THE ACQUISITION BY A COMPANY OF ITS OWN SHARES IN TERMS OF SECTION 48 OF THE COMPANIES ACT 71 OF 2008

by

TJ SCOTT
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Tobias Johannes Scott
(10598627)

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SUMMARY

The capital maintenance rules stem from the English company law and were primarily aimed at protecting the rights of a company’s creditors. Before the introduction of the Companies Amendment Act 37 of 1998, a company was prohibited from purchasing its own shares. After this legislation was passed, a company was able to do so, provided that it satisfied the solvency and liquidity test and also complied with the new statutory provisions set out by sections 85 to 89 of the Companies Act 61 of 1973.

Section 48 of the Companies Act 71 of 2008 now regulates the acquisition by a company of its own shares, as well as the acquisition of shares in its holding company by a subsidiary company. The above actions also fall under the ambit of a “distribution” as defined in the Act and therefore need to satisfy the requirements of section 46 of the Act as well. Unlike its predecessor, the provisions in the new Act are very broad and devoid of guidelines. The emphasis is placed on companies satisfying the principles of solvency and liquidity. Non-adherence to these provisions gives rise to the personal liability of the company’s directors.

The provisions of section 48 do not apply where a dissenting shareholder exercises his appraisal rights in terms of section 164 of the new Act, or where a company redeems redeemable securities. These exceptions do, however, still amount to “distributions” and will accordingly need to satisfy the requirements contained in section 46 of the Act.

Redeemable securities were initially not exempted from the provisions of section 48. This would potentially have given rise to a situation where a company could approach a court in terms of section 48(6) to reverse a redemption of its securities. It would have had dire consequences for financing by way of redeemable securities. In terms of the Companies Amendment Act 3 of 2011 redeemable securities are now specifically exempted from the provisions of section 48.

In terms of the new Act a subsidiary company is allowed to purchase shares in its holding company to a maximum of 10% in the aggregate of the issued shares of any share class, provided that no voting rights attached to such shares may be exercised. The new Act fails to properly address some of the issues regarding the “round-tripping” of dividends and the declaration of a dividend in specie that were already identified as far back as 2001.
Where the consideration for a repurchase constitutes a “dividend” as defined in the Income Tax Act 58 of 1962, the company will be liable to pay secondary tax on companies in respect thereof. If a distribution does not constitute a dividend, capital gains tax is payable with regard to it.

Share repurchases are allowed in terms of Canadian corporate law after the legislative reform which occurred in that country during the 1970’s. The Canadian Business Corporations Act contains provisions that bear a striking resemblance to the provisions of the new Act adopted in South Africa.

Whilst the basis and rationale behind the new corporate legislation cannot be faulted, a host of issues and concerns still remain. The unfortunate consequence is that the new Act lacks transparency and is fraught with clumsy errors.

**KEYWORDS**

capital maintenance, share repurchase, subsidiary acquisition, solvency and liquidity, distributions, director’s liability, dissenting shareholder appraisal rights, redeemable securities, “round-tripping”, dividend in specie, secondary tax on companies, capital gains tax
1 Introduction

1.1 Background

The Companies Act\(^1\) finally came into operation on 1 May 2011. This signified the culmination of the first comprehensive review and reform of the South African company law after the findings of the Van Wyk De Vries Commission resulted in the promulgation of its predecessor, the 1973 Act.\(^2\) The need for reform arose out of the changes that had taken place in South Africa over the preceding years on its political, economical and social landscape.

The rationale behind the review was to ensure new legislation that would be appropriate to the legal, economic and social context of South Africa as a constitutional democracy and free-market economy.\(^3\) The need was obvious, as the pace of development meant that many of the concepts and provisions of the previous dispensation had become outdated in the modern economy.

The purpose of the new Act is set out in section 7 thereof. It primarily aims to promote compliance with the Bill of Rights and to promote the development and innovation of, and investment in the South African economy. It further seeks to reaffirm our concept of the company as a means of achieving economic and social benefits, whilst also balancing the rights and obligations of shareholders and directors within companies and encouraging the efficient and responsible management of these companies.

The new Act abolishes all remaining remnants of capital maintenance from our company law by replacing it with the dual requirement of solvency and liquidity. The capital rules for companies are now for the first time wholly governed by an ability to repay debts as they become due, whilst also ensuring that a company’s assets equal or exceed liabilities.

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\(^1\) 71 of 2008.
\(^2\) See in general GN 1183 GG 26493 of 23 June 2004 7-9.
\(^3\) GN 1183 GG 26493 of 23 June 2004 7.
1.2 **Purpose and objective**

This dissertation will focus on the capital rule in terms of which a company can acquire its own shares. This will include the situation where a subsidiary acquires shares in its holding company, as this constitutes an indirect acquisition of shares.

These acquisitions are regulated by the provisions of sections 46 and 48 of the new Act. The objective of this dissertation is to analyze and evaluate these provisions critically and specifically address certain issues arising from these new provisions in respect of repurchases.

Three specific issues, namely the status of redeemable securities regarding share repurchases, subsidiary acquisitions and the tax implications of repurchases will be evaluated.

1.3 **Delineation**

This dissertation will proceed from the initial prohibition in terms of which a company could not acquire its own shares, to the current position where such an acquisition is authorized subject to certain provisions.\(^4\)

The origins of the capital maintenance rule prohibiting a company from acquiring its own shares will be discussed from its initial incorporation into South African law by various judgments during the early years of the 20\(^{th}\) century, to the relaxation and abolition of this rule by the reforms enacted during 1999 by the insertion of sections 85 to 90 into the 1973 Act.

The provisions of sections 46 and 48 of the new Act will be discussed in detail to highlight the new requirements for effecting an acquisition by a company of its own shares, or an indirect acquisition of shares by a subsidiary in its holding company. The status of redeemable securities in relation to share repurchases, along with subsidiary acquisitions and the tax implications of repurchases will be evaluated thereafter.

\(^4\) See Cassim “The reform of company law and the capital maintenance concept” 2005 *SALJ* 283 285. The author alludes to the four categories of capital maintenance rules. This dissertation will be limited to the rule according to which a company could not purchase its own shares.
I shall also compare the new process to the process reflected in Canadian law by the Canadian Business Corporations Act, the provisions of which bear a remarkable resemblance to our new provisions regarding share acquisitions.

14 Research methodology

The Companies Act, as amended by the Companies Amendment Act, will be referred to as the primary source for purposes of this dissertation. In certain instances, specific reference will be made to certain changes or insertions that were enacted by the latter. Reference will be made to the 1973 Act to illustrate the state of affairs before the new Act came into operation. Where the tax implications of share repurchases are discussed, reference will be made to the Income Tax Act.

Other sources will include textbooks by recognised authors, along with various publications in legal journals. Reference will also be made to case law to illustrate how South African courts, as well as courts abroad, interpret certain provisions.

2 The evolution from capital maintenance to solvency and liquidity

2.1 The origins of capital maintenance

The capital maintenance rules stem from English company law. At the heart of these rules is the belief that the issued share capital of a company constitutes a guarantee fund intended for the payment of claims of the creditors of a company. The result was therefore that it was

\[ \text{\textsuperscript{5} 71 of 2008.} \]
\[ \text{\textsuperscript{6} 3 of 2011.} \]
\[ \text{\textsuperscript{7} 58 of 1962.} \]
\[ \text{\textsuperscript{8} See Cassim & Cassim “The capital maintenance concept and share repurchases in South African law” 2004 ICCLR 188.} \]
prohibited to reduce the issued share capital of a company, unless such a reduction was authorised by statute or another legal rule.

For purposes of this dissertation, I shall focus on the rule that prohibits a company from purchasing its own shares. This rule was formulated more than 120 years ago in *Trevor v Whitworth*\(^9\) and clarified the position in the English law after a number of conflicting judgements.\(^{10}\)

In this landmark ruling it was held that a company could not purchase its own shares. Any attempt by a company to purchase its share was void on two grounds. The first ground entailed that the company’s object as defined in its memorandum did not include the capacity to purchase its own shares and that such a purchase of shares would therefore constitute an *ultra vires* act. Secondly, and even assuming that a purchase of that kind was *intra vires* the company, there would be no capacity to effect such a transaction, because it would constitute a contravention of the provisions and principles of the Companies Act (UK) of 1877.\(^{11}\)

This rule is primarily aimed at protecting the rights of a company’s creditors.\(^{12}\) The rule is based on the fact that, even though creditors run the risk in the ordinary course of business that a company’s capital may be diminished, it would be greatly prejudicial to them if a company had the freedom to distribute its assets amongst its shareholders, because it would undermine the notion that the issued share capital of a company is regarded as a guarantee fund to which a creditor is entitled to look at as security.\(^{13}\)

There are a number of other factors that justify the need for this rule. Chief amongst these are *inter alia* to prevent directors of a company from maintaining themselves in control by manipulating the voting power; to prevent the abuse of limited liability by the shareholders and

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\(^9\) (1887) 12 App Cas 409.

\(^{10}\) For a brief synopsis and background see Trichard *et al* “Purchase by a Company of its own Shares” 1989 *Transactions of the Centre for Business Law* 4-5.

\(^{11}\) 40 & 41 Vict c 26.

