SECTION 48 OF COMPANIES ACT 71 OF 2008: A CRITICAL ANALYSIS

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DEFINITIONS OF KEY TERMS AND CONCEPTS

Assets: - a valuable property or possession that can be exchanged for more value.[1]

Capital:- value invested by company's shareholders and lenders in the company's assets in order to grow profits.[2]

Liabilities:- amounts in value owing by a company to third parties (suppliers, lenders etc).[3]

Share buyback(s):- a corporate transaction(s) in which a company buys back its issued shares from its shareholders.[4]

The 1926 Companies Act:- Companies Act 46 of 1926

The 1973 Companies Act:- Companies Act 61 of 1973

The 1999 Companies Act:- Companies Amendment Act 37 of 1999

The 2006 Companies Act:- Corporate Laws Amendment Act 24 2006

The 2008 Companies Act:- Companies Act 71 of 2008[5], as amended by Companies Amendment Act 3 of 2011

[1] Longman Business English Dictionary, Fourth Impression, Longman 2001, at page 23.
[2] *Ibid*, at page 61.
[3] *Ibid*, at page 269.
[4] *Ibid*, at page 57.
[5] The Act came into operation with effect from 1 May 2011.

CHAPTER 1

INTRODUCTION

1.1. BACKGROUND

Capital maintenance is a doctrine from which the prohibition of companies from buying back their own shares is derived. The logical thrust of the doctrine is that the company's capital must not be reduced (or depleted) to the detriment of creditors who have a staked claim against such capital (especially upon the company's wounding up).[6]

In South Africa, until the coming into effect of the 1999 Companies Act,[7] the doctrine had been inherited from the UK jurisdiction,[8] and codified in the 1973 Act. Over the years, South African courts had interpreted and developed the doctrine into a body of rules geared towards ensuring the protection of creditors' and shareholders' interests/claim in the companies' capital. In both the UK and South Africa, the founding principle[9] of the doctrine was entrenched and developed in company law and the loadstar for such development had been the Trevor v Whitworth case.[10]

The Trevor v Whitworth case was precedent-setting in South African company law. In the case, Lord Watson stressed the necessity of keeping the company's capital intact in order to protect the interests of creditors "*who have the right to look to the monies subscribed as source out of which the companies' liabilities to*

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6 See, for example, Ooregum Gold Mining Company of India Ltd v Roper [1892] AC 125 (HL), at page 133; Also Cohen NO v Segal 1970 (3) 702 (W), at page 312.

7 Specifically, section 85 of the 1999 Companies Act.

8 Trevor v Whitworth [1897] 12 App Cas 409 (HL).

9 That is to prevent companies from reducing their own capital.

10 *Ibid.*

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them were to be met."[11] This was later to be followed in a series of decisions in our courts.[12]

Through the 1999 Companies Act, South Africa took the initial step towards breaking away from the doctrine of capital maintenance and introduced a solvency and liquidity regime. Specifically, section 85 of the 1999 Companies Act provided, in parts, that for any share buyback transaction, the company must ensure that immediately after such transaction its assets exceeded (or equaled) its liabilities and that it was able to pay its debts as they became due.

Currently, section 48 of the 2008 Companies Act[13] consummates said break from the doctrine in that it firstly permits share buyback transactions and secondly provides for an elaborate regime under which such transactions are permitted.

At the core of section 48 is the principle that share buybacks are a permissible form of distribution, hence subject to section 46. Section 46 provides that in any share buyback, the company must engage in and pass the solvency and liquidity tests. Other than section 48, there are a host of other supporting provisions in the 2008 Act which are meant to enhance section 48.[14]

The permitting of share buyback transactions has been a welcome legislative intervention[15] given the modern commercial realities which do not admit to the rigidity of capital maintenance doctrine. The real test is the extent to which the new share buyback regime, in terms of section 48, adequately and/or reasonably protects the interests of creditors and shareholders in light of the abolition of capital maintenance doctrine.

11 Trevor v Whitworth, *op cit*, at page 416.
12 For example, Cohen NO v Segal, *op cit.*
13 This section is to be read in conjunction with, specifically, sections 46, 4 and 1 of the 2008 Companies Act.
14 For example, sections 20, 77 and 165of the 2008 Companies Act.
15 Initially through section 85 of the 1999 Companies Act and now in terms of section 48 of the 2008 Companies Act.

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1.2. PROBLEM STATEMENT

Creditors and shareholders are the two most import stakeholders in a company's capital.[16] The interest of creditors in a company's capital is derived from the fact that, as Lord Halsbury put it in Ooregum Gold Mining Company of India Ltd v Roper[17], *"… every creditor of the company is entitled to look to that capital as security.*" Shareholders have an even more direct interest in the company's capital for the simple reason that they are investors who are not only entitled to dividends but also legitimately expect favourable returns on their investments.

There is a general consensus among legal scholars, both locally and internationally, that capital maintenance rules are archaic and have no place in modern commercial reality. Indeed most jurisdictions[18] are either moving away from the rules or have completely abandoned them. The 2008 Companies Act has decidedly abandoned the capital rules.

More specifically, section 48 of the 2008 Companies Act allows companies to acquire their own shares and identifies such acquisition as a form of distribution for which companies have to comply with the solvency and liquidity requirements as set out in section 46.

Given the pre-eminence of creditors' and shareholders' interests as vested in the company's capital, it is axiomatic that any piece of legislation that allows companies to buy back own shares, as section 48 of the Companies Act does, must contain safeguards aimed at protecting the interests of creditors and shareholders. The question arises; to what extent the new share buyback regime adequately protects the creditors and shareholders in the company's capital.

The object of this research is to analyse the core provisions of the new buyback regime and assess the extent to which they protect creditors and shareholders.

16 Other stakeholders to the company include the public and the state.
17 Ooregum Gold Mining Company of India Ltd v Roper, *op cit*, at page 133.
18 Notably, in the UK.

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The area of focus for this research is on private companies as single entities and those in a group structure. This research does not particularly deal with listed companies which have their own listing requirements except by way of comparative analysis.

1.3. SCOPE DELEANATION

This research focuses on one aspect of two most significant changes brought by the 2008 Companies Act to company's capital regime,[19] namely, the share buybacks in terms of section 48. The other significant change is in terms of section 44 which allows companies to provide financial assistance for the subscription of securities in the company.

Furthermore, this research is limited to the share buybacks regime as set out in section 48 to an extent that the provisions of the section have a material bearing on the protection or otherwise of creditors' and shareholders' interests in company's capital. It does not purport to be an exhaustive study on every aspect of the section and of the subject itself.

1.4. METHODOLOGY

The approach of this research is mainly analytical and comparative. This research seeks to analytically engage the core provisions of the new share buybacks regime in the following manner:

> Provide a historical perspective of the legislative evolution of the share buybacks regime to what it currently is as provided for in section 48. This is done by way of analysing firstly the pre-existing capital maintenance rules as codified in the 1973 Companies Act and secondly the codification

[19] These changes were largely foreshadowed in the 1999 Companies Act.

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of the share buyback regime initially under the 1999 Companies Act and eventually under the 2008 Companies Act.[20]

Review literature by both local and international legal scholars on the subject of share buyback transactions. These include published works such as books, journal articles, reports and notes.

Providing a jurisprudential insight as to how our courts, after the 1999 Companies Act, have dealt with the share buybacks. This is done in comparison with the jurisprudence of international jurisdictions.[21] For this a comparative and critical analysis of case law is undertaken.

1.5. SIGNIFICANCE

As stated above, in enacting, *inter alia,* the share buybacks the legislature has taken a decisive clean break from the anachronistic capital maintenance rules by adopting a new company's capital regime based on the solvency and liquidity requirements.

The 2008 Companies Act only came into effect on 1 May 2011 and the interpretation of section 48 is yet to come before our courts. One thing for certain is that the question about the extent to which the new share buybacks regime protects the creditors' and shareholders' in the companies' capital is going to be the focal point of future litigation.[22] This is particularly so given the fact that, if international experience is used as a measure, share buybacks have become the most popular method of redistributing and/or re-organising companies' capital structure.[23]

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[20] Whilst the two Acts are the area focus of the analysis, other amending acts as well as policy reform documents such as explanatory memoranda are looked into as well.

