

Capital rules in the Companies Act 71 of 2008

A Dissertation

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TABLE OF CONTENTS

	Page No.
CHAPTER 1: INTRODUCTION	1
1 INTRODUCTION	1
1.1 Capital Rules	2
1.2 Share Capital	2
1.3 The capital maintenance principle	3
2 RESEARCH QUESTION	4
3 SCOPE OF THE STUDY	4
4 SIGNIFICANCE OF THE STUDY	5
5 DELINEATIONS AND LIMITATIONS OF THE STUDY	5
6 PRELIMINARY LITERATURE SURVEY	6
6.1 The capital maintenance principle	6
6.2 Perceptions regarding the capital maintenance principle	6
6.3 The relaxation of the capital maintenance principle	7
7 PROPOSED METHODOLOGY	7
 CHAPTER 2: HISTORICAL OVERVIEW OF CAPITAL RULES	 8
1 INTRODUCTION	8
2 SOURCES OF THE CAPITAL MAINTENANCE RULE IN SA	10
2.1 English Law	10
2.2 The old Act	11
3 CONCLUSION	11



CHAPTER 3: THE AMENDMENT	12
1 INTRODUCTION	12
2 OTHER JURISDICTIONS	13
2.1 Introduction	13
2.2 <i>Australia</i>	13
2.2.1 Introduction	13
2.2.2 Reduction of share capital	14
2.2.3 Share buy-backs	16
2.2.4 Financial Assistance	16
2.2.5 Distributions	17
2.3 <i>United States of America (“USA”)</i>	18
2.3.1 Introduction	18
2.3.2 <i>Delaware</i>	20
2.3.2.1 Introduction	20
2.3.2.2 Share repurchases	21
2.3.2.3 Distributions	22
2.3.3 <i>California</i>	22
2.3.3.1 Introduction	22
2.3.3.2 Solvency and liquidity	23
2.3.3.3 Distributions	23
2.3.3.4 Share repurchases	24

2.3.4	Conclusion	25
2.4	England	26
2.4.1	Introduction	26
2.4.2	Reduction of capital	26
2.4.3	Financial assistance	27
2.4.3.1	Financial assistance for the acquisition of shares in a public company	28
2.4.3.2	Financial assistance by a public company for the acquisition of shares in its private holding company	29
2.4.4	Share repurchases	30
2.4.5	Distributions	30
2.4.6	Conclusion	30
3	THE SOUTH AFRICAN PERSPECTIVE	31
3.1	Introduction	31
3.2	Financial assistance	32
3.2.1	Introduction	32
3.2.2	The history of section 38	36
3.2.3	Financial assistance	38
3.3	Loans to directors	38
3.4	Distributions	40
3.4.1	Introduction	40
3.4.2	Payments to shareholders	40
3.5	Share repurchases	41
4	CASE LAW	42
5	CONCLUSION	43
	CHAPTER 4: SOLVENCY AND LIQUIDITY	44

1	Introduction	44
2	SHAREHOLDER PROTECTION	45
3	THE SOLVENCY AND LIQUIDITY TEST	45
4	THE NEW PROTECTION	46
5	DIRECTORS' LIABILITY	47
	CHAPTER 5: CONCLUSIONS AND RECOMMENDATIONS	48

CHAPTER 1

INTRODUCTION

1 INTRODUCTION

The amendment of the old South African companies Act¹ has been underway for a while and now finally the Act has been repealed by Companies Act 71 of 2008.² This research explores the impact of the amendment of the old Act by the new Act on South African company law and the operation of a company. The focus of the study will be on the effect of the amendment on capital rules.

The capital maintenance principle will also be explored in depth because of the impact it had on capital rules in South Africa. The principle has after all been a common thread that ran through most of the rules pertaining to capital for decades.

I will also look at the protection that the current rules offer to creditors and shareholders respectively *vis a vis* the protection offered by the new rules.

The research includes but is not limited to discussion on the following topics:

1. Financial Assistance for purchase of own shares, which is topical in the new South Africa due to Broad Based Black Economic Empowerment;
2. Loans to directors, because of the sensitivity of ensuring that the directors do not abuse their positions and conflict of interest;
3. Distributions will be discussed because they also affect the company's capital and most importantly to the exclusion of the company's creditors. This is a new insertion in the new Act; and
4. Acquisition of own shares which is a form of capital reduction and contrary to the capital maintenance principle.

¹ The South African Companies Act 61 of 1973, hereinafter referred to as the old Act.

² Referred to hereinafter as the new Act.

1.1 Capital rules

Capital Rules are rules that govern the how and when the capital of the company should be used. Capital can be defined as the contribution made by the company founders in exchange for shares in the company.³

1.2 Share capital

The definition of a share in the old Act is that a share in relation to a company, means a share in the share capital of that company and includes stock; and in relation to an offer of shares for subscription or sale, includes a share and a debenture of a company, whether a company within the meaning of the Act or not, and any rights or interests (by whatever name called) in a company or in or to any such share or debenture.⁴ The nature of a share is also defined in section 91.

Section 74 of the old Act provides that share capital can be divided into shares having par value or it may consist of shares having no par value, provided that all the ordinary shares and all the preference shares must consist of either the one or the other.⁵

There are two types of companies that could be formed under the old Act, a company with share capital and one without share capital with the liability of its members limited by its memorandum of association.⁶

A company with share capital acquires capital by issuing shares to its member who stand to lose no more than the amount paid by them for their shares in the company.⁷ This type of company is referred to as the more important of the two.⁸

³ See paragraph 1.2 below.

⁴ S 1 of the old Act.

⁵ Pretorius *et al* Hahlo's South African law through cases 121.

⁶ S 19(1) of the old Act.

⁷ Cilliers *et al* 31.

⁸ Cilliers *et al* 31.

A share is defined in the new Act as one of the units in which a propriety interest in a profit company is divided.⁹ The new Act proceeds to extend the definition of a share as being a moveable property, transferable in any manner provided for or recognized by the Act or other legislation,¹⁰ this meaning is similar to the one contained in section 91 of the old Act.

The new Act provides for two types of companies; a company with and a company without profit.

Capital has three roles, the first two being financing of the company and a margin of safety for creditors, which are regarded as economical roles.¹¹ The third role of share capital is the legal role, which is used to create rights duties and legal relationships.¹²

The old Act unlike the Continental and the English company laws did not prescribe the minimum amount of capital for either private or public companies.¹³ The old Act required only that before the certificate to commence business is issued by the registrar of companies, the company must lodge among other things, a statement of the opinion of each director to the effect that the capital of the company is adequate for its purposes, or if not, the reasons why it is inadequate and the manner in which and the sources from which the company will be financed.¹⁴

1.3 The capital maintenance principle

Capital maintenance is a principle that was formulated in the Victorian era in English law. The main aim of the principle was to maintain the company's capital in order to protect creditors.

⁹ S 1 of the new Act.

¹⁰ S 35(1).

¹¹ Van der Linde Aspects of regulation of share capital and distribution to share holders (LLD dissertation 2008 UNISA) 7.

¹² Van der Linde 7.

¹³ Pretorius *et al* 121.

¹⁴ Pretorius *et al* 121.

2 RESEARCH QUESTION

There are a few issues that come to mind to be addressed in this research project but only three are going to be the subject of this research; (1) the impact of the amendment on capital rules (2) whether the amendment offers some form of improvement on the old Act with regards to the capital rules; and (3) whether the protection offered by the new Act is sufficient for the interests of both creditors and shareholders.

3 SCOPE OF THE STUDY

Company law in South Africa was governed by the old Act. Prior to the amendment, the old Act supported the capital maintenance principle. The provisions were followed by the courts and strengthened through the provisions in the old Act¹⁵. The approach was such that the capital constituted a fund to which the creditors of the company must look for the satisfaction of their claims and that the fund must be maintained¹⁶.

In her foreword in the South African Company Law for the 21st Century Guidelines for Corporate Law Reform,¹⁷ the then minister of Trade and Industry Mandisi Mpahlwa states that the current framework of the old act is built on foundations put in place in Victorian England in the middle of the nineteenth century and that the framework upon which our company legislation is based has been questioned by the English themselves. England reviewed its company law, doing away with the concept of capital maintenance which resulted in the publication of the final report of the Company Law Review Steering Group in July 2002.¹⁸

It then became clear that there was a need to bring South African company law on par with international legislation, hence the new Act.

¹⁵ Cilliers *et al* 322.

¹⁶ Cilliers *et al* 322.

¹⁷ GG 26493 of 2004-06-23.

¹⁸ GG 26493 of 2004-06-23.

Other sections such as section 78 of the old Act maintained the share capital by providing that all proceeds of an issue of non par value shares be paid up share capital. The par value and non par value system has also been abolished by the new Act.¹⁹

4 SIGNIFICANCE OF THE STUDY

There are a number of articles written on the topic of capital rules. The comments have been made regarding a specific amendment to the rules as and when the amendment is proposed and when it is effected, for example, section 38(2) (d) in the Companies Amendment Act 37 of 1999²⁰ has seen a bit of criticism and the most vigorously commented on sections 38(2A) and 38(2B) brought by Corporate Laws Amendment Act 24 of 2006.²¹ Now that the new Act is complete *albeit* not yet in force, it gives us the opportunity to look at all the long awaited and debated amendments, this time not individually, but as a whole, to see whether the various sections are in harmony with each other unlike the current ones which have been criticised for being confusing and some for being in conflict with one another.

This will also be an opportunity to explore the effectiveness of the protection the new capital rules offers ex the capital maintenance concept and if the sacrifice was worth it.

5 DELINEATIONS AND LIMITATIONS OF THE STUDY

The biggest obstacle in this research will be the lack case law based on the new Act, due to it not having come into effect yet. The courts have not yet had a chance to apply the new rules. Act 24 of 2006 will assist in providing some material on the amended section 38 as there is a lot of opinion with regards thereto, and as previously mentioned, some of the amendments contained in Act 24 of 2006 now form part of the new Act.

¹⁹ See chapter 3 paragraph 3.2.

²⁰ Hereinafter referred to as the 1999 Act.

²¹ Hereinafter referred to as Act 24 of 2006.

