n58.
[136] Cilliers *et al* (2000) 118.
[137] Delport (2011) 21 n58.
[138] s1.
[139] *Re Hydrodam (Corby) Ltd* [1994] 2 BCLC 180 (Ch) at 183; [1994] BCC 161, as quoted in Pretorius JT *et al* (eds) (1999) 240-241.
[140] s72(1).

authority excludes the delegation of responsibility, contrary to the decision in *Fisheries Development Corporation v Jorgenson* 1980 (4) SA 156 (W).[141]

The requirement of board authorisation in section 46(1)(a)(ii) differs from the s46(1)(c) requirement in that it has no similar provision as the time constraint stipulated in s46(3), irrespective of the "and" function utilised in section 46(1); therefore, the board may authorise the acquisition of own shares at any stage before such a decision is actively implemented.[142] This structure constitutes an error of deduction, as the following scenario illustrates. The publication of considering a proposal with a view on a possible distribution has the effect of increasing short-term demand, given that the issued share capital remains invariable during the process, and therefore rendering supply perfectly inelastic.[143] Once the 120 day period (considering that this encompasses four cycles of thirty day moving averages, and that the company's equity may therefore be subject to serious trading activity) lapses and the directors omitted the resolution, the increased overall value of equity constitutes an advantage that develops as a simulation of the traditional object of share repurchase in undervalued companies. The possibility of classifying such activities as prohibited trading practices[144] or as a false, misleading or deceptive statement, promise or forecast[145] in terms of the Securities Services Act[146] falls outside the ambit of this work.

3. Managerial capacity to authorise distributions

From a capital budgeting point of view, a company constitutes a collection of projects and investments.[147] Therefore, growth activities can be evaluated by using either the Net Present Value ("NPV") Rule or the Internal Rate of Return ("IRR") Rule[148] (since the collection is a portfolio,[149] the correct term in portfolio return measurement would be "money-weighted rate of return").[150] The former is calculated as:[151]

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[141] Delport (2011) 88 n58.
[142] Van der Linde (2009) 3 *TSAR* 484 at 492.
[143] Parkin (2011) 22 *et seq*.
[144] s75(3)(h) or s75(3)(i) of Act 36 of 2004.
[145] s76 of Act 36 of 2004.
[146] 37 of 2004.
[147] DeFusco *et al* (2011) 312.
[148] *Id* at 312-314.
[149] *Id* at 312.
[150] *Id* at 319-321.
[151] *Id* at 313.

$$NPV = \sum_{t=0}^{N} [CF_t /(1 + r)^t]$$

Where CF_t is the cash flow for period t with N periods, which is divided by the present value factor, made up of one plus discount rate r to the power of the applicable period t.[152] The calculation of a positive present value of future cash flows constitutes a lucrative project and a negative result the opposite.[153] However, it is imperative to note that a NPV equal to zero constitutes business growth with no growth in shareholder wealth.[154]

The company has been likened to the long-term interests of the shareholders.[155] In addition, not only would the members of the company have the ultimate pronouncement in cases of concurrent powers,[156] but the general meeting also had the power to remove directors.[157] Whereas the directors could declare interim dividends,[158] the shareholders had the power to authorise final dividends at a general meeting[159] – sometimes subject to director's recommendations.[160] The capital maintenance rule aside, the company or subsidiary acquiring the company's shares according to the 1973 Companies Act was a matter of authorisation in special resolution[161] as a measure to protect shareholders.[162]

The new Act amended the prior situation in two regards. Firstly, in contradiction with the decision in *Ex parte Russlyn Construction (Pty) Ltd*,[163] section 66(1) extends the powers of the board to manage the business *and affairs* of the company,[164] who moreover have the authority to exercise all the powers and execute all the functions of the company, subject to

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[152] *Ibid*.
[153] *Id* 313-314.
[154] *Ibid*; distinguish this from the calculation where NPV is made equal to zero, in which case subsequent positive cash flows would be equal to the investment and one can calculate internal rate of return – DeFusco (2011) 314 *et seq*.
[155] *Hutton v West Cork Railway Co* (1883) 23 ChD; *Isle of Wight Railway Co v Tahourdin* (1883) 25 ChD 320.
[156] Cilliers *et al* (2000) 86.
[157] s220 of Act 61 of 1973.
[158] Cilliers *et al* (2000) 354 n68.
[159] *Id* at 354.
[160] *Ibid*.
[161] s85(2) of Act 71 of 2008.
[162] Cilliers et al (2000) 325-326; *vide* par 6 *infra*.
[163] 1987 (1) SA 33 (D) 35-37.
[164] Own italics; Delport P (2011) *Lecture for TOR 802* 9 March 2011.

the provisions of the Act and the MOI. Not only does this equate the company to the board,[165] but also renders all acts of directors to be corporate acts.[166] Therefore, the current legal position greatly departs from realistic financial data and raises an objection to questionable corporate regulation under the regime of the new Act. Secondly, section 46(1)(a)(ii) provides that all distributions, apart from section 46(1)(a)(i), are subject to board resolutions and constitute a prime example of the "divorce of control from ownership".[167]

4. Director's duties

According to Dodd, the underlying assumption permitting share repurchases to be made out of earned surpluses does not only preserve capital for the creditors' sake, but also does not pose any harm to shareholders as long as the acquisition was not executed for an improper motive.[168] The very basis of solvency and liquidity invalidates the basis of this argument in South African Law. Therefore, a different course of consideration for director's duties must be considered.

The resource allocation method in the secondary market is market price,[169] with joint stock capital positively managed[170] by directors[171] acting as agents and as trustees without being either one of the two.[172] Prior to section 66(1), directors were at times regarded as acting as agents nonetheless – in either legal terms[173] or economics terms.[174] In legal terms, the prevalence of *culpa* will be measured against an objective test of the agent's necessary knowledge, care and skill in execution.[175] More specifically, directors' duties are once more included in the Act: The fiduciary duty,[176] the duty of care and skill,[177] and a justification commonly known as the business judgment rule.[178] In economic terms, the principal's (shareholders') inclination to economics optimisation is voiced in the so-called Principal-

[165] Delport (2011) 66, 67.
[166] *Vide* Cilliers *et al* (2000) 117.
[167] Cilliers *et al* (2000) 86 n16.
[168] Dodd (1941) 89 *U. Pa. L. Rev. & Am. L. Reg.* 697 at 706.
[169] Parkin (2011) 38.
[170] Delport (2011) 90 n68.
[171] s66(1).
[172] Pretorius JT *et al* (eds) (1999) 270.
[173] Cilliers *et al* (2000) 117.
[174] Parkin (2011) 108.
[175] *Mouton v Die Mynwerkersunie* 1977 1 SA 119 (A).
[176] s76(3)(a) and s76(3)(b).
[177] s76(3)(c).
[178] S76(4).

Agent Problem, which comprises the reduction of managers' performance for own benefit and conversely the increased efficiency of the company.[179] This problem had already been identified by Smith in 1776:[180]

> "The directors of such companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company."

Even though section 76 *prima facie* supplies some protection from the envisaged dilemma quoted, section 66(1) renders the situation calamitous in that equates the directors to principals, leaving section 76(2)(a)(i) circuitous, and nullifies director's duties under the new corporate regime. None of the three proposed solutions to the Principal-Agent Problem – "ownership", long-term contracts and incentive pay – will serve their purposes; frankly, the current legislative dispensation on the matter will cause the solutions to directly constitute the exact opposite.