[21] New Zealand, the US and the UK.

[22] At the time of writing this research, no case involving share buybacks in terms of section 48 of the 2008 Companies Act had been decided in our courts.

[23] In the US and lately in the UK.

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From a jurisprudential point of view, this research undertakes an ambitious task of contributing towards how our share buyback regime should be approached, interpreted and applied.

From a practical point of view, this research hopefully provides company directors with insight to plan and execute the share bucks transactions.

The research analytically draws from the rich body of legal scholarship, case law and commentaries in order to provide insight to the share buyback regime within the scheme of section 48 of the Companies Act.

Furthermore, however welcome the permitting of the share buyback regime in terms of section 48 of the 2008 Companies Act is, this research points out the pitfalls in the share buyback regime specifically in relation to creditors' and shareholders' protection. These pitfalls may hopefully be of some assistance to future law reform on the subject matter.

1.6. RESEARCH LAYOUT

Chapter 1: An introductory chapter of the research that deals with the background, problem statement, scope, methodology, significance and chapter review.

Chapter 2: Tracks the historical and jurisprudential roots of the capital maintenance doctrine and how it became embedded into the fabric of our common law until 1999.

Chapter 3: Analyses the initial abandonment of the capital maintenance doctrine and the introduction of the share buyback regime in the 1999 Companies Act.

Chapter 4: Analyses the current share buyback regime in terms section 48 of the Companies Act and the extent to which it provides for

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creditors' and shareholders' protection in respect of company's capital.

Chapter 5: Analyses the share buyback regime in terms of section 48 of the Companies Act with focus on companies in a group structure and the extent to which it provides for creditors' and shareholders' protection in respect of company's capital.

Chapter 6: Analyses the extent to which creditors' and shareholders' interests are protected by the enforceability provisions in section 48 of the Companies Act.

Chapter 7: Analyses the directors' liability provisions under section 48 of the Companies Act and the protection of creditors' and shareholders' interests.

Chapter 8: Provides the overall conclusion of the research with specific reference to the creditors' and shareholders' protection under the current share buyback regime.

CHAPTER 2

CAPITAL MAINTENANCE DOCTRINE

2.1. INTRODUCTION

Until the decisive break brought about by the 1999 Companies Act, capital maintenance rules had become part of the fabric of our common law.[24] One aspect of the rules was the prohibition of companies from acquiring own shares unless specifically provided for in company law.

So entrenched was the rule against acquisition of own shares by companies that it was not even expressly stipulated in the 1926 Companies Act.[25]

The genesis of the capital maintenance rules derives from an 1887 English case Trevor v Whitworth,[26] in which Lord Watson stated their rationale as follows:

> "*Paid-up capital may be diminished or lost in the course of the company's trading: that is a fact which no legislation can prevent; but persons who deal with, and give credit to, a limited company, naturally rely upon the fact that the company is trading with a certain amount of capital already paid, as well as upon the responsibility of its members for the capital remaining at call; and they are entitled to assume that no part of the capital which has been paid into the coffers of the company has subsequently been paid out, except in the legitimate course of its business.*"[27]

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24 Cilliers et al, *Corporate Law*, 3rd Edition, (2000), Juta, at page 322.
25 The Unisec Group Ltd and Others v Sage Holdings Ltd (1986) 3 All SA 1 (T), at page 4.
26 Trevor v Whitworth, *op cit.*
27 *Ibid*, at page 423.

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At issue before the Lords in the Trevor v Whitworth case was a consideration of the Joint Stock Companies Act and whether it allowed the share buybacks. The Act contained two provisions which were considered germane for the determination of the point in issue, namely, the requirement that the company should specify its nominal capital and procedure for reducing the company's capital.[28]

According to McCabe, the Lords reasonably concluded, by way of inference, that "*the Legislature was obviously concerned that the capital of companies should not be reduced by distribution except in the manner set out in the legislation, which require court's approval.*"[29]

What is clear from the Trevor v Whitworth case is the principle that creditors of companies have legitimate interest/claim in the companies' capital and that such interest/claim needed protection. This is more so since the advent of limited liability companies where creditors have no recourse against shareholders in the event of diminished capital of companies.[30]

Over the years, until 1999, the prohibition of buybacks as established in Trevor v Whitworth became firmly part of our common law. Cilliers *et al*[31] point out that certain provisions of the Companies Act used the principles as set out in Trevor v Whitworth as a "*touchstone and further entrenched the capital maintenance principle.*"[32]

Other than in the UK and South Africa, the prohibition of buybacks along the Trevor v Whitworth principles was also followed over the years in other

[28] McCabe B, "*The Desirability of a Share Buy-Back Power*", Bond Law Review (115).
[29] *Ibid*, at page 116.
[30] Cilliers *et al,Corporate Law*, *op cit*, page 322.
[31] *Ibid*, at page 322.
[32] *Ibid*, at page 322: also see specifically sections 38, 79 and 81 to 82 of the 1973 Companies Act.

jurisdictions, notably in Canada, Australia and New Zealand but was rejected in the US.[33]

In our jurisdiction the effect of the capital maintenance rules, so argues Pretorius[34], was "*to turn capital into a rigid yardstick fixing the minimum value of the net assets which must have been raised initially and then, as far as possible, retained in the business*."[35]

In Cohen, NO v Segal,[36] a case which preceded the coming into effect of the 1973 Companies Act, Boshoff J stated that *"… Whatever has been paid by a member cannot be returned to him and no part of the corpus of the company can be returned to a member so as to take away from the fund to which the creditors have a right to look as that out of which they are to be paid. The capital may be spent or lost in carrying on the business of the company, but it cannot be reduced except in the manner and with the safeguards provided by the statute.*"[37]

The learned Judge in the Cohen, NO v Segal found that dividends could not be declared in a manner that diverted the corpus of the company to the shareholders. Consequently, concluded the learned Judge, a resolution which "*declares a dividend to be paid out of the capital of the company is ultra vires the company*."[38]

The Trevor v Whitworth principle on capital maintenance was further confirmed as part of our common law subsequent to the 1973 Companies Act. In The Unisec Group Ltd and Others v Sage Holdings Ltd,[39] Coetzee J, confirming on appeal the earlier decision of Goldstone J, remarked that "*Since the earliest days of company law it has been firmly recognized that a company cannot buy its own*

33 Cassim *et al*, *Contemporary Company Law*, *op cit*, page 268 – 269.
34 Pretorius JT, "*Capital Maintenance Doctrine in South African Corporate Law*"; www2.accaglobal.com; 2000.
35 *Ibid*, at page 1.
36 Cohen, NO v Segal, *op cit*.
37 *Ibid*, at page 312.
38 *Ibid*, at page 313: Also see *Ex Parte Vlakfontein Gold Mining Co Ltd (1970) 2 All SA 84 (T)* where Galgut J declined to confirm the capital reduction in protection of the creditors.
39 The Unisec Group Ltd and Others v Sage Holdings Ltd 1986 (3) SA 259 (T).

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shares for the reasons set forth … in Trevor v Whitworth… The illegality and voidness of such a purchase actually came to be regarded as part of the common law …"[40]

In the Cohen, NO v Segal[41] and Unisec Group Ltd and Other v Segal[42] cases, the court emphasised that the amount of company's share capital must be fixed in the memorandum of association[43] and that any transaction by the company that is geared at reducing the said fixed amount would be *ultra vires.* It appears that, as Cilliers *et al* correctly observed,[44] the capital maintenance doctrine did not necessarily develop independently in our common law but was tied to the *ultra vires* doctrine.

Apart from the share buyback transaction, reduction of company's fixed capital fund could be achieved through other means.[45] It follows that under our common law and before the coming into effect of the 1999 Companies Act, all of acts were prohibited through the capital maintenance doctrine.

2.2. CONCLUSION

At the core of the capital maintenance doctrine was a declared objective of protecting the interests of creditors by insulating a fixed company's capital fund against possible reduction through inward transactions.