\(^{12}\) See Trichard *et al* 8-10; Cassim & Cassim 188; Bhana “The company law implications of conferring a power on a subsidiary to acquire the shares of its holding company” 2006 *Stell LR* 232; Cassim 2005 *SALJ* 283.

\(^{13}\) Cassim 2005 *SALJ* 285.
directors of a company; the fact that a company cannot be a member of itself. Furthermore, the purchase of its shares by a company was not regarded as a forfeiture or a surrender of shares; it was seen as an unauthorised reduction of the share capital of a company; the Companies Act (UK) 1877 impliedly prohibited it; and it was not incidental to a company’s objects.14

2.2 Share repurchases in South Africa

The rule prohibiting the purchase by a company of its own shares forms part of our common law and was followed in various decisions.15 In passing judgment in The Unisec Group Limited and Others v Sage Holdings Limited16, Coetzee J observed that:

“The illegality and voidness of such a purchase actually came to be regarded as part of the common law and is so treated in a number of judgments and by textbook writers. The prohibition against such acquisition was not even expressly contained in any of the company statutes until some 50 years ago. So fundamental is this principle.”

It is therefore apparent that this rule has formed part of our law for many years. Over the years, and especially after the development of the company group concept, the prohibition on a company to purchase its own shares increasingly came under more scrutiny and criticism.17

Four major reasons were advanced in support of the argument that share repurchases should be allowed under certain circumstances.18 First, it would enable a company to protect the value of its shares, especially against the activities of foreign speculators. Secondly, where a company administrates an employee share scheme, it would enable companies to

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14 Trichard et al 9-16.
15 See Jacobs v African Agricultural and Finance Corporation Limited 1905 TH 47; Wolfe Liquidators v Smyth and Crawford 1914 CPD 193; The Unisec Group Limited and Others v Sage Holdings Limited [1986] 3 All SA 1 (T).
16 [1986] 3 All SA 1 (T) 4.
17 Cassim “The right of a company to purchase its own shares” 1985 THRHR 318 321. For a discussion of the rule and exceptions to it in modern English law, see Davies Gower and Davies’ Principles of Modern Company Law (2008) 316-319.
repurchase shares held by employees after such employees have left the employ of the company. Thirdly, a company could also use the capacity to repurchase shares to avoid a hostile takeover. Finally, it would enable the shareholders of companies with unlisted shares to find prospective purchasers for their shares.

The major disadvantage in allowing a company to repurchase its own shares lies in the fact that it can open the door for abuse. This is due to the fact that the repurchase of its shares by a company could amount to trafficking in those shares and could possibly unduly influence the price of the shares.19

In May 1998 the Department of Trade and Industry announced that it intended to allow companies to repurchase their shares and simultaneously gazetted draft legislation to this effect.20 This led to the promulgation of the Companies Amendment Act 37 of 1999, which came into effect on 30 June 1999. The amendments introduced in this act signified a departure from the outdated concept and rules of capital maintenance in favour of the more practical principles of solvency and liquidity.21

2.3 The concept of solvency and liquidity and the Companies Amendment Act 37 of 1999

In terms of this new legislation, it was now permissible, under certain circumstances, for a company to repurchase its own shares.22

The amendment referred to an “acquisition” of shares. The use of the term was problematic, due to the fact that an “acquisition” was not defined in the Act. It would appear

21 It should, however, be pointed out that some elements of capital maintenance remained and therefore still formed part of the South African legal landscape until the promulgation of the Companies Act 71 of 2008 some 12 years later.
that an “acquisition” entailed more than just a plain purchase of shares and included subscriptions for shares, as well as purchases of shares otherwise than for cash.\textsuperscript{23}

A company could acquire its own shares by special resolution if it was authorised to do so by its articles of association.\textsuperscript{24} Any shares acquired in such a way had to be cancelled and acquired the status of authorised unissued shares. This also meant that the share capital of the company concerned had to be reduced accordingly. A company could not repurchase its shares to such an extent that only redeemable or convertible shares would remain.\textsuperscript{25}

The repurchase of shares would only be allowed in instances where there were reasonable grounds to believe that, after the payment, the company would be in a position to pay its debts as they fall due in the ordinary course of business and that the consolidated assets of the company, fairly valued, would exceed the consolidated liabilities of the company.\textsuperscript{26} This principle is known as the solvency and liquidity test and it constituted the third requirement to enact a share repurchase.\textsuperscript{27}

The solvency and liquidity approach was a deviation from the common law principle of capital maintenance. The question that arose was whether the new amended legislation abolished the capital maintenance dispensation. It was held in \textit{Capitex Bank Ltd v Quorus Holdings Ltd}\textsuperscript{28} that, whilst the new statutory dispensation dramatically altered the capital maintenance rules and their application, the rules still had a residual function to protect creditors and shareholders alike from potential abuses of power on a company’s behalf. The rules were thus still in play and would continue to play a role until they were finally abolished when the Companies Act 71 of 2008 came into operation on 1 May 2011.

\textsuperscript{23} Cassim “The new statutory provisions on company share repurchases: A critical analysis” 1999 \textit{SALJ} 760 763.
\textsuperscript{24} S 85(1) of the Companies Act 61 of 1973.
\textsuperscript{25} S 85(6).
\textsuperscript{26} S 85(4).
\textsuperscript{27} A special resolution and authority to do so in terms of the company’s Memorandum of Association being the other two requirements.
\textsuperscript{28} 2003 3 SA 702 (W) 705.
The question that arose after the amendment and upon a reading of section 85(4) was whether one should measure solvency and liquidity at the stage when the repurchase was agreed upon, or when it was performed. It was argued that the company should be liquid and solvent at both moments and that the company should, after payment for the repurchase be able to pay its debts as they becomes due in the ordinary course of business and also be in a position where its assets, fairly valued, would exceed its liabilities.\(^{29}\)

Where a share repurchase agreement was agreed upon in contravention of the solvency and liquidity test, the agreement was unlawful\(^{30}\) and the directors of the company would be held jointly and severally liable to the company for any amount paid in respect of the acquisition and not recovered.\(^{31}\) A director of the holding company of the company could also be held liable for contravention of section 85(4).\(^{32}\) Even though this amendment now enabled a company to acquire its own shares without imposing restrictions on the source of funds utilized for such a repurchase, the personal liability of directors effectively imposed a heavy responsibility on directors not to take unreasonable risks when doing a repurchase.\(^{33}\)

Section 87 lays down the procedure for effecting a share repurchase. It must be noted at the outset that this procedure was very prescriptive and elaborate.\(^{34}\) Section 87(1) provided for certain disclosure provisions where a company purchased its own shares. These included delivering or mailing a copy of the written offering circular to each of its registered shareholders in a manner as provided for in the company’s articles, stating the number and class or kind of its issued shares which the company is proposing to acquire, as well as specifying the terms and reason for the offer. A copy of this offering circular also had to be lodged with the Registrar of Companies within 15 days after the date on which it was delivered or mailed to the shareholders of the company.

\(^{29}\) Cassim 1999 SALJ 769.
\(^{30}\) See Capitex Bank Ltd v Quorus Holdings Ltd supra.
\(^{31}\) S 86(1).
\(^{32}\) S 86(6).
\(^{33}\) Cassim 1999 SALJ 765.
\(^{34}\) Cassim 1999 SALJ 762.
Where a company made an offer to repurchase its shares and its shareholders were willing to sell more shares than the company had offered to repurchase, the company was under an obligation to repurchase shares from all the shareholders who accepted the offer proportionate with the number of shares which each shareholder was willing to sell.\textsuperscript{35} The view was held that the shareholders concerned here were only those to whom the company had made the offer to repurchase and who had subsequently accepted the offer.\textsuperscript{36}

Although an offer had to be made to all the shareholders, there was nothing that precludes only certain shareholders from accepting the offer. Share repurchases appeared similar to dividend payments, because money was transferred to shareholders in both cases. It would therefore have been easy to take the approach that the creditors were safeguarded as long as the solvency and liquidity test was satisfied.\textsuperscript{37} The fact that a payment was only made to a vendor-shareholder meant that it differed from a dividend payment. Dividend payments treated all shareholders of a specific class the same \textit{pro rata} their shareholding. There was no requirement that a repurchase should do the same.\textsuperscript{38}

The purpose of these provisions was to ensure that all shareholders were treated equally, where a repurchase of shares was contemplated. It disregarded the risk that a repurchase could be effected from certain shareholders only, without all the shareholders being afforded an opportunity to consider relinquishing their shares.\textsuperscript{39}

A contract with a company in terms of which the company agreed to repurchase its shares was enforceable against that company, except to the extent where the company would be in breach of the solvency and liquidity test as laid down in section 85(4).\textsuperscript{40} In such a case, the

\textsuperscript{35} S 87(4).
\textsuperscript{36} See Meskin \textit{et al} Henochsberg \textit{on the Companies Act} (2004-) 186.
\textsuperscript{37} Cassim 2005 \textit{SALJ} 287.
\textsuperscript{38} Cassim 2005 \textit{SALJ} 287.
\textsuperscript{39} Consider a situation where the directors of a company realise that a company is headed for financial ruin and resolve to repurchase the shares that they hold in their individual capacity. The other shareholders are prejudiced by this, as they are not afforded an opportunity to relinquish their shares. The action of the directors means that the value of the remaining shares is diluted, whilst it also connotes that they afforded themselves the opportunity to abandon the proverbial sinking ship.
\textsuperscript{40} S 88(1).
company could also not enforce the contract against the seller of its shares, as it had breached the solvency and liquidity requirement.\textsuperscript{41} Notwithstanding the provisions of section 88(1), a contract for the repurchase of shares may also have been unenforceable in instances where the result of the repurchase would be that a company would remain with only redeemable or convertible shares in issue.\textsuperscript{42} The same would be true where a company acquired its shares without the necessary authorisation required in terms of section 85(1). Such an acquisition would be null and void.

