

CORPORATE LAW:

A Legal Comparison between section 38, 226, 90
and 85 of the Companies Act, 1973, and
section 44, 45, 46 and 48 of the
Companies Act, 2008

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1. Introduction

The current Companies Act¹ demonstrates many deficiencies and does not meet all the requirements of modern companies.² The most important deficiencies in it relate to capital maintenance rules, corporate governance and shareholder protection.

The concept of par value shares is of no economical significance, as shares exist with low par value or of no par value. This concept has been scrapped altogether in many jurisdictions. The concept of par value shares also forms part of the capital maintenance rule, which many jurisdictions have replaced with more effective forms of protection for creditors. The capital maintenance rule has to a large extent been rendered ineffective in South African law through amendments to the present Companies Act. Among other things, the rule does not allow companies to make distributions to its shareholders out of its capital and also prohibits companies from providing financial assistance for the acquisition of its shares.³

Corporate governance has predominantly been regulated by common law and codes of corporate practice rather than by statute. This has resulted in confusion and uncertainty, especially with regard to the fiduciary duties of directors.⁴

Another downside of the prevailing Companies Act is that it lacks effective enforcement mechanisms, resulting in directors and senior management, to a large extent being rendered immune to their wrongdoings and negligence. Litigation by offended parties are often expensive and protracted, whilst class actions and attorneys' contingency fees are still relatively novel and immature. Another problem is that the public institutions tasked with the investigation of,

¹ Act 61 of 1973.

² Harty Rushmere *The e-files* Volume 13 (Oct 2004).

³ See vn 2.

⁴ See vn 2.

and possible enforcement of remedial measures against such wrongdoings and negligent actions lack adequate resources and powers in terms of the current Act.⁵

The objective of the new Companies Act⁶ is to render company law more readily accessible and to make it simpler by maintaining the least possible mandatory rules and prohibitions. Moreover, it endeavors to bring company law in line with the company laws of other countries. In doing so, it is believed that it will give rise to increased certainty in the conduct of business which would result in more foreign investments. In addition, it aims to encourage reference to a wide range of judicial precedents, opinions and practice, thereby reducing the uncertainty and costs of litigation.⁷

The current Act gives priority to the interests of shareholders and creditors and takes little (if any) regard to the interests of others who have significant interests in companies, albeit not by way of profits or credit.

The new Companies Act will change virtually all the rules relating to all aspects of a company. Some of the important changes relate to the following:

2. Financial Assistance: Section 38 of the 1973 Companies Act

Originally, the provisions of section 38 of the Companies Act of 1973, (Act No. 61 of 1973 - "Act") was derived from the English Companies Act of 1948, which prohibited companies from providing financial assistance for purposes of the acquisition of their own shares.⁸ It was incorporated into the Act in support of the

⁵ See vn 2.

⁶ Act 71 of 2008.

⁷ See vn 2.

⁸ Heidi Miller and Mzi Mgudlwa *Financing empowerment – The implications of Section 38 of the Companies Act (2003\037\BEE\CR) p2.*

rule that a company may not purchase its own shares and thereby reduce its capital, in order to protect the interests of creditors and minority shareholders.⁹ However, section 38 of the Act currently alleviates the matter by determining that the provision by a company of financial assistance to a person for the purchase by that person of the company's own shares does not necessarily lead to a reduction of capital, provided that the person in question is able to comply with his, her or its duty to repay the shares.¹⁰

The Companies Amendment Act, 1999 (Act No. 37 of 1999), later repealed the prohibition against a company buying its own shares, without removing the prohibition in section 38 of the Act. The legislature incorporated the solvency and liquidity test into the share repurchase provisions as a substitute for the capital maintenance principle, since positive results in terms of the aforesaid test is considered as adequate protection for minority shareholders and creditors.¹¹

This legal reformation would be in line with international company law, such as the New Zealand Companies Act of 1993, which treats financial assistance given by a company for the purchase of its shares as being the same as a company buying back its own shares. This is allowed as long as the solvency and liquidity test is complied with and the financial assistance is limited to a maximum of five per cent of shareholder capital.¹²

The solvency and liquidity test provides protection for minority shareholders and creditors for the purpose of a repurchase of shares.¹³ This test allows funds to be made available for the repurchase of shares only when the funds do not exceed the net assets of the company. The liquidity test prohibits a company from making any payment to acquire shares that it has issued if there are reasonable grounds for believing that the company is, or would after the payment be, unable

⁹ See vn 8.

¹⁰ See vn 8.

¹¹ See vn 8.

¹² See vn 8.

¹³ Section 85 of the Companies Act 61 of 1973.

to pay its debts as they become due in the ordinary course of business. The solvency test, in turn, prohibits a company from making any payment to acquire shares that it has issued if there are reasonable grounds for believing that the fairly valued consolidated assets of the company, after the payment, would be less than the consolidated liabilities of the company.¹⁴

These tests provide sufficient protection for minority shareholders and creditors of the company and similarly, should also provide sufficient protection with regards to the provision of financial assistance to third parties for purposes of acquiring shares in the company. Should additional protection be required, it would be possible for the legislature to designate special circumstances where financial assistance may be given and also to limit the extent of such financial assistance.¹⁵

2.2 Section 38 and Subsidiaries

Section 38(1) of the Act generally prohibits a company from giving any financial assistance, whether directly or indirectly, for the purchase of, or subscription for its shares. It also does not allow a subsidiary to provide financial assistance to any person for the purchase or subscription of shares in its holding company.¹⁶ The extension of this prohibition to a subsidiary expressly ignores the fundamental principle of company law as referred to in *Salomon v A Salomon & Co Ltd* [1897] AC 22 (HL), namely, that a subsidiary is to be regarded as a separate legal entity from its holding company and should therefore be treated the same as any other unrelated independent company. A statement in this vein was made in *Adams v Cape Industries Plc* [1991] ALL ER 927 (ChD and CA), at 1019, by Slade LJ:

¹⁴ See vn 8.

¹⁵ See vn 8.

¹⁶ FHI Casim *Unravelling the Obscurities of Section 38(2)(d) of the Companies Act* 122 SALJ 493 2005.

‘Our law for better or worse, recognises the creation of subsidiary companies, which though in one sense the creatures of their parent companies, will nevertheless fall to be treated as separate legal entities with all the rights and liabilities which would normally attach to separate legal entities.’

Section 38(1) discards this principle and instead treats the holding company and its subsidiaries as one entity. These provisions do however not apply to the converse, in that they do not prohibit a holding company from giving financial assistance for the purchase of, or subscription for shares in its subsidiary.¹⁷ Furthermore, the said section does not forbid the provision of financial assistance for the purchase of, or subscription for shares in any subsidiary of a subsidiary of a holding company.¹⁸ In this vein, Gower states that sections 151 – 153 of the English Companies Act of 1985, which prohibit the provision of financial assistance by a company for the purchase of its shares, likewise do not apply to financial assistance given by a holding company for the acquisition of shares in its subsidiary company.¹⁹

The origins of the general prohibition against the giving by a company of financial assistance for the acquisition of its shares can be traced back to 1926. At the time the Greene Committee²⁰ drew attention to the potential for abuse that arises when speculators or financiers use the funds of a company to pay for the purchase by them of the company’s shares. This undesirable practice received further attention from Lord Greene in *Re VGM Holdings Ltd* [1942] 1 ALL ER 226; [1942] Ch 235 (CA) and was referred to by Schreiner JA in *Goldwell (Pty) Ltd v Rostra Printers Ltd* 1959 (4) SA 419 (A) at 426A.²¹ In *Chaston v SWP Group plc* [2003] 1 BCLC 675 (CA) in para 31, Arden LJ viewed section 38 in the modern context and stated: ‘The general mischief, however remains the same,

¹⁷ See vn 16.

¹⁸ G Brian Parker & Martin Buckley *Buckley on the Companies Act* 14 ed (1981) vol 1 at 156, in relation to section 54 of the English Companies Act, 1948 which is identical to section 38(1) of the Companies Act.

¹⁹ Paul L Davies *Gower and Davies’ Principles of Modern Company Law* 7 ed (2003) 261n52.

²⁰ *Company Law Amendment Committee Report* (1926) Cmnd 2657 paras 30 – 31.

²¹ See vn 16.

namely that the resources of the target company should not be used, directly or indirectly to assist the purchaser financially to make the acquisition.'