However, over the years, it became clear that the capital maintenance doctrine was too rigid and therefore out of sync to the realities of the modern commercial world. This was to an extent that even in the UK[46] there was a shift from the

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40 *Ibid*, at page 4.
41 Cohen NO v Segal, *op cit.*
42 The Unisec Group Ltd and Others v Sage Holdings Ltd, *op cit.*
43 Section 6 of the 1926 Companies Act.
44 Cilliers *et al*, *Corporate Law*, op cit, at Colliers, at page 322.
45 For example, company's provision of financial assistance for purchase of own shares or issuing of company's shares at a discount.
46 English Companies Act of 1985.

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rigidity of the doctrine. The expediency to modernize our company law in this regard and adopt a flexible approach to company's capital was initially grasped by the legislature in the 1999 Companies Act and later developed in the 2008 Companies Act, both of which notably introduced the solvency and liquidity based approach in line with international trend.

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CHAPTER 3

SHARE BUYBACKS IN TERM OF THE 1999 COMPANIES ACT

3.1. INTRODUCTION

The 1999 Companies Act[47] provided a radical shift from the capital maintenance rules as enunciated in the Trevor v Whitworth and developed in our common law.[48] In the Memorandum on the Objects of the Companies Amendment Bill 1999,[49] the primary motivation to permit companies to acquire own shares is stated as follows:

> "*The principles of capital maintenance have undergone significant changes in almost all countries. The modern notion of capital maintenance is that companies may reduce capital, including the acquisition of their own shares, but subject to solvency and liquidity criteria. This has the advantage of affording protection to creditors whilst at the same time giving flexibility to companies to achieve sound commercial objectives. These aspects of flexibility and achievement of sound commercial objects have become extremely important since South Africa's re-entry into the global market.*"[50]

Section 85 of the 1999 Companies Act permitted a company to acquire its own shares provided it was so authourised in its articles of association[51] and that

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47 Sections 85 – 90 of the 1999 Companies Act.

48 Cilliers *et al*, *op cit*, at page 322: Also see Cassim FHI and Rehana Cassim "*The Capital Maintenance Concept and Share Repurchase in South African Law*", (2004) International Company Law Review 188; Jooste R "*Can Share Capital be Reduced Other than by Way of a Buy-Back?*", (2005) 122 SALJ, at page 294; Delport P "*Company Groups and the Acquisition of Shares*", (2001) 13 South African Merc LJ at page 121.

49 Memorandum on the Objects of the Companies Amendment Bill, 1999.

50 *Ibid*, at B17D – 99.

51 Section 85(1) of the 1999 Companies Act.

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such acquisition was approved by its members by way of special resolution.[52] Furthermore, the section provided that said approval may be a general approval (to acquire own shares) which approval is valid until the next annual general meeting unless varied or revoked before then, or it could be an approval directed at of specific repurchase transaction.[53]

The provision referred to above was clearly meant for the protection of shareholders.[54] If a company contemplated a share buyback transaction in terms of section 85(1), it was enjoined firstly to be authorised in terms of its articles of association and secondly to obtain approval of the shareholders by way of a special resolution.

Authorisation in terms of the company's articles meant that for any share buyback transaction agreement to be validly concluded, the shareholders ought to have specifically sanctioned it. Otherwise, the contemplated transaction would be *ultra vires* the company and therefore void.

In instances where the share buyback transaction was duly authorised, a company was then required to obtain the approval of the shareholders by way of a special resolution.[55] The special resolution might be specific to the contemplated transaction or might be generally approving of share buyback transactions.[56]

Section 87(1) provided legislative machinery for obtaining the requisite special resolution. In terms of the sub-section, the company was obliged to deliver a circular to all its shareholders stating the details[57] of the proposed buyback transaction. The circular also had to be lodged with the Registrar of companies.

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52 Section 85(1) of the 1999 Companies Act.
53 Section 85(2) – (3) of the 1999 Companies Act.
54 Cilliers *et al*, *Corporate Law*, *op cit*, at page 325.
55 Section 85(1) of the 1999 Companies Act.
56 *Ibid.*
57 This included the number and class or kind of affected shares as well as the terms and reasons of the offer.

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At the core of section 85 was a conceptual novelty[58] of solvency and liquidity requirements.[59] In terms of section 85(4), a company might not acquire its own shares if there was a reasonable ground for believing that, after the acquisition, it would not be able to pay its debts in the ordinary course of its business (solvency) and that its liabilities would exceed its fairly valued assets (liquidity).

Legal scholars[60] are in agreement that the twin tests of solvency and liquidity signalled a major shift from the capital maintenance rules as developed in our common law. Cilliers *et al*[61] correctly contend that any possible "*prejudice*"[62] to creditors brought about by the permission of companies to purchase own shares, is "*excluded*" by the solvency and liquidity requirements. Simply put, the directors of the transacting company are obliged to objectively predict that after the transaction, the company will be able to satisfy any legitimate claims the creditors might have against the capital of the company. If it appears to the directors that any such claims might not be met, the transaction should not proceed despite the fact that it was authorised by the company and approved by the shareholders.

Nothing in section 85 suggested that any agreement in terms of the section 85(1) between the company and the vendor shareholder but which was contrary to section 85(4) was in itself illegal. In Capitex Bank Ltd v Qorus Holdings Ltd and Others[63], the first case which dealt with section 85, Malan J, held that *"… in view of the provisions of ss 85(1) and 38(2)(d), it cannot be said that the mere purchase or the mere conclusion of an agreement of purchase and sale or other transaction relating to the 'acquisition' by a company of its own shares is prima*

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58 A novelty in the sense that it had never been used in our company laws although it was certainly in use in other international jurisdiction.

59 Section 85(4) of the 1999 Companies Act.

60 For instance, for Cilliers et al it "*radically changed*" the rules; for Cassim it "*sweeps away*" the rules; for Delport it obliterated the rules.

61 Cilliers *et al , Corporate Law, op cit,* at page 324.

62 Prejudice to creditors becomes real when a limited liability company with diminished capital is wound up and creditors' claims against the company remain unfulfilled.

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

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facie illegal. Only payment made in contravention of s 85(4) would result in an illegality."[64]

In terms of section 85(9), even in circumstances where a company was duly authorised, the transaction duly approved and the solvency and liquidity requirements satisfied, a company might still not proceed to acquire own shares if, as a result of the acquisition, there would no longer be any shares remaining other than convertible or redeemable shares.[65]

Own shares which had been acquired by the company to the satisfaction of all the section 85 requirements were required, in terms of section 85(8), to be cancelled as issued shares and restored to the status of authorised but unissued shares. The principle here, according to Pretorius,[66] is that the share capital of the company will be reduced by the shares acquired in terms of section 85(1).[67]

Because the share buyback transactions had to be approved by shareholders even though executed by the board of directors, section 86 outlines liabilities attaching to both directors and shareholders of the company.

One provision that sought to further enhance the protection of creditors was section 86(3) which empowered creditors of the company which had acquired own shares in breach of section 85(4) to approach the court for an equitable relief.[68]

Section 89 made the share buybacks,[69] directors' and shareholders' liability,[70] procedural[71] and enforceability[72] requirements of share buyback agreements,

64 *Ibid* , at page 309.
65 The effect of section 85(9).
66 JT Pretorius "*Capital Maintenance Doctrine in South African Corporate*", *op cit.*
67 *Ibid, at* page 2.
68 Such relief may include an order obliging the vendor shareholder to return a consideration for the shares, an obligation for the transacting company to issue equivalent shares to the shareholder or any equitable order.
69 Section 85 of the 1999 Companies Act.
70 Section86 of the 1999 Companies Act.
71 Section 87 of the 1999 Companies Act.
72 Section 88 of the 1999 Companies Act.

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applicable, *mutatis mutandis*, to companies in a group structure. However, only subsidiary companies might acquire shares in their holding companies.

A further proviso in terms of section 89 was that subsidiary companies could only acquire holding companies' shares to a maximum of 10% in the aggregate of the number of shares issued.

The provisions discussed above clearly resonated with the declared policy motivations as set out in the Memorandum on the Objects of the Companies Amendment Bill, 1999, more specifically, the protection of creditors and shareholders in a flexible legislative framework.