There were two instances where the disclosure provisions did not apply.\textsuperscript{43} First, there was the instance where a company repurchased its shares in terms of a special resolution and in accordance with the provisions of section 85(2). Secondly, the disclosure provisions would also not be applicable where a company was listed on the Johannesburg Stock Exchange. In such particular instances, the repurchases were done in accordance with the rules and listing requirements of the stock exchange.

Prior to the 1999 amendment, section 39(1) of the 1973 Companies Act prohibited a subsidiary company from owning shares in its holding company. The rationale behind the prohibition was that a subsidiary acquisition was seen as an indirect acquisition by a company of its own shares and subsequently as an evasion of the rule in \textit{Trevor v Whitworth} that could lead to abuse which could prejudice shareholders and creditors of the company.\textsuperscript{44} After the amendment, a subsidiary could acquire up to a maximum of 10\% of the issued shares of its holding company.\textsuperscript{45} This 10\% threshold was applicable to the combined holdings of all subsidiaries in its holding company. Subsequently, all subsidiaries of a holding company were entitled to hold only 10\% in the aggregate of the issued shares in the holding company at any given time. Section 39(1) was amended to stipulate that no voting rights would be attached to shares held by a subsidiary in its holding company.

\textsuperscript{41} See Meskin \textit{et al} 186(1).
\textsuperscript{42} Meskin \textit{et al} 186(1).
\textsuperscript{43} S 87(2).
\textsuperscript{44} See Butler 1999 \textit{Stell LR} 298; Cassim 2005 \textit{SALJ} 499.
\textsuperscript{45} S 89.
3 Share repurchases in terms of the Companies Act 71 of 2008

3.1 General

The repurchase of its shares by a company and the acquisition by a subsidiary of shares in its holding company is now regulated by section 48 of the new Companies Act. Unlike its predecessor, the provisions in the 2008 Act are very broad and devoid of guidelines. This is similar to the provisions in the Canadian Business Corporations Act 1974, upon which it would appear the new provisions relating to share acquisitions are based.46 The emphasis is placed on the principles of solvency and liquidity, and non-adherence thereto leads to director’s liability.

Like the 1973 Act, the new Act does not define the term “acquisition”. The new Act lays down that shares attain the status of authorised but unissued shares, once they have been acquired in terms of section 48.47 This legislative construction is necessary, due to the fact that a company cannot literally hold shares in itself, as this would imply that a company holds rights against itself. This would clearly constitute an untenable situation. Van der Linde48 argues that the term “acquisition” should include any instance where a shareholder relinquishes rights in respect of a share to the company. Where the company gives consideration for the relinquishment, this will constitute a distribution and section 46 will apply. Section 48 will also apply, barring the two exceptions discussed below.49

Once shares have been repurchased in terms of the provisions of section 48, they have the same status as authorized but unissued shares.50

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46 See § 5.4 post for a discussion on the acquisition of its own shares by Canadian corporations. The resemblance between the provisions of our new Act and those of the Canadian Business Corporations Act are striking.
47 S 35(5).
48 “The regulation of distributions to shareholders in the Companies Act 2008” 2009 TSAR 484 488.
49 See § 3.2 post.
50 S 35(5).
There are two instances where the provisions of section 48 do not apply. The first instance is where a dissenting shareholder exercises his appraisal rights in terms of section 164 of the Act and the second is where a company redeems any redeemable securities in accordance with the terms and conditions of those securities.

The provisions relating to the purchase of its shares by a company or an acquisition by a subsidiary of shares in its holding company do not apply to a making of a demand, the tendering of shares and payment by a company to a shareholder in terms of a dissenting shareholder’s appraisal rights in terms of section 164.\(^5\)

Where a company has given notice to its shareholders of a meeting to consider adopting a resolution to amend its memorandum of incorporation by altering the preferences, rights, limitations or other terms of any class of its shares in any matter materially adverse to the rights or interests of holders of those shares (or particular class of shares), as contemplated in section 37(8)\(^5\) or to enter into a fundamental transaction as contemplated by sections 112, 113 or 114, such notice must include a statement informing shareholders of their rights under section 164.\(^5\) Any shareholder who objects to the passing of such a contemplated resolution may give the company notice in writing of such objection, provided that the resolution has not yet been voted on.\(^5\) Where a company adopts such a resolution, it must send a notice declaring that it has been passed within 10 business days to every shareholder that objected.

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\(^5\) S 48(1)(a).
\(^5\) The wording of s 164(2)(a) is unfortunate in that it refers to a “materially adverse” influence on shareholders’ rights or interests, whereas s 37(8) refers to any amendment to a company’s Memorandum of Incorporation that “materially and adversely” affects a shareholder’s rights. It is submitted that “materially adverse” and “materially and adversely”, given a specific context, may have different meanings and it is therefore not exactly clear what the legislature’s intention was in this instance. A further problem is the inclusion of the “interests” of a shareholder, which is a term that has a much broader scope than the rights, preferences or limitations that might be derived from holding a particular share.
\(^5\) S 164(2)(a)-(b).
\(^5\) S 164(3).
in writing to the resolution and had not withdrawn the objection.\textsuperscript{55} A shareholder may then demand that a company pay him the fair value of all the shares of the company held by that shareholder if the shareholder sent a written notice of his objection and, in the case of an amendment to the company’s Memorandum of Incorporation, holds shares of a class that are materially and adversely affected by the amendment, and such a resolution has been passed.\textsuperscript{56} There is a proviso to this right to the effect that the shareholder must have voted against the resolution\textsuperscript{57} and has complied with all the procedural requirements of section 164.\textsuperscript{58} Where a company failed to give notice of a contemplated meeting or failed to disclose the dissenting shareholder’s appraisal rights in such a notice, a dissenting shareholder is not required to send a notice of his objection in writing to the company.\textsuperscript{59} A dissenting shareholder who has given proper notice in terms of this section may make a demand for the fair value of his shares by giving the company written notice within 20 days after having received notice from the company of the adopted resolution.\textsuperscript{60} Once a demand has been sent, a shareholder will have no further rights in respect of the affected shares, except to the fair value thereof, unless he withdraws his demand or the resolution is revoked by the company,\textsuperscript{61} in which event his rights in respect of the affected shares are reinstated without interruption.\textsuperscript{62} Where a shareholder exercises his rights in this instance, the provisions of section 48 relating to share acquisitions will not apply.\textsuperscript{63}

\textsuperscript{55} S 164(4). S 164(4)(b) further requires that a person who has objected to a resolution should not have voted in favour of such a resolution. Why a person objecting to a proposed resolution would vote in favour of it seems unclear. It is also not clear how a company would be able to ascertain how a shareholder voted, except in the case where a vote was conducted by a show of hands.

\textsuperscript{56} S 164(5)(a)-(b).

\textsuperscript{57} As already indicated, it is unclear how a company could be aware of how a shareholder voted, especially where a vote was carried by way of a secret ballot. Given this fact, the provision appears superfluous and even nonsensical.

\textsuperscript{58} S 164(5)(c).

\textsuperscript{59} S 164(6).

\textsuperscript{60} S 164(7).

\textsuperscript{61} S 164(9).

\textsuperscript{62} S 164(10).

\textsuperscript{63} S 164(19). This subsection also states that such an action does not constitute a distribution and therefore s 46 will also not apply.
The new Act initially only provided for the exception with regard to the dissenting shareholders’ appraisal rights in terms of section 164. The second exception in respect of redeemable securities was added by the Companies Amendment Act 3 of 2011. The amended provision now enacts that the provisions of section 48 will not apply to the redemption by the company of any redeemable securities in accordance with the terms and conditions of those securities.\textsuperscript{64} This exception will later be discussed in detail.\textsuperscript{65}

3.3 The concept of a “distribution” – section 46

A repurchase of shares, or the acquisition of shares by a subsidiary in its holding company is regarded as a distribution in terms of the new Act. For the purposes of this dissertation, the relevant parts of the “distribution” concept are defined as follows:

‘distribution’ means a direct or indirect –

(a) transfer by a company of money or other property of the company, other than its own shares, to or for the benefit of one or more holders of any of the shares, or to the holder of a beneficial interest in any such shares, of that company or of another company within the same group of companies, whether –

(iii) as consideration for the acquisition –

(aa) by the company of any of its shares, as contemplated in section 48; or

(bb) by any company within the same group of companies, of any shares of a company within that group of companies;\textsuperscript{66} ...