5. Targeted share repurchase[181]

The focus of this paragraph, to be read with Chapter 3 paragraph 7, is mainly greenmail as it pertains to shares, and not as it pertains to debentures.[182]

The lawfulness of certain merger and acquisition ("M&A") defense tactics vary greatly between the American system on the one side, and the United Kingdom's and continental systems on the other.[183] Whereas the acquisition of own shares to decrease the probability of

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[179] Parkin (2011) 108, 109.
[180] Smith (2003) 941.
[181] *Vide* Macey & McChesney (1985) 95 Yale L. J. 13; Bebel (1987) 18 Tex. Tech. *L. Rev.* 1083; Gilson (1988) 88 *Columbia L. Rev.* 329; Eckbo (1990) 25 *J Financ Quant Anal* 491; Mikkelson & Ruback (1991) 22 *RAND J Econ* 544; Peyer & Vermaelen (2005) 75 *J Financ Econ* 361.
[182] *Vide* Kahan & Rock (2009) 103 *Nw. U. L. Rev.* 281.
[183] Arnold (2010) 448.

a take-over may be lawful in the latter countries,[184] the targeted share repurchase is criticised.[185]

The targeted share repurchase, also known as a negotiated stock repurchase and as greenmail, has been erroneously defined by Engle as occurring when a shareholder acquires a significant stake in a company and subsequently threatens the company with a hostile take-over unless a share repurchase at premium takes place.[186] In reality greenmail contains four elements, namely threat, compliance, agency and a potential hostile take-over.[187] That which is etymologically "corporate blackmail"[188] overlaps with blackmail in criminal law terms;[189] therefore Engle's reference to "a threat" will constitute a threat to blackmail, which would in theory carry the same sentence as blackmail.[190]

Even though greenmail is not regarded as unethical,[191] it was previously unlawful if not executed according to certain rules of disclosure[192] and is currently unlawful if not approved by the Takeover Regulation Panel and the relevant securities holders, or if not in terms of an obligation entered into prior to the time provided for in section 126(1).[193] Its unlawfulness in circumstances not provided for would presumably be due to its legal overlap with the requirements of blackmail in criminal law.[194] Unlawfulness is not excluded through a party's rightful conduct (therefore, the distinction between a "threat" and "bargaining power" becomes irrelevant), but rather through examining the manner of conduct and the envisaged consequence (a subjective test).[195] The manner of conduct may constitute intimidation, and the offeror's envisaged outcome will be personal benefit.[196]

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[184] Ch 3 par 7.3.
[185] Arnold (2010) 449.
[186] Engle (2007) 5 *DePaul Bus. & Com. L. J.* 427 at 429.
[187] Freeman *et al* (1987) 6 *J Bus Ethics* 165 at 168-169.
[188] *Vide id* at 168.
[189] Snyman (2006) 400 *et seq*.
[190] *Id* at 283, 402.
[191] *Vide* Freeman *et al* (1987) 6 *J Bus Ethics* 165.
[192] Rule 33 and Rule 7 of the Securities Regulation Panel: Securities Regulation Code on Take-overs and Mergers and the Rules and rules under section 440C read with sections 440C(1) and section 440C(3)(i) and (ii) and 440C(4)(d) and (e) of Act no 61 of 1973 as amended.
[193] Regulation 112 of the Companies Regulations, 2011.
[194] Snyman (2006) 400 *et seq*.
[195] *Id* at 402.
[196] *Ibid*.

6. Shareholder protection

It is important to note that Aiken's statement *supra*[197] contains an inherent risk for shareholders and an inherent hazard for potential investors. In cases pertaining to the repurchase of securities below par value in the United States of America ("USA") – whether Utah Securities Corporation's 1915 repurchase of 6% notes, Armour and Company's 1932 repurchase of bonds or The International Securities Corporation of America's 1932 repurchase of 5% bonds – the gains were included as current income.[198] Such a practice expands the net distributable profits, which influences the earnings per share ("EPS") ratio.[199] Not only was such a practice deceptive due to the fact that the profit constituted nonrecurring income, but also because the profit was made to the detriment of the company's own securities holders.[200]

It is common cause that "ownership" in small and medium companies were originally arranged according to pure utilitarianism, given that the main economic belief in the 19th century was that equality conveys efficiency.[201] As the direct flipside of shareholder democracy, the protection of minority interests could have been previously effected through section 252 of the 1973 Act and currently section 163(1) of the 2008 Act, even though the latter is (contrary to the 1973 Act) result-based.[202]

Contrary to small and medium companies,[203] large companies, as stated by Berle and Means, create a "centripetal attraction which draws wealth together into aggregations of constantly increasing size, at the same time throwing control into the hands of fewer and fewer men."[204] The effect is not only that the term "minority protection" subsequently constitutes a misnomer, but shareholder "democracy" soon developed into shareholder "plutocracy".[205] In isolation, section 37(2), subject to paragraphs (a) and (b), as well as section 35(2) strengthens

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[197] Ch 1 par 3.
[198] Graham & Dodd (2009) 420-421; *contra* the 1933 Gulf State Steel Corporation acquisition of own securities where the profit was credited to surplus – Graham & Dodd (2009) 421.
[199] Cilliers *et al* (2000) 212; Graham & Dodd (2009) 420-423.
[200] Graham & Dodd (2009) 420.
[201] Parkin (2011) 52.
[202] Delport (2011) 159 n 25.
[203] Pretorius JT *et al* (eds) (1999) 3.
[204] John H Farrar & Brenda M Hannigan *Farrar's Company Law* 4ed (1998) at 8 – 13, as quoted in Pretorius JT *et al* (eds) (1999) 4.
[205] Becht, Bolton & Röell (2007) 834.

this stance: Given the initial unpopularity of non par value shares ("NPV shares"),[206] it is strange to imagine how par value shares ("PV shares") could disenfranchise shareholders[207] when it is already a given fact that the nominal value has no relation to the market value;[208] moreover, NPV share will marginilise a true democratic regime in companies.[209]

Decisions such as *Sammel v President Brand Gold Mining Co Ltd*[210] have often been curbed by statutorily restraining the control of large shareholders for the purpose of not only boosting the liquidity of secondary markets, but also to increase shareholder democracy.[211] An example of the latter is the disclosure requirement.[212] It is submitted that the disclosure requirement is an ineffective measure, given that share price movements occur prior to the report of fundamentals.[213] This principle is sustained by the fact that share prices are included as one of the 12 components of the National Bureau of Economic Research's Index of Leading Economic Indicators.[214] Could a better approach possible be voting right restrictions?[215]

Whereas in some countries the board of directors is relied on as the main mechanism for co-ordinating shareholder actions (and have yet also proven to be ineffective),[216] this duty falls on the court in South African company law and subsequent eliminates managerial discretion in such cases.[217] Even though board authorization is an alterable provision and a company's MOI can impose authorisation or approval of distributions by the shareholders in respect of all or any distributions by the company, in which case directors will have to comply with it,[218] the lack of such a provision will be contrary to the purpose of the Act in section 7(b)(iii) and section 7(i).

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[206] Cilliers *et al* (2000) 223.
[207] Cassim F, Davis D & Geach W (eds) (2009) 43-44.
[208] Cilliers *et al* (2000) 222.
[209] *Vide* Cilliers *et al* (2000) 104.
[210] 1969 (3) SA 629 (A) as quoted in Delport (2011) 156.
[211] Becht, Bolton & Röell (2007) 833.
[212] Pretorius JT *et al* (eds) (1999) 3; *vide*, for example, s56(5), s56(7) and s122.
[213] Sine & Strong (2011) 648.
[214] *Ibid*.
[215] Becht, Bolton & Röell (2007) 834 n8.
[216] *Id* at 833.
[217] *Ibid*.
[218] Delport (2011) 59 n32.

All things being equal, despite La Porta, Lopez-de-Silanes, and Shleifer's anti-director rights index that shows that common law jurisdictions provide greater shareholder protection,[219] the power vested in directors to make a section 48 distribution in terms of the common law-inspired Companies Act 71 of 2008 eradicates the "initial protection of shareholders" in share repurchase situations.

7. Conclusion

Apart from existing legal obligations as a *iusta causa* for the section 48 acquisition of shares – which is already shrouded in vagueness – shareholder approval has been substituted by board approval. Though possibly manageable, section 66(1) of the Act renders the situation economically illogical and therefore jurisprudentially unjustifiable. Directors duties have been diminished to a fiction, putting the power to execute section 48 distribution into potentially irresponsible hands. Furthermore, the legislation falls short of basing shareholder protection on economically feasible principles.

[219] Becht, Bolton & Röell (2007) 870 *et seq*.

Chapter 3: Acquisition of own shares

1. Introduction

Even though the acquisition of own shares has diverse commercial functionality, its primary regulation is via a single statute. This chapter questions such conditions in the light of corporate and economic efficiency.