3.2. CONCLUSION

The share buyback regime in terms of the 1999 Companies Act sought to create balanced protection of shareholders' and creditors' interests. Shareholders were protected by the requirements that they need to firstly authorise the company acquire own shares and approve such transaction by way of special resolution.

Furthermore, the creditors' interests were generally protected by the solvency and liquidity tests requirements. Furthermore, creditors had residual right of recovery from shareholders for share buyback transactions which turned out to be in contravention of section 85(4).

The extent to which creditors and shareholders were adequately protected by the 1999 Companies Act buyback regime is dealt with in comparison with the buyback regime 2008 Companies Act in the following chapters.

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CHAPTER 4

SHARE BUYBACKS IN TERMS OF THE 2008 COMPANIES ACT

4.1. BACKGROUND

The 2008 Companies Act only came into effect in 1 May 2011. Its capital structure regime picks up and develops on the underlying theme of previous amendments, notably the 1999 Companies Act and the 2006 Companies Act. As stated in the Explanatory Guide[73] to the Act, the 2008 Companies Act "*provides for a shift from the capital maintenance regime based on par value to one based on solvency and liquidity …*".[74] As argued in Chapter 2, the protection of creditors' and shareholders' interests in the company's capital remains a necessary implication of this aspect of company law reform.

The need for the afore-mentioned protection is born out of the simple fact that share buyback transactions necessarily reduce/affect the capital of the company. Van der Linde,[75] quoting Dugan[76] with approval, points out three attendant risks of share buyback transactions as follows:

> *"(1) A distribution of assets with the attendant risks of assets stripping and debt avoidance:*
>
> *(2) A reorganization of ownership with the risk of unfair and discriminatory treatment of shareholders; and*

73 The Companies Act 71 of 2008, An Explanatory Guide, Dti, 2010.
74 *Ibid*, at page 38.
75 Van der Linde: "*Share Repurchases and the Protection of Shareholders*", (2010) Vol 2 TSAR.
76 Dugan: "*Repurchase of Own Shares for New Zealand*" in Farrar (ed) *Contemporary Issues in Company Law* (1987), at page 98.

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(3) A transfer of shares which may lead to insider trading and market manipulation."[77]

It is, however, generally accepted that the advantages[78] of share buyback transactions far outweigh their attendant risks in the modern commercial reality, hence their enactment in terms of section 48 of the 2008 Companies Act. In the main, flexibility, rather than the doctrinaire rigidity as postulated by the outdated capital maintenance rules, augurs well for companies' continued growth in the modern market driven economy.

4.2. SECTION 48 OF THE 2008 COMPANIES ACT

4.2.1. Introduction

Section 48(2)(a) provides that a company "*may acquire its own shares, if the decision to do so satisfies the requirements of section 46:*" Section 46, *inter alia*, stipulates the solvency and liquidity requirements for a distribution as elaborated upon in section 4.

4.2.1. Protection of shareholders under section 48

Unlike its predecessor, section 85 of the 1999 Companies Act,[79] section 48 does not require a share buyback transacting company to be authorised in terms of it Memorandum of Incorporation. Neither is this requirement contained in section 46.[80]

It is submitted that omission of the requirement for company's authority to enter into share buyback transactions attenuates the shareholders' protection in the scheme of the current share buyback regime.

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77 Van der Linde: "*Share Repurchases and the Protection of Shareholders*", 2010 (2) TSAR, at page 288.
78 See Blackman *et al, "Commentary on the Companies Act",* Loose-leaf 2003 Vol 1, where advantages of share buybacks are listed and discussed.
79 Section 85(1) of the 1999 Companies Act.
80 Cassim *et al*; *Contemporary Company Law*, *op cit,* at page 275.

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It has been suggested that the legislature's omission of shareholder authorisation in section 48 was not "*intentional*"[81]. However, it is submitted that this omission appears to have been deliberate on the part of the legislature in that it is consistent with the provisions of section 20[82] which provides, *inter alia*, that if the company's Memorandum of Incorporation limits, restricts or qualifies the powers of that company, no action of that company shall be void only by reason of that limitation, restriction or qualification.

Section 15(2)(a)(ii)[83], read with the definition of "*alterable provision*"[84] in terms of section 1, provides that the Memorandum of Incorporation of any company may include a provision altering the effect of any alterable provision of the Act. It can therefore be argued that despite the enactment of share buybacks in terms of section 48, shareholders can still utilise the alterable provision regime in terms of section 15 through the company's Memorandum of Incorporation to limit, restrict or qualify the powers of the company to transact in own shares.

However, Cassim *et al* convincingly argue that there is nothing in section 48 which expressly states that it is meant to be an alterable provision as contemplated in section 15 read with section 1 and therefore section 48 is not an alterable provision.[85]

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81 Wainer HE: "*The New Companies Act: Peculiarities and Anomalies*", (2001) 118 SALJ 133, at page 820 and Cassim *et al: Contemporary Law, op cit*, at page 275.

82 Section 20(1)(a) of the 2008 Companies Act.

83 See article by Holman J based on interview with Michael Katz, www.polity.org.za, 6 November 2009, on the flexibility the 2008 Companies Act affords to companies by way of alterable provisions.

84 Section 1 defines "*alterable provision*" as "*a provision of this Act in which it is expressly contemplated that its effect on a particular company may be negated, restricted, qualified, extended or otherwise altered in substance of effect by that company's Memorandum of Incorporation;*"

85 Cassim et al: *Contemporary Law*, *op cit*, at page 275 and Van der Linde: "*The Regulation of Distributions to Shareholders in the Companies Act*", 2009 3 TSAR, at page 492. Van der Linde contends that although the Act does not prescribe any form of authorization or approval of distributions by the shareholders, the company's Memorandum of Incorporation can impose requirements in respect of distributions. The view of Cassim et al is more preferable than the latter in that it is based on the provisions of the Act as they stand.

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In the result, a share buyback transaction would not be void for want of authority if it is specifically prohibited in the company's Memorandum of Incorporation, more so in that share buybacks are consistent with the 2008 Companies Act.[86]

The more telling omission on the part of the legislature is that section 48, read with section 46, makes no mention of the shareholders' special resolution requirement. Previously, the requirement was contained in section 85(1) of the 1999 Companies Act.[87]

Furthermore, section 46, which has to be read in conjunction with the enabling section 48 provisions, suggests that it is the board of the company which has to take a resolution to transact in a share buyback undertaking. The absurdity of this legislative formulation looms large when one takes into account the fact that, ordinarily, it is the company/shareholders (through the company's Memorandum of Incorporation) which mandates the directors to embark on a specified transaction and not the other way round.

Van der Linder[88] considers the approach in other comparable international jurisdictions[89] with regards to company authorization for buyback transactions. The author points out that in the UK, shareholder approval is required for buyback transactions and that the type of approval needed and the procedural requirements thereof depend on the kind of buyback involved.[90]

In New Zealand,[91] a repurchase of shares by a company is done with the agreement of all shareholders and further that a company may only accept an

86 See the anti-avoidance provision in section 6 of the 2008 Companies Act.
87 Section 85(2) provided that the approval by the shareholders of buyback transactions might be a general approval or a specific approval for a particular transaction.
88 Van der Linde, "*Share Repurchases and the protection of shareholders*", *op cit*, from page 289.
89 UK Companies Act 2006; New Zealand Companies Act 1993 and US Model Business Corporations Act.
90 Van der Linde, "*Share Repurchases and the protection of shareholders*", *op cit*, at page 290: A distinction is made between off-market repurchase, market repurchase and repurchases out of capital.
91 Section 107 of New Zealand Companies Act 1993.

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offer made by a vendor-shareholder with the "*unanimous assent*" of the shareholders.[92]

In the US,[93] companies have general power to buyback own shares "*without any need for shareholder approval or authorization in the company's constitution.*"[94]

Section 48 of the 2008 Companies Act follows the US approach by not requiring shareholders' approval for share buybacks.[95] It appears that one of the reasons for the legislature's apparent aversion towards conferring powers of approval to shareholders in buyback transactions is the considerable scope for abuse it gives to the controlling shareholders.[96]

In the US, the law-makers seem to have left it to courts to curve out and formulate restrictions on the powers of directors of companies acquiring own shares. Over the years, the US courts have formulated restrictions which "*address some of the concerns of shareholder protection in the absence of a regulated procedure.*"[97]

The US has had a long history of share buyback transactions. South Africa only recently adopted a share buyback regime,[98] having come out of the archaic clutches of capital maintenance rules. What South African companies need, in order to plan and execute buyback transactions, is a clear shareholder protection provision and proper guidelines[99] which restrict voter rights to curb possible abuses by the controlling shareholders.