\textsuperscript{64} § 48(1)(b).
\textsuperscript{65} See § 4.2 post.
\textsuperscript{66} See s 1 of the Act sv “distribution”. This definition thus provides that all acquisitions by companies within a group structure are regarded as distributions. This should be distinguished from the provisions of section 48 which only regulates the situation where a subsidiary company acquires shares in its holding company.
Distributions are now regulated by section 46 of the new Act. In terms of the provisions of this section, a company must not make a distribution unless it is pursuant either to an existing legal obligation of the company or a court order, or the board of the company has authorized such a distribution by way of a resolution.\textsuperscript{67}

For purposes of this dissertation, I shall focus on distributions authorized in terms of a resolution by the board of a company. Such distributions would typically include the pay-out of a dividend, share repurchases by a company, or a share acquisition by a subsidiary company in its holding company. The last two instances are of particular relevance in the context of this dissertation.

A distribution should only be made in instances where it reasonably appears that the company will satisfy the solvency and liquidity test immediately after completing the proposed distribution. This test is formulated in section 4 of the new Act. It states that the test is satisfied at a particular time if the assets of a company, fairly valued,\textsuperscript{68} equal or exceed the liabilities of that company at fair value, and it further appears that the company will be able to pay its debts as they become due in the ordinary course of business for twelve months after consideration of the test. In the case of distributions, a company should cover its debt for twelve months after the distribution. As a company must make a distribution within 120 business days after the resolution has been taken authorising such a distribution,\textsuperscript{69} it means that a company will have to cover its debt for a period in excess of twelve months.

The specification of the twelve-month time period has not escaped criticism. Van der Linde\textsuperscript{70} argues that although it creates more certainty for directors when authorising a distribution, it may be detrimental to a company’s creditors who have longer term commitments.

\textsuperscript{67} Section 46(1)(a).
\textsuperscript{68} Section 4(2)(b) requires the board to consider a fair valuation of the company’s assets and liabilities, including any reasonably foreseeable contingent assets and liabilities, irrespective of whether they arose from the proposed distribution, or otherwise. The board may also consider any other valuation of the company’s assets and liabilities that is reasonable in the circumstances. It is not quite clear what the legislature’s intention was by adding this last provision.
\textsuperscript{69} Section 46(3).
\textsuperscript{70} Van der Linde “The solvency and liquidity approach in the Companies Act 2008” 2009 TSAR 224 229.
that are not payable within twelve months. Her estimation is that the imposition thereof is undesirable and that the decisive factor should be the “ordinary course of business” of each company when judging its liquidity. She proposes that, in the event of an insistence on a specified time period, the use of a presumption that a company did not satisfy the test if it is liquidated within a certain time, would be a better solution. This would provide more protection to creditors than the test as it is currently formulated because they would not have to prove that the assessment made by the directors authorising the distribution was unwarranted if the company is liquidated within a certain period after the distribution.71

The test is objective in nature. It requires a company, and by implication its board,72 to consider all reasonably foreseeable financial circumstances of the company at the time when the test is applied. All the financial information that is considered must be based on accounting records and financial statements that satisfy the requirements laid down by sections 28 and 29 of the new Act.73 Van der Linde argues that the reference to debts as they become due or payable in the ordinary course of business implies that a cash flow prediction should be used, taking into account not only current assets of the company, but also future income, credit supplied and prospective liabilities of the company.74 The test is satisfied even if it later appears that the prediction was wrong, provided that the prediction was reasonable.75

When the test is applied under circumstances where a distribution is to be made in the form of money or property, any amount required to satisfy the preferential rights of preference shareholders upon liquidation should not be included as a liability, if those rights are superior

71 Van der Linde 2009 TSAR 229-230. She qualifies this proposal by hinting that a shareholder should be able to raise a lack of causation as a defence to escape liability for the repayment of a distribution. It is, however, emphasized by the author that she would prefer a simple test without the imposition of any time periods.
72 S 66(1) states that the board must manage the business and affairs of the company and that it has the authority to exercise all the powers and perform all the functions of the company, except to the extent that the Act or the company’s Memorandum of Incorporation provides otherwise.
73 S 4(2). S 28(1) requires that a company’s accounting records has to be accurate and complete, whilst s 29(1)(d) requires compliance with financial reporting standards.
74 Van der Linde 2009 TSAR 226.
75 Van der Linde 2009 TSAR 236.
to the preferential rights of the shareholders receiving the distribution.\textsuperscript{76} This qualification is only applicable when the test is applied in respect of a distribution in the form of a transfer of money or property.\textsuperscript{77} These rights should not be taken into account, unless the company’s Memorandum of Incorporation specifically stipulates that it should. It is unclear why this qualification is restricted to distributions by way of a transfer of money or property, thereby excluding distributions by way of incurrence or forgiveness of an obligation.\textsuperscript{78} It has been suggested that the preferential liquidation rights of preference shareholders are only relevant to the solvency leg of the solvency and liquidity test.\textsuperscript{79} This is due to the fact that these rights can never be regarded as debts due by the company in the ordinary course of business. It is argued, and correctly so in my opinion, that liquidation preferences should be taken into account in the solvency leg of the test, with an election to the company to exclude it expressly if not required.\textsuperscript{80} The rationale for this submission is that a company should not be allowed to make distributions to ordinary shareholders that will endanger the preferential rights to return capital that has been granted to such holders.\textsuperscript{81, 82}

As previously indicated, it is the board of a company who would ordinarily be tasked with applying the solvency and liquidity test. Where a distribution is made, the board has to

\textsuperscript{76} S 4(2)(c).
\textsuperscript{77} S 4(2)(c) only applies to a distribution made in terms of paragraph (a) of the definition of distributions, meaning a transfer of money or property.
\textsuperscript{78} Van der Linde 2009 TSAR 232. The author stresses that while it is clear that provision should be made in the appropriate circumstances for preferential liquidation rights where a distribution involves a transfer of money or property, the position regarding the other methods of distribution remains unclear. She submits that the uncertainty arises from the use of two negative phrases in the qualification and avers that a possible interpretation thereof is that, in instances of other distributions, the preferential rights should always be taken into account. The other possible interpretation is that they should never be taken into account, notwithstanding any provisions relating thereto in a company’s Memorandum of Incorporation. She correctly points out that both interpretations appear to be absurd.
\textsuperscript{79} Van der Linde 2009 TSAR 232.
\textsuperscript{80} Van der Linde 2009 TSAR 233.
\textsuperscript{81} Van der Linde 2009 TSAR 233.
\textsuperscript{82} It should be noted that the concepts of “ordinary” shareholders and “preference” shareholders has been abolished by the new Act. S 36 authorizes a company to issue different classes of shares. Each class will have a distinguishing designation, as well as preferences, rights, limitations and other terms associated with such class. The reference accorded to a preferential right attaching to a class of shares should be seen in this context.
acknowledge by way of resolution that it has applied the solvency and liquidity test, and that it has reasonably concluded that the company will satisfy the requirements of the solvency and liquidity test immediately after completing the proposed distribution. A distribution may only be made after such a resolution has been adopted.

If the distribution has not been carried out within 120 business days after the board acknowledged that it has applied the solvency and liquidity test, the test must be reconsidered and the board should not make any distribution, unless the board has adopted a further resolution acknowledging the new application of the solvency and liquidity test.

It would appear that once the board has made an acknowledgement in terms of section 46(1)(c), it is obliged to proceed with that distribution. The phrasing of section 46(2) is extremely unfortunate, as it directly conflicts with the objective requirement in section 46(1)(b). It has been proposed that provision should be made for a retraction of its acknowledgement by the board in cases where it subsequently appears that a company will no longer satisfy the solvency and liquidity test. This proposition should be supported and incorporated into the Act by way of an amendment, as a company should never be forced to proceed with a distribution where it no longer appears that it will satisfy the solvency and liquidity test. The current situation is in direct conflict with the principles and spirit upon which the new Act was founded.

Where a distribution is made that is contrary to the provisions of section 46, a director may incur personal liability. This will happen if such director was at the meeting where the board

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83 S 46(1)(c).
84 S 46(2).
85 Van der Linde 2009 TSAR 239.
86 S 46(2). It is submitted that this is inferred from the phrase “... the relevant distribution must be fully carried out, subject only to subsection (3)...” (my emphasis).
87 See Van der Linde 2009 TSAR 239. The author argues that a company may even be obliged to proceed with and complete a distribution within the initial 120-day period after the initial acknowledgement, even if the company no longer satisfies the solvency and liquidity test. It seems strange that a company can be obliged to proceed with a potentially unlawful distribution, simply by reason of an acknowledgement made by its board. It is submitted that this could never have been the intention of the legislature.
88 Van der Linde 2009 TSAR 239.
approved the distribution and the director failed to vote against the distribution, despite knowing that the distribution was contrary to the provisions of section 46. 89 It should be pointed out at this stage that “knowing” is defined in the new Act. 90 When the term is applied in respect of a person and regarding a particular matter, it can either mean actual knowledge of that matter or, in some circumstances, even deemed knowledge. A person would be deemed to have knowledge if that person was in a position in which he reasonably ought to have had actual knowledge, investigated the matter to an extent that would have provided him with actual knowledge, or taken other measures that would be reasonably expected to provide him with actual knowledge, and provided that such measures were taken. It is clear from this definition that a director will not be able to raise a defence of not having had knowledge of a contravention. It is submitted that the fiduciary duties owed to the company by a director in his capacity as director, combined with the concept of “deemed knowledge” derived from the definition of “knowing” in the Act, means that a director would always be deemed to have knowledge of a contravention of section 46. Even where there is no actual knowledge, the objective nature of “deemed knowledge” would always imply that a director reasonably ought to have known about a contravention of the provisions of section 46. A director should therefore always ensure that he possesses all information that might possibly be relevant when he participates in a decision to make a distribution in terms of section 46.