While other countries which adopted the same prohibition have since modified and scaled it down, section 38 of the Act has remained virtually unchanged in its original form, except for the insertion in 1999 of section 38(2)(d) into the Act. After laying down the general restriction against the provision of financial assistance for the purchase of shares of a company, section 38(2) specifies four exceptions to the prohibition where transactions of this nature are permitted. Only the fourth exception in section 38(2) merits discussion in this case. It reads as follows:

'The provisions of subsection (1) shall not be construed as prohibiting -

(a)

(d) the provision of financial assistance for the acquisition of shares in a company by the company or its subsidiary in accordance with the provisions of s 85 for the acquisition of such shares'²²

The quoted part of the section appears to be poorly drafted with a lack of punctuation. Accordingly, it is difficult to construe and open to different interpretations. It is therefore not surprising to find that textbook writers and academics have different views and opinions with regard to the meaning of this specific section. Blackman *et al* are content to state in a terse paragraph that the meaning of section 38(2)(d) is not obvious and that: '... it is unclear how a company can give itself financial assistance to purchase its own shares or the shares of its holding company.' They continue by stating: '... perhaps it was intended that section 38(2)(d) should refer, not to section 85, but to section 89.'²³ Henochsberg discards the first part of section 38(2)(d) and attempts to explain the effect of the rest of the subsection in a brief passage.²⁴ Delpont disregards section 38(2)(d) on the basis that: '.... due to [these] uncertainties, the exclusion

²² Inserted by section 3 of Act 37 of 1999.

²³ MS Blackman, RD Jooste & GK Everingham *Commentary on the Companies Act* (2002) vol 1 para 4-66.

²⁴ PM Meskin & B Galgut *Henochsberg on the Companies Act* 5 ed (1994) vol 1 78(1) – 79.

contained in section 38(2)(d) is therefore virtually useless.²⁵ Kathleen van der Linde rejects this view.²⁶

The first part of s 38(2)(d) does not prohibit that which is authorised in terms of section 38(1), namely: ‘... the provision of financial assistance for the acquisition of shares in a company by the company’. It does however go further and ostensibly permits a company to give ‘financial assistance’ to itself in order for it to acquire its own shares.²⁷ In this regard it has been said, with reference to section 38(2)(d) that: ‘... the person who acquires the shares is the company, so the exclusion applies to financial assistance given to the company by the company. This in law is clearly impossible.’²⁸ Van der Linde states that it is: ‘...obviously not possible for the company to give assistance to itself and no exemption is called for.’²⁹

Delport³⁰ argues that the only function of the exclusion is that it allows or purports to allow the giving of financial assistance by a company to itself (which is impossible); by a holding company (only) to its subsidiary which is acquiring shares in the holding company (but that it does not allow the holding company to give assistance to a third party for the purpose of or in connection with the acquisition by a subsidiary of the shares in the holding company); by a subsidiary to its holding company when the holding company is acquiring its own shares (which, Delport maintains, the company can do in any case, provided it complies with s 37). Delport regards the last two options as alternatives, depending on the correct interpretation of the provision.³¹

²⁵ PA Delport *Company groups and the acquisition of shares* (2001) 13 *Merc LJ* 121 at 125 – 126.

²⁶ Kathleen van der Linde *Financial assistance for the acquisition of shares in accordance with section 85 of the Companies Act – A reply to Delport* (2001) 13 *SA Merc LJ* 437.

²⁷ See vn 16.

²⁸ See vn 25 at 126.

²⁹ See vn 26.

³⁰ See vn 25 at 126.

³¹ See vn 16 at 437.

Whenever a different interpretation is given to the wording 'financial assistance' in section 38(1), it may strictly be possible for a company to give financial assistance to itself for the purchase by it of its own shares.³² If a company wishes to repurchase its own shares, but it lacks the finances to pay for the shares, it could borrow money from a bank or other financier to enable it to pay for the shares it wishes to repurchase. It could also give security for the loan by mortgaging its assets.³³ Although this does not seem very likely, the distinct possibility still exists, since the directors could have 'reasonable' grounds for believing that the company will still comply with the solvency and liquidity tests, thereby satisfying the requirements of s 85(4)(a) and (b). If it had it not been for the first part of section 38(2)(d), there would have been a great risk that such a transaction would have contravened the provisions of s 38(1) which would result in a criminal offence and in the transaction having no force and effect.³⁴ The directors could under such circumstances potentially be held liable for damages for breach of their fiduciary duties for having entered into an illegal transaction on behalf of the company.³⁵

Legal practitioners in England have argued that, as a result of allowing companies to repurchase their own shares, a company could well (strange as it may seem) give 'financial assistance' to itself for the purchase by it of its own shares. In this regard it is remarked that: 'The concept of a company giving financial assistance to itself may, at first seem strange, but such a result now seems possible due to the lifting of the prohibition on companies buying their own shares.'³⁶

The assertion that section 38 prohibits a company from giving financial assistance to someone else to purchase its shares and that any security given by

³² See vn 16 at 496.

³³ See vn 16 at 496.

³⁴ *Lipshitz NO v UDC Bank Ltd* 1979 (1) SA 789 (A) at 802 E-F and 803 A-B.

³⁵ *Jacobson v Liquidator of M Bulkin and Co Ltd* 1976 (3) SA 781 (T) at 791A.

³⁶ *Graham Stedman & Janet Jones Can a company give financial assistance to itself?* (1983) *LS Gazette* 2419 at 2419.

it to fund a share buy-back is given for its own benefit and not to financially assist anyone, does not advance the matter any further.³⁷ The fact that the financial assistance is given for the company's own benefit is not relevant for purposes of section 38 of the Act, although it is certainly a relevant factor in terms of English law. The reason for this is the wording of the equivalent legislation in England. Section 153(2)(b) of the English Companies Act, 1985 ('English Companies Act'), determines that the provision of financial assistance is not prohibited if: '... the assistance is given in good faith in the interests of the company.' Thus the argument raised by Price,³⁸ which is based on that section, is not relevant to South African law.

Whatever the interpretation given to section 38 of the Act, the word 'person' includes natural persons as well as legal persons such as bodies corporate and companies. Since the word 'person' includes a legal person, section 38 of the Act is applicable to a company purchasing its own shares, and this means that there is no basis in law for stating that it is 'clearly impossible' for a company to give financial assistance to itself.³⁹ Nothing in the wording of section 38(1) indicates that the company whose shares are being bought is to be excluded from the category of persons who are prohibited from giving financial assistance.⁴⁰ Arden LJ acknowledged the possibility of a company giving financial assistance to itself,⁴¹ although he admitted that it would constitute an 'unusual case'. In English law, section 153(1)-(4) of the English Companies Act provides a comprehensive list of transactions exempted or excluded from the general prohibition against the giving of financial assistance of which section 153(d) explicitly excludes the giving of financial assistance for a redemption or purchase of shares made in accordance with the provisions of that Act.⁴² Section 153(3)(d)

³⁷ AB Price *Company acquisition of own shares – Some practical problems* (1991) 12 The Company Lawyer 61 at 62.

³⁸ See vn 37.

³⁹ See vn 16 at 497.

⁴⁰ Ellis Ferran *Company Law and Corporate Finance* (1999) 378-9.

⁴¹ *Chaston v SWP Group plc* [2003] 1 BCLC para 47.

⁴² See vn 16 at 498.

is evidentially a typical ‘avoidance of doubt’ provision.⁴³ According to Ferran,⁴⁴ even if section 153(3)(d) qualified as an ‘avoidance of doubt’ provision, it is an indication that: ‘...the legislature must have considered that an acquisition by a company of its own shares, could if not specifically excluded fall within the scope of the ban on the giving of financial assistance.’

The Second European Directive on Company Law (No 77/91 (EEC); 1977 OJ L26) which applies only to public companies, reads as follows: ‘A company may not advance funds, nor make loans, nor provide security, with a view to the acquisition of its shares by a third party.’ This wording specifically excludes any possibility of the prohibition against financial assistance being applied to the acquisition by a company of its own shares.⁴⁵ Although section 38 of the Act is drafted in a manner which leaves much room for doubt, section 38(2)(d) serves an important purpose, which in my considered opinion leaves no rational justification for the statement that the first part of s 38(2)(d) of the Act is ‘virtually useless’.⁴⁶

The Company Law Review Steering Group⁴⁷ made certain recommendations which stated that: ‘The Department has also proposed a further exemption that financial assistance by a company or its subsidiary for the purpose of a transaction by the company which is itself the subject of a specific exemption under section 153(3) or (4) is permitted.’ Even though this statement was made with reference to English law, it is nevertheless relevant to the importance of and the rationale underlying section 38(2)(d) of the Act.⁴⁸

⁴³ John H Farrar, Nigel E Furey, Brenda M Hannigan & Philip Wylie – *Farrar’s Company Law* 2ed (1988) 168.