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92 Van der Linde, "*Share Repurchases and the protection of shareholders*", *op cit*, at page 293.
93 In the jurisdictions of Delaware, California and under Model Business Corporation Act.
94 Van der Linde, "*Share Repurchases and the protection of shareholders*", *op cit*, at page 296.
95 And also by not requiring authorization in terms of the Memorandum of Incorporation.
96 Van der Linde, "*Share Repurchases and the protection of shareholders*", *op cit,* at page 299: An example of such abuse is where controlling shareholders vote for the acquisition of their own shares at an excessive price.
97 Van der Linde, "*Share Repurchases and the protection of shareholders*", *op cit*, at page 296.
98 Through the 1999 Companies Act and more comprehensively in the 2008 Companies Act.
99 Leaving it to our courts to develop shareholders' protection principles, as in the US, does not augur well for certainty which companies legitimately expect of the new share buyback regime.

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In the result, the utility[100] of special resolution by shareholders in share buyback transactions lies in the fact that it provides the most effective and immediate protection to shareholders who would make an informed vote. *A fortiori*, the fact that section 48 does not make provision for authorisation of buyback transactions makes a case for the inclusion of special resolution requirement in the section more compelling.

It is suggested that one of the focal points of future company law reform should be to consider the incorporation of shareholders' approval as a requirement for share buyback transactions with an in-built regime of voting restrictions imposed on shareholders to curb possible abuses.[101]

4.2.2. Protection of creditors under section 48

Section 35(2) has abolished the concept of par value shares in our company law. Section 48 replaces par value shares and nominal capital with the concept of solvency and liquidity.

Section 48 stipulates that the section has to be read in conjunction with the distribution provision in terms of section 46. Section 46 enjoins the board of directors[102] to proceed with any proposed distribution (share buyback transaction) if:

"(a) It reasonably appears that the company will satisfy the solvency and liquidity test immediately after completing the proposed distribution; and

(b) the board of the company, by resolution, has acknowledged that it has applied the solvency and liquidity test, as set out in section 4, and

[100] Especially in the South African context where share buyback regime is a fairly new phenomenon.
[101] Van der Linde, "*Share Repurchases and the protection of shareholders*", *op cit*, at page 299.
[102] Per section 46(2) of the 2008 Companies Act.

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> *reasonably concluded that the company will satisfy the proposed distribution.*"

It is noted that whilst section 85 of the 1999 Companies Act had built in the solvency and liquidity requirements into its own provisions, section 48 seeks to import the requirements through cross-referencing to section 46.

Apart from the apparent shoddy draftsmanship on the part of the legislature in this regard, it has been convincingly argued by some legal scholars[103] that said cross- referencing creates a major conflation (and confusion) of a "*decision*" to undertake a share buyback transaction[104] with the actual effecting of the "*distribution*" transaction of the transaction as set out in section 46.[105]

The above-mentioned cross-referencing, as argued by Van der Linde[106] and Cassim *et al,*[107] creates an impression that the decision[108] to buy back shares requires the company to be solvent and liquid at the time is taken whereas the company is expected to be in a position to satisfy the solvency and liquidity requirements immediately after the completion of the distribution transaction.

Section 48 clearly identifies share buyback transactions as a form of distribution hence subject to the solvency and liquidity test requirements stipulated in section 46. More pointedly, section 1 defines "*distribution*" as involving the transfer of a company's money or property to holders of shares as, inter alia, a consideration for the acquisition of shares "*by a company of any of its shares, as contemplated in section 48*;"

[103] Van der Linde, "*The regulation of distribution to shareholders in the Companies Act 2008*", 2009 2 TSAR, at page 492 and Cassim *et al*, *Contemporary Company Law*, *op cit*, at page 74.
[104] Which in terms of section 48 has to comply with the distribution requirements thereof.
[105] Section 46 provides a company may make any proposed distribution if it reasonably appears that it will satisfy the solvency and liquidity test immediately after the distribution and upon the resolution of the board of the company acknowledging that it has applied the test and therefore reasonably concluded that the company passed it.
[106] Van der Linde, "*The regulation of distribution to shareholders in the Companies Act 2008*", *op cit*, at page 492.
[107] Cassim *et al*, "Contemporary Company Law", op cit, at page 274.
[108] Cassim *et al* (*Contemporary Company Law*), make a point that a mere decision to buy back shares of the company in itself can do no harm but it is the distribution pursuant to the decision that is potentially harmful and therefore subject to the solvency and liquidity requirements. Also see Van der Linde ("*The regulation of distribution to shareholders in the Companies Act 2008*"), at page 493.

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In terms of section 46, a company must not make any proposed distribution transaction unless, *inter alia*, firstly it reasonably appears that the company will satisfy the solvency and liquidity tests immediately after the proposed transaction and secondly that the board of directors has to acknowledge by resolution that it has applied the tests and reasonably concluded that the company will satisfy them immediately after the transaction.

The content and scope of the solvency and liquidity tests are set out in section 4. Generally, in terms of section 4, the tests entail a consideration of "*all reasonably foreseeable financial circumstances of the company at that time*" and an assessment of whether: firstly, the company's assets, as fairly valued, equal or exceed its liabilities as fairly valued (the solvency test): secondly, it appears that a company will be able to pay its debts as they become due in the ordinary course of its business for a stated period[109] (the liquidity test).

Furthermore, section 4[110] provides guidelines as to the type and quality of financial information which falls to be considered to make the requisite assessment.[111]

a. Solvency element of the test

It has been pointed out by Van der Linde[112] that, with regards to the shareholders' protection, the solvency requirement's theoretical justification lies in the proposition that it affords "*advance recognition to the ultimate priority that creditors enjoy over shareholders upon dissolution of the company by preventing the company from favouring its shareholders through partial liquidation.*"[113]

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109 The period is fixed at 12 months following the share buyback transaction.
110 Section 4(2) of the 2008 Companies Act.
111 Section 4(2) enjoined the company embarking on a proposed distribution to base its consideration of financial information on proper accounting records of the company and proper financial statements of the company.
112 Van der Linde, "*The solvency and liquidity approach in the Companies Act 2008*", 2009 2 TSAR 2009.
113 *Ibid*, at page 226.

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In terms of section 48(1)(a), a company is permitted to acquire its own shares if, at the time of the transaction, all the reasonably foreseeable financial circumstances of the company show that its assets (fairly valued) are equal or exceed its liabilities (fairly valued).

The solvency element requires a consideration of the net assets[114] and liabilities at a particular time. Van der Linde[115] argues that the requirement that there be a consideration of all reasonably foreseeable financial circumstances in respect of the solvency element involves a measure of prediction which is more suited to the liquidity element of the test. According to Van der Linde, unlike the liquidity element provision,[116] the solvency is element provision is formulated objectively with reference to a particular point in time, hence it does not utilize predictive words such as "*appears*" and "*will*" as found in the liquidity provision.

It is submitted that the scheme of section 48 read with the other related sections suggests that the consideration of solvency and liquidity of the company is geared towards enabling the company to "*predict*" the financial position of the company up to a particular point in time, namely, immediately after the distribution transaction.[117] The solvency enquiry involves a balance-sheet[118] based approach of determining the actual financial position of the company immediately after the transaction whilst the liquidity enquiry involves a cash-flow[119] based analysis of the company in order to forecast what its financial position after the transaction.