Firstly, the acquisition of own shares is denoted; thereafter, its variety and motivations are explored in order to make economic sense of this corporate action. Apart from the confusion that has been described in the previous chapters the greatest dissident factor – the creditor – is examined. The chapter ends with an in-depth study of the use of acquisition of own shares in the field, as a manner of speaking, of take-overs and reorganisations.

2. Misperceptions surrounding share repurchases

The corporate activities predominantly regulated by section 48 of the Companies Act 71 of 2008 are indiscriminately referred to as "share repurchases"[220] or "share buy-backs"[221] in general parlance. These two terms are misleading in three regards.

Firstly, "share repurchases" must be differentiated from "repurchase agreements" ("repos") in commercial, and not technical, terms. Technically, both are "agreements" and, according to the *lex mercatoria* and subsequent acceptance in canon law of the rules of *ex nudo pacto oritur actio*[222] and *pacta sunt servanda*,[223] also contracts. Commercially, a "repurchase agreement" refers to a sale and consequent repurchase at a higher price at a future date.[224] This was employed in the Middle Ages to circumvent the Church's prohibition of interest on

[220] *Vide* Van der Linde (2010) *TSAR* 288.
[221] *Vide* Arnold (2010) 412.
[222] "an agreement gives rise to an action" – Thomas *et al* (2000) 234.
[223] "agreements are binding" – Thomas *et al* (2000) 234.
[224] Fleuriet (2008) 21,22.

money loans, the latter which was strongly sustained by the likes of Thomas Aquinas and St Augustine.[225] The repurchase market is presently the global-leading "short-term money market" [*sic.*] and is used by investment banks to fund their inventory of securities.[226]

Secondly, the terms "share repurchase" and "share buy-back" are misnomers in that they presuppose the employment of cash funds. In 1980, Oelofse's critique on the provisions of financial assistance in section 38 of the Companies Act 61 of 1973 was based on its restricted ambit of sale; therefore, excluding barter.[227] Oelofse argued that the provisions should cover the "acquisition" of shares. By applying the same logic, one will note that the legislature included barter in so-called "share repurchases" in the new Companies Act. Whether this takes place as a distribution or in terms of a scheme of arrangement, the Act refers to an "acquisition" rather than a "purchase".

Cilliers *et al* differentiate between "acquisition of own shares" and "repurchase of shares".[228] The authors contrast "share repurchase" activity, which is acknowledged as an "acquisition" in section 85 of the Companies Act 61 of 1973, to the redemption of redeemable preference shares. Even though the authors refer to redemption as "repurchase of shares",[229] and correctly emphasize the misappropriated activity as a "purchase",[230] redemption will, needless to say, constitute a "purchase" in terms of the 1973 Act funds are transferred to these redeemable preference shareholders from the capital redemption reserve fund,[231] and a barter if the redeemable preference shares are replaced by shares issued for this redemption. Furthermore, redemption is not a corporate activity that is generally associated with "share repurchase" as a commercial term.

3. Denoting the "acquisition of own shares"

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[225] *Id* at 19, 21, 22; "repurchase agreement" is also an indiscriminate commercial term, since it actually refers to repurchases (a mixture of cash transaction and forward contract in which the seller repurchases the object later at a higher price and is effected through a single contract containing a *pactum de retrovendendo* or a *pactum de retroemendo*) and sell/buy-back transaction (two contracts, and the seller's inflated repurchase price was debited by any of the object's fruit that the buyer retained) – *vide* Stoop, Thomas & Van der Merwe (2000) 326.
[226] Fleuriet (2008) 22.
[227] Cilliers *et al* (2000) 329 n44; for more clarity on barter transactions, *vide Mountbatten Investments (Pty) Ltd v Mahomed* 1989 (1) SA 172 (D).
[228] *Contra* Cilliers *et al* (2000) 323 *et seq* and Cilliers *et al* (2000) 326 *et seq*.
[229] Cilliers et al (2000) 326-327.
[230] *Ibid*.
[231] Cilliers et al (2000) 337.

3.1. General construction of meaning

The new Companies Act supplies no statutory definition for "acquisition of own shares", or any similar term in accordance with the *eiusdem generis* rule. Neither is there a common law denotation in the light of the capital maintenance rule. Therefore, the term will retain its ordinary meaning,[232] as restricted by certain directives in the Act. For a more comprehensive analysis of the constitutive parts of the general term, refer to Chapter 1 paragraph 4.2.1 and paragraph 2 *supra*.

3.2. Company offers

Neither section 48 nor sections 114 and 115 contain any provision pertaining to the manner through which a "beneficiary"[233] or holder[234] will be granted an offer by a company to re-acquire its share capital.[235] At its most basic level, Delport states that the action will include an offer by the company and an acceptance by the shareholders.[236] This would particularly relate to open market repurchases ("OMRs"), entailing listed companies and executed through a predetermined structure. Even though such a structure may grant the company flexibility in the levels and timing of repurchases, the company has little control over share prices during or after such repurchases.[237] Frankly, it has been proven that, on an economic level, different factors drive the *level* of repurchases and the *timing* of repurchases.[238] Therefore, it must be noted that greatest problem with OMRs crystallise firstly through the application of the solvency and liquidity test[239] and secondly through the discretion[240] of the board to execute a section 48(2)(a) distribution. It is submitted that the discretion of the board relates to the gratuitous nature of the distribution,[241] but not to an *ex post facto* determination of the level of repurchases, and that the solvency and liquidity test will proactively influence such considerations.

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[232] This train of thought was also followed by Lord Kilbrandon in *Brutus v Cozens* [1972] 2 All ER 1297 (HL) at 1303*h – j*, as quoted by Coetzee DJP in *Ex Parte NBSA Centre Ltd* 1987 (2) SA 783 (T) at 786.
[233] In cases other than that specified in s48(8)(b); *vide* ch 1 par 4.2.4. *supra*.
[234] In cases as specified in s48(8)(b); *vide* s117(1)(e).
[235] Delport (2011) 61.
[236] *Ibid*.
[237] Luning E (2007) 20, 21.
[238] Skinner (2008) 87 *J Financ Econ* 582 at 583.
[239] s46(1)(b) and s46(1)(c).
[240] *Amalgamated Packaging Industries v Hutt* 1975 (4) SA 943 (A), as quoted in Botha (2005) 114.
[241] *Vide* ch 1 par 4.2.

Another example is the targeted share repurchase, as discussed *supra*.[242]

3.3. Company invitations

Even though not stated in so many words, Delport's description *supra*[243] implies a critical shortcoming in South African securities regulation, particularly in the light of the discrepancy between the definition of "offer" in section 142(1) of the 1973 Act and section 95(1)(g) of the current Act. The reference to an offer not including an invitation is evident,[244] and section 95(1)(m) excludes section 48(2)(a) and section 48(2)(b) distributions from the ambit of "secondary offering[s]" [*sic*.]. This may be a fortunate case of excluding analogous interpretation[245] – also in the absence of the application of the mischief rule[246] in section 101(3)(a)(ii) for the purpose of the methods to follow. Hopefully, clarity will be gained through subsequent *subsecuta observatio*.[247]

The fixed-price tender offer is method that predates OMRs – where a company sets an invitation to shareholders to offer their shares to the company at a selected price.[248] The outcome of such a method may either be undersubscription – a positive outcome, since it indicates effective signalling – or oversubscription, through which general practice dictates a *pro rata* repurchase.

Another example includes the Dutch-auction tender offer[249] as discussed at paragraph 7.3 *infra*.