⁴⁴ See vn 40.

⁴⁵ See vn 16 at 498.

⁴⁶ See Delpont at 25 and Van der Linde at 26 saying that ‘no exception is called for’.

⁴⁷ Department of Trade and Industry ‘Modern company law for a competitive economy, company formation and capital maintenance’ (October 1999) (URN 99/1145) at 152.

⁴⁸ See vn 16 at 498.

In accordance with principles stated above, it was in the past generally not permissible for companies to repurchase their own shares.⁴⁹ Nevertheless, companies in South Africa are currently authorized to repurchase their own shares in terms of sections 85-89 of the Act.⁵⁰ These new provisions require approval by special resolution and compliance with the liquidity and solvency test as laid down in section 85(4)(a) of the Act before a company may validly repurchase its own shares.⁵¹ The shares that the company has repurchased must be cancelled and restored to the status of unauthorised share capital.⁵² Section 89 of the Act states that: ‘... subsidiary companies may *mutatis mutandis* in accordance with sections 85, 86, 87 and 88 acquire shares in their holding companies to a maximum of ten per cent in the aggregate of the number of issued shares of the holding company ...’. This section does however not apply to the acquisition of shares by a holding company in its subsidiary. The shares that a subsidiary has acquired in its holding company do not have to be cancelled upon acquisition of the shares by the holding company, but may be held as treasury shares.⁵³

The English law is in contrast to the above, in that s 160(1) and (2) of the English Companies Act state that the company’s shares must be repurchased either out of distributable profits or out of the proceeds of a fresh issue of shares made for that purpose alone, except in the case of a private company, which, under strict conditions, may make a payment out of capital.

Historically, in most common-law jurisdictions, including ours, a company could not be a member of its holding company. The reason being that this was seen as an indirect acquisition by a company of its own shares and therefore, an evasion of the rule developed in *Trevor v Whitworth*⁵⁴ that a company may not purchase

⁴⁹ *Trevor v Whitworth* (1887) 12 App Cas 409 (HL).

⁵⁰ See vn 16 at 499.

⁵¹ *Capitex Bank Ltd v Qorus Holdings Ltd* 2003 (3) SA 302 (W) at 309 C.

⁵² Section 85(8).

⁵³ Section 89 read with section 39.

⁵⁴ (1887) 12 App Cas 409 (HL).

its own shares. A subsidiary was also prohibited not only from purchasing shares in its holding company but also from giving any financial assistance for the acquisition of shares in its holding company.⁵⁵ The concept of a company being prohibited from purchasing its own shares, whilst a subsidiary could hold shares in its holding company, does not make sense.⁵⁶

Currently, in terms of English law, section 23 of the English Companies Act stipulates that: ‘... a body corporate cannot be a member of a company which is its holding company and any allotment or transfer of shares in a company to its subsidiary is void’. Thus, a subsidiary may, subject to a number of exceptions, still not in terms of English law be a shareholder of its holding company.⁵⁷ The reason for the prohibition is to prevent the ‘trafficking’ in its own shares by the company by indirect means.⁵⁸

In sharp contrast, in South African law, section 89 of the Act, has since 1999 permitted a subsidiary, in accordance with the provisions of s 85-88, to acquire shares in its holding company up to a maximum of ten per cent in the aggregate of the number of issued shares in the holding company.⁵⁹ Section 89 provides as follows:

‘Subsidiary companies may *mutatis mutandis* in accordance with sections 85, 86, 87 and 88, acquire shares in their holding company to a maximum of 10 per cent in the aggregate the number of issued shares of the holding: Provided that this section shall not apply to the acquisition of shares by a holding company in a subsidiary of itself.’

Even though the intention of section 89 of the Act might have been to limit the holding by a subsidiary in its holding company to ten per cent of the issued capital of the holding company, its wording deals only with an acquisition and not a holding by a subsidiary of shares in its holding company.⁶⁰

⁵⁵ P Lipton & A Herzberg *Understanding Company Law* 2 ed (1986) 140.

⁵⁶ See vn 16 at 499.

⁵⁷ See vn 16 at 499.

⁵⁸ *Palmer's Company Law* Release 93, November 2003, 6100/2-3, para 6.430.

⁵⁹ See vn 16 at 500.

⁶⁰ Harvey E Wainer *The Companies Act Changes – Problems and Doubts* (2001) SALJ 133.

Owing to the fact that a subsidiary is now authorised to buy up to ten per cent of the shares in its holding company, it makes sense that section 38(2)(d) of the Act should allow the holding company to also give financial assistance to the subsidiary for the acquisition of shares in its holding company.⁶¹ Nevertheless, it still remains important to protect creditors and minority shareholders, which is the main objective of the share buy-back provisions.⁶² Section 38(2)(d) of the Act states that such financial assistance be given: ‘... in accordance with the provisions of section 85 for the acquisition of such shares.’ This means compliance with the provisions of section 85 of the Act before a company may acquire its own shares.

The above entails the passing of a special resolution and a positive result from the solvency and liquidity test.⁶³ In addition, section 38(2)(d) of the Act requires that whenever a holding company gives financial assistance to its subsidiary for the acquisition of shares in its holding company, that such assistance must be given in accordance with the requirements and safeguards as stipulated in section 85 of the Act. This provision ensures that where financial assistance has been given by the holding company to its subsidiary for the acquisition of shares in the holding company, this is not construed as indirect financial assistance by the holding company for the acquisition of its own shares within the scope of 38(1) of the Act.⁶⁴

As a result of section 38(2)(d) of the Act, a company may only give financial assistance to its holding company for the acquisition of its own shares, if the holding company has approved the same by means of a special resolution and also complies with the solvency and liquidity test. Owing to these safeguards, creditors and minority shareholders are given more efficient protection.⁶⁵ The

⁶¹ See vn 16 at 500.

⁶² See vn 16 at 500.

⁶³ See vn 16 at 500.

⁶⁴ See vn 16 at 500.

⁶⁵ See vn 16 at 500.

second part of section 38(2)(d) may predominantly be regarded as ‘an avoidance of doubt’ provision. It does not appear to have been the objective of the legislature to substantially change the basic prohibition in section 38(1) of the Act against a company giving financial assistance for the purchase of, or subscription for the shares of a company.

2.3 Section 38 and Black Economic Empowerment (‘BEE’)

As indicated before, section 38 of the Act prohibits a company from giving any financial assistance, whether directly or indirectly to any person, for the purpose of purchasing shares in the company. ‘Vendor financing’ is a term used to describe finance given either by the target company or its shareholders to an empowerment group in order to finance the acquisition of equity in the target company.⁶⁶

Section 38 of the Act does not allow vendor financing and that means that the target company may not provide any financial assistance to the empowerment group, which normally lacks collateral to raise finance from commercial banks on normal commercial terms.⁶⁷ Because of this rule vendor financing, when it involves BEE transactions, is limited to, among others, share incentive schemes for employees, which seldom result in black persons owning a substantial stake in the target.⁶⁸

The possibility of a target company giving financial assistance for the acquisition of its shares by itself will not be the ultimate solution to the lack of finance for BEE. However, it does make it easier for large private corporations and empowerment groups to conclude more of these transactions in a financial system which is not adequately geared towards financing empowerment.⁶⁹

⁶⁶ See vn 8 at 1.

⁶⁷ See vn 8 at 1.

⁶⁸ See vn 8 at 1.

⁶⁹ See vn 8 at 3.

3. Financial Assistance: Section 44 of the 2008 Companies Act

Section 44 of the new Companies Act, 2008 (Act No. 71 of 2008 - '2008 Act'), is substituted for section 38 of the Act that deals with the provision of financial assistance by a company for the acquisition of its shares. The provisions of section 44 of the 2008 Act provides an inherent right to a company to provide financial assistance for the acquisition of its own shares to any person, provided the company is permitted to do so by its Memorandum of Incorporation, and also that it complies with sections 44 (3) and (4).

Thus if a company's Memorandum of Incorporation does not prohibit the company from giving financial assistance, "...the board may authorise the company..." to provide financial assistance. The wording of section 44(2) appear erroneous and are in need of correction, since it is indeed the company that needs to authorise the board to provide financial assistance for the acquisition of the companies shares.