3 4  The requirements for a share repurchase

A decision to acquire its own shares has to be taken by the board of a company. 91 Initially the position was uncertain, as the Act was silent on who should take a decision on behalf of a

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89 S 46(6). Provision is also made in this section for the situation where directors can adopt a resolution in terms of s 74 by way of written consent. This means that where a director gave his written consent whilst aware that the distribution was in contravention of s 46, he would incur personal liability.

90 S 1 sv “knowing”, “knowingly” or “knows”.

91 S 48(2)(a).
company to acquire its shares.\textsuperscript{92} The Companies Amendment Act\textsuperscript{93} clarified this situation by amending section 48(2)(a) to stipulate that the board may determine that a company will acquire its own shares.

A company is prohibited from acquiring its own shares, if the result of such an acquisition would be that there would no longer be any shares in issue, other than those held by subsidiaries of the company, or all the remaining shares are convertible or redeemable.\textsuperscript{94}

An agreement with a company in terms of which the company acquires its own shares, is enforceable against that company, as long as there was a valid decision taken by the board of the company to acquire such shares and the acquisition does not have the effect that the only shares remaining in issue are held by subsidiaries of the company, or are redeemable or convertible shares.\textsuperscript{95} A third party who disposed of its shareholding in the company will therefore be able to enforce such an agreement against the company, if the above provisions have been fulfilled.

Where a company alleges that it is unable to fulfil its obligations in terms of an enforceable agreement due to the operation of section 48(2) and (3), it can approach a court for relief.\textsuperscript{96} If a court is approached in terms of this provision, the company carries the burden of proof to indicate that fulfilling its obligations pursuant to the agreement for the acquisition of the shares would put it in breach of the provisions of section 48(2) and (3).\textsuperscript{97} Should the company successfully discharge the burden of proof, the court may make an order that it deems just and equitable, after having had regard to the financial circumstances of the company.\textsuperscript{98} The court is also obliged to ensure that the person to whom the company is indebted in terms of the

\textsuperscript{92} The presumption created by s 66(1) entails that the board would have this authority, unless it was specifically excluded by the company’s Memorandum of Incorporation.

\textsuperscript{93} 3 of 2011.

\textsuperscript{94} S 48(3).

\textsuperscript{95} S 48(4).

\textsuperscript{96} S 48(5)(a). The section only refers to “a court”. The presumption of statutory interpretation that a word carries its ordinary meaning, unless there is an indication to the contrary, infers that this would include both the Magistrates’ Court and the High Court.

\textsuperscript{97} S 48(5)(b).

\textsuperscript{98} S 48(5)(c)(i).
agreement is paid at the earliest possible date compatible with the company satisfying its other financial obligations as they fall due and payable.\textsuperscript{99}

When a company acquires shares in contravention to the provisions of sections 46 and 48, it can, within 2 years after such an acquisition has been made, approach a court for an order to reverse the acquisition. The court may order the person from whom the shares were acquired to return the amount paid by the company and order the company to issue to that person an equivalent number of shares of the same class as those acquired by the company.\textsuperscript{100}

This provision is problematic. It might be of great potential prejudice to a shareholder or former shareholder of the company. One can take as an example the situation where a shareholder does not have the necessary capital or cash flow to reimburse a company for a repurchase that was effected in contravention of the provisions of sections 46 and 48. Where that company has approached a court and a subsequent order has been issued ordering a return of money, the shareholder who is unable to comply with it may find himself in contempt of such court order, even where he has been acting \textit{bona fide} at all times. This situation seems untenable.

A further provision was added with regards to the acquisition of shares by section 32(e) of the Companies Amendment Act.\textsuperscript{101} Section 48(8)(a) now requires that a decision by the board of a company for the acquisition of its own shares or for the shares of its holding company must be approved by a special resolution of the shareholders of the company if any of the shares to be acquired would be purchased from a director or prescribed officer of the company, or a person related to a director or prescribed officer of the company.\textsuperscript{102} It is submitted that the rationale behind this provision was probably to ensure transparency and

\begin{align*}
\textsuperscript{99} & \text{S 48(5)(c)(ii).} \\
\textsuperscript{100} & \text{S 48(6).} \\
\textsuperscript{101} & \text{3 of 2011.} \\
\textsuperscript{102} & \text{Related persons are defined in s 2(1) of the Act. In this context a related natural person would mean a person married to that person, or living in a relationship similar to a marriage or separated by no more than two degrees of natural or adopted consanguinity or affinity. A related juristic person would mean a juristic person that is directly or indirectly controlled by a director or prescribed officer of the company.}
\end{align*}
good corporate governance, whilst also affording protection to the shareholders against the
potential abuse of their powers by the directors of the company. Section 66(1) of the new Act
by implication confers the ultimate authority to the board to manage the company.

Section 48(8)(b) further requires a company to do an acquisition of its own shares or the
shares of its holding company by way of a scheme of arrangement in terms of sections 114
and 115 of the new Act, if the acquisition, considered alone or together with other transactions
in an integrated series of transactions, involves the acquisition by the company of more than
5% of the issued shares of any particular class of the company’s shares.

4 The evaluation of selected issues relating to the new provisions

4.1 The status of redeemable shares

As stated above, the exception regarding redeemable securities was only introduced by
the Companies Amendment Act. Before this enactment, there was great uncertainty whether
section 48 would apply to share redemptions. Because the term “acquisition” is not defined,
the question that arose was whether a redemption of redeemable securities would constitute
an “acquisition” for the purposes of section 48. The argument was that any dealing between a
shareholder and a company in terms of which a shareholder exchanges shares for
consideration, which would include redemption, could constitute an acquisition as defined in
the Act.

Under the 1973 Act, the redemption of preference shares were dealt with separately from
shares repurchases in general. This was because, unlike the provisions for share
repurchases in general, section 98 did not require a shareholder approval or the application of
the solvency and liquidity test.

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103 See §3.2 ante.
104 The new Act defines both “shares” and “securities”. The definition of “securities” includes shares.
105 3 of 2011.
107 The redemption of preference shares was regulated by s 98 of the 1973 Act, whilst share
repurchases in general were regulated by ss 85-88.
In terms of the new Act, all share acquisitions are treated in a uniform manner and in accordance with the provisions of section 48. The main concern regarding whether a redemption constitutes an “acquisition” is the provision contained in section 48(6) which gives a company the right to approach a court for an order to reverse an acquisition that was contrary to the provisions of sections 46 and 48 within two years of the date of that acquisition. As financing by way of redeemable securities is commonplace in the South African economic landscape, this would be a material issue for any holder or potential holder of redeemable securities. Redeemable securities would not be such a popular financing vehicle and attractive investment opportunity to potential holders where the issuing company could approach a court to reverse a redemption where the issuing company itself did not comply with the statutory provisions. In my opinion, the risk to holders of these redeemable securities would be far too great. For instance, in a situation where a redemption would be reversed by a court in terms of section 48(6), a holder would have to repay the capital amount received, possibly together with interest accrued after the repayment, to the issuing company. The holder’s only remedy under these circumstances would be to hold the directors personally liable in terms of section 77 to recoup their investment.

It is submitted that the inclusion of redeemable securities under the provisions of section 48 would have been the death knell to financing by way of redeemable securities in South Africa. This was probably one of the many reasons why redeemable securities were specifically excluded from the provisions of section 48 by the Companies Amendment Act.109

Whilst redeemable securities are now specifically excluded in terms of section 48, the redemption of such securities still constitutes a “distribution” as defined by the Act and is thus regulated by the provisions of section 46.110 The board of a company will subsequently still have to apply the solvency and liquidity test, along with all the other provisions of section 46.

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108 See *Webber Wentzel Comment on the Companies Amendment Bill [B 40-2010]* 7.
109 3 of 2011.
110 A redeemable share, due to the rights, preferences and limitations attached to it, will represent an existing legal obligation to the company and will subsequently fall under s 46.
It is unfortunate that the Companies Amendment Act of 2011 did not address the status of redeemable securities after the act of redeeming them has been concluded. Section 35(5) of the Act only refers to shares that are acquired in terms of section 48 and section 164. It is not clear whether it was the legislature’s intention to omit redeemable securities from section 35. The principles of company law dictates that these securities should be cancelled and either extinguished, or remain as authorised but unissued securities. Approached from a practical perspective, such securities should attain the status of authorized but unissued securities in line with the provisions of section 35(5). It is submitted that section 35(5) should be amended to include a provision to this effect.

4.2 Share acquisitions by subsidiaries in its holding company

The concept of company groups is an economical reality. This concept entails that there is a holding/subsidiary relationship. What follows is that a holding company is in a position where it controls it subsidiaries.

Several consequences flow from the existence of a company group, amongst other the fact that control is centralized under the holding company and that there is a requirement to prepare consolidated financial statements. What is of critical importance when dealing with company groups, is to strike a balance between the principles of separate legal entities with their own interests, assets and liabilities, and the significance of group relationships with regard to the opportunity and possibility of abuse.