It is therefore clear that the solvency consideration is essentially a factual enquiry based of the company's financial records whilst the liquidity enquiry is essentially

[114] According to Van der Linde ("*The solvency and liquidity approach in the Companies Act 2008*", op cit, at page 225), a distribution may only be made out of the net assets of the company because a solvency test entails that the assets of the company should exceed its liabilities after said had been taken into account.
[115] Van der Linde, "*The solvency and liquidity approach in the Companies Act*", *op cit*, page 235.
[116] Section 4(1)(b) of the 2008 Companies Act.
[117] Section 46(1)(a) and (b.)
[118] Vander Linde, "*The solvency and liquidity approach in the Companies Act*", *op cit,* at page 226.
[119] *Ibid.*

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predictive. It is this nuanced difference that the legislature has not expressly and adequately reflected in its formulation of the distribution (buyback) regime. Lack of clear formulation on the part of the legislature is further compounded by cross-referencing[120] section 46 in section 48 which obfuscates rather than clarifies the share buyback regime. However, that the legislature preferred not to include words such as "*appear*" and "*will*'[121] in the solvency provision under section 4 points to the fact that the legislature was alive to the difference in the two requisite elements.

b. Liquidity element of the test

According to Van der Linde,[122] the liquidity requirement of the test is theoretically justified on the basis that it seeks to address "*the fundamental expectation of creditors to be paid on time and also fits well with the representation a company is said to make when it incurs debt, namely that it reasonably expects to be able to pay as and when the debt becomes due.*"[123]

In terms of section 4(1)(b), a company is permitted to proceed with a distribution transaction (share buyback) if, after considering all the foreseeable financial circumstances of the company, it appears that it will be able to pay its debts as they become due in the course of its business for the period of twelve months.

It is clear that in terms of section 4(1)(b), a company has to foreseeably remain liquid for a fixed period of twelve months after the transaction. Section 85 of the 1999 Companies Act did not contain a fixed period within which a company is required to remain liquid.

120 Van der Linde, "*The regulation of distribution to shareholders in the Companies Act 2008*", *op cit*, at page 492. and Cassim *et al*: *Contemporary Company Law*, *op cit*, at page 274.
121 These words, which indicate the predictive nature of the enquiry, are included in the liquidity provision under section 4(1)(b).
122 Van der Linde, "*The solvency and liquidity approach in the Companies Act*", *op cit*.
123 *Ibid*, at page 226.

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The fixing of the time period for liquidity follows the UK approach and the JSE Listing requirements.[124] Van der Linde[125] argues that whilst the fixing of the time period serves a legitimate purpose of providing certainty for transacting directors, it has the potential of disadvantaging the creditors who have foreseeable long-term commitments that are not payable within twelve months.[126]

It is however submitted that it is desirable to have a fixed period of time for the company's liquidity in the "*ordinary course of business*" as provided for in section 4(1)(b). Absent a fixed time period, as in the case of section 85 of the 1999 Companies Act, a company would have to take into account and predict on every possible future liquidity position (however remote) *ad nauseam.* This will certainly frustrate the implementation of the share buyback (and other distributions) regime.

c. Valuation of assets and liabilities

Section 4 provides guidelines for the consideration of financial information for purposes of distribution transactions.[127] In terms of section 4(2)(a), any financial information to be considered must be based firstly on accounting records that satisfy the requirements of section 28[128] and secondly on financial statements that satisfy the requirements of section 29.[129] This provision prescribes the content and quality of the financial information that falls to be considered for a distribution transaction.

Furthermore, section 4(2)(b) provides guidelines for valuation of assets and liabilities of the transacting company. The valuation "*must*" include any

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124 Listing Requirements of the JSE Limited, par 5.69(c).

125 Van der Linde, "*The solvency and liquidity approach in the Companies Act*", *op cit*, op cit.

126 *Ibid*, at 229, Van der Linde suggests that the alternative approach may be to create a presumption that a company would not have satisfied the liquidity requirement if it is liquidated within a specified time period.

127 This is an innovation which was not included under section 85 of the 1999 Companies Act.

128 Properly kept accounting records of the company.

129 Properly kept financial statements of the company.

reasonably foreseeable contingent assets and liabilities,[130] irrespective of whether they arise from the transaction or not. It is further provided that a transacting company "*may*" consider any other valuation of its assets and liabilities that are reasonable in the circumstances. This provision defines the scope of the information that is to be considered for a distribution transaction.

However laudable section 4(2) may be in its attempt to provide guidelines to company directors involved in distributions, it is certainly not a model of clarity in the way it is crafted and formulated. As pointed out by Van der Linde,[131] whilst in terms of the provisions any financial information must be based on the accounting records and financial statements of the company, it is however difficult to see how a liquidity enquiry, which is essentially predictive in its purpose, can exclusively rely on recorded financial information of the company.

2.3. CONCLUSION

Section 48 is, in large measure, a commendable endeavour on the part of the legislature to move away from the rigidity of capital maintenance doctrine. It improves, in terms of guidelines and details, from the previous section 85 of the 1999 Companies Act.

However, with regards to the protection of shareholder's interests in the company's capital, the section still falls short. That the legislature chose not to include shareholders' authorization requirement (in terms of the Memorandum of Incorporation) for share buyback transactions is understandable in light of the fact that such transaction are specifically permitted in the Act.[132]

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[130] Vander Linde, "*The solvency and liquidity approach in the Companies Act*", *op cit,* at page 231, Van der Linde states that contingent liabilities are possible liabilities and that contingent assets are assets that the company may acquire in the future. The author points out that these contingencies will not be reflected in the accounting records and financial statements of the company.

[131] Vander Linde, "*The solvency and liquidity approach in the Companies Act*", *op cit,* at page 30.

[132] Also note the provisions of section 20 to the effect that no agreement shall be void only by reason that it is beyond the authority of the company.

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Notwithstanding the above, the omission of shareholders' approval requirement for the share buyback transactions remains a cause for concern in that it leaves shareholders vulnerable at the time a determination to buy back shares is made by the company's board of directors. This should be one of the areas of focus for future company law reform.

Whilst the solvency and liquidity test requirements in terms of section 48 provide a welcome flexibility in dealing with company's capital, the section still requires improvement in its formulation. Otherwise in substance, the section does provide creditors with adequate protection in the company's capital.

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CHAPTER 5

SECTION 48 AND COMPANY GROUPS

5.1. INTRODUCTION

Up until the enactment of section 89[133] of the 1999 Companies Act, a subsidiary of a holding company had been prohibited from acquiring shares in its holding company in terms of section 39[134] of the 1973 Companies Act. Cassim *et al*, correctly point out that section 39 was aimed at preventing an indirect return of capital to shareholders and the indirect trafficking of shares by a holding company.[135]

At the time,[136] the underlying justification for the prohibition of this type of acquisition was aptly captured by Coetzee J in Unisec Group Ltd and Others v Sage Holdings Ltd wherein the learned judge remarked that such an acquisition "*cannot possibly have any income or investment advantage for the holding company, as opposed to a purely speculative one by trafficking in them*."[137] Obviously, this prohibition had its roots in the capital maintenance doctrine which was progressively abandoned in the 1999 Companies Act[138] and more decisively in the 2008 Companies Act.[139]

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133 Section 89 of the 1999 Companies Act provided that "*Subsidiary companies may mutatis mutandis in accordance with section 85, 87 and 88, acquire shares in their holding companies to a maximum of 10 per cent in the aggregate of the number of issued shares of the holding company: Provided that this section shall not apply to the acquisition of shares by a holding company in a subsidiary of itself.*"

134 Section 39(1) provided that "*Save as is provided in this section, no company shall be a member of a company which is its holding company, and any allotment, issue of transfer of shares of a company to its subsidiary shall be void.*"

135 Cassim *et al*: *Contemporary Company Law*, *op cit*, at page 282.

136 When section 39 of the 1973 Companies Act was still in place.

137 The Unisec Group Ltd and Others v Sage Holdings Ltd, *op cit*, at page 5.

138 Section 89 of the 1999 Companies Act.

139 Section 48(2)(b) of the 2008 Companies Act.

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Section 89 of the 1999 Companies Act, *inter alia,* provided that subject to the solvency and liquidity requirements as contained in section 85, subsidiary companies might acquire shares in their holding companies to a maximum of 10% in the aggregate of the number of issued shares of the holding companies.