In terms of section 44 (3) of the 2008 Act a company may only provide financial assistance if that financial assistance is provided:

- '...(i) pursuant to an employee share scheme that satisfies that requirements of s 97; or
- (ii) pursuant to a special resolution of the shareholders, adopted within the previous two years, which approved such assistance either for the specific recipient, or generally for a category of potential recipients, and the specific recipient falls within that category;'

Before financial assistance may be provided, the board must be satisfied that the company would comply with the solvency and liquidity test⁷⁰ immediately after

⁷⁰ S 4 of the Companies Act 71 of 2008.

giving financial assistance⁷¹ and also that the terms under which the financial assistance is proposed to be given are fair and reasonable to the company.⁷²

In terms of section 4 of the 2008 Act, a company will comply with the solvency and liquidity test if the aggregate assets of the company, as fairly valued, exceed the liabilities of the company and that it appears that the company will be able to pay its debts as they become due in the ordinary course of business for a period of 12 months. Furthermore, section 44 (4) places a duty on the board of the company to ensure that all conditions or restrictions as set out in the company's Memorandum of Incorporation have been satisfied prior to the giving of financial assistance. Any decision by the board to provide financial assistance which is inconsistent with the provisions of section 44 or with the requirements or prohibitions of the Memorandum of Incorporation will be void.⁷³

It is interesting to note that whereas section 38 of the Act restricts the provision by companies of financial assistance for the acquisition of their shares, subject to the exceptions as given in section 38(2) of that Act, the 2008 Act now allows companies to provide financial assistance, provided that the provisions of sections 44 (3) and (4) are complied with. A material difference between section 38 of the Act and the 2008 Act is therefore that a company will now be able to provide financial assistance to any person (provided that section 44 is complied with), whereas that is not possible in terms of section 38 of the Act.

4. Loans to Directors: Section 226 of the 1973 Companies Act

The Legislature enacted section 226 of the Act, evidently in acknowledgement of the powerful position held by directors and managers of a company. Such position of power may potentially be abused by directors and management for

⁷¹ S 44 (3)(b)(i).

⁷² S 44 (3)(b)(ii).

⁷³ S 44 (5).

their own benefit and to the detriment of the company, including its shareholders.⁷⁴ In dealing with this issue, Goldblatt AJ stated the following:

‘The clear purpose of s 226 of the Act is to prevent directors or managers of a company acting in their own interests and against the interests of shareholders by burdening the company with obligations which are not for its benefit but for the benefit of another company and/or for the benefit of its directors and/or shareholders.’⁷⁵

Accordingly, section 226 of the Act endeavors to regulate and prohibit transactions of this nature, subject to certain exceptions.⁷⁶ Exceptions are provided: ‘... presumably on the basis that in the excepted circumstances there are sufficient safeguards to establish a likelihood that the use of the company’s assets for the benefit of its directors or managers or of companies controlled by them, will also be of benefit to the company and not at its expense.’⁷⁷ Section 226 of the Act may be divided into three parts, namely, prohibitions,⁷⁸ exceptions to the prohibitions,⁷⁹ and the consequences of any contravention.⁸⁰

4.1 Regulation other than Section 226 of the Act

Section 226 of the Act has no negative affect on any rule of law regulating directors’ interests in the contracts envisaged by the section, or imposing any liability on directors for breach of duty.⁸¹ The transactions which are not covered by section 226 will also be covered by these rules of law, so the fact that certain loop-holes may exist in section 226 does not mean that the transactions which are not regulated by this section are unregulated.⁸² Directors’ interests which are

⁷⁴ Richard Jooste *Loans to Directors – an Analysis of Section 226 of the Companies Act* (2000) 12 *SAMLJ* 269.

⁷⁵ *Standard Bank of SA Ltd v Neugarten & others* 1988 (1) SA 652 (W).

⁷⁶ See vn 74 at 269.

⁷⁷ *S v Pourolis & others* 1993 (4) SA 575 (W) (per Stegmann J).

⁷⁸ S 226(1) read with s 226(1A).

⁷⁹ S 226(1B) and s 226(2) read with s 226(3).

⁸⁰ S 226(4).

⁸¹ See vn 74 at 271.

⁸² See vn 74 at 271.

regulated in company contracts are derived from the Act as well as the common law. Blackman gives the common law position as follows:⁸³

‘If a director wishes to contract with his company, or has an interest in a contract which his company proposes to enter into with a third party, and he is not permitted also to act on the company’s behalf in the matter either by its members or by its articles, he must, in so far as the contract is concerned, entirely shake off his relationship with the company, act openly and in good faith, and (where he is the other party to the contract) deal with the company at arm’s length. This rule has been referred to as the “fair-dealing rule”.⁸⁴

Moreover, sections 295 and 296 of the Act supplement section 226. Section 295 requires disclosure in the annual financial statements of certain transactions falling within the exceptions to the prohibitions in section 226 and section 296 requires disclosure in the annual financial statements of loans to persons who later become directors.⁸⁵

4.2 Interpretation of Section 226 of the Act

When analysing section 226, it is important to take note of the approach of the courts as evidenced by the judgment of the Appellate Division in *Bevray Investments (Edms) Bpk v Boland Bank en andere*.⁸⁶ In the case, Grosskopf JA stated:⁸⁷

‘Die breë oogmerk of oogmerke van die bepaling is natuurlik duidelik. Maatskappye word bestuur deur direkteure en bestuurders. Hierdie direkteure en bestuurders kan hul bevoegdhede misbruik vir hul eie voordeel. Daarbenewens kan die direkteure of bestuurders van houermaatskappye hulself onbehoorlik bevoordeel deur hul beheer oor filiaalmaatskappye. Die wetgewer wou die moontlikheid van sulke wanpraktyke beperk. Die wetgewer het egter nie hierdie oogmerk probeer verwesenlik deur ‘n algemene of absolute verbod te plaas op alle transaksies tussen ‘n bestuurder of direkteur en ‘n betrokke maatskappy waardeur die bestuurder of direkteur bevoordeel kan word nie. Klaarblyklik sou so ‘n verbod onprakties wees. Daar moet noodwendig baie

⁸³ MS Blackman *The Law of South Africa sv ‘Companies’* vol 4 part 2 1st reissue (1996) par 130 – WA Joubert.

⁸⁴ See vn 83 at 212.

⁸⁵ See vn 74 at 272.

⁸⁶ 1993 (3) SA 597 (A).

⁸⁷ At 623E-J.

omstandighede wees waarin dit nie onbehoorlik is vir 'n direkteur of bestuurder om geldelike voordele te ontvang van die maatskappy wat hy bestuur of wat deur sy maatskappy beheer word nie. Die wetgewer het hieself dus beperk tot 'n verbod op sekere bepaalde transaksies wat as *prima facie* onaanvaarbaar beskou is, nl die maak van sekere lenings en die voorsiening van sekere sekuriteite. Selfs hier is die verbod egter nie absoluut nie – sekere transaksies wat binne die trefwydte van die verbod val, was nogtans vir die wetgewer onaanvaarbaar. Om vir sulke transaksies voorsiening te maak, bevat subart (2) 'n langerige lys uitsonderings op die verbodsbepalings in subart (1). Die wetgewer se spesifieke oogmerk met art 226 was dus om sekere bepaalde vorms van geldelike bystand te verbied onderhewig aan bepaalde uitsonderings. Met die een hand verbied hy; met die ander hand veroorloof hy. Daar was dus nie 'n eenvoudige of ongekwalfiseerde oogmerk wat as toetssteen by die uitleg van die artikel gebruik kan word nie.'

4.3 The Scope of the Prohibitions

The prohibitions as provided in section 226 of the Act do not apply to directors only, but also to others. Section 226 of the Act applies the similarly to 'managers' as well as directors. A 'manager' is defined as: '.... any person who is a principle executive officer of the company for the time being, by whatever name he may be designated and whether or not he is a director.'⁸⁸ Whenever an officer has executive functions and is in charge of a major section of the company then he or she is regarded as a manager. The influential position that these people are in may without question be abused and that could have detrimental affects on the company. It is therefore justifiable to include them within the ambit of the said provision.⁸⁹

Section 226 of the Act includes under 'officer' also 'any managing director, manager or secretary'.⁹⁰ There is thus a distinction drawn between a manager and a secretary. This section does not regulate loans to secretaries, but a person who is appointed as a secretary may also perform managerial functions, such as

⁸⁸ S 1 sv 'director' of the Act.

⁸⁹ See vn 74 at 272.

⁹⁰ S 1 sv 'officer' of the Act.

financial management.⁹¹ Even though a person is appointed as a secretary and he or she performs the functions of a manager, section 226 will apply to him or her.