4. Reasons for the acquisition of own shares

Skinner contends that the early 1980s marked the emergence of the share repurchase as an economically momentous occurrence in the USA.[250] This may be a valid argument by comparison to dividends[251] in the light of Skinner's focus on net repurchases,[252] but not as a

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[242] Ch 2 par 5.
[243] Par 3.2.
[244] *Cf* s142 definition of "offer" in the 1973 Act.
[245] *Vide* Botha (2005) 110.
[246] *Heydon's Case* [1584] EWHC Exch J36, 76 ER 637, Pasch 26 Eliz at 2 and 3.
[247] *Vide* Botha (2005) 87.
[248] Luning E (2007) 21.
[249] *Ibid*.
[250] Skinner (2008) 87 *J Financ Econ* 582 at 582.
[251] *Id* at 582, 583.

generalisation – share repurchases augmented much earlier. The magnitude of considerations spent on share repurchases baffled the corporate class in the early 1970s in the USA,[253] and the funds raised through repurchases in the late 1960s exceeded the value of initial public offers ("IPOs") and seasoned equity offers by one-third.[254] This can also be understood by Skinner's calculation of net repurchases *supra* in the South African context on the basis of the retirement method, i.e. (in mathematical terms) inferring that the amount of treasury shares is equal to x and $x = 0$, where $\textit{share issuance} - \textit{share repurchases} = y$, and if $y < 0$, then $\textit{share repurchases} = 0$.[255] Even companies with a culture of dividend distributions are currently converting their pay-out policies to share repurchases.[256] It has been contended that dividend distributions equal share repurchase distributions in value in the corporate sphere.[257] For the board, and especially in the light of Chapter 2 paragraph 3, it is important to note that share repurchases supply managers with a flexible pay-out policy[258] and longer pay-out intervals allow repurchases to adjust quickly to earnings.[259]

In the USA positive returns on share repurchases have been ascribed to the expectation that companies will exercise stock options – the so-called "exchange option explanation" of Ikenberry and Vermaelen.[260] Given the incomplete and untimely information surrounding share repurchases in the USA at the time of the said authors' publication, the more exact measurements of Zhang may be necessary.[261] Contrary to smaller companies that benefit from share repurchases, larger companies undertake share repurchases upon the belief that their shares are undervalued and, unfortunately, the short term economic response in share value on securities markets were measured on the Hong Kong Stock Exchange as being insignificant.[262] The lack of superior price performance for the same on the long run was also evident in Hong Kong.[263]

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[252] *Id* at 587.
[253] Norgaard & Norgaard (1974) 3 *Financ Manage* 44.
[254] Elton & Gruber (1968) 23 *J Financ* 135 at 135.
[255] Skinner (2008) 87 *J Financ Econ* 582 at 587 n7.
[256] *Id* at 583.
[257] Oded & Michel (2008) 64 *Financial Analysts Journal* 62.
[258] Skinner (2008) 87 *J Financ Econ* 582 at 584.
[259] *Ibid*.
[260] Zhang (2005) 29 *J Bank Financ* 1887 at 1888.
[261] *Id* at 1888-1889.
[262] *Id* at 1892-1897.
[263] *Id* at 1898-1900.

One may be somewhat inclined to view Zhang's study as a corroboration of the accounting perspective that share repurchases have no result on shareholder value for shareholders – frankly, the total value of repurchases equates the accrued value to the *corpus*; the *corpus*' cash simply shifts its ownership from the *corpus* to the shareholders.[264] This is known as the "EPS enhancement fallacy" associated with share repurchases,[265] and is somewhat reminiscent of Miller and Modigliani's first proposition indicating the lack of influence of dividends on share value.[266] Both of these theories that presuppose "perfect markets",[267] e.g. in the M&M theory transactions costs are equal to zero.[268]

However, in terms of quantitative analysis, the acquisition of own shares should increase the remaining shares' value. By voiding the *corpus* of a safe asset such as cash, the resultant relative increase of risky assets – according to the risk-return principle – increases expected earnings per share:[269]

$$CV = s \div \bar{X}$$

The scale-free measure of coefficient of variation *CV* is the statistical sample standard deviation *s* (i.e. the amount of risk) per unit of mean return *X*.[270] A more precise method may be the so-called Sharpe Ratio:[271]

$$S_h = (\bar{R}_p - \bar{R}_F)/s_p$$

The Sharpe Ratio S_h for a given portfolio *p* is the mean excess return, constituted by the difference between the return to the portfolio R_p and the mean return to a risk free-asset R_F (such as South African Government Bonds), divided by the standard deviation *s*.[272]

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[264] *Ibid*.
[265] *Ibid*.
[266] Wolmarans (2003) 11 *Meditari Accountancy Research* 243; Luning (2007) 18.
[267] Oded & Michel (2008) 64 *Financial Analysts Journal* 62 at 71.
[268] E.g. Bagwell (1991) 22 *RAND J Econ* 72 at 77.
[269] Oded & Michel (2008) 64 *Financial Analysts Journal* 62 at 65.
[270] DeFusco (2011) 393-395.
[271] *Id* at 395-399.
[272] *Ibid*.

5. Creditor Protection

The English approach, in accordance with Lord Herschell's decision, was that creditors looked to the company's joint stock capital as the resource for settlement of liabilities.[273]

In the American case of *Percy v Millaudon* 3 La. 568 (1832)[274] the court rejected the notion of share repurchases on the basis that the reduction of capital was an impairment to *inter alia* the creditors. Even though the judicial support for the acquisition of own shares was increased at the turn of the 19th century, the American courts were not oblivious the creditor protection.[275] In cases such as *Boggs v Fleming* 66 F. (2d) 859 (C.C. A. 4th, 1933)[276] courts denied the right to enforcement of the acquisition of own shares if the company became insolvent prior to performance (however, certain courts did take a contrary view in cases of constructive notice, e.g. First Trust Co. v Illinois Central Ry., 256 Fed. 830 (C.C.A. 8th 1919));[277] in *Fitzpatrick v McGregor* 133 Ga. 332, 65 S. E. 859 (1909)[278] the creditors could recover the insolvent company's performance.

The exact meaning of a "creditor" in the new Act is uncertain, given the exclusion of notes and loans from debt instruments.[279] Debentures, similar to other loans, constituted external equity and also liabilities in accounting practice.[280] Since debentures have never been defined,[281] the term had been acknowledged as inclusive of all debt issues;[282] therefore, the provisions of section 43(1)(a)(ii) constitute a problem of exegesis *versus* hermeneutics[283] in addition to the presumption that legislation does not intend to unnecessarily amend existing law.[284] Given the fiction of Legislative intention,[285] the only possible interpretation is to be found in the decision of Bowen LJ:[286]

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[273] *Trevor v Whitworth* (1887) 12 App Cas 409 (HL).
[274] Dodd (1941) 89 *U. Pa. L. Rev. & Am. L. Reg.* 697 at 699.
[275] *Id* at 701.
[276] *Ibid*.
[277] *Id* at 702.
[278] *Ibid*.
[279] s43(1)(a)(ii).
[280] Cilliers *et al* (2000) 235.
[281] *Ibid*.
[282] *Id* at 236.
[283] *Vide* Botha (2005) 62.
[284] *Id* at 45.
[285] *Id* at 68.
[286] *English and Scottish Mercantile Investment Co v Brunton* [1892] 2 QB 700 at 712, as followed by Ward J in *Coetzee v Rand Sporting Club* 1918 WLD 74, and quoted in Pretorius JT *et al* (eds) (1999) 171.

> "The first is a simple acknowledgement, under seal, of debt; the second an instrument acknowledging the debt, and charging the property of the company with repayment,; and the third an instrument acknowledging the debt, and charging the property with repayment and further restricting the company from giving any prior charge."

Therefore, the deduction is that the first possibility is excluded from the ambit of "debt instrument" is excluded from the provisions of section 43(3)(a). This section provides for "special privileges" regarding corporate control. The jurisprudential basis of a "special privilege" remains uncertain. Upon the assumption of control rights, this is submitted to be an aspect of over-regulation. The historical under-enforcement problem relating to debentures (due to ignorance of contraventions, considerable barriers in the enforcement of rights without the assistance of the trustee and the trustee's inadequate motivation in robustly enforcing debenture holders' rights) has been largely improved through creditor activism, especially due to increased involvement of hedge funds.[287]

6. Redeemable securities

Redeemable preference shares were excluded from ambit of the capital maintenance rule; however, redemption authorisation through special resolution was purely for the benefit of the company and, inversely, the right could be renounced by the company.[288] Section 37(5) of the Act provides that a company's MOI may provide for redeemable shares. The preferential exclusion is apparent, but falls outside the ambit of this work. Suffice to assume that redemption is subject to section 46 and section 48 of the Act.[289]

The result of a company or subsidiary acquiring a company's shares may not constitute a situation where only convertible or redeemable shares are in issue.[290] It is unclear why the legislation singles out only these two types of shares.[291] Nevertheless, the *raison d'être* for the provision relating to redeemable shares stands most likely, *ex visceribus actus*, in relation to section 22. Keeping in mind that external equity is deemed to be a liability in accountancy

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[287] See in general Kahan & Rock (2009) 103 *Nw. U. L. Rev.* 281.
[288] *AA Mutual Insurance Association Ltd v Century Insurance Co Ltd* 1986 (4) SA 93 (A) at 100-101, justifiable in the the correspondence between s43 of Act 46 of 1926 and s98(1) of Act 61 of 1973.
[289] s37(5)(b).
[290] s48(3)(b).
[291] Delport (2011) 61 n45.

practice:[292] In an event where redeemable shares, as the only joint stock capital of a company, are redeemed for a consideration specified in section 37(5)(b)(ii), the company will be void of assets. By envoking a situation contemplated in section 4(1)(a) of the Act, the applicable company will not pass the solvency test and could subsequently be regarded as factually insolvent. This would be a prohibited trading practice in terms of section 22(1)(b).