An acquisition by a company of shares in its holding company is seen as an indirect share repurchase. This is due to the fact that the holding company ultimately exercises control over the subsidiary and would therefore be in the position to make the ultimate decision regarding a potential acquisition by the subsidiary.

111 Delport “Company groups and the acquisition of shares” 2001 SA Merc LJ 121.
112 See Delport 2001 SA Merc LJ 122; Bhana 2006 Stell LR 233.
113 See Salomon v Salomon & Co Ltd 1897 AC 22 (HL).
In terms of the new Act, a company is a subsidiary of another company if the latter, together with its subsidiaries and nominees, can directly or indirectly exercise or control the exercise of the general voting rights associated with issued securities of the former or has the right to appoint or elect, or control the appointment and election of directors of the former who control a majority of votes at a board meeting.\(^\text{114}\)

As previously indicated,\(^\text{115}\) the new Act allows the board of a subsidiary company to acquire shares in its holding company. There are two qualifications to these subsidiary acquisitions. The first is that the beneficial shareholding of all subsidiaries of a particular holding company may not exceed 10% in the aggregate of the issued shares of any class of shares.\(^\text{116}\) Secondly, no voting rights that may be attached to shares acquired by a subsidiary may be exercised while such shares are held by the subsidiary.\(^\text{117}\)

There are several advantages to allowing a subsidiary to acquire shares in its holding company.\(^\text{118}\) Chief amongst these are the increased flexibility it allows businesses to achieve sound commercial objectives. There is also a potential tax advantage to a company group where the holding company proposes to effect a share repurchase, as it can rather have a subsidiary acquire its shares subject to the qualifications of the Act. With these indirect shares acquisitions, no secondary tax on companies will be payable.\(^\text{119}\)

The biggest risk associated with these indirect share repurchases are the potential for abuse. Businesses can potentially mask or camouflage the true state of affairs by simulating certain acts using intricate group structures.\(^\text{120}\)

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\(^\text{114}\) S 3(1)(a). The ability to control the general voting rights is not limited to being pursuant to a shareholder agreement. This implies that parties will be able to create subsidiary relationships by virtue of consensus.

\(^\text{115}\) See §3.1 ante.

\(^\text{116}\) S 48(2)(a)(i).

\(^\text{117}\) S 48(2)(a)(ii).

\(^\text{118}\) Bhana 2006 \textit{Stell LR} 239-244.

\(^\text{119}\) See §4.3 \textit{post}.

\(^\text{120}\) Bhana 2006 \textit{Stell LR} 241.
One of the biggest issues identified after subsidiary acquisitions had for the first time been allowed by the 1973 Act, was the occurrence of what is now known as dividend “round-tripping”.\(^{121}\) This occurs when a wholly owned subsidiary receives a dividend from the shares it holds in its holding company. This amount is then paid back as a dividend to the holding company, which then pays it out to its shareholders, including the subsidiary, yet again as a dividend. This cycle perpetuates itself. While increased dividends are usually associated with an increase in earnings, this is not the case with round-tripping. The increased dividends are not additional income, but rather part of the original distributable income that is being redistributed. It is abundantly clear that this position represent an easy opportunity to misrepresent and/or distort the true state of affairs of a company to its creditors and minority shareholders.\(^{122}\)

Even though the issue around round-tripping was identified and criticised as early as 2001,\(^{123}\) the legislature failed to address the potential for abuse of control associated with it. To this day, this type of conduct is still possible. It is submitted that the fact that this issue was not addressed in the new Act constitutes a missed opportunity to curtail this potential abuse of control.

Another issue that arises where a company holds a share in its holding company, is the situation where the former company declares a dividend *in specie* of the shares in its holding company. This would entail that the holding company now acquires shares in itself through the dividend *in specie* and the question that inevitably arises is what the status of these shares would be after this action.\(^{124}\) The acquisition was not done in terms of section 48, which means

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\(^{121}\) See Delport 2001 *SA Merc LJ* 124; Bhana 2006 *Stell LR* 241-242; *The Unisec Group Ltd v Sage Holding Ltd* 1986 3 All SA 1 (T) 5-6.

\(^{122}\) See the reference by Coetzee J in the *Unisec* judgment at 6 to this phenomenon as being fraught with “evil and mischief”.

\(^{123}\) Delport 2001 *SA Merc LJ* 124-125.

\(^{124}\) Delport 2001 *SA Merc LJ* 127.
that the shares will not be regarded as authorised unissued shares.\textsuperscript{125} Section 35(3) of the new Act prohibits a company from issuing shares to itself. Although it is not the holding company but rather the subsidiary company issuing the shares here, the issue surrounding the status of these shares are still not properly addressed. The position in terms of the 1973 Act would have entailed that the common law must apply.\textsuperscript{126} It is submitted that this would still be the case, as the new Act does not specifically provide for this situation. The inevitable outcome would therefore still be that, under the remnants of capital maintenance, the shares acquired in this way would have to be extinguished.\textsuperscript{127} This is an unfortunate consequence, because it is clear that the purpose of the new Act is to abolish all remnants of the principles of capital maintenance. Against this backdrop, the legislature’s failure to address this deficiency is nothing short of astounding.

It has been pointed out as early as 2006 that, when permitting a subsidiary acquisition in its holding company, one is dealing with two separate legal entities and the question that arises is which company ought to comply with the relevant legislative provisions of such an acquisition.\textsuperscript{128} Whilst section 48 expressly enacts that the subsidiary company’s board should authorise the acquisition in the holding company, the Act is unclear as to which entity should comply with the provisions of section 46. The question becomes particularly relevant given the personal liability of directors which results from a distribution that contravenes the provisions of section 46.\textsuperscript{129} Although common sense dictates that it should be the subsidiary company that complies with section 46, one has to bear in mind that the counter party in such an indirect share acquisition controls the subsidiary. When one is dealing with a wholly owned subsidiary, the \textit{de facto} decision to acquire shares in the holding company is in actual fact then taken by the holding company. Given this fact, it should be prudent when dealing with acquisitions

\footnotesize{\textsuperscript{125} S 35(5). Even though the original acquisition of the shares in the holding company was effected in terms of s 48, the declaration of a dividend \textit{in specie} in no way constitutes a share acquisition in terms of s 48. \\ \textsuperscript{126} Delport 2001 \textit{SA Merc LJ} 127. \\ \textsuperscript{127} Delport 2001 \textit{SA Merc LJ} 127. \\ \textsuperscript{128} Bhana 2006 \textit{Stell LR} 238. \\ \textsuperscript{129} S 46(6).}
where the acquiring party is a wholly owned subsidiary, to ensure that both companies comply
with the provisions of section 46. It is, however, submitted that the legislature’s failure to
address the relevant compliance with section 46 properly should be rectified by effecting an
amendment to require compliance by the subsidiary company and, in the case of a wholly
owned subsidiary, by the holding company as well.

4.3 The tax implications of a share repurchase and subsidiary acquisitions

Although I shall not endeavour to address the tax relevant implications in detail, a basic
understanding of the tax treatment will be presented. When one analyses the tax implications
of share repurchases and subsidiary acquisitions, the Income Tax Act\textsuperscript{130} should be considered
in addition to the provisions of the new Act.

There are two recent developments regarding taxation that became effective as of 1
January 2011. The first development was the insertion of a new definition for “dividend” in the
Income Tax Act.\textsuperscript{131} “Dividend” now means any amount transferred or applied by a company for
the benefit of any shareholder in relation to that company by virtue of any shares held by that
shareholder in that company, whether by distribution or as consideration for the acquisition of
any share in that company.\textsuperscript{132} It is therefore clear that share repurchases are included in this
definition. There are a number of exclusions from the definition. Chief amongst them are
acquisitions by companies listed on the JSE of its own shares. These acquisitions are done in
terms of the JSE Listing Requirements.

The other development is the concept of “contributed tax capital” (“CTC”). A company’s
CTC consists of its stated capital or share capital and share premium immediately prior to 1
January 2011, minus so much stated capital, share capital or share premiums that would have
constituted a dividend under the old definition of a “dividend”, had it been distributed by the

\textsuperscript{130} 58 of 1962.
\textsuperscript{131} 58 of 1962.
\textsuperscript{132} S 1 sv “dividend”.

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company before that date, plus consideration received or accrued to the company for the issue of shares on or after 1 January 2011. The relevance of the concept of CTC is that in the event of a non-listed company repurchasing its own shares, the amount for such shares shall not constitute a dividend for tax purposes if the amount paid for the repurchase of the shares results in a reduction of CTC.

Where consideration for a repurchase is covered by the definition of a “dividend” for tax purposes, a company will be liable to pay “secondary tax on companies” (“STC”) at a rate of 10% of the net amount of the distribution. Such an amount is deemed to have been declared by the company on the date on which shareholders become entitled to the distribution.

The definition of “gross income” in section 1 of the Income Tax Act includes any amount received or accrued to a shareholder by way of dividend. Dividends received from South African companies are exempt from taxation in the hands of the shareholder. However, this exemption is not applicable where it forms part of a consideration in respect of a share repurchase were the shares bought were held as trading stock.

To the extent that a distribution does not constitute a dividend, there might be potential “capital gains tax” (“CGT”) implications. Such an amount will constitute a “capital distribution” which is defined as any distribution, or part thereof, that does not constitute a dividend.