The section under discussion prohibits loans made by a company not only to its own directors and managers but also to the directors and managers of the lending company's holding company and any other company which is a subsidiary of its holding company.⁹² The extension of the prohibition beyond a loan by a company to its own directors or managers, to a loan to a director or manager of its holding company is understandable, given the potential for abuse of the power which the holding company and its directors and managers hold over subsidiaries.⁹³ Nevertheless, a subsidiary may make a loan to its holding company which, in turn, can make a loan to a director or manager of the holding company (relying on s 226(2)(a)) without falling foul of s 226. Naturally, the holding company itself (not its director or manager) will then be indebted to its subsidiary. In addition, section 37 of the Act will provide the subsidiary with some protection.⁹⁴ However, the prohibition on a company to make a loan to a director or manager of the company's fellow subsidiary does not make sense.⁹⁵

Instead of including within the prohibitions in section 226(1) a loan by a company to directors or managers of its subsidiary and then taking it out again by way of the exemption in s 226(2)(f) of the Act, the Legislature could have just included it in the prohibitions.⁹⁶ This could have been done by changing the wording of section 226(2)(a)(iii), for example, to refer to: '... any other company (other than its own subsidiary) which is a subsidiary of the holding company'.⁹⁷ This could

⁹¹ See vn 74 at 272.

⁹² S 226(1)(a)(ii) and (iii) of the Act.

⁹³ See vn 74 at 273.

⁹⁴ See vn 74 at 273.

⁹⁵ See vn 74 at 273.

⁹⁶ See vn 74 at 274.

⁹⁷ See vn 74 at 274.

have avoided the anomaly that has resulted from the wording of section 226(2)(f) of the Act.⁹⁸

In the case of bodies corporate controlled by directors and managers the intention of the Legislature with regard to the restrictions on companies making loans to their directors could easily have been effectively circumvented by a company making a loan to a company or body corporate controlled by the director or manager.⁹⁹ Section 226(1)(b) has made provision for this possibility. In *S v Pourolis Stegmann J* gave an incorrect example how s 226(1)(b) of the Act applies to a specific situation:

‘Consider a group of four companies in which a holding company H, has two subsidiary companies respectively called S1 and S2. The fourth company in the group is a subsidiary of S2 and is called S2S....I now extend the example by introducing a fifth company, X, which is loosely associated with the group. Specifically, one Mr. D, a director of S2 and also controls X, s 226(1)(b) prohibits loans by S2 to X. It also prohibits loans to X by S2’s holding company H.’

The last sentence would be correct only in circumstances where company H had a holding company, but this is not the case in the example cited by Stegmann J.

The provisions of section 226(1)(b) not only covers companies controlled by directors or managers but also other ‘bodies corporate’ so controlled, such as close corporations, clubs, and other associations with corporate status.¹⁰⁰ Foreign bodies corporate, whether or not they are ‘external companies’,¹⁰¹ are implicitly included.¹⁰²

⁹⁸ See vn 74 at 274.

⁹⁹ See vn 74 at 274.

¹⁰⁰ See vn 74 at 274.

¹⁰¹ See s 1 sv ‘external company’ of the Act.

¹⁰² A Hyman *Guarantees for Companies Controlled by Directors* (1977) SA Company LJE 23.

4.4 Exceptions to the Prohibitions

As in the case of other provisions of the Act, section 226 also contains a number of possible exceptions to the prohibitions contained in it, in respect of which Stegmann J remarked:¹⁰³

'I think it is appropriate to recognise, as the legislature has done, that, in certain controlled circumstances and to a certain limited extent, the use of a company's assets for the benefit of its directors and managers, and of other companies controlled by them, may also be of benefit to the company as a whole. The legislature has therefore found it appropriate to regulate the matter in a way which designed to ensure that a company's assets are employed for the benefit of the company as a whole, and not for the private benefit of its directors or managers, or of companies controlled by them, save in particular circumstances. The particular excepted circumstances have been identified by the legislature, presumably on the basis that in the excepted circumstances there are sufficient safeguards to establish a likelihood that the use of the company's assets for the benefit of its directors or managers or of companies controlled by them, will also be a general prohibition against the use of a company's assets in certain proscribed ways for the benefit of its directors or managers, or any company controlled by them, and then to provide a frame-work of exceptions according to which the use of a company's assets in the otherwise proscribed ways for the benefit of its directors or managers, or companies controlled by them, is to be regulated.'

In terms of section 226(1B) of the Act: Where company A makes a loan to, or provides security on behalf of company A's holding company, or a subsidiary of company A's holding company, which transaction falls within the prohibition in section 226(1)(b) because the holding company or subsidiary, as the case may be, is controlled by one or more directors or managers of company A or company A's holding company, or a subsidiary of company A's holding company, section 226(1)(B) exempts that transaction.¹⁰⁴ If a director of company A's holding company (company H) for example, held more than fifty per cent of the equity share capital of company H, a loan by company A to company H would fall foul of

¹⁰³ See vn 77 at 589C-F..

¹⁰⁴ See vn 74 at 283.

the prohibition in section 266(1)(b) but would be exempted by s 226(1B) of the Act.¹⁰⁵

The exemption is in line with the Legislature's intention not to prohibit the freedom of movement of funds within a group of companies, which prohibition would restrict the effective use of group resources.¹⁰⁶ Loans and the provision of security 'upwards' and 'sideways' within a group of companies are regulated by section 37 of the Act and section 226(1B) brings section 226 into line with section 37 of the Act.¹⁰⁷

Section 226(2)(a) of the Act states that the prohibitions in section 226(1) do not apply to a company making a loan to, or providing security on behalf of, the company's own director or manager or a company or body corporate controlled by one or more of its directors or managers, with the prior consent of all the members of the company or in terms of a special resolution relating to the specific transaction.¹⁰⁸ It has been held that the exception in s 226(2)(a) applies even if the director or manager of the lending company to whom the loan is made is also a director or manager of the lending company's holding company or a subsidiary of the holding company.¹⁰⁹ In this vein the Appellate Division held:¹¹⁰

'Die gewone, letterlike en grammatikale betekenis van die woorde wat die wetgewer in art 226 gebruik het, bied 'n duidelike antwoord op hierdie vraag. Kragtens subart (2) is die verbodsbepalings in subart (1) "nie van toepassing" ten opsigte van, onder andere, "die maak van 'n lening deur 'n maatskappy aan sy eie direkteur" onder bepaalde omstandighede. Dit beteken eenvoudig dat waar 'n maatskappy 'n gemagtigde lening aan sy eie direkteur maak, sodanige transaksie nie geraak word deur enige van die verbodsbepalings in subart (1) nie. So 'n lening word gevolglik nie verbied bloot omdat die persoon wat die lening ontvang, toevallig ook 'n direkteur van die houermaatskappy (subart (1)(a)(ii)) of 'n direkteur van 'n ander filiaal van die houermaatskappy (subart 1(a)(iii)) is nie.

¹⁰⁵ See 74 at 283.

¹⁰⁶ See 74 at 283.

¹⁰⁷ S 37 seeks to protect the lending company by way of certain disclosure and liability provisions

¹⁰⁸ See 74 at 283.

¹⁰⁹ *Bevray Investments (Edms) Bpk v Boland Bank Bpk* 1993 (3) SA 597 (A).

¹¹⁰ At 620-621 (per Groskopf JA).

In *Bevray Investments (Edms) Bpk v Boland Bank Bpk*¹¹¹ the court held that the exception in s 226(2)(a) applied even if the director or manager to whom the loan had been made was also a director of the lending company's holding company or a subsidiary of it.

Section 226(2)(b) of the Act actually contains two exceptions. It exempts anything done to provide any director or manager with funds (a) to meet expenditure incurred or to be incurred by him for the purposes of the company; or (b) to enable him or her to properly to perform his or her duties as director or manager of the company.¹¹² Section 226(2)(c) of the Act exempts anything done bona fide in the ordinary course of the business of a company which actually and regularly carries on the business of making loans or providing security. In order for the exemption to be applicable the business of making loans or providing security must be carried out as a matter of routine and not only occasionally, but it need not be the sole, main, or substantial part of the company's business.

Section 226(2)(d) of the Act exempts the provision of money or making of loans by a company for the purposes mentioned in section 38(2)(b) and (c) of the Act. As indicated above, section 38 prohibits a company from giving financial assistance for the purchase of, or subscription for, its own shares or those of its holding company. Section 38(2)(b) of the Act exempts from the prohibition the provision of money to a share incentive trust set up for the benefit of employees, including salaried directors. Section 38(2)(c) exempts from the prohibition loans to employees other than salaried directors.