5.2. SECTION 48(2)(b) OF THE 2008 COMPANIES ACT

Section 48(2)(b) provides that, subject to the requirements as set out in section 46, any subsidiary of a company may acquire shares in that company subject to stipulated limitations and requirements. In terms of section 48(2)(b)(i) a subsidiary may not acquire more than 10%, in aggregate, of the number of issued shares of any class of that company or for the benefit of all of the subsidiaries of the company. Furthermore, section 48(2)(b)(ii) provides that no voting rights attached to the acquired shares may be exercised by the subsidiary whilst it remains the subsidiary of the company.

Section 1 defines a "*group of companies*" as involving "*two or more companies that share a holding or subsidiary relationship.*" Furthermore, section 3 stipulates that a company is a subsidiary of another company (holding) if that holding company directly or indirectly controls the majority of the voting rights in the subsidiary company or has the right, through its exercise of majority vote, to appoint directors of the board of the subsidiary company. At the core of the definition of the subsidiary/holding company is the company's ability to exercise effective control over the affairs of another company. It is therefore this company group concept that the legislature employs in section 48(2)(b).

The provisions of section 48(2)(b) clearly make a determination for the subsidiary's acquisition of holding company's shares subject to the distribution requirements as set out in section 46.[140] This is a marked improvement from the earlier version of section 48(2)(b)[141] which was unclear in this regard.

5.2.1. Solvency and liquidity requirements

With regards to the solvency requirement, section 4(1) merely refers to the assets and liabilities of a company and does not distinguish companies in a group structure.[142] It appears that only the assets and liabilities of the transaction subsidiary, as fairly valued, will be taken into account in determining the solvency of the company for purposes of a distribution.

It is clearly not desirable, as the legislature seems to have appreciated, to factor in the aggregate assets and liabilities of a group as there is a danger that, as Jooste points out, an insolvent company may pass the solvency test by relying on the assets of other companies in its group.[143]

It appears from the reading of the liquidity requirement in terms of section 4(2)(b) that this test applies in respect of individual companies and not groups.[144] In other words, it is the acquiring subsidiary which has to be liquid and not all the member companies of the group.

5.2.2. Limitation of acquired shares

A company in a group, having satisfied the requirements of section 4, may not proceed to acquire more than the maximum of 10% in aggregate, of the number

[140] This was clarified in terms of section 32 of Companies Amendment Act 3 of 2011. The earlier version of section 48(2)(b) left it open to the interpretation that share buyback transactions in group of companies were not subject to section 46.

[141] Before its amendment in terms of Companies Amendment Act 3 of 2011.

[142] In its un-amended form, section 41(1) referred to the "*aggregate assets*" and "*aggregate liabilities*" of companies in a group structure.

[143] Jooste R, "*Issues Relating to the Regulation of 'Distributions' by the 2008 Companies Act*", SALJ, Vol 126 (Part 4) 2009, at page 641.

[144] Van der Linde, "*The solvency and liquidity approach in the Companies Act*", *op cit*, at page 229.

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of issued shares in its holding company in terms of section 48(2)(b)(i). This limitation is borrowed from the provisions of section 89 of the 1999 Companies Act, safe for the fact that section 48(2)(b)(i) refers to classes of shares in relation to the limitation.

According to Cassim *et al*,[145] it is not clear whether the limitation of 10% applies to each class of shares or to the total of shares irrespective of their class.[146] It should be borne in mind that in terms of the previous section 89, the limitation was in respect of all the issued shares irrespective of their class.

Furthermore, it appears that in determining the number of shares a subsidiary has in its holding company, shares held by the subsidiary before it became a subsidiary of that company (prior holdings) are to be taken into account.[147]

However, it is arguably clear from the wording of the section that the legislature intended that all the shares in possession of the subsidiary which were acquired from the holding company should be taken into account. This is borne by use of the word "*held*" instead of "*purchased*" in relation to the shares to which the limit applies.

It is submitted that in order to curb the possible abuse of share buyback transactions in companies that are part of a group structure, the entire shareholding, and not only the one actually purchased, should be taken into account in determining the 10% threshold. This enhances the shareholder protection purpose as a declared objective of the 2008 Companies Act.

[145] Cassim *et al*: *Contemporary Company Law, op cit:* And also see Wainer: *"The new Companies Act: Peculiarities and Anomalies", op cit.*
[146] Cassim *et al*, *Contemporary Company Law*, *op cit*, page 283.
[147] Cassim *et al*, *Contemporary Company Law*, *op cit*, page 283.

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5.2.3. Restriction of voting rights

In terms of section 48(2)(b)(ii), the voting rights attached to the acquired shares are not exercisable by the subsidiary company for as long as it remains a subsidiary.

It is clear from the wording of the section that voting rights in respect of prior holdings (shares acquired by the subsidiary before it became the subsidiary), would remain exercisable.[148]

The only problem associated with this section, as identified by Wainer[149] and Cassim *et al*,[150] is that it only neutralises voting rights of shares acquired from the holding company when the acquiring subsidiary was a subsidiary and that it silent on prior share holdings.

Similarly,[151] it is arguably clear that the legislature intended to neutralize the voting rights attached to all the shares acquired by the subsidiary from its holding company, hence the similar use of the word "*held*"[152] in respect of the number of shares that the subsidiary has in its holding company.

5.3. CONCLUSION

The potential danger of permitting a subsidiary from purchasing shares of its holding company is that, if unchecked, it may amount to legislative sanctioning of share trafficking. Recognising this fact, the legislature has, other than the board of directors' approval and the solvency and liquidity test requirement (which are dealt with in Chapter 5), put in place provisions which are geared towards keeping the potential abuse in check.

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[148] Cassim *et al*, *Contemporary Company Law*, *op cit*, at page 285.
[149] Wainer, *"The new Companies Act: Peculiarities and Anomalies", op cit*, at page 821.
[150] Cassim et al, *Contemporary Company Law*, *op cit*, at page 285.
[151] As in the discussion about voting rights.
[152] Instead of "*purchased*".

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The above-mentioned provisions include limitation on the number of shares that may be acquired in the holding company[153] and restriction imposed on the voting rights of the shares so acquired.[154] Save for the unsatisfactory manner in which these provisions have been formulated, which may require reconsideration in the future, the provisions substantively add to the protection of creditors' and shareholders' interests in the company's capital by curbing possible share trafficking.

[153] Section 48(2)(b)(i).
[154] Section 48(2)(b)(ii).

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CHAPTER 6

ENFORCEABILITY OF SECTION 48 AGREEMENTS

6.1. INTRODUCTION

Section 48 decrees a numbers of jurisdictional requirements that must be met and/or satisfied for a company to proceed with a share buyback transaction. These apply to both individual and group companies.

Once the board of directors of a company has satisfied itself and has also declared that it is satisfied that said jurisdictional requirements have been met / satisfied or are likely to be, the agreement recording the share buyback transaction is obviously valid in terms of the provisions of section 48. The legal status of such an agreement is defined in terms of section 48(4) which decrees that the agreement is enforceable against the company.

6.2. SECTION 48(4)

Section 48(4) provides that, subject to subsections 3 and 4 thereof, any agreement for a share buyback transaction is enforceable against the transacting company.

However, said agreement would not be enforceable if the execution thereof would result firstly in the company falling foul of the liquidity and solvency requirements as set out in section 46 read with section 4 or if the execution of the agreement would result in there being no longer remaining shares available in the company other than subsidiaries' shares or convertible or redeemable shares.[155]

A share buyback agreement, like any other agreement in terms of the Act, is subject to the provisions of section 218 which stipulates, *inter alia*, that nothing in the Act renders void any agreement unless a court has made that declaration of voidness. Therefore, a buyback agreement which is contrary to the provisions of subsections (2) and/or (3) is not void but voidable.[156]

Section 48(4) affords transacting companies with a statutory defense against the decreed enforceability of buyback agreements. Section 48(5) provides content to section 48(4) in that it places the burden of proof[157] on companies who seek to escape enforceability.

There transacting company is enjoined[158] in terms of section 48(5) to allege and establish that that the impugned share buyback the fulfillment of its contractual obligations would result in the company being rendered insolvent and/or illiquid or that there would be no longer transactional shares in terms of section 48.

In an application in terms of section 48(5)(a), the court, if satisfied that that the enforceability of the transaction is impeded by any resulting breach of subsection (2) and/or (3), may make an order which is just and equitable given the financial circumstances of the company. Such an order may ensure that the vendor shareholder is paid expeditiously.