6 PRELIMINARY LITERATURE SURVEY

6.1 The capital maintenance principle

The old Act had provisions through which the maintenance of the companies' capital was guaranteed, one of the ways to guarantee the maintenance of capital was for example, via section 38 which provided that a company may not give financial assistance in any form to anyone for the purchase of its own shares subject to some exceptions.²²

The amendment of section 38 of the old Act by the 1999 Act is one of the first steps towards the reform of the South African company law as we know it and company law in general, then again the amendment through Act 24 of 2006 which included the insertion of sections 38(2A) and 38(2B). Section 38(2A) provided that the Act does not prevent the financial assistance if the board is satisfied that after the transaction the consolidated assets of the company fairly valued will be more than its consolidated liabilities, this is referred to as the solvency and liquidity test. The section also provides that in addition to the requirement of solvency, for the duration of the transaction the company must be able to pay its debts as and when they come along²³. This test is currently being used in most international jurisdictions as a replacement for the capital maintenance system. Section 38(2B) provided that directors must be accountable for contingent liabilities resulting from the provision of assistance in terms of section 38(2A).

6.2 Perceptions regarding the capital maintenance principle

The principle has been regarded as outdated by many writers. It has been found that it is too stringent and does not allow any room for flexibility and as a result hinders the good business opportunities and that alone makes it ineffective.

The emergence of Broad Based Black Economic Empowerment was one of the factors that influenced the insertion of sections 38(2A) and 38(2B), in order to provide BEE companies and individuals access to finance in the promotion of the objectives

²² S 38 of the old Act.

²³ S 38(2A) of the old Act.

thereof.²⁴ The Corporate Laws amendment Bill, Act 24 of 2008 (“the amendment Act”), in its memorandum of objectives, termed the objective of the amendment shareholder diversification. The other reason is the move of the world economies towards that direction. The United States was one of the examples provided in the amendment Act as one of the corporate systems that have favored the solvency and liquidity test over the preservation of capital in the amendment Act.

Van der Linde’s article provides the international perception of capital maintenance. Her article indicates where other jurisdictions are with regards to capital maintenance, and indicates that most international company laws have relaxed their capital maintenance rules to make room for the new more flexible regime of solvency and liquidity. She has compared South African company law rules to jurisdictions such as United States and England.

6.3 The relaxation of the capital maintenance principle

South Africa has effected the relaxation of the capital maintenance rules in the new Act which has seen the amendments of most of the sections that were contained in the old Act that prevented a company from using its capital; for fear that the loss will be that of the creditors. Protection to the creditors is now provided by the solvency and liquidity requirements.

7 PROPOSED METHODOLOGY

I intend to do a critical comparative analysis of the capital rules provisions in the new Act. I will compare the new provisions to the old. My aim is also to highlight the reasons for the repulsion of the old Act. I will do that by looking at the history and the application of the provisions of the old Act in practice to date, its effect on the South African Company law and the differences between the two Acts²⁵ in respect of the capital rules. I will also attempt to determine whether the new Act offers an improvement on the old Act with regards especially to the solvency and liquidity test.

²⁴ Act 24 of 2006.

²⁵ The old Act and the new Act.

I will look at international legislations including the American, Australian and most importantly English company law regarding capital rules and a comparison between them and the South African legislation will be made, specifically the new Act. It is very important to do the comparison in order to see how much influence foreign legislature had on the repulsion of the old Act. Any influence or similarities between our Acts and foreign law will be highlighted.

The effect of the amendment (be it before or after the new Act) on the corporate world will also be tested by looking at opinion of legal experts through literature and articles written on the topic, together with case law related thereto.

CHAPTER 2

HISTORICAL OVERVIEW OF CAPITAL RULES

1 INTRODUCTION

A company is formed mainly to provide its founders some form of gain,²⁶ in which case one would believe that legislation governing companies should protect that objective for fear of rendering the formation of a company an unattractive notion and to also promote freedom of trade.

The old Act has been ensuring the protection and maintenance of the companies' shares and capital, by among others, preventing the company from acquiring its own shares and providing loans for the acquisition of said shares. These provisions were set to sustain the old capital maintenance rule.

Cassim²⁷ says that capital maintenance was formulated in English law and formed part of the South African company law when it was codified into the old Act *via* various sections, and the two main reasons for the formulation of the capital maintenance

²⁶ Cilliers Benade *et al* 322.

²⁷ "The reform of company law and the capital maintenance concept" 2005 SALJ 285, hereinafter referred to as FHI Cassim.

principle were to protect shareholders and to provide the creditors with a fund on which they can rely on for the satisfaction of their claims.²⁸

The rule as it was, was found to be inefficient, but could be justified in the fact that shareholders demonstrated strong tendencies to act opportunistically at the expense of creditors and would if they could make excessive distributions payments to themselves while some directors have shown a tendency to draw excessive salaries and benefits from the companies.²⁹

According to FHI Cassim, the classical capital maintenance rule has got nothing to do with the protection of the creditors; its objective was to ensure that the issued share capital of a company is maintained so that the company does not return its issued share capital to its shareholders except where authorized by the Companies Act.³⁰ He believes that creditors do not deal with a company on the basis of its issued share capital and that few of them use it to measure its credit worthiness³¹ therefore the rule is not there to protect creditors.³²

Being that as it may, the question is why would the rule prevent the company from returning the funds to the shareholders in the first place? I respectfully believe that ultimately, and contrary to what FHI Cassim states, the aim of the rule is to protect the creditors and this principle was confirmed in the cases of *Ooregum Gold Mining Company of India Ltd v Roper* [1892] AC 125 (HL) and *Cohen v Segal* 1970 (3) SA 702 (W).

I respectfully agree with FHI Cassim when he says that creditors do not use the company's issued share capital to measure its creditworthiness, which is only an indication of the ineffectiveness of the rule, it doesn't however change the fact that the aim of preventing the return of share capital to the shareholders is to maintain the capital for purposes of having some funds for creditors if and when they are needed although the share capital may not always be adequate enough to safeguard.³³ The rule

²⁸ Cilliers Benade *et al* 322.

²⁹ FHI Cassim 284.

³⁰ See FHI Cassim at 285.

³¹ FHI Cassim *supra*.

³² FHI Cassim *supra*.

³³ FHI Cassim *supra*.

does not discriminate against share capital based on size; it prevents its alienation for the protection of creditors no matter the size.³⁴

FHI Cassim categorizes the rules relating to capital maintenance into four groups.³⁵ According to him these rules were a result of the capital maintenance principle: (1) the rules relating to the raising of capital; (2) the rule that dividends may not be paid out of capital; (3) the rule preventing a company from purchasing its own shares; and lastly (4) the rule preventing a company from providing financial assistance for the purchase or subscription to its shares³⁶. These rules were incorporated into the old Act in a form of various sections, and the impact of the new Act on these sections will be discussed in detail in chapters to follow.

2 SOURCES OF THE CAPITAL MAINTENANCE RULE IN SA

2.1 English Law

Common law has played and will in my view continue to play a very important role in the South African law. English law has had a great influence on the way South Africa thinks when it comes to the codification and implementation of our laws. And it is no surprise that such influence is present in South African company law and most importantly the company law statutes.

As previously mentioned in Chapter 1, the capital maintenance rule was established in English Law through cases like *Trevor v Whitworth* (1887) 12 App Cas 409 (HL) 416. In *Trevor v Whitworth supra*, a company had bought more than a fourth of its paid up capital prior to the date of its liquidation which was paid or was to be paid to the company's shareholders in consideration for their ceasing to be shareholders as the company was being liquidated. The court held that if the transaction is not supported by the objectives in the company's memorandum of association it has difficulty in seeing how the transaction can be justified and that if it is supported then it means that the

³⁴ FHI Cassim *supra*.

³⁵ FHI Cassim *supra*.

³⁶ FHI Cassim *supra*.

shareholders are claiming payment of the sums they paid for their shares against creditors who had a right to look to the monies as the source out of which the company's liabilities to them were to be met.³⁷

Even though the English have rid themselves of the rule, the European Commission's High Level Group of Company Law Experts, which was responsible for the development of the company law policy of the European Union, recently confirmed that the protection of shareholders and creditors forms an integral part of any company law system.³⁸ FHI Cassim proposes that the South African company law follow this approach rather than the North American one.³⁹

2.2 The old Act

The old Act followed the capital maintenance rule as formulated in English law. It became a code of conduct for company law in South Africa. All companies in South Africa had to be formed, operated and terminated in accordance with the rules put down by the Act.⁴⁰ The old Act was and still is, at least until the full operation of the new Act, the main source of capital maintenance in South Africa.

Several amendments have been made to the old Act since the Companies Amendment Act 76 of 1974, which were inconsistent with the capital maintenance principle and in favour of the solvency and liquidity concept. However, prior to those amendments, the old Act was protective of the capital maintenance principle.

3 CONCLUSION

English law has always had a great influence in South African law. Their influence will always be a part of our law because of the history. Common law rules that we use are remnants of such influence and became part of our law in this respect when we adopted

³⁷ *Trevor v Whitworth supra.*

³⁸ FHI Cassim 285.

³⁹ FHI Cassim 285.

⁴⁰ The old Act.

the capital maintenance principle that was formulated in the English case *Trevor v Whitworth* above, and then entrenched into our Companies Act.

CHAPTER 3

THE AMENDMENT

1 INTRODUCTION

This chapter seeks to showcase the road that led to the abolition of the capital maintenance rule as it were and the repeal of the old Act. Over the years the capital maintenance rule became less and less favoured. It has been described by FHI Cassim and R Cassim in “The capital maintenance concept and share repurchases in South African Law”⁴¹ as archaic and outdated⁴² the reason being not only that both the English, who are its founders and Australian legislatures no longer applied it but also because the principle was imperfect and the rules that applied the principle of capital maintenance were said to be imprecise and uncertain⁴³ and there was therefore a desire to ensure that South African company law is more easily understandable and that it simplified by containing as few mandatory rules and prohibitions as possible.⁴⁴

There have been a few amendments to the old Act in the past but none as long anticipated and as grand as the one brought about by the new Act. The new Act has moved South African company law towards the use of the solvency and liquidity test instead of the absolute capital maintenance rule. The rule is not wholly replaced but has in my opinion been made more flexible by the addition of the solvency and liquidity test.