Owing to the provisions of section 226(2)(e) of the Act a company is able to assist a director or manager with his housing needs, if approval is granted in a general meeting by means of an ordinary resolution. In terms of section 226(2)(f) of the Act a loan made or security provided by a company on behalf of a director

¹¹¹ 1993 (3) SA 597 (A).

¹¹² See *vn* 74 at 284.

or manager of a subsidiary of the company will be exempt, if the director or manager is not also a director or manager of the company itself.¹¹³

In general, section 226 of the Act is poorly drafted and this has led to anomalies and inadvertent omissions. Because of the way the words 'directly or indirectly' were interpreted in *S v Pourolis*,¹¹⁴ the prohibitions in this section could be circumvented easily.¹¹⁵ The consequences of the section could also be avoided by the resignation and reappointment of a director or manager with a loan having been made in the interim.¹¹⁶ 'Control' is also not properly defined in the section and needs to be brought in line with the concept 'control' in the definition of 'subsidiary' in the Act.

5. Loans to Directors: Section 45 of the 2008 Companies Act

Section 45 of the 2008 Companies Act is intended to replace section 226 of the Act with regard to loans or other financial assistance to the directors of a company by the company. The provisions of section 45(2) of the 2008 Act allows a company to give direct or indirect financial assistance to a director or prescribed officer of the company or of a related or inter-related company or corporation, if authorised¹¹⁷ to do so by the board of the company.

Section 226 of the Act differs from section 45 of the 2008 Act in the sense that section 226 does not allow a company to make a loan to a director of the company itself, or of its holding company or of any company which is a subsidiary of the holding company.¹¹⁸ Any company which is controlled by any

¹¹³ In such a case one of the other exceptions may apply. Such a loan or provision of security is, of course, prohibited only in the first place if the company providing the loan or security has a holding company.

¹¹⁴ 1993 (4) SA 575 (W).

¹¹⁵ See vn 74 at 289.

¹¹⁶ See vn 74 at 289.

¹¹⁷ Again, as in s 44 of the Companies Act 71 of 2008, the wording of the section is incorrect, as it should state that the company can authorise the board.

¹¹⁸ S 226 (1)(a).

director or manager of the company is also prohibited by the Act from receiving a loan from the company.¹¹⁹ To the contrary, section 45 of the 2008 Act expressly allows a company to make a loan or other financial assistance to any company to which a director of the lending company is also related to. The latter section further also allows the lending of money to any other related or inter-related company.¹²⁰

‘Financial assistance’ in the 2008 Act includes the lending of money, guaranteeing of a loan or of another obligation and securing any debt or obligation.¹²¹ Money lent to a director in the ordinary course of the company’s business will not fall within the ambit of section 45 of the 2008 Act.¹²² Another transaction that will be excluded from the ambit of section 45 is an accountable advance given to a director to meet legal expenses in relation to a matter concerning the company, advances to meet anticipated expenses to be incurred by the person on behalf of the company and also an amount given to defray the person’s expenses for removal at the company’s request.¹²³

The board may authorise a loan to a director if the provision of financial assistance is pursuant to an employee share scheme that satisfies the requirements of section 97¹²⁴ or if the financial assistance is pursuant to a special resolution of the shareholders, adopted within the previous two years, which approval was for a specific recipient or for a category of potential recipients and the specific recipient falls within that category.¹²⁵ Furthermore the board should be satisfied that the company will satisfy the solvency and liquidity test immediately after providing the financial assistance.¹²⁶

¹¹⁹ S 226 (1)(b).

¹²⁰ S 45 (2).

¹²¹ S 45 (1)(a).

¹²² S 45 (1)(b)(i).

¹²³ S 45 (1)(b)(ii) and (iii).

¹²⁴ S 45 (3)(a)(i).

¹²⁵ S 45 (3)(a)(ii).

¹²⁶ S 45 (3)(a)(b).

Even if the board has complied with all the provisions in section 45(3) of the 2008 Act, they must also ensure that any conditions of restrictions relating to the granting of financial assistance as set out in the Memorandum of Incorporation has been complied with.¹²⁷ Section 45(5)(a) of the 2008 Act states that whenever the board of a company adopts a resolution to provide financial assistance or a loan, written notice of that resolution must be provided to all shareholders (unless every shareholder is also a director) and also to a trade union representing the employees, within ten business days after the board adopts the resolution. This must be done whenever the total of the loan or other financial assistance, together with any other such resolution during the financial year, exceeds one-tenth of one per cent of the company's net worth at the time of the resolution. Section 45(b) of the 2008 Act states that written notice of the resolution must be given within 30 days after the end of the financial year, in any other case that doesn't fall under s 45 (a) of the Act.

Any resolution adopted by the board of a company which does not comply with the provisions of section 45 of the 2008 Act, or that does not satisfy the restrictions and requirements of the Memorandum of Incorporation, will be void¹²⁸ and any director who was present at the meeting when the resolution was adopted and failed to vote against the resolution will be held liable.

6. Capital maintenance: Section 90 of the 1973 Companies Act

One of the most fundamental principles in our company law was that a company may not return its share capital to shareholders and this also meant that dividends could only be paid out of profits.¹²⁹ One of the cornerstones of South African company law was that the share capital of a company should be a

¹²⁷ S 45 (4).

¹²⁸ S 45 (6)(a) and (b).

¹²⁹ Kathleen van der Linde *Capital maintenance is dead – long live solvency and liquidity* (1999) 7 Juta's Bus. L. 155.

guarantee fund for its creditors and should therefore, as far as possible, be sacrosanct.¹³⁰ Lord Halsbury, L.C, declared that: ‘... the capital is fixed and certain and every creditor of the company is entitled to look to that capital as his security.’¹³¹ This was repeated in *Cohen NO v Segal*¹³² where the court stated that: ‘... whatever has been paid by a member cannot be returned to him and no part of the corpus of the company can be returned to a member so as to take away from the fund to which the creditors have a right to look as that out of which they are to be paid. The capital may be spent or lost in carrying on the business of the company, but it cannot be reduced except in the manner and with the safeguards provided by the statute.’ All of this changed when the Companies Amendment Act 37 of 1999 came into operation. Companies were from then onwards allowed to buy back shares from their shareholders and in the process return share capital to them,¹³³ as well as pay dividends out of share capital.

‘The term capital maintenance is really actually a misnomer, for a company is not required to keep its capital intact. The capital of a limited company is not a debt owing by it to its shareholders, and if the capital is lost, the company is under no legal obligation either to make it good, or, on that ground only, to wind up its affairs.’¹³⁴ The rule is in fact not that a company must maintain the capital it raises, but instead that it must raise the capital that it aims to raise and, when not in liquidation, it may return that capital to its shareholders otherwise than in terms of a reduction of capital authorised by the Act.¹³⁵

Section 90 of the Act regulates the making of payments by a company to its shareholders. This section defines ‘payment’ as including any direct or indirect

¹³⁰ Bruce Cleaver *Certain consequences of the recent amendments brought about by the Companies Amendment Act 37 of 1999* at 1.

¹³¹ *Ooregum Gold Mining Company of India Ltd v Roper* [1892] A.C 125 at 133.

¹³² 1970 (3) S.A 702 (W) at 705H.

¹³³ Kathleen van der Linde *A company's purchase of its own shares* (1999) 7 *JBL* 68.

¹³⁴ Per Lindley LJ in *Verner v General & Commercial Investment Trust* [1894] 2 Ch 239 (CA) at 264-265.

¹³⁵ JT Pretorius *Capital Maintenance Doctrine in South African Corporate Law* Student Accountant Magazine 1 Oct 2000.

payment or transfer of money or other property to a shareholder by virtue of the shareholder's shareholding in the company, which will include dividends and the return of contributed capital. Payments made to shareholders in their capacity as creditors are not regulated by section 90, because the payment is seen as being to a creditor, and not to a shareholder. Section 90 of the Act also contains certain exclusions, where payments to shareholders will not be regulated by that section, namely:

- (a) payments for the acquisition of the shareholder's shares in terms of section 85 of the Act;
- (b) the redemption of redeemable preference shares in terms of section 98 of the Act;
- (c) the acquisition of shares in terms of a court order (such as an order in terms of section 252 of the Act; and
- (d) the issue of capitalisation shares.

Section 90(3) of the Act defines 'payment' as:

'For the purposes of this section "payment" includes any direct or indirect payment or transfer of money or other property to a shareholder of the company by virtue of the shareholder's shareholding in the company, but excludes an acquisition of shares in terms of section 85, redemption of redeemable preference shares in terms of section 98, any acquisition of shares in terms of an order of Court and the issue of capitalization shares in the company'.