Where a capital distribution is received, it must be treated as proceeds when disposing of the share. This means that where a capital contribution with regard to a share repurchase exceeds the base cost, a taxable capital gain would have been achieved. CGT will be payable on this taxable gain.

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133 Ibid.
134 S 64B(4)(c).
135 S 10(1)(k)(i).
137 Para 76.
5  A comparative perspective – the Canadian position

5.1  The Development of Canadian corporate law

Until the latter half of the eighteenth century, corporate activity in Canada was negligible. This was mostly due to the fact that most corporate activity in the English colonies was carried out by English companies, operating from England.\(^{138}\) The pervasive influence of English trading monopolies, together with colonial exploitation and the questionable status of companies after the Bubble Act were the major contributors to the lack of corporate activity in Canada at that stage.\(^{139}\)

The first incorporation of Canadian businesses occurred during the nineteenth century. The incorporation of businesses was effected in three different ways.\(^{140}\) An individual corporation\(^{141}\) could be created by the British Parliament. A corporation could also be created by the applicable colonial legislation, or under general statutes that were passed to help incorporation in certain industries.

During this time, there was a clear tendency to follow and adopt the American experiences when it came to business matters. This included the use of general incorporation legislation as easy methods of incorporation.\(^{142}\) The approach led to the introduction of Canada’s first general statute of incorporation in 1850. Generally, the Canadian legislature preferred the American approach to the more complex approach adopted by the English legislature with the Joint Stock Companies Act of 1844.\(^{143}\) American influences were growing rapidly in the Canadian economy. This was greatly due to the combined factors of the free trade philosophy


\(^{139}\) Welling 49. See fn 22 for an explanation of the great stock swindle that resulted from the South Sea Bubble.

\(^{140}\) Welling 50-51.

\(^{141}\) A “corporation” in the Canadian context is similar to our concept of a “company”.

\(^{142}\) Welling 51.

\(^{143}\) 7 & 8 Vict c 110 (UK).
of English liberalism trumping the former colonial trade preferences, as well as the rapidly expanding American economy of that period.\textsuperscript{144}

During the nineteenth century, there were two types of corporate statutes in Canada. There were the \textit{letters patent} statutes which resembled the Charter Corporations prevalent in England before 1720, and the English model statutes,\textsuperscript{145} which created corporations similar to the companies created under England’s Joint Stock Companies Act of 1844.\textsuperscript{146}

The division in Canada between the two models was predominantly geographical in nature.\textsuperscript{147} Until the 1870’s the Canadian provinces existing at the time, namely Ontario, Quebec, New Brunswick, Nova Scotia, Prince Edward Island and Manitoba, as well as Canada’s federal jurisdiction primarily featured the \textit{letters patent} model. The three westernmost provinces of British Columbia, Alberta and Saskatchewan, together with Newfoundland, all adopted the English model. Nova Scotia discarded the \textit{letters patent} model in favour of the English model at the beginning of the twentieth century.

\section*{5.2 Legislative reforms and the Canada Business Corporations Act}

Canadian corporate law was radically reformed during the 1970’s.\textsuperscript{148} It started when Ontario discarded the \textit{letters patent} statute and dismissed the English model as also being outdated. The result was a completely overhauled and new system, combining the American model statute\textsuperscript{149} with some innovative statutory remedies.\textsuperscript{150}

\begin{flushleft}
\textsuperscript{144} Welling 52.
\textsuperscript{145} This model is also referred to as the “contractarian” model, the reason therefore being that the principle underlying this model is the fact that a company’s statute is a contract between the company and its individual shareholders and that all rights derived from it are therefore contractual in nature.
\textsuperscript{146} Welling 44.
\textsuperscript{147} Welling 54-55.
\textsuperscript{148} Welling 55-57.
\textsuperscript{149} The American model relied on a division of power regime.
\textsuperscript{150} Welling 55.
\end{flushleft}
In 1975 the Canada Business Corporations Act\textsuperscript{151} (“CBCA”) was adopted. This legislation was essentially a variation of the reforms initiated in Ontario during the early seventies. Most of the Canadian provinces, with the exception of Nova Scotia, Prince Edward Island and British Columbia adopted statutes remarkably similar to the CBCA, whilst Quebec partially enacted the new model.\textsuperscript{152}

The effect of this reform was that corporate law in most parts of Canada was now based on four major principles, being corporate personality, managerial power, majority rule and minority protection.

This new model relied on a statutory division of power. All participants in a Canadian corporation are differentiated as directors, officers and shareholders.\textsuperscript{153} The model does not constitute a contract amongst the participating individuals, but each person attaining a particular status is assigned statutory obligations in terms of the articles of incorporation of the specific corporation.

There are vast differences between this model and the English model. The English model is based on a statutory contract entered into between the individual shareholders and the company respectively. As such, each individual shareholder has certain rights and obligations arising from the provisions of the agreement entered into with the company and the other shareholders. The CBCA model can be distinguished in that it is based on a statutory division of powers, and is fundamentally oriented towards a stakeholder’s status and remedies, as opposed to the rights-oriented approach of the English model.\textsuperscript{154}

For the purpose of this dissertation, I shall focus on the CBCA model which is based on a statutory division of powers.

\begin{thebibliography}{9}
\bibitem{151} SC 1974-75 c 33.
\bibitem{152} Welling 56.
\bibitem{153} Welling 59-60.
\bibitem{154} Welling 58.
\end{thebibliography}
5.3 The nature of shares in Canadian corporate law

A share is classified as property. It describes certain rights that the proprietor of that share has. These rights are different in nature and can be exercised in different ways against different entities or persons.\textsuperscript{155} The totality of all rights, privileges, restrictions and conditions comprises a share.\textsuperscript{156}

Shares allocate risk of loss, power of control and participation in a corporation’s profits.\textsuperscript{157} All shares are regarded as equal, unless a corporation’s articles of incorporation provides otherwise. Most corporations create different classes of shares with differing participation rights. The rationale behind this division is the element of flexibility which is brought about by the division.\textsuperscript{158} Prospective shareholders have a range of choices regarding a potential investment in a corporation. This will range from primarily investing in the potential of an enterprise to being active participants in the future control of the corporation.\textsuperscript{159}

Whilst shares were traditionally divided into “common” shares and “preference” shares, this terminology has since been abandoned.\textsuperscript{160} Corporations are now authorised to provide for more than one class of shares, provided that the corporation’s articles of incorporation set out the rights, privileges, restrictions and conditions attaching to the shares of each potential class.\textsuperscript{161}

A class of shares is described as a sub-group of shares to which the corporate constitution assigns rights and conditions in common, which distinguish them from other shares.\textsuperscript{162} The general rule under statutory provisions like section 24(4) of the CBCA provides that the rights,
privileges, restrictions and conditions attaching to the shares of each class must be provided equally to all the shares of that particular class.  

5 4  **Acquisition of its own shares by a corporation**

The notion of the acquisition by a company of its own shares was a foreign concept in Canadian corporate law until the reform of the 1970’s. The CBCA and its various provincial variations now contain certain provisions allowing corporations to purchase their own shares. The provisions relating to these share acquisitions are very broad and not particularly prescriptive. There are no guidelines and the emphasis is rather placed on the use of solvency tests and shareholder remedies.

A purchase or redemption of a corporation of its own shares constitutes a reduction in the capital of the corporation. This is an exception to the principle of capital maintenance and is strictly regulated.

The Canadian statutes make provision for a general prohibition, similar to the test as laid down in *Trevor v Whitworth*, with exceptions. These exceptions include *inter alia* situations where the statutes and articles of a corporation provide for a repurchase of shares, or where a *bona fide* compromise of a dispute relating to shares takes place and where a corporation accepts a voluntary surrender of fully paid-up shares. The general prohibition prohibits a corporation from holding its own shares or those of its holding corporation. It further prohibits a corporation from permitting its subsidiary bodies corporate from acquiring its shares. The exceptions to the prohibition are found in sections 30(2) and 31 to 34 of the CBCA.

163 Welling 604.
164 See Trichard et al 64-65. The suggestion was only made in 1960 for the first time. Initially, the reaction was unfavourable.
165 Trichard et al 66.
166 Trichard et al 65.
167 Trichard et al 65.
168 S 30(1) CBCA.
Section 30(2) states that where a subsidiary body corporate is not a corporation in terms of the CBCA, the holding corporation must cause such subsidiary body corporate to dispose or sell any shares held in it within five years from the date on which the subsidiary body corporate became a subsidiary, or from the date since when the holding corporation continued under the CBCA. There is thus a positive duty on the holding corporation to ensure that the subsidiary disposes of shares in the holding corporation held by the subsidiary. The holding corporation can ensure compliance with this provision, because it has control over the subsidiary.\(^{169}\)

Section 31(1) permits a corporation to hold shares in itself for the purpose of attaining or maintaining a specific level of Canadian ownership or control to enable the corporation to qualify under federal or provincial law for licences, permits, grants, benefits or payments. The exception in section 31 also permits the holding of both the shares of a corporation and its holding body corporate as legal representative or by way of security for the purpose of a transaction entered into by a corporation in the ordinary course of business that includes the lending of money.\(^{170}\)

Sections 32 to 34 relate to the purchase, acquisition and redemption of shares issued by a corporation. Provision is made for three separate instances where a corporation may acquire its own shares. A corporation may firstly acquire its own shares to satisfy the claim of a dissenting shareholder or court order.\(^{171}\) Secondly, and provided that it would remain solvent and liquid, a corporation may, subject to its articles, acquire its own shares to settle or compromise a debt or claim, to eliminate fractional shares, or to fulfil an agreement to repurchase shares from a director, officer or employee of the corporation.\(^{172}\) Thirdly, a corporation may acquire its own shares for any other purpose, provided that such a purchase

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169 The nature of the relationship between a holding entity and its subsidiary implies that the holding entity has effective control of the subsidiary.