The international perspective regarding capital maintenance is discussed in paragraph 2 below.

⁴¹ Hereinafter referred to as FHI and R Cassim.

⁴² FHI and R Cassim.

⁴³ Cilliers Benade *et al* 322.

⁴⁴ Levin A “The proposed new Companies Act” October 2004 Harty Rushmere the e-files.

2 OTHER JURISDICTIONS

2.1 Introduction

It is very crucial for me to begin by outlining the international perspective on company law before the new South African approach is drawn out, merely because the South African legislature has used the international legislation as guidance. First we adopted the English rule of capital maintenance in the past and now that the English and most of the West have abolished the rule, *albeit* not completely⁴⁵ we need to follow suit. The amendments are not only meant to do away with an ineffective capital maintenance rule but also to catch up with international legislations, which will make global trade a bit easier due to uniform rules of trade between companies.

The west have for a while now done away with the capital maintenance rule and codified the new solvency and liquidity approach. The old English approach to capital rules and capital maintenance was amended by way of the Company Law Review Steering Group in July 2002.⁴⁶

2.2 Australia

2.2.1 Introduction

Just like South African law, Australian law has also been greatly influenced by English law. *The Australian Corporations Act 50 of 2001*⁴⁷ governs company law in Australia. Unlike the South African Acts which have one volume each⁴⁸ the *Corporations Act* is divided into five volumes and deals with transactions affecting share capital in Chapter 2J of volume 1.

⁴⁵ See chapter 2 paragraph 2.1.

⁴⁶ GG 26493 2004-06-23.

⁴⁷ Hereinafter referred to as the *Corporations Act*.

⁴⁸ The new and old Act.

Similar to the new Act, Australia also has a policy that all shares in a company have no par value.⁴⁹

2.2.2 Reduction of share capital

The *Corporations Act* allows a company to reduce its share capital.⁵⁰ This Act is very direct in its language with regards to the reduction of capital.

The *Corporations Act* even provides for alternative ways to reduce capital without authorization by law.⁵¹ In accordance with section 256B of the *Corporations Act* the share reduction can only be done subject to the conditions that the transaction is fair and reasonable to the shareholders as a whole, it does not materially prejudice the company's ability to pay its creditors and it is approved by the shareholders. The two notable differences between the provisions of this section to those contained in both South African Acts⁵² is that the South African Acts provide that both solvency and liquidity requirements must be satisfied when alienating capital and they provide in some sections a period within which the test is expected to be satisfied, this section⁵³ only requires one part of the twin test, liquidity. One of the ways that a company can reduce its capital under the *Corporations Act* is if the company cancels uncalled capital.⁵⁴

The *Corporations Act* proceeds to define what it regards as a reduction of share capital in section 256B(2). A cancellation of a share for no consideration is a reduction.⁵⁵ The reduction of a partly paid share is a reduction.⁵⁶ The Act⁵⁷ differentiates between equal or selective reduction. A share capital reduction is an equal reduction if it relates only to ordinary shares, applies to each ordinary share holder in proportion to the number of

⁴⁹ S 254C of the *Corporations Act*.

⁵⁰ S 256B of the *Corporations Act*.

⁵¹ S 256B supra at 51.

⁵² The new and the old Act.

⁵³ S 256B.

⁵⁴ Note 1 S 256B of the *Corporations Act*.

⁵⁵ S 256B(c).

⁵⁶ S 256B(1A).

⁵⁷ *The Corporations Act*.

ordinary shares they hold and the terms of the reduction are the same for each ordinary shareholder, if not, then the reduction is regarded as selective.⁵⁸

Section 256B clearly protects both shareholders and creditors. However creditor protection is not applicable if the cancellation of a share is without consideration.⁵⁹ The Act,⁶⁰ (except for section 254T, which as outlined in paragraph 2.2.5 below is due to be amended to do away with capital maintenance) also leaves no doubt as to whether or not it is still in favour of capital maintenance, specifically in section 256B.

The effects of non compliance with section 256(B) are contained in section 256(D). Non compliance by the company does not make the transaction or contract invalid and the company is not guilty of an offence⁶¹ however the individuals involved in the company's contravention of section 256B will be civilly liable⁶² or commit an offence if they are dishonest as well.⁶³ Section 258 provides that unlimited companies may reduce their share capital in any way.

Other ways to reduce share capital besides share buy-backs include the cancellation of forfeited shares,⁶⁴ the redemption of redeemable preference shares out of the proceeds of the new issue of shares made for the purpose of the redemption,⁶⁵ the reduction due to cancellation of shares returned in terms of section 651C, which includes returning security as part of an election refers to a situation where a person returns to the company any security in respect of any security issued by the company, the company must cancel those securities as soon as possible. In terms of section 651B, in which a person may elect to take a new form of consideration if they make an election and return to the bidder any consideration they have already received and any necessary transfer documents, section 724(2) which refers to choices that are open to persons offering security where the disclosure document conditions are not met or the document

⁵⁸ S 256B(2) of the *Corporations Act*.

⁵⁹ S 256B(c) of the *Corporations Act*.

⁶⁰ *The Corporations Act*.

⁶¹ S 256D(2) of the *Corporations Act*.

⁶² S 256D(3), Note 1 of the *Corporations Act*.

⁶³ S 256D(4) of the *Corporations Act*.

⁶⁴ S 258D of the *Corporations Act*.

⁶⁵ S 258E of the *Corporations Act*.

is defective, section 737 which refers to the rights of investors to return the security issued in contravention of section 724 in exchange for a cash refund.

Failure by the company to refund the money will see to the directors being held personally liable or section 738 refers to securities issued in contravention of section 736 that may be returned within one month for a cash refund and the reduction of share capital because of an order under section 1325A.

2.2.3 Share buy-backs

Another way for a company to reduce its share capital is by buying back its own shares. The *Corporations Act* also provides that a company may buy back its own shares provided that the transaction does not prejudice its ability to pay its creditors.⁶⁶ Unlike section 256B, this section does not provide protection to the shareholders; it only provides that the share buy back must not prejudice the company's ability to pay its creditors, the one reason one can think of for this omission is that the company i.e. the shareholders would have approved the transaction thereby not necessitating their protection from prejudice that might be caused by the transaction.

Once the transfer of the shares to the company has been registered, the shares are cancelled.⁶⁷ This is similar to the provisions of the old Act.⁶⁸ The directors may have to compensate the company if the company becomes insolvent when it enters into the buy-back agreement.⁶⁹

2.2.4 Financial Assistance

Financial assistance by a company for the purchase of shares in itself is also allowed in the *Corporations Act*.⁷⁰ This is only allowed if the company remains liquid after the approval; and the transaction is approved by the shareholders and it does not prejudice

⁶⁶ S 257A of the *Corporations Act*.

⁶⁷ S 257H(3) of the *Corporations Act*.

⁶⁸ S 85(8) of the old Act.

⁶⁹ S 1317H of the *Corporations Act*.

⁷⁰ Part 2J.3 s 260A of the *Corporations Act*.

the interests of the shareholders.⁷¹ Once again this section is also silent on the issue of solvency whereas its South African counterparts, section 38⁷² and section 44⁷³ contain both the solvency and liquidity requirements. They do not on the other hand contain the specific requirement relating to the interests of the shareholders.

The penalty for non compliance with the provisions of section 260A of the *Corporations Act* is similar to that contained under section 256D.

While financial assistance for the purchase of the company's own shares was prohibited in the old Act,⁷⁴ subject to certain exceptions, it is now allowed by section 44 of the new Act subject to certain conditions.⁷⁵

2.2.5 Distributions

Section 254T of the *Corporations Act* provides that dividends may only be paid out of profits. This provision is *pro* capital maintenance and differs from the South African position regarding payments of dividends. The new Act currently allows for dividends to be paid out of capital provided that the company complies with conditions provided.⁷⁶ There is a proposal by the Commonwealth Treasury to change the provision to allow payment of dividends out of capital if:

- (a) the company's assets exceed its liability and the excess is sufficient for the payment of a dividend;
- (b) it is fair and reasonable to the company's shareholders as a whole, and
- (c) it does not materially prejudice the company's ability to pay its creditors.⁷⁷

⁷¹ S 260A(1)(a) and (b) of the *Corporations Act*.

⁷² S 38 of the old Act.

⁷³ S 44 of the new Act.

⁷⁴ See paragraph 3.3.

⁷⁵ See paragraph 3.1.3.

⁷⁶ See paragraph 3.3.

⁷⁷ KPMG "Corporations Act amendments impacts parent entity, dividend and other areas" 2009 Flash Report.

2.3 United States of America (“the USA”)

2.3.1 Introduction

As with many laws in the USA, company law in the United States varies from one state to another. While there has been an effort to harmonise the corporation laws in America by many of the states adopting the 1969 and the revised 1984 Model Business Corporation Act (“MBCA”), there is still variation in the way many states regulate the corporations.⁷⁸ The law of the state in which a corporation has been incorporated will apply to that corporation.⁷⁹

Van der Linde differentiates between the types of surplus that can or cannot be used for distribution.⁸⁰ She also classifies the different distribution rules of different states into different categories.⁸¹ Prior to the 1980 amendments that altered the contribution and distribution rules, the 1969 *MBCA* was initially based on non-impairment of stated capital⁸² and it is referred to as the traditional statute, while the 1984 *MBCA* is an example of net-worth or modern statute.⁸³

The traditional statute allowed for distributions to be made only if the net assets of a company exceed its stated share capital and only out of earned surplus except in certain circumstances, special distribution could be made out of capital or unearned surplus.⁸⁴

The modern approach which was first adopted in California in 1977, when the rules related to stated capital and surplus were eliminated and all distributions were made subject to compliance with the test retained earnings or maintaining a fixed financial ratio of equity to debt.⁸⁵ This approach also considers net worth of a company over state

⁷⁸ Van der Linde 155.

⁷⁹ Van der Linde 156.