The payment of interest on shares is also a payment by virtue of a shareholder's shareholding and has not been excluded from the provisions in section 90 of the Act. A big advantage of section 90 of the Act is that it constitutes an alternative to section 79 of the Act, which requires the approval of the Minister of Trade and Industry.¹³⁶

¹³⁶ See vn 129 at 155.

A company is now able to pay dividends out of share capital, as long as the company complies with the solvency and liquidity test, which protects the company's creditors. Section 90(2) of the Act prohibits a company from making a payment to shareholders if there is reason to believe that:

- (a) the company is, or would after the payment be unable to pay its debts as they become due in the ordinary course of business, which is the liquidity test; or
- (b) the consolidated assets of the company, fairly valued, would after the payment be less than the consolidated liabilities of the company, which is the solvency test.

Since investor and creditor protection is covered by solvency measures, the preclusion of financial assistance, which remains extant in section 38 of the Act, appears to be unnecessary.¹³⁷ Bearing in mind the harsh consequences of a breach of section 38 and the commercial realities, the continued existence of this section of the Act undermines the new philosophy and is restrictive of the encouragement of commercial activity.¹³⁸

Owing to the provisions of section 90 of the Act, a company is now able to pay dividends out of share capital as long as the company complies with the requirements of the section, which must be met when the actual payment is made. If a company's financial situation has changed since a dividend was declared, and it no longer complies with the solvency and liquidity test, the company will not be allowed to pay those dividends. If there is in fact a time delay after the decision to make a payment and before the actual payment was made, it is very difficult for shareholders to determine whether the company's financial situation is still in order and the shareholders will have to rely on the directors for information regarding the company's financial situation. Moreover, the fact that section 90 of the Act makes no provision for any time-limit before

¹³⁷ See vn 135.

¹³⁸ See vn 129 at 155.

payment of the dividends, the potential liability of the shareholders is increased, as the company's financial position could change during that time.¹³⁹

Section 90 of the Act requires that a company's articles must authorise the company to pay dividends out of capital to shareholders. The section is not clear on whether the authorisation should refer to compliance with section 90 before payment can be made, or if a general authorisation would be order, since it states only that the company is allowed to make the payments to shareholders. However, section 90 is very clear on the fact, if the company's articles do not allow a payment out of capital, that the company will only be allowed to pay dividends out of profits.

Companies have an inherent right to declare dividends out of profits, therefore some companies' articles might not say anything about the payment of dividends. In such cases the common-law rule that a company may only pay dividends out of divisible profits would most likely still apply, as our law presumes that a statute does not change the common-law position.¹⁴⁰ These companies will also have to amend their articles if they wish to make a payment of dividends in terms of section 90. That section was incorporated to make it simpler for companies to make payments to shareholders, and therefore companies which do not make provision for the payment of dividends would still be able to pay shareholders in terms of the common-law, but not in terms of section 90 of the Act.¹⁴¹

In the past companies had to rely on the provisions of sections 83 and 84 of the Act whenever they wanted to reduce their capital. Section 83 allowed a company to reduce its share capital by special resolution if it had no creditors or if all its creditors consented to the reduction. If the company could not reduce its capital under section 83, the reduction had to be confirmed by the court, reliant on section 84. After section 90 was implemented, companies no longer had to

¹³⁹ See vn 129 at 155.

¹⁴⁰ See vn 129 at 156.

¹⁴¹ See vn 129 at 156.

make use of sections 83 and 84, as the procedures were expensive and the same effect could be achieved using section 90 of the Act.

A lot of advantages came with the implementation of section 90 of the Act. Because of section 90 companies are able to maintain a flexible capital structure at low costs. The articles of companies may easily be amended to enable them to make use of the new provision and creditors are protected by the solvency and liquidity requirements, as well as the potential liability of the shareholders.

7. Distributions: Section 46 of the 2008 Companies Act

Companies wishing to make distributions to their shareholders, will in future, have to comply with the provisions of section 46 of the 2008 Act. A 'distribution' in terms of section 1 of the Companies Act 71 of 2008 is defined as:

'...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 of that company or of another company or of another company within the same group of companies whether-
 - (i) in the form of a dividend;
 - (ii) as a payment in lieu of a capitalization share, as contemplated in section 47;
 - (iii) is consideration for the acquisition-
 - (aa) by the company of any of its shares, as contemplated in section 48; or
 - (bb) by any company within the same group of companies, of any shares of a company within that group of companies; or
 - (iv) otherwise in respect of any of the shares of that company or of another company within the same group of companies, subject to section 164 (19);
 - (b) incurrence of a debt or other obligation by a company for the benefit of one or more holders of any of the shares of that company or of another company within the same group of companies; or
 - (c) forgiveness or waiver by a company of a debt or other obligation owed to the company by one or more holders of any of the shares of that company or of another company within the same group of companies,
- but does not include any such action taken upon the final liquidation of the company.'

A company wishing to make a distribution may not do so unless the distribution has been authorised by the board of the company by special resolution, or if the distribution is pursuant to an existing legal obligation of the company.¹⁴² The board, before making the distribution, has to acknowledge that the company has complied with the solvency and liquidity test. Moreover, it has to appear reasonable that the company will indeed satisfy the solvency and liquidity test immediately after the distribution has been made.¹⁴³ If a company is obliged to make a distribution by a court order and, after consideration of the solvency and liquidity test it appears that the company will not be able to comply with the provisions of section 46 of the 2008 Act, the company may apply to a court for an order varying the original order. In such a case, the court may make an order which is just and equitable to ensure that the person who is entitled to a payment from the company, is paid at the earliest possible time. The order should be compatible with the company satisfying its other financial obligations as they fall due and payable.¹⁴⁴

A very important and necessary provision introduced by the 2008 Act is section 46(3), which places a time-limit on the company if it wishes to make a distribution. This section states that if a company has decided to make a distribution,¹⁴⁵ the actual distribution has to be made within 120 days after the board acknowledgement has been obtained as contemplated in section 46(1)(c) of the 2008 Act. If the company does not make the distribution within the prescribed time-limit, the board must reconsider the solvency and liquidity test with respect to the remaining distribution and the company must not proceed with the distribution unless the board adopts a further resolution as contemplated in section 46(1)(c) of the 2008 Act.

¹⁴² S 46 (1)(a).

¹⁴³ S 46(1)(b) and (c).

¹⁴⁴ S 46 (5)(a) and (b).

¹⁴⁵ Either by special resolution or court order or an existing legal obligation.

Shareholders would welcome this change to South African company law, as they could be confident that when a company is making a distribution, it would be in the financial position to do so. The provisions of the Act make it very difficult for shareholders, since section 90 of the Act does not put a time-limit on the payment to shareholders after the decision was made to do so. This increased the liability of shareholders, as the company's financial position could have changed since the decision to make the payment was made.¹⁴⁶

When a company makes a distribution in the form of an incurrence of debt, the requirements of section 46 applies at the time that the board resolves that the company may incur the debt or obligation. It does not apply to any subsequent action of the company in satisfaction of that debt or obligation, except to the extent that the resolution, or the terms and conditions of the debt or obligation provide otherwise.¹⁴⁷

A director who was present or who participated in the meeting where the board approved a distribution and who failed to vote against the decision, despite knowing that the distribution was not complying with the provisions of section 46 of the 2008 Act, will be held liable.¹⁴⁸ Section 90 of the Act protects creditors through the solvency and liquidity test and the potential liability of the shareholders. The 2008 Act now shifts the liability to the directors, who are in the best position to know what the company's financial position is when the decision to make the payment and the payment itself is made. In terms of section 77(3) of the 2008 Act a director of a company is liable for any loss, damages or costs sustained by the company as a direct or indirect consequence of the director having been present at a meeting, or having participated in the making of a decision and having failed to vote against a resolution approving such

¹⁴⁶ See p. 28 par 2.

¹⁴⁷ S 46 (4).

¹⁴⁸ S 46 (6).

distribution, under circumstances where such a director knew that the distribution was contrary to section 46 of the 2008 Act.¹⁴⁹

In terms of section 20(6) of the 2008 Act each shareholder will have a claim for damages against any person who fraudulently or due to gross negligence causes the company to do anything inconsistent with that Act,¹⁵⁰ unless that transaction has been rectified. This means that if the shareholders have suffered damages resulting from non-compliance by directors with the provisions of the 2008 Act, they will have a personal claim against the directors for the damages caused.