Moreover, if the transacting company proceeds to effect the share buyback transaction and acquires the shares in terms of section 48 under in a manner that contravenes the jurisdictional requirements of section 46 as set out above, the company may, in terms of section 48(6), apply to court for an order reversing

155 Cassim *et al*: *Contemporary Company Law*, *op cit*, at page 279.
156 It has to be declared by the court on application.
157 Section 48(5)(b).
158 In a court application in terms of section 48(5)(a).

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the acquisition. However, such application for a reversal order has to be brought by the company within two years of after the acquisition.[159]

In the application in terms of section 48(6), if the court is satisfied that the transaction falls foul of section 46, it may order the return of the amounts paid by the company from the vendor shareholder[160] and compensation that shareholder by issue of equivalent shares.[161]

It should be borne in mind that the application to court as envisaged in section 48 may be brought by shareholders on behalf of the company by way of derivative action as contemplated in section 165 of the Act.[162]

6.3. CONCLUSION

A share buyback transaction agreement which satisfied the requirements of section 48 is valid and therefore enforceable against the company in terms of section 48(4). The scheme of our share buyback regime is one based on flexibility (solvency and liquidity tests) and it also shies away from the rigidity imposed by shareholder authorization and approval.

However, section 48(5) and (6) affords companies a residual right to reverse share buyback agreements if it appears that their execution would result in contravention of the provisions of section 48. The power of reversal resides with the court if the company establishes that the contravention will ensue by executing the agreement.

In the result, section 48(5) and (6) introduces a safety net for a further protection of the creditors' and shareholders' interests in the company's capital.

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[159] Cassim *et al*: *Contemporary Company Law, op cit,* at page 280.
[160] Section 48(6)(a).
[161] Section 48(6)(b).
[162] Section 165 provides, *inter alia*, that a shareholder may serve upon a company to commence or continue legal proceedings, or take related steps, to protect the legal interests of the company.

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CHAPTER 7

DIRECTORS' LIABILITY IN TERMS OF SECTION 48

7.1. INTRODUCTION

Section 48(a) and (b) entrusts the determination to embark on a share buyback transaction on the board of directors and further places certain obligations on them.

The board of directors has to consider all the reasonably foreseeable financial circumstances of the company and objectively predict that the company will be solvent and liquid immediately after the share buyback transaction. The board of directors is also required to acknowledge by resolution that it has applied the solvency and liquidity tests and has reasonably concluded that the company will satisfy the tests immediately after the transaction.

In the absence of shareholder authorisation and shareholder approval requirements in section 48, the task of considering the liquidity and solvency entrusted, based on all the reasonably foreseeable financial circumstances of the company, on the board of directors is not only an enormous one but also exposes directors risk of being sued breach of fiduciary duties. Section 48(7) therefore regulates directors' liabilities for share buyback transactions. It is to be noted that the 2008 Companies Act has in large measure codifies[163] the common law principles of director's fiduciary duties.

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[163] See section 77(2).

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7.2. SECTION 48(7)

Section 48(7) provides that a director of a company which has transacted in terms of section 48(2) and (3) will be liable if that director was present at the meeting where the board approved the transaction and failed to vote against the transaction despite knowing that it was contrary to the provisions of section 48(2) and (3).

In giving content to the directors' liability, section 48(7) refers to section 77. The reference to section has the following important legal consequences:

> The directors who were party to unlawful share buyback transaction can be liable for breach of fiduciary duties based on common law principles for any resulting loss, damage or costs incurred by the transacting company;[164] and

> The directors who were party to unlawful share buyback transaction can be liable in delict for any resulting loss, damages or costs incurred by the transacting company.[165]

Fiduciary duties involve duties bestowed by law on a director for the simple reason that he/she stands in a relationship of trust to a company. Therefore, fiduciary duties require that a director must act *bona fide* and in the interest for the benefit of the company. Liability for breach of fiduciary duties is a *sui generis* in that it is not founded in delict or contract.[166] In terms of these duties, a director is duty-bound, for instance, to avoid conflict of interest between his/her personal financial interest and those of a company, act within the limitations of prescribed powers in the of the memorandum of association, exercise proper discretion and act for a proper purpose to the benefit of the company.[167]

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[164] Section 77(2)(a).
[165] Section 77(2)(b).
[166] Cilliers *et al*, *Corporate Law*, *op cit*, at page 141.
[167] These duties are set out in section 76 and elaborated upon in common law.

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If the above duties are breached, liability in respect of a director arises in relation to the company for which he/she was discharging the functions of a director.

A duty of care and skill enjoins a director to discharge his/her functions[168] with a degree of care and skill expected of a director in that position. The duty has both the objective[169] and subjective[170] elements.[171]

The liability for breach of the duty of care and skill is founded in delict. In order for liability to stand, this requires that all the elements of Acquilian liability,[172] namely act/omission, wrongfulness, fault, causation and loss, must be established.

However, section 76(4) introduces a concept of business judgment principle.[173] It stipulates that a director may escape liability if he/she can establish that there was a rational basis for believing that the decision was taken bona fide and in the best interest of the company.

Specifically, section 48(7) circumscribes the directors' liability by referring to section 77(3)(e)(vii)[174] which defines the extent of the liability. Section 48(7) decrees that the directors' liability will only arise if the director was present and participated at the meeting[175] where the acquisition was approved[176] and despite knowing that the acquisition was contrary to sections 48 and/or section 46, failed to vote against it.[177]

[168] Bona fide and for the benefit of a company.
[169] Duty of care, section 76(3)(c)(i).
[170] Duty of skill, section 76(3)(c)(ii).
[171] Section 76(3).
[172] Lillicrap Wassenaar and Partners v Pilkington Brothers SA Pty Ltd [1985] 1 All SA 347(A).
[173] Havenga, "*The Business Judgment Rule – Should We Follow The Australian Example?*", (2000) 12 SA Merc LJ.
[174] This section relates to director's liability arising out of an unlawful acquisition by a company of its shares, or the shares of its holding company, despite the director knowing that the acquisition was unlawful.
[175] Subject to section 74 which makes provision for a decision to be adopted by written consent of a majority instead of voting at a meeting.
[176] Section 48(7)(a).
[177] Section 48(7)(b).

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Section 48(7) is a far-reaching improvement from its predecessor, section 86(1) which only prescribed liability to directors who merely allowed a company to acquire own shares unlawfully. Section 86(1), the way it was crafted, could mean that liability extended to every director regardless of being present and participated in the approval meeting. Section 48(7) attaches liability specifically to those directors whose action or omission causally[178] resulted into a company incurring loss, damages or costs.

With regards to shareholder' protection, section 165 empowers shareholders to bring derivative action against delinquent directors for breach of their duties in approving an unlawful buyback transaction. This action is derivative in the sense it is brought by the shareholders on behalf of the company[179] for recovery of any loss, damage and/ costs incurred by the company.

7.3. CONCLUSION

Section 48(7) provides a measure of protection to shareholders in light of the abolition of capital maintenance doctrine. The section has a deterrent effect on directors and also provides a simplified checklist of the do's and don'ts for directors who enter into share buyback transactions. This is a critical advantage of codifying the common law principles as it relates to the fiduciary duties and duty of care and skill.

Moreover, the shareholders have a residual right to bring derivative action on behalf of the wronged company to recover loss, damages and/or costs occasioned by the directors' breach of duties. This adds to the protection of shareholder's interests in the company's capital.

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178 Being present at the meeting and not voting against the acquisition despite knowing that it was unlawful.
179 Directors owe duties to the company as a separate legal entity and not to the shareholders.

CHAPTER 8

CONCLUSION AND BIBLIOGRAPHY

CONCLUSION

The share buyback regime in terms of section 48 of the 2008 Companies Act is one of the aspects through which the legislature has decisively moved away from the capital maintenance doctrine.

Save for the areas of concern which are highlighted and discussed in this research, the regime offers a comprehensive package which ensures flexibility and legal certainty for share buyback transactions.

Most importantly, the regime provides for sufficient safeguards and guidelines which are aimed at protecting the interests of both the creditors and shareholders in the company's capital.

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