⁸⁰ Van der Linde *supra*.

⁸¹ Van der Linde *supra*.

⁸² Van der Linde *supra*.

⁸³ Van der Linde *supra*.

⁸⁴ Van der Linde 157.

⁸⁵ Van der Linde 158.

capital as long as there is an excess of assets over liabilities then a distribution can be made.⁸⁶

The 1969 *MBCA* was revised in 1979 and 1980 when distributions became subject to the net asset test.⁸⁷ There is however two States that have not adopted the *MBCA*, Delaware and California. Van der Linde uses these states to create a comparison with South Africa⁸⁸ against skepticism from other researchers regarding the difficulties and dangers of comparing American law to South African law,⁸⁹ probably because there are some 50 odd states in the USA and as previously mentioned they each have their unique approach on the application of company law and as a result it would be very difficult for one to do a comparison of each state to South Africa. Van der Linde's approach will be followed and the company law application of the said two states will be briefly compared to the old and new South African approach on capital maintenance.

Van der Linde's comparisons begin by highlighting the different terms used in each country to refer to the subject matter. For example, Americans refer to it as stated capital while in South Africa we refer to it as issued share capital and what we refer to in South Africa as liquidity is referred to as solvency in the States.⁹⁰

Before proceeding, it is imperative that I mention that van der Linde's research was based on the South African company law prior to the repeal of the old Act; therefore most of the references made by her will be pre the new Act.

⁸⁶ See Van der Linde at 158.

⁸⁷ Van der Linde *supra*.

⁸⁸ Van der Linde *supra*.

⁸⁹ See Van der Linde at 159.

⁹⁰ Van der Linde *supra*.

2.3.2 Delaware

2.3.2.1 Introduction

As previously mentioned above⁹¹ the application of company law in the United States varies from state to state. Delaware is regarded as the most favourite for companies to be incorporated in, due to what has been regarded as lenient regulation.⁹² *The Delaware General Corporation Law Title 8*, (“the Corporation Law”), became more permissive than any other corporation statute of its time after its revision in 1899.⁹³ The Corporation Law adopted certain principles from the *MBCA* in 1969.⁹⁴

With regards to the authorized share capital, the *Corporation Law* requires that the authorized capital be set out in its certificate of incorporation and if there is one class of shares the certificate must reflect the total number of authorised shares.⁹⁵ Similar to the old Act, the Delaware system still differentiates between par value and non par value shares,⁹⁶ while the new Act has done away with the par value share system, all shares are currently non par.⁹⁷ The old Act provided that the amount of capital in respect of par value shares be stated while the *Corporation Law* has no such requirement, and does not prescribe a minimum amount of share capital.⁹⁸

All ordinary shares or all preference shares must be of one kind in South Africa⁹⁹ whereas in Delaware different series of shares in any class can have different rights, but all shares in a class must be either par value or no par value.¹⁰⁰

Section 151(b) of the *Corporation Law* provides that shares can be subject to redemption and if they are redeemed, the requirement is that immediately after redemption the corporation must have one or more shares of one or more classes or series in issue with voting rights. In South Africa however, shares that are not

⁹¹ See chapter 3 paragraph 2.2.

⁹² See Van der Linde Chapter 4 Paragraph 2.1.

⁹³ See van der Linde *supra*.

⁹⁴ Van der Linde *supra*.

⁹⁵ See Van Der Linde chapter 4 paragraph 2.2.1.

⁹⁶ Van der Linde *supra*.

⁹⁷ S 35 of the new Act.

⁹⁸ Van der Linde *supra*.

⁹⁹ S 74 of the old Act.

¹⁰⁰ See Van der Linde chapter 4 paragraph 2.2.3.

redeemable or convertible must remain in issue after their repurchase,¹⁰¹ van der Linde thinks that the former approach is more preferable than the latter.¹⁰²

Van der Linde also regards the South African system's treatment of capital accounts as complicated. Section 78 of the old Act provides that there should be a separate account for preferent and ordinary share account, while the *Corporation Law* requires one account for both par and non par value shares, called the stated capital account.¹⁰³ Another difference with regards to the capital accounts is that a premium received in respect of par value or non par value shares needs to be stated in South Africa and that is not the case in Delaware and premium is referred to as surplus in Delaware. There is also no restriction in Delaware as to the portion of consideration received for no par value shares that have to be regarded as share capital, while in South Africa the full consideration is regarded as share capital¹⁰⁴ and van der Linde once again prefers the Delaware approach to the South African one in this regard because it is more flexible.¹⁰⁵

2.3.2.2 Share repurchases

With regards to share repurchases, section 160(a) of the *Corporation law* provides a corporation with the power to purchase its own shares but a company may not purchase or redeem its own shares if the company's capital is impaired or such transaction would cause the company's capital to be impaired.¹⁰⁶ This is called the capital impairment test which is undertaken by means of revaluing the company's assets and liabilities to see if it is possible to redeem the shares and if there is a surplus the directors do not have to pass a resolution setting out the surplus.¹⁰⁷ The South African approach to share repurchases is discussed in paragraph 3.6 below.

¹⁰¹ Van der Linde.

¹⁰² Van der Linde *supra* at 94.

¹⁰³ Van der Linde chapter 4 paragraph 2.2.4.

¹⁰⁴ Van der Linde paragraph 2.2.4.

¹⁰⁵ Van der Linde *supra* at 111.

¹⁰⁶ S 160(a)(1) of the *Corporations Law*.

¹⁰⁷ Van der Linde 179.

2.3.2.3 Distributions

The old Act provided for distributions in various sections which were never grouped together as such, the new Act provides for distributions in section 46.¹⁰⁸

Payments of dividends are provided for in section 170 of the *Corporation law* and forms part of distributions. In terms of section 170, distributions may be paid out of the shares of the company's capital stock, if the company is non stock, then out of surplus and where there is no surplus out of net profits of the fiscal year in which the dividend was declared. The directors may not pay such a dividend if the capital of the corporation has been diminished by the depreciation in value of its property.

2.3.3 California

2.3.3.1 Introduction

California was the first capital in the USA to do away with the legal capital regime and was a great influence on the *MBCA*.¹⁰⁹ Van der Linde considers California to be a great state for comparison not only for the aforementioned but also because of its size and economic significance. The company law in California is governed by Chapter 682 of the statutes of 1975 which van der Linde refers to as the California Corporations Code and which I will continue to refer to as the *Corporations Code* hereinafter.

Unlike the *Corporations Act* and the South African law the law in California does not have a formal provision for the reduction of share capital.

Van der Linde discusses several issues on the law in California a great deal of which falls under distributions which is defined by the *Corporations Code* as the transfer of shares or property by a corporation to its shareholder without consideration, whether by way of dividend or otherwise, other than a dividend in shares of the corporation or the purchase or redemption of its shares for cash or property, including the transfer,

¹⁰⁸ See paragraph 3.4 below.

¹⁰⁹ Van der Linde 188.

purchase or redemption by a subsidiary of the corporation. (See paragraph 3.4 for the South African definition of distribution).

Shares in California as in South Africa¹¹⁰ and Australia do not have par value.¹¹¹

2.3.3.2 Solvency and Liquidity

Similar to the South African Acts, a distribution in California is also subject to the solvency and liquidity test or what they refer to as the equity solvency test.¹¹² It is said that because both shareholders and directors can be held liable for unlawful distributions,¹¹³ a more objective test of the corporation's financial situation rather than a frame of mind is preferable.

2.3.3.3 Distributions

Distributions in California are defined as the transfer of cash or property to shareholders for no consideration by way of dividends or otherwise.¹¹⁴ The Code offers protection to both shareholders and creditors with regards to distributions.

A company may not make a distribution unless it is in terms of sections 500 to 503 of the *Corporations Code*. Van der Linde¹¹⁵ has divided the exceptions as follows:

1. Section 500, the retained earnings test as it requires the retained earnings the company immediately before the distribution to be equal to or exceed the amount of the proposed distribution;
2. The asset liability-asset ratios test in terms of section 500(b)(1) and (2);
3. Section 501, the equity solvency test;

¹¹⁰ The new Act.

¹¹¹ S 402(c).

¹¹² S 501 of the *Corporations Code*.

¹¹³ This provision is contrary to the *Corporations Act* and the South African Acts where only directors and individuals involved in the company's contravention are held liable and not the Company.

¹¹⁴ S 166 of the *Corporations Code*.

¹¹⁵ See Van der Linde chapter 4 paragraph 3.4.2.

4. Preferential dividend and distributions.¹¹⁶ South Africa company law protects the interests of the minority because of the potential abuse of power by the majority shareholders; Californian law on the other hand protects the interests of the preferred classes of shareholders when a distribution is made to classes enjoying a lower priority.
5. Section 503, prevents a company from making a distribution out of any shares of its stock unless the amount of the retained earnings of the corporation immediately prior thereto equals or exceeds the amount of the proposed distribution plus the aggregate amount of the cumulative dividends in arrears on all shares having a preference with respect to payment of dividends over the class or series to which the distribution is made, the section proceeds to place further conditions on the distribution made under it.

Section 316 of the *Corporations Code* holds directors responsible for approving unlawful distributions. All the directors responsible are held jointly and severally liable to the company for the benefit of all creditors and shareholders.¹¹⁷ The directors are liable for the amount of the illegal distribution or the fair market value of the property if the distribution consisted of property together with costs involved and interest.¹¹⁸ The penalty for making unlawful distribution in the new Act is contained in section 77.

2.3.3.4 Share repurchases

Section 207(d) of the *Corporations Code* allows companies to re-purchase their own shares, but only the purchase or redemption of shares for cash is referred to as a distribution.

The shares that the company acquires are restored to the status of authorised but unissued unless the articles prohibits it,¹¹⁹ in which case the articles have to be

¹¹⁶ S 502 of the *California code*.

¹¹⁷ S 316(a) of the *Corporations Code*.

¹¹⁸ S 316(d) of the *Corporations Code*.