170 See Trichard et al 66.

171 S 33(2) CBCA. In this particular instance, there is no requirement for a two-pronged solvency and liquidity test as required in the other two instances discussed hereafter.

172 S 33(1) CBCA.
would not make the corporation insolvent.\textsuperscript{173} This means that a corporation can essentially acquire its own shares for whatever reason it deems necessary, provided that it is authorised to do so by its articles of incorporation and the acquisition would not have the effect of making the corporation insolvent.

The solvency test under section 32 of the CBCA is two-fold in nature and a failure to comply with the requirements will prevent the corporation from making any payment necessary to acquire shares. The first leg entails that, to avoid the prohibition, the corporation must have reasonable grounds for believing that the corporation is at the time of payment, or would after the payment, be unable to meet its liabilities as they become due.\textsuperscript{174} This is the liquidity leg of the test. The second leg requires that there must not be reasonable grounds for believing that the realizable value of the corporation’s assets would be less than the aggregate of its liabilities and its stated capital of all classes.\textsuperscript{175} This is the solvency leg of the test. There may be instances where a corporation may have difficulty determining the realizable value of its assets. For example, how would one determine the value of patents and trademarks?\textsuperscript{176} Another example that springs to mind, concerns the goodwill of a corporation. A corporation may have difficulty in valuing its goodwill. The goodwill in this context will be the premium that a prospective buyer is willing to pay to actually acquire the business. This implies a very subjective valuation, as different people will place differing premiums on what they are willing to pay for a business. There may even be instances where the goodwill of a company should not be treated as a realizable asset.

After a company has acquired or redeemed its shares, such shares are either to be cancelled or restored to the status of authorised unissued shares.\textsuperscript{177} They are subsequently no longer “held” by the corporation in the true sense of the word. This situation differs from the

\begin{footnotes}
\footnote{173} S 32 CBCA.
\footnote{174} Trichard \textit{et al} 66.
\footnote{175} Trichard \textit{et al} 66-67.
\footnote{176} Trichard \textit{et al} 67.
\footnote{177} S 37(5) CBCA.
\end{footnotes}
so-called “treasury shares” of certain jurisdictions\textsuperscript{178} in terms of which legal entities are allowed to hold shares in itself, without having to cancel those shares.

A redemption of shares may be made where shares have been issued as redeemable shares and the redemption or purchase price does not exceed the redemption price as stated in the corporation’s articles, or is calculated according to a formula that is stated in the corporation’s articles.\textsuperscript{179} The redemption of shares is also restricted by a solvency test. This solvency test is, however, generally less onerous than the test laid down in section 32(2)(b) of the CBCA.\textsuperscript{180}

When an acquisition or redemption has not satisfied the solvency test, the directors of a corporation are personally liable for any unrecovered amount paid by the corporation.\textsuperscript{181}

6 Conclusion

As indicated, significant strides have been taken in the roughly 120 years that have passed since the rule in \textit{Trevor v Whitworth}, prohibiting the repurchase by a company of its own shares, was formulated. Whilst the 1973 Act was initially founded on the principles of capital maintenance, the Companies Amendment Act\textsuperscript{182} introduced the concept of solvency and liquidity into South African company law for the first time in 1999. The decision in \textit{Capitex Bank Ltd v Quorus Holdings Ltd} confirmed that the outdated concept of capital maintenance was now replaced by the dual requirement of solvency and liquidity, even though the principle of capital maintenance still fulfilled the residual function of protecting the creditors and minority shareholders of a company.

\textsuperscript{178} The United States recognises the concept of treasury shares and it is regulated by various pieces of legislation in the different states. In the United Kingdom, the Companies Act of 1993 repealed the initial ban on treasury shares that was prevalent in the United Kingdom.

\textsuperscript{179} S 37(1).

\textsuperscript{180} Trichard et al 67.

\textsuperscript{181} S 113(2) CBCA.

\textsuperscript{182} 37 of 1999.
With the introduction of the new Companies Act,\textsuperscript{183} the concept of capital maintenance was finally abolished. The principles of solvency and liquidity now replaced it as the basis for the capital rules in the new legislation. Whereas the provisions relating to acquisitions by a company of its own shares were very prescriptive and elaborate under the 1973 Act, the new Act introduced a very broad procedure that was generally devoid of guidelines.\textsuperscript{184}

In terms of the new Act, the onus is now on the board of directors, possessing the ultimate authority to act on behalf of and manage the company, to ensure that a company complies with the solvency and liquidity requirements as defined and prescribed. Where there is non-compliance with the statutory requirements, directors run the risk of incurring personal liability for potential losses suffered as a result of such non-compliance. This personal liability arises from the fiduciary duty that directors owe to a company. As indicated, the new statutory definition of “knowing”, “knowingly” and “knows” might prove extremely problematic to a board in that it might deter directors from acknowledging that they have applied the solvency and liquidity test, for fear of the risk of incurring personal liability. This can partially be attributed to the fact that the implication of the statutory definition is that even where directors did not have actual knowledge, they might still run the risk of incurring personal liability.\textsuperscript{185}

The new statutory requirement for distributions as set out in section 46 is not without issues. What appears to be the major flaw of these new provisions is the fact that, as the relevant section currently reads, it appears that, once the board has made the initial acknowledgement that it has applied the solvency and liquidity test, it has to proceed with the proposed distribution where it falls within 120 business days after the initial acknowledgement. This will even be the case if it later appears that the solvency and liquidity requirement may no longer be satisfied after the distribution.\textsuperscript{186} As emphasized, it is of paramount importance that the Act be amended to provide for a retraction of the initial acknowledgement in circumstances where it appears, before the proposed distribution, that the company would no longer satisfy

\textsuperscript{183} 71 of 2008.
\textsuperscript{184} See §2 3 and §3 1 ante.
\textsuperscript{185} See §3 3 ante.
\textsuperscript{186} See §3 3 ante.
the solvency and liquidity requirements. Such a provision would in my opinion also go a long way towards alleviating the risk of incurring personal liability when directors are contemplating a proposed distribution.

What further becomes abundantly clear when one reviews the Act, is that it is still rife with grammatical errors and omissions. As indicated, the cross referencing between sections 164 and 38, where the former refers to a “materially adverse” effect and the latter to “materially and adversely”, leads to great uncertainty as to what the legislature’s exact intention was.187 When one considers the fact that the Companies Amendment Act188 presented an ideal opportunity to address these issues, it is almost inconceivable that elementary errors of this kind are still blemishing the Act. What is even more disconcerting, is that such an amount of oversights, uncertainties and ambiguities appear from a dissertation of limited scope, like this one, in which only a few sections of the new Act have been subjected to scrutiny.

As previously indicated, the legislature inexplicably squandered the opportunity to address the issues relating to subsidiaries acquiring shares in their holding companies in the new Act.189 When one takes cognisance of the fact that there are publications dating back more than 10 years, alluding to the issues relating to the round-tripping of dividends and the situation where a dividend in specie is declared, the failure to address these issues at all in the new Act becomes even more perplexing. It is submitted that both these issues should be addressed by enacting an amendment to the Act to the effect that shares held by a subsidiary shall not be entitled to receive dividends for as long as those shares are held by a subsidiary.

The other issue that was referred to in respect of distributions, is the Act’s failure to stipulate who should comply with the provisions of section 46 where a subsidiary acquires shares in its holding company.190 What is significant in this regard, is the fact that the holding company ultimately exercises control over the subsidiary and will subsequently make the

187 See fn 51 ante.
188 3 of 2011.
189 See §4 2 ante.
190 See §4 2 ante.
decision. The Act should be amended to make express provision that the subsidiary company must comply with section 46. Only in the case of a wholly owned subsidiary should the holding company also be required to satisfy the requirements of section 46. Such a proposed amendment would recognise the principle of a separate legal personality with regard to the separate entities, whilst also acknowledging the concept of company groups and the possibility of abuse.

Although some of the uncertainties pertaining to the status of redeemable securities have been clarified after the enactment of the Companies Amendment Act, there are still doubts regarding the legislature's exact intention in respect of these shares. Section 35(5) should also be amended to provide for redeemed shares to attain the status of authorised unissued shares, as the only possible inference can be that this must have been the legislature’s intention.

In principle, the basis and rationale behind the new corporate legislative dispensation cannot be faulted. In the fast-paced and ever developing modern global economy of the 21st century, the need for change was inevitable. What has, however, become abundantly clear, as partially illustrated in this dissertation, is that a host of issues and concerns has not been properly addressed before the new Act came into operation on 1 May 2011. Whilst one can only speculate as to the exact reason for this, you are inevitably forced to draw the conclusion that this new piece of legislation lacks transparency and is fraught with clumsy errors. This assertion brings to mind the age-old adage: If one cannot set out to do something properly, why bother in the first place?

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