Section 32 of the Companies Amendment Act amended the exclusions in terms of section 48(1) so as to encompass redeemable securities. According to this amendment – now section 48(1)(b) of the Act, section 48 does not apply to the redemption of redeemable shares. The latter excludes redeemable shares as a distribution in terms of that definition in section 1 at paragraph (a)(iii)(aa), though it does not affect its classification in accordance with paragraph (a)(iv) of the same.

Nevertheless, the Act supplies no version of section 98 of the 1973 Act, and it is uncertain how redeemable securities will be regulated. Given the presumption of effectual and purposeful legislation[293] this will have to be regulated by section 46.

7. Take-overs and reorganisations

Section 114(4) provides that section 48 will apply in the event of "any re-acquisition by a company of any of its previously issued shares", presumably a scheme of arrangement situation.[294] The qualification for this section is that the acquisition of own shares, even "together with other transactions in an integrated series transactions", will be subject to the provisions of sections 114 and 115 if the acquisition exceeds 5% of the issued shares of a particular class.[295]

It is uncertain what the definition and time-frame implied in "considered alone, or together with other transactions in an integrated series of transactions"[296] will be. The wording is similar to that of section 41(3), even though section 41(4)(b) defined the definition and time-frame as specifically applicable to section 41(3). Though not particularly used by South

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[292] Cilliers *et al* (2000) 200.
[293] *R v Forlee* 1917 TPD 52, as quoted in Botha (2005) 74-75.
[294] s114(1)(e).
[295] s48(8)(b).
[296] *Ibid*.

African courts, an analogical interpretation[297] may render the content of section 41(4)(b) similar to the said phrase in section 48(8)(b).

Given that the section 48 acquisition of own shares is inclusively defined in the definition of "acquisition" in section 117(1)(a), section 48(8)(b) is most likely based on disclosure relating to incremental changes in shareholding.[298] The problem in theory is that the provisions of section 48(8)(b) only relate to Part A of Chapter 5; therefore, the definition of "acquisition" in section 117(1)(a) most likely relates to all acquisitions of own shares, and not only those exceeding five percent. Hopefully, the practical solution will lie with the definition of "affected transaction"[299] and its inclusion of section 114.[300]

7.1 Disclosure requirement

Whilst probably understandable that section 122 was included to prevent dawn raids,[301] it introduced a twofold problem in situations relating to the acquisition of own shares.

Firstly, whereas the situation prior to the Companies Amendment Act created the loophole of executing a share repurchase as either a section 48 distribution or section 114 scheme of arrangement, the subsequent situation of executing share repurchases exceeding 5% of a particular class through section 114 presents a redundant situation. In accordance with section 122(1), it is inconceivable that a regulated company needs to notify itself following an incremental change in a class' shareholding. Yet, the definition of "beneficial interest" in section 1 does not deny such an act and section 35(3) also falls short in that it prohibits the *issue* of shares to a company itself.

7.2 Mandatory offers

A person who acquires securities of a company to the extent that the person can exercise at least the prescribed percentage of voting rights of a company[302] (presumably of all the companies' securities *in toto*), is compelled to make a mandatory offer (also known as a

[297] Botha (2005) 110.
[298] s122(1)(a).
[299] s117(1)(c).
[300] s117(1)(c)(iii).
[301] Arnold (2010) 445.
[302] s123(2)(b) and s123(2)(c).

"mandatory bid") to the remaining security holders of that company.[303] The "prescribed percentage" is prescribed by the Minister,[304] as advised by the Panel,[305] and may not exceed 35% of the voting rights in a company.[306] According to Regulation 86(1), the prescribed percentage is 35% "of the issued voting securities of the company".

Section 123(2)(a)(i) of the Act provides that the stipulations relating to mandatory offers also apply to situations where regulated companies acquires their own shares in cases provided for in section 48.

In the light of the exclusion of the acquirer's "intention" in cases relating to mandatory offers,[307] the Act naturally presents the following predicament: In cases where the company acquires its own shares, the cancellation of such shares reciprocally increases the voting rights *in toto* of remaining shareholders. If this increase causes a shareholder to hold at least the prescribed percentage, the said shareholder will be compelled to make a mandatory offer. In such circumstances, the mandatory offer can only be omitted in regulated companies through an ordinary resolution of the independent[308] holders of the general voting rights of all issued securities of that company.[309] Such a waiver is recommended[310] to conform to Guideline 2/2011 of the Takeover Regulation Panel.

The waiver probably qualifies as a measure of shareholder protection, but the recognition of shareholders' requests at such a stage is jurisprudentially odd and non-correlative if the act that triggered the section 123 situation initially fell beyond the control of the shareholders, i.e. with the Board.

7.3 Share repurchases for take-over preclusion

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[303] s123(3).
[304] According to s1, "[m]inister" relates to "the member of the Cabinet responsible for companies".
[305] According to s1 "[p]anel" relates to the Takeover Regulation Panel.
[306] s123(5).
[307] *Vide SRP v MGX Holdings Ltd* 16026/03.
[308] According to Regulation 81(i), this would relate to a person with no conflict of interest (Regulation 81(i)(i)) and partiality (Regulation 81(i)(ii).
[309] Regulation 86(4).
[310] Guideline 2/2011 par 1.4.

If one takes into account that mergers and acquisitions ("M&A") are actually only *one* of the ways in which business growth can be generated,[311] and that the benefits of M&A are questioned at times,[312] it is difficult to imagine M&A activity having a notable frequency. However, strategic acquisitions spread the inclination to pursue the same efforts in a particular industry, regardless of the aforesaid. Mergers seem to surface in waves.[313]

Given the existence of such cycles,[314] there was a particular prevalence of share repurchases in late twentieth century USA in order to deter take-overs – a movement that was so extensive that various companies asserted their share repurchases as not deterring a possible take-over.[315] In such circumstances the financial model would comprise two stages – a distribution stage and a take-overs stage (these stages require no explanation)[316] – and three consequences – the liquidation effect, the type effect and the disproportionate-adjustment effect.[317]

The ask price of shareholders' equity ("reservation values") is at any given moment heterogeneous[318] so that it will constitute an upward sloping supply curve.[319] By using a Dutch auction, the company invites shareholders to make an offer to the company to sell a certain quantity of their shares to the company at a price within the price range stipulated in the invitation.[320] During the distribution stage, the share repurchase will reduce the liquidation value of a company (liquidation effect)[321] and since the company will buy the