¹¹⁹ Van der Linde chapter 6 paragraph 3.6.6.

amended immediately upon acquisition to say that shares cannot be issued again.¹²⁰
The status of the re-purchased shares in South Africa was that they were cancelled.¹²¹

The *Corporations Code* does not provide separately for liability for unlawful repurchases.¹²² The section that provides liability for unlawful distributions by directors is section 316 of the *Corporations Code* and the liability of shareholders who enter into the illegal distribution knowingly is contained in section 506 of the *Corporations Code*. This is similar to the new Act which also imposes liability for contraventions of most provisions (sections 44, 45, 46, 47 and 48) contained in one section, section 77.

2.3.4 Conclusion

It is not easy to understand the format of the American statutes as compared to the South African and English. However the similarities with regards to the abandonment of the capital maintenance rule are clear.

The repurchase of shares is allowed by both California (Section 207(d)) and Delaware as long as the capital is not impaired.

The distributions are also allowed in California with the condition that the company passes the equity solvency test (sections 500- 503 of the *Corporations Code*), which is the equivalent to the solvency and liquidity test. Distributions in Delaware can be paid out of the share stock capital provided that the company's capital is not diminished.

¹²⁰ Van der Linde *supra* at 125.

¹²¹ S 85(8) of the old Act.

¹²² Van der Linde Chapter 4 paragraph 3.6.4.

2.4 England

2.4.1 Introduction

The *English Companies Act of 2006* (“the English Act”) was assented to in 2006. Van der Linde mentions the various Acts that regulate some aspects of English company law, but the *English Act* as the main regulator.¹²³

Part 17 of the *English Act* deals with the company’s share capital. Section 540 deals with shares and defines them as shares in the company’s capital. The section also prohibits conversion of shares into stock and stock created prior to the Act maybe converted back into shares in accordance with section 620.¹²⁴

In relation to a member, a share or any interest is defined as personal property and not in the nature of real estate.

Contrary to Delaware and same as South Africa the *English Act* requires that shares having capital have a fixed value.¹²⁵

2.4.2 Reduction of Capital

A limited company may reduce its share capital in any way if approved by special resolution and supported by a solvency statement,¹²⁶ and if prior to the approval the position is not such that there is no member holding shares in the company other than redeemable shares.¹²⁷ This is governed by Part 17 chapter 10.

The solvency statement in this case must be made 15 days prior to the passing of the resolution to reduce capital and both the statement and the resolution should be registered.¹²⁸ To be valid the solvency statement must be formed by opinion of each director that there is no ground on which the company could then be found to be unable

¹²³ Van der Linde 37.

¹²⁴ Ss 540(2) and (3).

¹²⁵ Van der Linde.

¹²⁶ Ss 641(1)(a) and (b).

¹²⁷ Ss 641(2).

¹²⁸ Ss 642(1)(a) and (b).

to pay its debts¹²⁹ and that if there is intention to wind up the company within 12 months of that date that the company will be able to pay its debts within the 12 months of the commencement of the winding up or will be able to pay its debts as they become due and payable during the year immediately following the date.¹³⁰

In terms of section 656 of the *English Act*, should a company's net assets fall below half or less than half of its called-up share capital there should be an extraordinary general meeting which must be held within 56 days of the day when a director became aware of the situation.¹³¹

2.4.3 Financial Assistance

Governed by part 18 chapter 2, unlike its South African equal, the definition of financial assistance in the *English Act* is contained separately from the section under which the terms and conditions in which a company may provide financial assistance are provided, it is also more detailed in that regard. In terms of the *English Act* financial assistance may be given by way of a gift, a guarantee indemnity or release or waiver except an indemnity in respect of the indemnifier's own neglect or default,¹³² by way of a loan or any other agreement under which any of the obligations of the person giving the assistance are to be fulfilled at a time when in accordance with the agreement any obligation of another party to the agreement remains unfulfilled, or may be by way of an assignment or novation of rights arising under a loan or such other agreement.¹³³ In the new Act¹³⁴ the definition of financial assistance is not separately provided for. Financial assistance in South Africa can be given by way of a loan, a guarantee the provision of security or otherwise.¹³⁵ This definition unlike the English definition is not as detailed and not as definite and as a result still open to interpretation due to the use of the words "or otherwise". The same definition was used in the old section 38 of the old Act and left

¹²⁹ S 643(1)(a).

¹³⁰ S 643(1)(b)(i) and (ii).

¹³¹ Van der Linde Chapter 2 paragraph 2.7.

¹³² S 677(1)(a) and (b).

¹³³ S 677(1)(c).

¹³⁴ S 44(2) of the new Act.

¹³⁵ S 44(2) of the new Act.

it up to the courts to handle the battle between parties as to whether their transaction falls within the meaning of financial assistance or not. I suspect that this will not be such an issue in the new Act as the new section is no longer a prohibiting but an enabling section.

The major difference in the two definitions is section that section 677(1)(d) of the *English Act* provides that financial assistance is made where the net assets of the company are reduced to a material extent by giving the assistance or the company has no assets.

2.4.3.1 Financial assistance for the acquisition of shares in a public company

The *English Act* separates the acquisition between private and public companies for the acquisition of shares. Section 678 of the *English Act* provides that it is unlawful for a company or its subsidiary to give financial assistance for the purpose of acquiring shares directly or indirectly before or at the same time as the acquisition.¹³⁶ It provides that the company may give financial assistance for the acquisition of shares in itself or its holding company provided that the principal purpose of the assistance was not to assist in the acquisition of shares and the assistance for the acquisition of the shares was incidental to a larger purpose of the company¹³⁷ and in good faith and in the interest of the company.

Section 678(3) proceeds to provide that it is unlawful for a company or its subsidiary to provide financial assistance to anyone who has acquired shares in it or in its holding company and as a result has incurred debt and the assistance is to reduce or discharge such debt if that company is a public company. A company may however give financial assistance resulting in the reduction or discharge of a debt incurred by anyone as a result of acquiring shares in the company or its holding company, provided that such reduction or discharge is not the principle purpose of the financial assistance and that it is incidental to a larger purpose of the company.¹³⁸

¹³⁶ S 678(1).

¹³⁷ S 678(2).

¹³⁸ S 678(4) of the *English Act*.

2.4.3.2 Financial assistance by a public company for the acquisition of shares in its private holding company

A public company may not provide financial assistance to anyone directly or indirectly for the acquisition of shares in its holding company if such holding company is a private company before or at the same time as the acquisition, except if the financial assistance for the acquisition of the shares is not the principle purpose of the transaction and only incidental thereto.¹³⁹

Contravention of sections 678(1) and (3) and 679(1) and (3) is an offence by the company and every officer in the company who is in default.¹⁴⁰

The new Act does not make a differentiation between a public and private company for purposes of section 44,¹⁴¹ it is an umbrella provision for both private and public companies. The company that provides financial assistance in contravention of section 44 does not commit an offence, instead the director or a prescribed officer or a person who is a member of the committee of a board of a company or of the audit committee,¹⁴² who was present or participated in the making of such decision and failed to vote against the unlawful resolution knowing that the financial assistance approved by the resolution is inconsistent with the provisions of section 44 is held liable in terms of section 77.¹⁴³

A person found guilty in terms of section 680 of the *English Act* is liable on conviction on indictment to a fine or imprisonment not exceeding 2 years or both.¹⁴⁴

¹³⁹ S 679 of the *English Act*.

¹⁴⁰ S 680(1)(a) and (b) of the *English Act*.

¹⁴¹ See paragraph 3.2.3.

¹⁴² S 77(1)(a) and (b), and provides further that it is irrespective whether or not such person is also a member of the company's board.

¹⁴³ S 77 of the new Act imposes liability on directors.

¹⁴⁴ S 280(2)(a).

2.4.4 Share repurchases

A limited company may purchase its own shares in terms of Part 18, chapter 4 of the *English Act*. The shares must be paid for on purchase. A private limited company on the other hand may purchase its own shares out of capital.¹⁴⁵

Similar to the old Act,¹⁴⁶ where a limited company buys the shares they are either cancelled, thereby diminishing the amount of the company's issued capital unless they were held as treasury shares in terms of section 724 of the Companies Act. The South African Act is silent on the issue of treasury shares.

2.4.5 Distributions

Distributions in the *English Act* can still only be made out of distributable profit, which is the excess of net assets over the company's capital, and the share capital should still be maintained unless the reduction thereof is confirmed by the court.¹⁴⁷ This is governed by part 23 chapter 1. Just like South Africa, distributions include dividends and any other payments to shareholders but exclude repurchases and redemptions similar to section 90 of the old Act.¹⁴⁸

2.4.6 Conclusion

The *English Act* is more similar to the South African Acts than other legislations except for the fact that it makes a differentiation between private and public companies when coming to financial assistance and share repurchases and financial assistance (see paragraph 2.4.3 and 2.4.4 above) and that it does not allow the financial assistance for purchases of shares.

¹⁴⁵ S 692 of the *English Act*.

¹⁴⁶ See paragraph 3.

¹⁴⁷ Van der Linde Chapter 2 paragraph 4.

¹⁴⁸ Van der Linde Chapter 2 paragraph 4.

The shares in the *English Act* are also cancelled after being purchased by the company as in the old Act. It also allows to a great extent a company to reduce its capital.

Financial assistance in the *English Act* is defined separately from the provisions relating to financial assistance for purchase of shares.

The *English Act* adopts the solvency and liquidity test when dealing with reduction of capital.

3 THE SOUTH AFRICAN PERSPECTIVE

3.1 Introduction

The four groups of rules as set out by FHI Cassim¹⁴⁹ are discussed below, together with their amendments into the new Act.

The system of par value shares has been done away with in the new Act. The old Act used to differentiate between shares with par value and shares with no par value. Section 35(2)¹⁵⁰ provides that a share does not have a nominal or par value. Companies may no longer issue par value shares, however in terms of section 35(6) the existing par value shares already issued may remain.¹⁵¹ This is the trend in most of the legislations discussed above.

FHI Cassim believed that the principle of no par value just like that contained in section 82 should be preserved. The new Act has now maintained that sentiment in terms of section 35.¹⁵²

¹⁴⁹ FHI Cassim 285.

¹⁵⁰ S 35(2) of the new Act.

¹⁵¹ S 35(6) provides that despite the repeal of Act 61 of 1973, a share issued by a pre-existing company, and held by a shareholder immediately before the effective date, continues to have all the rights associated with it immediately before the effective date, irrespective of whether those rights existed in terms of the company's Memorandum of Incorporation or in terms of that Act (Act 61 of 1973).

¹⁵² FHI Cassim 286.

3.2 Financial Assistance

3.2.1 Introduction

This provision has been the most topical and the most analysed and criticised of all of the provisions that upheld the capital maintenance rule. It is said to be the sub-set of the capital maintenance principle, the function of which has more recently found fewer supporters with many commentators, international and local recognizing no need to prevent a company from financing the acquisition of its own shares where it is shown to be solvent and liquid.¹⁵³

Section 38 of the old Act prevented a company from financing the purchase of its own shares or the subscription thereto as part of the capital maintenance rule. The section also prevented a subsidiary from providing financial assistance for the purchase or the subscription of the shares in its holding company.

The first criticism I can mention is that the latter prohibition which was rightfully pointed out by FHI Cassim in his article “Unraveling the obscurities of section 38(2)(d) of the Companies Act”¹⁵⁴ to be ignoring the fundamental principles of company law that a subsidiary, like any other company is to be regarded as a separate legal entity from its holding company. He quotes the statement made by Slade LJ in the case of *Adams v Cape Industries Plc* [1999] ALL ER 927 (ChD and CA) at 1019, where the judge notes that our law recognizes the creation of subsidiary companies, which though in one sense are the creatures of their parent companies, will nevertheless fall to be treated as separate legal entities with all the rights and liabilities which would normally attach to separate legal entities. In the same breath the same provision does not prohibit the holding company from providing financial assistance for the purchase or subscription of shares in the subsidiary company. This proves to be one of the many flaws of section 38 and therefore the capital maintenance rule.

Section 38(2) provides the exceptions to the prohibitions contained in section 38(1), giving rise to a second criticism by Cassim, being that the section is difficult to construe

¹⁵³ Chirwa L “Bill Empowers Poorer Partners”.

¹⁵⁴ Hereinafter referred to as Cassim.

and understand which difficulty came from the lack of proper punctuation resulting in its intent and effect being blurred as to its true meaning.¹⁵⁵ For example section 38(2)(d), which was added by section 3 of the 1999 Act, provides that the company may give financial assistance to a company or its subsidiary for the acquisition of own shares in accordance with section 85, this was regarded as a curious exception¹⁵⁶ in that, how can a company provide itself financial assistance?

The above question and the issue of whether a subsidiary's separate legal personality is recognized by section 38(2)(d) were answered in the case of *Ex Parte Standard Bank Group Limited and Liberty Group Limited [2007] 4 All SA 1298 (W)*, Cassim provides the summary of the decision in his journal "Ex parte Standard Bank Group LTD and Liberty Group LTD- black economic empowerment schemes and section 38(2)(d) of the Companies Act".¹⁵⁷ In this case and in order to meet the requirements of the of the financial sector charter regarding equity ownership, Standard Bank Group ("SBG") and Liberty Group engaged in a scheme of arrangement in which their ordinary shareholders would dispose of a certain number of shares to SBG's wholly owned subsidiaries and some of the shares were to be transferred to SBG's trust for employees which would ensure a broad based black economic empowerment transaction. SBG was to provide the finance to enable the subsidiaries to acquire the shares.

All the formal requirements for a scheme of arrangements in terms of the companies Act were complied with after which all the shares in the subsidiaries were to be transferred into the two black empowerment companies that were elected by SBG.¹⁵⁸ The Liberty Group transaction was similar to the SBG one,¹⁵⁹ and will not be detailed hereunder.

The court found that both SBG and Liberty Group had provided finance to their subsidiaries to acquire shares in their holding companies, which was, prior to the

¹⁵⁵ Cassim *supra*.

¹⁵⁶ Cilliers Benade *et al* 330.

¹⁵⁷ Hereinafter referred to as Ex Parte Standard Bank.

¹⁵⁸ Ex Parte Standard Bank *supra*.

¹⁵⁹ Ex Parte Standard Bank *supra*.

insertion of section 38(2)(d) not permitted by the old Act (section 38(1)) but was now allowed by section 38(2)(d). Cassim, brings to light that the court went much further than necessary by not only addressing the question of whether the company can provide financial assistance to its subsidiary for the purchase of its own shares but also stated that the subsidiary may also give financial assistance to its holding company for the acquisition of shares in itself.¹⁶⁰ Cassim regarded the finding as a controversial extension of section 38(2)(b), which was in his opinion in the current case not in issue and not necessary for the court to address.

Regardless of whether or not the provision was in issue the court voiced its opinion regarding section 38(2)(b), which was that it is not in compliance with the basic principles of company law of separate legal personality of a subsidiary (see Slade LJ in *Adams v Cape Industries Plc* [1999] ALL ER 927 (ChD and CA) at 1019).

Cassim proceeds to address some of the issues that he had regarding the judgment of the court in this cases. The other issue which he brings up is that the court did not address the question of whether or not the SGB and Liberty Group transactions were contrary to section 38(1).

Cassim R and MF Cassim in “*Gardner v Margo: A misapplication of section 38 of the companies Act*”¹⁶¹ criticise the decision in the case of *Garner v Margo* 2006(6) SA 33 (SCA), in which section 38 was an issue. In this case the court had to decide on whether or not the provision of a guarantee by a company constituted financial assistance. At first glance and in terms of section 38 of the old Act, a provision of a guarantee is contained in section 38(1)¹⁶² as one of the methods in which a company would be regarded as having provided financial assistance. In this case the Joubert had instructed Gardner to sell his (Joubert’s) shares in OTR. OTR had in terms of the mandate given to Gardner by Joubert, given Joubert a guarantee that he will not receive anything less than R5,141, 432 for the sale of shares.

¹⁶⁰ Ex Parte Standard Bank *supra*.

¹⁶¹ Hereinafter referred to as Cassim R and MF.

¹⁶² S 38(1) provides that- (1) No company shall give, whether directly or indirectly, and whether by means of a loan, guarantee, the provision of security or otherwise, any financial assistance...

At the time when the shares were sold OTR was experiencing financial difficulties and according to one confidential OTR report, seven weeks before the mandate was entered into, OTR was not going to last long. Joubert and Gardner were the founding members of OTR. After giving the mandate to Gardner to sell his shares, Joubert ceded the rights regarding the mandate to Margo, who then sued Gardner and OTR for payment of the unpaid proceeds of the sale of the shares which Gardner had sold. Gardner had apparently paid a substantial amount of the proceeds of the sale to OTR and Margo then held OTR and Gardner jointly and severally liable for part of the proceeds.

The two appellants argued that Joubert had no residual rights under the mandate against either of them at the time of the cession to Margo and that Margo had no rights against them as a result. This defense was rejected by the court *a quo* and Margo's claim was upheld.

Gardner and OTR appealed the decision. Margo also held OTR liable in terms of the guarantee that OTR had given to Joubert which was also ceded to him. Margo argued that to the extent that he was awarded or recovered an amount that was less than the amount that OTR had guaranteed Joubert, and OTR was therefore liable for the difference. OTR then contended that the guarantee he had given to Joubert constituted a contravention of section 38 as in was an indirect or direct financial assistance by OTR for the purpose of a purchase to be made of Joubert's shares in OTR within the scope of section 38 and therefore the guarantee was invalid and unenforceable.

The court held that Joubert and therefore Margo were only entitled to receive 40 cents per share out of the proceeds of the sale and that any amount received in excess of 40 cents per share would be paid to OTR. With regards to the number of unaccounted shares, the court found that Gardner had sold the shares and that Margo had a claim for those shares but only 40 cents per sold share and not at the market rate at the time.

On the matter of whether the guarantee was in conflict with section 38 or not, the court found that the guarantee did not fall foul of the section. The court referred to the case of *Lipschitz NO v UDC Bank Ltd 1979(1) SA 789 (A)* by saying that the court in *Lipschitz v*

UDC above accepted the distinction made by the court in the *Gradwell (Pty) Ltd v Rostra Printers Ltd 1959 (4) SA 419 (A)* case between the ultimate goal of the transaction and its direct object and to accept that it is only the direct object that is relevant and that if the direct object is not the provision of financial assistance by the company for purpose of buying its shares then it is irrelevant that the ultimate goal of the transaction was to enable a person to purchase those shares, the court in *Gradwell v Rostra* above went on to emphasise that financial assistance within the meaning of section 38 is given only when the direct object of the transaction is to assist another financially, and that it is not contravened when the direct object is merely to give to another that which he is already entitled.

Even though this view is supported by the *English Act* regarding financial assistance which provides that the company may give financial assistance for the acquisition of shares in itself or its holding company provided that the principal purpose of the assistance was not to assist in the acquisition of shares but that the assistance merely incidental to the larger purpose of the company (see paragraph 2.4.3 above), Cassim R and MF are of the opinion that the court erred in finding that the guarantee given by OTR to Joubert was not against the provisions of section 38.

3.2.2 The History of Section 38

As previously mentioned in chapter 1, the emergence of Broad Based Black Economic Empowerment (“BEE”) was one of the motivating factors for the amendment of section 38. The Broad Based Black Empowerment Act 53 of 2003¹⁶³ came into effect in 2003. The objectives of the BEE Act are outlined in section 2 of the BEE Act as follows:

- a) to facilitate broad-based black economic empowerment by promoting economic transformation in order to enable meaningful participation of black people in the economy;

¹⁶³ Referred hereinafter as the BEE Act.

- b) achieving a substantial change in the racial composition of ownership and management structures and in the skilled occupations of existing and new enterprises:
- c) increasing the extent to which communities, workers, cooperatives and other 50 collective enterprises own and manage existing and new enterprises and increasing their access to economic activities, infrastructure and skills training;
- d) increasing the extent to which black women own and manage existing and new enterprises, and increasing their access to economic activities, infrastructure and skills training;
- e) promoting investment programmes that lead to broad-based and meaningful participation in the economy by black people in order to achieve sustainable development and general prosperity;
- f) empowering rural and local communities by enabling access to economic activities, land, infrastructure, ownership and skills; and
- g) promoting access to finance for black economic empowerment.