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[311] Fleuriet (2009) 221. Other methods include: organic growth ["BHP to concentrate of organic growth" <http://www.ibtimes.com/articles/101532/20110117/bhp-to-concentrate-on-organic-growth.htm> (accessed on 17 February 2011)], joint ventures [Cahill T (2009) "Caxton venture said to start $500 million hedge fund" <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=awg3J_ggE.Uk> (accessed on 17 February 2011)] and alliances [Sweney M (2008) "New York Times and CNBC in alliance" <http://www.guardian.co.uk/media/2008/jan/08/rupertmurdoch.newscorporation> (accessed on 17 February 2011)].
[312] Arnold (2010) 450.
[313] Harford J (2004) "What drives merger waves?" <http://faculty.bschool.washington.edu/jarrad/OldSite/papers/harford-what_drives_merger_waves.pdf> (accessed on 17 February 2011); Fleuriet (2009) 226.
[314] Fleuriet (2008) 226-228; Lipton M (2006) "Merger waves in the 19th, 20th and 21st centuries" <http://osgoode.yorku.ca/media2.nsf/58912001c091cdc8852569300055bbf9/1e37719232517fd0852571ef00701385/$file/merger%20waves_toronto_lipton.pdf> (accessed on 17 February 2011)
[315] Bagwell (1991) 22 *RAND J Econ* 72 at 72.
[316] *Id* at 74.
[317] *Id* at 76.
[318] *Id* at 75.
[319] *Id* at 73.
[320] *Id* at 75.
[321] *Id* at 76.

shares that are tendered at the lowest price, the surplus shareholders' ask price is higher than the repurchase price paid (type effect).[322] Market frictions may cause some shareholders' ask prices to not correspond with the pre-repurchase liquidation value per share; therefore, the change in ask price may be disproportionate to the change in pre-repurchase liquidation value per share (disproportionate-adjustment effect).[323] During the take-over stage, the potential offeror will compare the maximum profit to be made from the take-over to the zero profit to be made in the event that no bid is made.[324] If less than half of the shareholders tender their shares to the offeror at every profitable offer price that the offeror has made, then it would be safe to assume that no take-over will be made.[325]

In this regard, rule 111 of the Companies Regulations, 2011 will apply. The board will have to be use the deterring repurchase in accordance with rule 111(1), and be wary of its application in rule 112 situations.

8. Conclusion

Bhagat and Romano view a share price as the discounted (in time and in risk) present value of all future cash flows that are expected to accumulate to a shareholder.[326] This definition is unsatisfactory in three regards. Firstly, the denotation is ignorant of equity classes, and given that the Act provides for preferences, rights and limitations on voting rights in section 37(2)(b), the current statutory situation already renders common law classifications misleading.[327] Secondly, the definition is redundant given that present value presupposes discounting.[328] Thirdly, future cash flows are subject to expectations (*spei*), rendering share price a variable rather than a quantity subject to even cash flows. In addition, this chapter has shown that the perfect market accounting perspective on share repurchases does not always correlate with the quantitative and economic perspectives on the topic.

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[322] *Id* at 76, 80.
[323] Id at 76, 77.
[324] *Id* at 81.
[325] *Ibid*.
[326] Bhagat & Romano (2007) 947-948.
[327] Delport (2011) 33 n40.
[328] DeFusco et al (2011) 255 *et seq*.

In the event of section 48(2)(a) payouts, the HPR model[329] may be inadequate due to the currency (D_1) constituting the company's performance on share repurchases and thus also affecting the value received, P_1. In such circumstances, either a money-weighted rate of return[330] (also known as the IRR rule,[331] and as algebraic method, is determined by equating the present value of outward cash flows and the present value of inward cash flows) [332] or the time-weighted rate of return[333] (where the holding period is fragmented into subperiods subject to significant cash inflows or outflows, the HPR for each subperiod is calculated, and compound the different HPR's where *holding period* $\leq$ *1 year*, or take the geometric mean[334] of annual returns where *holding period* $\geq$ *1 year*[335]).

Apart from the discussion on the history and rationale for the acquisition of own shares, this chapter highlights the shortcomings of a definition of "creditor" in order to discuss credit protection. Furthermore, it is quite apparent that the regulation of redeemable securities has become vague due to the amendments to the 2008 Act, and even though the loophole between section 48 and section 114 has been mended,[336] the scheme of arrangement procedure entailing share repurchases will present its own challenges.

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[329] Ch 4 par 5 *infra*.
[330] DeFusco (2011) *et al* 320-321.
[331] *Vide* Chapter 2 par 3 *supra*.
[332] *Vide* DeFusco *et al* (2011) 320.
[333] DeFusco *et al* (2011) 321-327.
[334] Geometric mean G for n observations for which the value of any observation X_i must be a natural number: $G = \sqrt[n]{(X_1X_2X_3\ldots X_n)}$ with $X_i \geq 0$ for $i = 1, 2, 3\ldots n$ – DeFusco *et al* (2011) 370.
[335] *Id* at 321-322.
[336] Delport (2009) 87 n31.

Chapter 4: Subsidiaries acquiring shares in the holding company

1. Introduction

There are various commercial justifications for a subsidiary's acquisition of shares in its holding company, ranging from subsidiaries hoping to reap economic benefits from the holding company to holding companies hoping to control the control of the holding company through its subsidiaries. Both of these perspectives will be taken into regard in this chapter.

In this chapter, the legal aspects of section 48(2)(b) will be discussed from an initial economic perspective, and later as an alternative to treasury shares. Finally, the role of financial assistance will be described.

2. Previous versus current legislation

Similar to the 1973 Act,[337] the 2008 Act provides for a subsidiary to acquire shares in its holding company. In addition,[338] another similarity pertains to the regulation of acquisition of own shares and the subsidiary's acquisition of shares in its holding company – whereas section 89 of the 1973 Act provides that the latter will be regulated analogous to the former, section 48 of the 2008 Act encapsulates both corporate payout policies into a single section and categorizes both as distributions.[339] Needless to say, the distribution provided for in section 48(2)(b) will also be subject to the provisions of section 46.

3. Implicit Rental Rate

[337] s89 of Act 61 of 1973.
[338] s48 of Act 71 of 2008.
[339] Ch 1 par 4.

The necessity of investors for a company constitutes capital for operations,[340] utilised in a manner that fulfills a company's goal: The maximisation of profits.[341] The increase of this value is evident from the Statement of Changes in Equity[342] as accumulated profit.[343] The prediction of corporate decisions (therefore, also the expected justification for executed decisions) pertains to opportunity cost and economic profit.[344] Opportunity cost, i.e. the maximum valued option of resource utilisation relinquished,[345] relates to section 48(2)(b) as implicit cost,[346] given that the capital maintenance rule has been substituted. In any event, a section 48(2)(b) distribution will be scrutinised in the light of the implicit rental rate[347] of the company's capital. It is interesting to note that in theory the company's greatest antagonist in this regard would be market constraint,[348] i.e. the company's own securities holders.

The practical animosity exercisable is only of a commercial nature.

The provisions of section 20(4), permitting shareholder(s), directors and prescribed officers to apply to the High Court for a restrictive interdict in the event of a company action being contrary to the Act, will be of little value to shareholders. The reference to increased enterprise efficiency in section 7(b)(i) will be inadequate to substantiate such an argument from both a legal and economic point of view. In law, legislation must be interpreted "from the bowels of the Act",[349] but supremacy of the express provisions relating to the purpose of legislation may be scrutinised as positivism.[350] From an economic view, the establishment of a social and ethics committee[351] and the enlightened shareholder approach[352] constitute socialist trends, and tilt the Big Tradeoff further into the lap of fairness.[353]

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[340] Cilliers *et al* (2000) 200.
[341] Parkin (2011) 100; *vide* ch 2 par 3.
[342] Cilliers *et al* (2000) 208.
[343] Cilliers *et al* (2000) 205.
[344] Parkin (2011) 101.
[345] *Ibid*.
[346] *Ibid*.
[347] *Ibid*.
[348] Parkin (2011) 104.
[349] Botha (2005) 74.
[350] *Id* at 82.
[351] s72(4).
[352] (Notice No. 1183, 2004) *Government Gazette* 26493:468 June 23.
[353] Parkin (2011) 53 *et seq*.

Section 20(5) can be used by the shareholders, directors or prescribed officers if the subsidiary acts inconsistent with limitations, restrictions or qualifications in the MOI – in this case, if the limitations, restrictions or qualifications could pertain to the external act of acquiring shares in its holding company. Section 10(d) of the Companies Amendment Act 3 of 2011 amended the nature of RF companies from legal entities subject to special conditions to that of restrictive conditions. Therefore, any company with the said limitations, restrictions or qualifications will necessarily be RF companies and the doctrine of constructive notice will apply to the holding company.[354] In the event of a section 48(2)(b) distribution with any of the above stipulations in the MOI, the provisions of section 20(5)(b) may apply and if indeed so, the proceedings will prejudice the holding company's right to damages. It is important to note that the applicability of section 20(5)(b) is subject to the fact that the holding company did have knowledge of the said stipulations in the MOI,[355] and that it did not obtain "those rights in good faith."[356] Clearly, knowledge of the stipulations does not necessarily render the holding company *mala fide*.[357] However, the original agreement will not be void in the light of section 218(1).