It is very clear from the first objective that the South African economy had to be transformed in order to accommodate or facilitate the BEE principles, and the only way the economy could change is to change the way the economy is regulated and that required the change in legislation, policies and regulations that affect the way the economy is run. These regulations, no doubt had to include Company law, being one of the first and foremost laws that affect the economy of this country. These objectives meant that exceptions and opportunities had to be created for black people as defined in the BEE Act to participate in the economy.

Another objective of the BEE Act is to promote access to finance to black people¹⁶⁴ in order to adhere to the spirit and objects of the BEE Act, but section 38 of the old Act was a huge road block to the success of this objective, as it prevented a company from providing financial assistance for the purchase of its own shares.

¹⁶⁴ S 2(g) of the BEE Act.

In the spirit of the objectives of BEE, this prohibition was removed by the Act 24 of 2006 by the addition of sections 38(2A) and 38(2B).

Section 38(2A)(a), provides for the solvency exception while section 38(2A)(b) provides for the liquidity solution. This was a move clearly indication both globalization of our legislation but also the promotion of the BEE Act.

Section 38(2B), provides that for the purposes of section 38(2A)(a) the directors must account for any contingent liabilities that may arise to the company, including liability that may arise as a result of providing assistance.

3.2.3 Financial Assistance

Having gone through a lot of scrutiny and criticism and many feeling that section 38 should be amended to bring it in line with the current global and local economic requirements, the new Act substituted the entire section 38 with the insertion of section 44. Whether or not this change caters for the changes required remains to be seen and tested once the Act comes into effect in 2010.

Section 44 provides that a company may approve financial assistance to any person for the purchase and or subscription of its shares subject to certain conditions.¹⁶⁵ The confusing and controversial section 38(d) has been discarded.

3.3 Loans to directors

Loans to directors for the purchase or the subscription of the company's shares was explicitly prohibited in section 38(1) of the old Act, except where that director was a

¹⁶⁵ The conditions for offering financial assistance in terms of s44 are that the transaction must be allowed by the company's memorandum and articles; and it is in terms of an employee share scheme or approved by specific or general special resolution passed within the previous two years and the board is satisfied that the company will pass the solvency and liquidity test. The old s 38, prior to its amendment, used to allow financial assistance for purchase of own shares in three instances; where it is in the company's ordinary course of business to lend money or, to people in the employ of the company other than directors to enable them to buy shares to be held by them as owners by the company to its subsidiary.

salaried employee and the loan was made for him to buy shares and hold on to them as the owner. The prohibition was more direct in section 226,¹⁶⁶ which prohibited loans to directors.

The new Act now provides that the financial assistance can be made to directors or prescribed officers of a company.¹⁶⁷ The Act proceeds to provide that the loan may not be made to cover the director's legal expenses in a matter concerning the company¹⁶⁸ or anticipated expenses to be incurred on behalf of the company.¹⁶⁹ Financial assistance in this case¹⁷⁰ as well as in terms of section 44 does not include the lending of money by the company in the ordinary course of the company's business if it is that company's business to lend money.

This can only be done if it is provided for in the memorandum of incorporation and it is authorized by the board.¹⁷¹ The resolution must be a special one and the solvency and liquidity test must be passed.¹⁷²

It is provided here that the board of directors must authorise the transaction, but it appears to be an error as the board of directors cannot be expected to make a decision regarding the provision of a loan to one of its board members, the company, i.e. the shareholders are supposed to pass a resolution in this regard. This section might leave a company vulnerable to the abuse by the directors. It is my opinion that the section should be amended to require a resolution by the company in order to prevent any potential abuse.

¹⁶⁶ The old Act.

¹⁶⁷ S 45 of the new Act.

¹⁶⁸ S 45(1)(b)(ii)(aa) *supra* at 189.

¹⁶⁹ S 45(1)(b)(ii)(bb) *supra*.

¹⁷⁰ S 45(1)(b)(i) *supra*.

¹⁷¹ S 45 *supra*.

¹⁷² S 45 *supra*.

3.4 Distributions

3.4.1 Introduction

Distributions are dealt with by section 46 of the new Act.¹⁷³ It is an amalgamation of the previous sections involving the transfer of the company's shares or property to the shareholders. Section 46 allows distributions to be made in instances where there is an existing legal obligation of the company, a court order or the distribution has been authorized by the board of the company and in addition, there must be a reasonable appearance that the company will satisfy the solvency and liquidity test immediately after the distribution.

The old Act had no such provision and all the sections that fall within the definition of a distribution in terms of section 46 were all separately contained in the old Act. It appears however that the grouping together of all these sections is a modern trend, as the same style of codification is present in the *Corporations Code* in the form of section 166. This to me appears to be a more convenient and tidier manner to deal with rules that have a similar application and can be dealt with in a group in stead of separately where they would in any case ultimately be treated the same with regards to their application, execution and consequences on non compliance.

3.4.2 Payments to shareholders

Payments to shareholders in terms of section 90 of the old Act also promoted the capital maintenance rule by preventing dividends from being paid out of issued capital. It was substituted by section 14 of the 1999 Act to enable companies to pay dividends out of

¹⁷³ S 1 of the new Act, defines distributions as a direct or indirect (a) transfer by a company of money or other property, other than its own shares to or for the benefit of one or more holders of the shares of that company, or of another company within the same group of companies, whether - (i) in a form of dividend; (ii) as a payment in lieu of a capitalization share, as contemplated in s 47; (iii) is consideration for the acquisition- (aa) by the company of any of its shares, as contemplated in s 48; or (bb) by any company within the same group of companies, of any shares of a company within the same group of companies; or (b) incurrance of a debt or other obligation by a company for the benefit of one or more holders of any of the shares of that company or another company within the same group of companies; or (c) forgiveness or waiver by a company of a debt or other obligation owed to the company by one or more holders of any of the shares in that company or of another company within the same group of companies, but does not include any such action taken upon the final liquidation of the company.

the issued capital or to return capital to its members. The protection to creditors in this instance is offered *via* two requirements: first, that the company is authorized to do so by its articles of association and second, that the company has reasonable grounds to believe that it would be able to satisfy the solvency and liquidity test after the payment.¹⁷⁴

FHI Cassim criticises this provision because it was silent regarding the liability of directors for wrongful payment and that it also did not require special resolution for the approval.¹⁷⁵ He believed that for the Act to be consistent section 90 had to be amended to be in line with section 85 which provides personal liability of directors for making wrongful payments.¹⁷⁶

The provisions of section 90 are now contained in the new Act under distributions, which deals with all the disposals of the company's shares and or assets to shareholders. Distributions are discussed in more detail in paragraph 3.4 above.

3.5 Share repurchases

The old section 85 allowed a company to acquire its own shares under certain circumstances, the measures of protection or prevention of abuse¹⁷⁷ in this case is the requirement that such acquisition be approved by special resolution¹⁷⁸ unlike section 90. The approval could be specific to that transaction or general. In the latter case the approval remains valid until the next annual general meeting.

The acquisition of own shares which does not include the demand or tendering of shares and payment by a company to a shareholder's appraisal rights, is regulated by section 48 in the new Act. It allows the company to acquire its own shares subject to the requirements contained in section 46. Section 48 allows a subsidiary to acquire shares in its own holding company but not more than an aggregate of 10% of the issued

¹⁷⁴ FHI Cassim 285.

¹⁷⁵ FHI Cassim 285.

¹⁷⁶ S 86(1).

¹⁷⁷ See Chapter 4 Paragraph 2.

¹⁷⁸ S 85(1) of the old Act.

shares. The section is silent as to what happens to the shares once bought back by the company. In the old Act, the shares so bought were cancelled and made unissued but authorized in terms of section 85, which resulted in the automatic reduction of capital.

Section 86 was specifically designed to ensure compliance with the provisions of section 85 or to make sure that whoever does not comply with the requirements of section 85 is held personally responsible. For example if a director or directors allow a company to acquire its own shares contrary to section 85 is held liable to restore the company any amount paid and not recovered by the company unless there is relief granted by court.¹⁷⁹

This means that the company will attempt to recover the funds and if it does not recover all of them, it can proceed against the directors responsible for the loss for the balance of the money unless they have received relief from the court for the liability.

The provisions of the old Act (section 85 as amended) regarding share repurchases, were regarded as “defective and lacking in technical quality.”¹⁸⁰ Despite the foregoing they were also seen as an improvement on the state of the law prior to the 1999 Act due to the abandonment of the capital maintenance rule.¹⁸¹

4 CASE LAW

After the initial amendments that incorporated the solvency and liquidity tests into the old Act, there are a few cases that have tested the “new law” prior to its time.

In *Capitex Bank Ltd v Qorus Holdings Ltd and Others* 2003 (3) SA 302, the company entered into an agreement in which it sold 4 million of its shares to the first defendant for R6million with interest. The second, third and fourth defendants had bound themselves as sureties and co-principal debtor to the first defendant.

¹⁷⁹ S 86(1).

¹⁸⁰ Cassim FHI and R.

¹⁸¹ Cassim FHI AND R *supra*.

The first defendant failed to pay for the shares in accordance with the agreement resulting in the law suit by the plaintiff and the second third and fourth defendant became jointly and severally liable with the first defendant for the first defendant's debt.

The second, third and fourth defendants excepted to the plaintiff's claim alleging that the agreement was invalid *ex facie* the plaintiff's declaration because companies were not allowed to purchase their own shares except in accordance with section 87 of the old Act read with section 85.

The Plaintiff's declaration made no reference to section 85 or 87 of the old Act, although in the principal agreement it stated that the first defendant had passed a resolution authorizing the purchase of the shares and that the approval was a general one in terms of sections 85(2) and (3) and sections 85-88.

The court held that the fact that reference to the resolution in the annexure of the agreement could not cure its omission to make reference to sections 85 and 87 in the declaration itself and that if specific allegations of validity were required and they had to appear in the declaration.