In the event that the subsidiary did not include the section 11(3)(b) "RF" element in its name, the subsidiary will be liable to the holding company for loss or damage suffered as a result of such a contravention.[358] The apparent exclusion of the doctrine of constructive notice in such circumstances[359] is somewhat ridiculous, given that the holding company's position entails an extent of investment to exercise control,[360] and the holding company's ignorance in investing significant capital in another company without sufficient investigation is uncanny.

Could the securities holders use a declaratory order in circumstances where the implicit rental rate is scrutinized? The use of a declaratory order would be subject to the circumstances provided for in section 161(1)(b)(ii), and given the situation described *supra* as it pertains to section 20(4), this would most likely not succeed. In the event that it does, it would be a tedious task to measure the "harm" rectifiable by the company in monetary terms.

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[354] s19(5)(a); Delport P (2011) *Lecture for TOR 802* 23 March 2011; Delport (2011) 22 n65.
[355] s20(5)(b).
[356] s20(5)(a).
[357] Delport P (2011) *Lecture for TOR 802* 23 March 2011.
[358] s218(2).
[359] s19(4).
[360] *Vide* s3.

4. An alternative to treasury shares

Given that a company acquires its own shares, this corporate action will universally have one of the following effects on the status of shares in any jurisdiction: The shares will be cancelled as both issued and authorized share capital; the shares will be cancelled as issued share capital, but will remain authorized share capital; the shares remain issued share capital, available for resale or annulment by the company.[361]

The latter option renders the equity to be regarded as "treasury shares", and as contradictory as such a description appears in accounting terms, so does it also constitute a pure legal fiction,[362] described by Ballantine as "legal magic".[363] The disapproval of treasury shares inherently verify the argument in Chapter 1 paragraph 4.2.1 – it is not *dominium* that proves treasury shares to be a predicament; rather it is the rule that no person may hold a personal right or a claim against himself. This rule is deduced from various sections in the *Institutes* of Justinian:: "*Idem juris est…rem suam quis stipuletur*" (pertaining to void stipulations),[364] "*Item nemo rem suam futuram in eum casum, quo sua fit, utiliter stipulatur*",[365] and "*nec enim quod actoris est, id ei dari oportet, quia scilicet dari cuiquam id intelegitur, quod ita datur, et ejus fiat, nec res, quœjam actoris est, magis ejus fieri potest.*"[366]

Even though the Act recognizes the second option *supra* – therefore, also the provisions relating to the reissue of such shares[367] - a jurisprudentially sound alternative to treasury shares is the subsidiary purchasing shares in its holding company. Such an alternative must comprise the holding company's ability to diminish the voting rights in its shares without cancellation of those shares, i.e. the ability to possibly sell those shares afterwards without the re-issuing the shares.

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[361] Cassim (2003) 151-152.
[362] *Id* at 138.
[363] *Ibid*.
[364] "It is the same…for a thing belonging to himself." – Inst 3 19 11.
[365] "No man can validly stipulate that a thing which may hereafter belong to him shall be given him when it becomes his." – Inst 1 19 22.
[366] "For it is not a duty to give the plaintiff that which is his own. To give a thing is to transfer the property in it, and that which is already the property of the plaintiff cannot belong to him more than it does already." – Inst 4 6 14.
[367] s38, s39, s40, s41.

In terms of section 35(3) a company may not issue shares to itself, and even though treasury shares are not regarded as being held by the company, section 35(5)(a) further provides that section 48 distributions will render the applicable shares unissued but authorized. In addition, the relationship between the holding company and the subsidiary contains some element of control,[368] and since the directors of the subsidiary have the power to effect a section 48(2)(b) distribution, the holding company controls the board of the subsidiary company through either the provisions of section 3(1)(a)(ii), or through the provisions of section 3(1)(a)(i) read with section 71(1) with *de facto* control. Therefore, the holding company holds the (indirect) control to the shares as required above.

Historically, the division of the singular into member and shareholder was indicative of the separate significance of control rights and economic *spei*. The current Act reintegrates these categories into the singular – "shareholder", as defined in section 1. In the 1973 Act, control rights in such circumstances were excluded by disregarding the membership of the subsidiary.[369]

5. Investors' Perspective

The justification for investing as a measure of increasing economic value at its most simplistic form relates to discounting:[370]

r = Real risk-free interest rate + Inflation premium + Default risk premium + Liquidity premium + Maturity premium[371]

Where *r* is the interest rate, *real risk-free interest rate* is the interest rate for a risk-free security for a particular period in the absence of inflation,[372] *inflation premium* is the reimbursement for inflation,[373] *default risk premium* is the reimbursement for the possibility of borrower's non-payment,[374] *liquidity premium* is the reimbursement for the risk of loss

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[368] *Vide* s3.
[369] s39 of the 1973 Act.
[370] Bhagat & Romano (2007) 947-948.
[371] DeFusco *et al* (2011) 257.
[372] *Ibid*.
[373] *Ibid*.
[374] *Ibid*.

comparative to fair value in the event of prompt conversion to currency,[375] and *maturity premium* reimburses investor's for market-related price sensitivity given maturity extension.[376]

This would be the case with investments as simple as annuities,[377] but naturally also extends to many fixed income instruments – whether secured or unsecured debt, credit enhancements, notes, zero-coupon bonds, commercial paper, etc.

Contrary to fixed income instruments, given the entity concept,[378] the reciprocal of that stated in paragraph 3.1 *supra* constitutes the rationale for investors investing in companies. For performance measurement,[379] given a particular portfolio, the investor may use the holding period return ("HPR") model:[380]

$$HPR = (P_1 - P_0 + D_1)/P_0$$

Where P_0 is the original investment,[381] P_1 is the value received at the end of the holding period,[382] D_1 is the currency paid by the company at the end of the holding period.[383] D_1 essentially constitutes dividends.[384]

However, a subsidiary's investment will be subject to certain restrictions. The primary restriction (that was not prevalent in the 1973 Act) is that subsidiaries' shareholding in a holding company cannot collectively exceed 10%.[385]

6. Financial Assistance

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[375] *Ibid*.
[376] *Ibid*.
[377] DeFusco *et al* (2011) 267 *et seq*.
[378] Cilliers *et al* (2000) 200.
[379] DeFusco *et al* (2011) 319.
[380] *Ibid*.
[381] *Ibid*.
[382] *Ibid*.
[383] *Ibid*.
[384] *Id* at 324-326.
[385] s48(2)(b)(i).

The law relating to financial assistance was originally a reaction against the circumvention of the prohibition of repurchasing shares in a company.[386] Given the leniency that has statutorily been introduced regarding the latter,[387] it can be deduced that the law relating to the former should have been accordingly amended.

Even though there is no statutory definition of "financial assistance", the term currently retains its common law meaning[388] and constitutes impoverishment in either the narrow[389] or the wide sense.[390] Actual leniency was first introduced with the inclusion of a subjective[391] solvency[392] and liquidity[393] test by Act 24 of 2006, and later with the insertion of section 38(2)(d) by Act 37 of 1999. Furthermore, whereas the 1973 Act took a general stance against financial assistance, the 2008 Act is more encouraging and the solvency and liquidity test[394] also differs from the previous with regard to satisfaction of the board pertaining to the time frame of liquidity.[395]

The 2008 Act also provides for a factual test[396] that the terms (not the transaction *per se*) for financial assistance must be fair and reasonable to the applicable company.[397] The latter, as well as section 44(5),[398] indicates the principle of severability of transactions, as was previously evident from case law.[399] However, the *raison d'etre* for the wording of section 44(5) escapes the reader. Even though legal interpretation fortunately still renders it effectual, based on the fact that section 44(5)(a) (as it pertains to section 44 *in toto*) and section 44(5)(b) (as it pertains to section 44(4) *per se*) is not only illogically disjunctive,[400] but also redundant.

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[386] Cilliers *et al* (2000) 329.
[387] s85 of the 1973 Act.
[388] Delport (2011) 55.
[389] *Gradwell v Rostra Printers* 1959 4 SA 419 (A), as quoted in Delport (2011) 55.
[390] *Jacobson v Liquidator of M Bulkin & Co* 1976 3 SA 781 (T), as quoted in Delport (2011) 55.
[391] See Delport (2011) 54 n8 and compare with s44 of the Act.
[392] s38(2A)(a)(i) of the 1973 Act.
[393] s38(2A)(a)(ii) of the 1973 Act.
[394] s44(3)(b)(i).
[395] Compare s38(2A)(a)(ii) of the 1973 Act and s44(3)(b)(i) of the 2008 Act.
[396] Delport (2011) 54 n9.
[397] s44(3)(b)(ii).
[398] "void *to the extent*" (own italics).
[399] Cilliers & Benade 335.
[400] Delport (2011) 55 n10.

Financial assistance to investors in order to obtain shares in the holding company is, in theory, an example of moral hazard. Since the general rule is that "[a] person usually comes into a fiduciary relationship when he controls the assets of another or holds the power to act on behalf of another",[401] the deduction was originally as follows: Since the directors have a fiduciary relationship with the company,[402] and the company was associated with the long term best interest of the shareholders,[403] the directors indirectly owed their duties to the shareholders. This situation has been changed by the current Act. However, the principle is as follows: Whereas directors receive share capital from investors and manage this capital according to their duties, financial assistance implied that the directors thereafter give this capital to parties who in no way owe a fiduciary duty towards the company. The question is: How can moral hazard be curtailed in the current Act?

7. Conclusion

Section 48(2)(b) constitutes a provision that can be approached from the economic inclinations of a subsidiary or from the view of the holding company for purposes of control. However, the subsidiaries will have little recourse against the inefficient use of company funds, and the new constitution of a ring-fenced company will expose applicable parties to much commercial litigation.

It would be correct to surmise that, in isolation, the holding company retains a valuable substitute to treasury shares, even though the implication invalidates the statutory nature of shares and sets legislative double standards. Furthermore, the liberal approach to financial assistance (that seems to have developed beyond its initial relation to indirect undermining of the capital maintenance rule) may pose some ethical questions.

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[401] Cilliers & Benade 139 n17.
[402] Cilliers & Benade 139.
[403] Ch 2 par 3.

Conclusion

In the first instance, it would not do justice to this work if a brief sketch of the future of share repurchases were excluded, especially since the jurisprudential basis would still often be section 48 of the Act. The acquisition of own shares has internationally been subject to innovation through its combination with equity derivatives in order to produce "synthetic repurchases".[404] For example, a bullish company may write over-the-counter ("OTC") put options to diminish the expenditure of the acquisition of own shares on the open market through receiving upfront put premiums.[405] Secondly, a company may write OTC call options on their shares as a hedging technique.[406] (For purposes of brevity, abandonment is not taken into regard here.)

Apart from options, forward contracts can also be utilised. In an accelerated share repurchase ("ASRs"), an investment bank short-sells a company's shares to that company, after which the bank will purchase the same amount of company shares on the open market.[407] The forward contract has a zero initial value and a value at maturity that constitutes the difference between the initial value at which of the company acquires the shares and the volume-weighted average price paid by the bank.[408] In the alternative, a company may use a structured share repurchase and enter into an agreement with an investment bank, whereupon the bank will acquire the company's shares and deliver the shares to the company only upon the date of maturity.[409] The price of the shares will be the strike price, constituting the sum of

[404] Luning (2007) 40.
[405] *Id* at 42.
[406] *Id* at 43.
[407] *Id* at 44.
[408] *Ibid*.
[409] *Id* at 44, 45.

the forward price and the bank's profit.[410] (For purposes of brevity, collateral is not discussed here.)

Lastly, a company may gratuitously distribute transferable put rights to its shareholders of which the strike price will be higher than the current market price.[411] Once these rights are exercised, the process is similar to that of a fixed-price tender offer.[412]

Secondly, it must be noted that the legislation fails at substantially comprising the purposes envisaged in section 7. Not only is there an imperative uncertainty regarding the validity of a *numerus clauses* of distributions, but the capital rules statutorily provided for are insufficient. Though it would only be logical to imagine that companies exercise foresight as investors do, the shortcomings underpinning the legislatively imperative financial spectrum renders capital management inhibited. Apart from the apparent enterprise inefficiency[413] that this anticipates, as well as the oversimplification[414] that it presents, the circumstance somewhat echoes the obiter dicta of Coetzee DJP in Ex Parte NBSA Centre.[415]

Thirdly, Chapter 2 and Chapter 4 show signs of jurisprudential uncertainty relating to shareholders' equity. However, the replacement of the special resolutions as the primary method for shareholder protection by a board that owes only a loyalty to itself is a more startling unsound implication. The author has aspired to measure the legislative framework to the quantitative reality, and found the two matters to be irreconcilable. It is uncertain why the Legislature embraces the enlightened shareholder approach when basic economic theory already underpins the scales of efficiency and fairness. It is submitted that the solution remains the *Hutton* case.

After distinguishing share repurchases from other repos and redeemable preference shares, the author has described the various forms that share repurchases may take. Perhaps more important is the difference between accounting and other financial analyses surrounding the effect of section 48(2)(a) distributions on the capital of companies.

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[410] *Ibid*.
[411] *Id* at 45.
[412] *Ibid*.
[413] *Cf* s7(b)(i).
[414] *Cf* s7(b)(ii).
[415] 1987 (2) SA 783 (T) at 791.

Whereas the author has tried to construct a manner through which creditor protection could be effected, the stance pertaining to redeemable preference shares remain vague. It is suggest that the Legislature reviews the definition of "debt instrument", and that redeemable securities (which should rather be known as "redeemable preference shares") should be clarified in the Act.

The Act supplies some challenges to the scheme of arrangement procedure, given that the accumulated effect of predicaments inherent to share repurchase create a dire situation in the disclosure of shareholding. Fortunately, mandatory offers and share repurchase for take-over preclusion have become manageable with the assistance of the Takeover Regulation Panel's Guidelines and the Companies Regulations, 2011.

The subsidiary's acquisition of shares in a holding company has been restricted by the application of the original percentage to all subsidiaries collectively. However, one can view such distributions from the perspective of the subsidiaries or the holding company. Suffice to say that the subsidiaries remedies are somewhat curtailed and that the holding company is granted the benefit of a substitute to treasury shares and a liberal approach to financial assistance. Unfortunately, the abuse of such institutions needs little discussion.

it is submitted that the solution that initially comes to mind to the problems inherent to section 48 distributions will be teleological interpretation. However, it is difficult to understand how a teleological interpretation can mend inherent imperative shortcomings in the Act. Perhaps a better solution will be for the Legislature to take the Act once more under consideration.

[13 336 words]

List of Abbreviations

Given the preference for abbreviations in footnotes according to the Law Faculty's dissertation guidelines, the author has used the standard abbreviations of local journals, the Bluebook abbreviations for foreign law journals and the ISI journal abbreviations for financial journals.

Account Rev	=	The Accounting Review
Columbia L. Rev.	=	Columbia Law Review
DePaul Bus. & Com. L. J.	=	DePaul Business & Commercial Law Journal
Financ Manage	=	Financial Management
J Bank Financ	=	Journal of Banking and Finance
J Bus Ethics	=	Journal of Business Ethics
J Financ	=	The Journal of Finance
J Financ Econ	=	Journal of Financial Economics
J Financ Quant Anal	=	The Journal of Financial and Quantitative Analysis
Nw. U. L. Rev.	=	Northwestern University Law Review
RAND J Econ	=	The RAND Journal of Economics
SALJ	=	The South African Law Journal
Tex. Tech. L. Rev.	=	Texas Tech Law Review
TSAR	=	Tydskrif vir die Suid-Afrikaanse Reg
U. Pa. L. Rev. & Am. L. Reg.	=	University of Pennsylvania Law Review and American Law Register
Yale L. J.	=	The Yale Law Journal

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