The question was whether the illegality or invalidity was apparent *ex facie* the declaration. The court held that section 85 as amended allowed the company to purchase its own shares replacing the capital maintenance rule, but that from sections 85 and 38(2)(d) the mere purchase or conclusion of an agreement of sale or other transaction relating to the acquisition by a company of its own shares was not *prima facie* illegal, only payment in contravention of section 85 would result in illegality.

5 CONCLUSION

The South African law on capital maintenance relies of the solvency and liquidity of a company with regards to the alienation of capital, and it does not, to my surprise follow the English approach one hundred percent, but seems to me that it has taken from various jurisdictions.

Most of the South African provisions allow the reduction of capital provided that the company remains solvent and liquid thereafter.

CHAPTER 4

SOLVENCY AND LIQUIDITY

1 INTRODUCTION

The protection to shareholders that was afforded to them by the capital maintenance rule has been criticized as being an imperfect way to protect creditors and that the rules that applied the principle were notoriously imprecise and uncertain.¹⁸²

Van der Linde¹⁸³ offers that the other role played by capital is that of organizing the rights of the shareholders in relation to creditors and among themselves.¹⁸⁴ She goes on to say that shareholders are subordinated creditors who occupy the lowest rank in the hierarchy of creditors.¹⁸⁵ That being said, there is no question that shareholder interest come after the interests of creditors and therefore the protection of creditors should rank above that of shareholders. Although shareholders contribute capital to the company they have no legal to the return of the share capital.¹⁸⁶

The above opinion clearly justifies the great deal of protection that has been offered to the creditors previously against the interests of the shareholders, that is, the emphasis on capital maintenance for the benefit of the creditors where loss by the shareholder of their contribution played second fiddle. Creditor protection is very critical to the sustenance of any company and it was secured in the past centuries by the capital maintenance rule, what we need to know is how well the interests of the creditors are protected under the current global legislations that have favoured solvency and liquidity of a company as protection over the old capital maintenance rule.

¹⁸² Cilliers Benade *et al* 322.

¹⁸³ See Van der Linde Chapter 1.

¹⁸⁴ Van der Linde *supra*.

¹⁸⁵ Van der Linde *supra*.

¹⁸⁶ Van der Linde *supra*.

2 SHAREHOLDER PROTECTION

In as much as the capital maintenance rule and the new solvency and liquidity test protect the creditor; there are some capital rules that can be said to favour the shareholder as well. Simply put, when a company is formed the founders contribute funds which we now call capital and the founders are referred to as shareholders. The main reason for forming a company is to gain some sort of profit with the exception of certain forms of companies, for example, companies without profit. It is therefore imperative that some form of protection be offered to the shareholders' interests by the Act, be it the old or the new one.

Some protection is offered by section 85(1)¹⁸⁷ of the old Act in the requirement that the acquisition of shares must be authorized by a special resolution.¹⁸⁸ The company proposing to acquire its own shares must in terms of section 87,¹⁸⁹ distribute a circular to all shareholders and to the registrar within that class of shares, containing all the information prescribed by the Act,¹⁹⁰ stating its intentions and terms and reasons for the offer. Section 87(3) contains the liability for contravention or non compliance with the provisions of the Act regarding the acquisition of own shares which is similar to that concerning prospectus requirements.

3 THE SOLVENCY AND LIQUIDITY TEST

This thesis would be incomplete if one does not deal with section 4 of the new Act, since it deals with the solvency and liquidity test, which in my view is, although not the entire protection to creditors but the replacement for the capital maintenance rule. This is a brand new insertion into the Act and it provides the requirements and the procedure to be followed in order for a company to satisfy the solvency and liquidity test. This is

¹⁸⁷ S 85.

¹⁸⁸ Cilliers Benade *et al* 325.

¹⁸⁹ S 87 of the old Act provides the procedure to be followed when a company proposes or acquires its own shares.

¹⁹⁰ S 87 *supra* at 198.

formulated more or less in the same fashion as to the requirements laid down by the old Act with regards to the advertisement of a prospectus.

The requirement that the company be liquid and solvent when there is alienation of shares and/or assets is contained in various sections.¹⁹¹ For the test to be satisfied by the company for the purpose of the Act the company has to consider all its reasonably foreseeable financial circumstances and the said financial information must be based on accounting records that satisfy the requirements of section 28¹⁹² and financial statements that satisfy the requirements of section 29.¹⁹³ The company must also consider the fair valuation of the assets and liabilities.¹⁹⁴

4 THE NEW PROTECTION

After having mentioned all the reasons from various writers and commentators that called for the amendment of the old Act, the issue now is whether or not the measures of protection offered by the new Act, especially the solvency and liquidity test are sufficient to protect the shareholders and most especially creditors.

The solvency and liquidity test requires the company to consider all its reasonably foreseeable financial future circumstances, that is, after the transaction the assets fairly valued will exceed its liabilities or if the company is a member of a group of companies that the assets will exceed the aggregate liabilities, and it appears that the company will

¹⁹¹ Ss 44, 45 and 46 of the new Act.

¹⁹² S 28(1)(a) and (b) of the new Act provide that a company must keep accurate and complete accounting records in one of the official records of the Republic to enable the company to satisfy obligations in terms of this Act or any other law with respect to the preparation of financial statements and including any prescribed accounting records, which must be kept at, or be accessible from, the registered office of the company. Ss 28(3)(a) and (b) provides that offence and the penalty for non compliance with the provisions of the section.

¹⁹³ S 29 provides that the financial statements provided by a company to any person for any reason must satisfy financial reporting standards in their form and content if such standards are prescribed. They must also fairly present the state of affairs and business of the company and explain transactions and the financial position of the business of the company and show the company's assets, liabilities and equity as well as its income and expenses and any other prescribed information, set out the date on which the statements were produced and the accounting period to which the statements apply; and

¹⁹⁴ Including any reasonably foreseeable contingent assets and liabilities irrespective of whether or not arising from the proposed distribution or otherwise and must consider any other valuation of the company's assets and liabilities that is reasonable in the circumstances.

be able to pay its debts as they become due and payable in the course of the business for a period of 12 months after the date on which the test is considered.

The effect of the requirement is that a company has to do a forecast into the next 12 months in order to make a call as to whether the test will be passed. How reliable the forecast is, is mostly dependent on the type of business the company is in and what external factors influence its profitability.

For example: In the case of *Kerr v Danier Leather Inc. 2007 SCC 44* the issue was whether the requirements of a prospectus were satisfied, the principle was that a company or the seller of particular shares had to provide the buyer with enough information to enable him to make an informed decision.¹⁹⁵ In this case the seller had to do a forecast on his financials in order to indicate to the prospective buyer how the company will perform in the future. The seller was a leather jacket manufacturer and retailer and due to an unusually warm winter that year the company did not do as well as forecast. The seller's forecast was as a result wrong, and such could easily be the case when using the solvency and liquidity principle.

5 DIRECTORS' LIABILITY

The new Act places upon the director a duty to ensure that any of the transactions approved by the company that have the effect of reducing the company's capital do not cause the company to be insolvent or illiquid.¹⁹⁶

The provisions of section 77 are stringent and harsher than its predecessors and might deter potential directors from taking positions as such for fear of being held personally liable. In some instances a director could be found liable for loss suffered due to a transaction contrary to the provisions of the Act,¹⁹⁷ or may also be held liable in terms of common law for violation of his fiduciary duties.¹⁹⁸

¹⁹⁵ S 148.

¹⁹⁶ S 77(4).

¹⁹⁷ S 77(3).

¹⁹⁸ S 77(2).

CHAPTER 5

CONCLUSION AND RECOMMENDATIONS

I am of the opinion that South Africa has made progress. We have certainly attained some form of flexibility with regards to the capital rules with the assistance of the twin requirements of solvency and liquidity.

It is common cause however that the capital maintenance rule was in place to protect creditors and shareholders and was in my opinion effective in doing so. The issues regarding capital maintenance in South Africa specifically became more apparent when BEE came to life. The problem was not that capital maintenance was ineffective in protection the creditors as it is but that it was too strict in doing so that it did not allow the BEE Act to be effected.

Companies in most jurisdictions also wanted the freedom to trade within themselves and with each other and the capital maintenance rule was preventing that to a great extent, and it was an almost uniform feeling that the capital maintenance rules prevented economic growth in general. The implementation of the solvency and liquidity test in most jurisdictions gave the companies the freedom they wanted. While global economic growth and uniformity is a noble idea in that it promotes trade between countries, one must also stop and think about the protection capital maintenance offered and the confidence it gave investors to put their monies in a particular company knowing that whatever happens their investments are protected. The question that follows then is, does the new regime of solvency and liquidity provide that kind of protection and perhaps even incite the confidence provided by the capital maintenance rule in investors.

In South Africa, issues of BEE, affirmative action and equality are ideals that the Constitution of this country is passionate about and their promotion is vital to the development of previously disadvantaged persons. The solvency and liquidity test has

opened a window of opportunity for those persons and it gives life to the spirit purport of the Constitution.

However splendid the idea of solvency and liquidity is, I feel that it is still very new, especially to South Africa and that we should tread very lightly and not lose sight of the capital maintenance principle as a whole. We should be able to test the effectiveness of this new regime before we dive head first into it especially because of the fact that its validity depends entirely on financial projections made by humans who in general are flawed and can make mistakes and who may not always be in control of the conditions that affect their businesses such as the weather as in the *Kerr v Danier Leather* case above in chapter 4 paragraph 4.

The English are still very conservative with regards to letting go of the capital maintenance principle altogether and we should take cue from them.¹⁹⁹

Our new Act seems to have embraced the solvency and liquidity tests to a great extent, but also just as the English have, with caution as indicated in the case of *Capitex v Qorus* above, in which it was held that the section 85 of the old Act as amended allowed the acquisition of own shares, which effectively replaced the outdated capital maintenance requirement with the modern requirements of solvency and liquidity. The court held further that however, the old prohibition retained a residual function as a guideline to protect creditors and shareholders against the abuse by companies of their power to repurchase their own shares.

The approach of adopting the solvency and liquidity principle while also maintaining the capital maintenance rule in order to protect the shareholders and creditors, followed in the *Capitex v Qorus* case above and the English, should be followed.

¹⁹⁹ FHI Cassim 285.

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