8. Share Repurchases: Section 85 of the 1973 Act

A vital amendment to the Act occurred when the right was conferred on companies by section 85 to repurchase their own shares.¹⁵¹ Until the Companies Amendment Act 37 of 1999, South African corporate law was one of the few common law jurisdictions which continued to prohibit companies from repurchasing their own shares.¹⁵² It was regarded as essential to protect the creditors, as well as the shareholders from the potential abuse of the share repurchase power of the company.¹⁵³ The reason being that a company could use this power to discriminate against shareholders who own the same class of shares and, furthermore, because share repurchases could affect the voting rights of the shareholders and at the same time the control of the company.¹⁵⁴

On the first issue, dealing with the statutory provisions relating to share repurchases¹⁵⁵ the court ruled that:

¹⁴⁹ S 77 (3)(e)(vi).

¹⁵⁰ Companies Act 71 of 2008.

¹⁵¹ FHI Casim & Rehana Casim *The Capital Maintenance Concept and Share repurchases in South Africa* (2004) 15(6) *ICCLR* 188-191.

¹⁵² See vn 151 at 2.

¹⁵³ See vn 151 at 2.

¹⁵⁴ See vn 151 at 3.

¹⁵⁵ *Capitex Bank Ltd v Qorus Holdings Ltd* 2003 (3) SA 302 (W) at 308I-309A.

“while the statutory provisions have dramatically changed the capital maintenance rule and the perceived protection it afforded to shareholders, the rule continued to have some residual function in South African law in that it remains an important guideline to protect creditors and shareholders against abuse of the power of a company to repurchase its own shares.”

Section 85(1) of the Act enables a company to acquire its own shares, provided that it is authorised to do so by its articles of association and the share repurchase has been approved by a special resolution passed by the members of the company. The approval may either be a general approval which is valid until the next annual general meeting unless varied or revoked earlier,¹⁵⁶ or it could be a specific approval for a particular acquisition.¹⁵⁷

Section 85(4)(a) and (b) of the Act prohibits a company from making any payment in whatever form for the acquisition of its shares if there are reasonable grounds to believe that the company will not comply with the solvency and liquidity tests. Section 85(4) of the Act therefore prohibits a company which is insolvent or illiquid, to proceed with such a transaction. The court held in *Capitex Bank Ltd v Qorus Holdings Ltd* that in terms of section 85(1), that an agreement relating to the acquisition by a company of its own shares is no longer illegal or unlawful, but that a payment made that does not comply with the solvency and liquidity tests as embedded in s 85 (4)(a) and (b) of the Act would result in the illegality of the share repurchase agreement.¹⁵⁸

The Act does not place any restriction on the source of the funds used for the repurchase of the shares. In order for a company to comply with the solvency and liquidity test, section 85(4) merely requires that the company should have “reasonable grounds” for believing that it is liquid and solvent. There is no prescribed minimum period after the share repurchase for which the company must remain liquid and solvent, although in the case of listed shares, a statement

¹⁵⁶ S 85(2) and 85(3).

¹⁵⁷ S 85(2).

¹⁵⁸ See vn 151 at 5.

is required from the directors that the company will remain liquid and solvent for a period of 12 months after the repurchase of the shares.¹⁵⁹

The directors of a company must therefore make sure that a company remains liquid and solvent in the event of the company repurchasing its shares.¹⁶⁰ Whenever the company does in fact become insolvent or illiquid after the repurchase transaction, the directors will be jointly and severally liable to restore to the company the amount paid by the company for the share repurchase and not otherwise recovered, subject to relief that a court may grant in terms of section 248 of the Act. This section grants the court the authority to exonerate a director who has acted honestly and reasonably and who ought fairly to be excused.¹⁶¹ In terms of the Act the directors of a company do not owe a fiduciary duty to the creditors of the company.¹⁶²

A director who is liable in terms of section 86(1) of the Act may apply to a court for an order forcing the selling shareholder to pay to the company any money which was paid to him by the company, which did not comply with the provisions of section 85(4). Creditors and shareholders may also make use of the right of recovery.¹⁶³ A creditor or shareholder is not permitted by the provisions in the Act to directly sue the directors of the company if the company did not comply with the solvency and liquidity tests.

Following the correct procedure when repurchasing shares is very important when it comes to preventing abuse of the share repurchase power and discrimination against shareholders holding the same class of shares.¹⁶⁴ There are two different procedures provided for. One is in terms of section 87(1) of the Act, which entails an offer to acquire unlisted shares from all registered

¹⁵⁹ r.5.69(c)(i) and (ii) of the JSE Listings Requirements .

¹⁶⁰ See vn 151 at 5.

¹⁶¹ S 86 (1).

¹⁶² See vn 151 at 5.

¹⁶³ See vn 151 at 5.

¹⁶⁴ See vn 151 at 5.

shareholders. The other is for a repurchase on the open market. It is preferable that companies repurchase their shares from shareholders on a pro rata basis so that all the shareholders can partake in the transaction on an equal basis.¹⁶⁵ If shareholders, after informed of a company's decision to repurchase shares, make an offer to dispose of a number which exceeds the number of shares that the company offered, the company is obliged to acquire the shares from the shareholders on a pro rata basis.¹⁶⁶ If a company fails to comply with the provisions of section 87(1) of the Act, the transaction will constitute a criminal offence.

The share buy-back provisions of the Act are often used by South African companies, especially those companies whose shares trade at a discount to their underlying net asset value and who have access to cash.¹⁶⁷ Companies mostly use excess cash to repurchase shares from their shareholders, although there is actually no reason why companies should not use other assets, like shares held by subsidiary companies, as the currency for share repurchases.¹⁶⁸ The repurchase of shares by companies also have certain tax consequences.

The current provisions of the Act pertaining to share repurchases are in some areas insufficient and lacking in technical quality.¹⁶⁹ Although much still has to be done in respect of South Africa's company law regarding share repurchases, progress has to date been made by partially abandoning the outdated concept of capital maintenance.¹⁷⁰ At the moment South African law is more or less in line with the laws of other common law countries.

¹⁶⁵ See vn 151 at 5.

¹⁶⁶ S 87 (4).

¹⁶⁷ See vn 130 at 2.

¹⁶⁸ See vn 130 at 2.

¹⁶⁹ See vn 124 at 190.

¹⁷⁰ See vn 124 at 190.

9. Share Repurchases: Section 48 of the 2008 Companies Act

A company wishing to acquire its own shares in terms of the 2008 Act will have to comply with section 48 of that Act. Since the definition of 'distribution'¹⁷¹ includes the acquisition of shares by a company, a company may only acquire its shares if the decision to do so complies with the requirements of section 46. The 2008 Act does not provide a definition of the term 'acquisition'. It stands to reason that a company cannot really acquire its shares, as it cannot hold rights against itself. Yet the term must be understood to include any instance where a shareholder relinquishes rights in respect of a share to the company, whether for consideration or not. If the company gives consideration for this, there will be a distribution. The term obviously includes share repurchases by agreement with the company. An advantage of the 2008 Act is that the redemption of shares is also regarded as an acquisition, so that the same financial restrictions apply to repurchases and redemptions. Redemptions must comply with the requirements for distributions set out in section 46, as well as those for the acquisition of shares set out in section 48 of the 2008 Act.¹⁷²

A subsidiary of a company may acquire shares in that company, provided the shares held by the subsidiary, or subsidiaries in aggregate does not exceed ten per cent of the total number of issued shares of any class of shares of the company and no voting rights may be attached to those shares, as long as they are held by the subsidiary companies.¹⁷³ This section has not changed the position as envisaged in section 89 of the Act.

A further provision of section 48 of the 2008 Act is that the company may not acquire its own shares, and a subsidiary of a company may not acquire shares of that company if, as a result of that acquisition the only remaining shares in the

¹⁷¹ S 1 of Companies Act 71 of 2008.

¹⁷² Kathleen van der Linde *The regulation of distributions to shareholders in the Companies Act (2008)* 3 *TSAR* 488.

¹⁷³ S 48 (2)(b)(i)-(ii).

company would be shares held by one or more subsidiaries of the company, or convertible or redeemable shares.¹⁷⁴

Although payments in satisfaction of a court order are in principle subject to the solvency and liquidity test, and the directors are obliged to consider the solvency and liquidity test, the 2008 Act makes provision that the company 'may apply' to court for an order varying its original order but that still ensures that the payment is made at the earliest possible date, compatible with the company satisfying its other financial obligations as they fall due and payable.¹⁷⁵

When a company acquires shares and that transaction does not comply with the provisions of section 48, the company may within two years after the shares have been acquired, apply to a court for an order reversing the acquisition. The court may order that the person from whom the shares were acquired must return the amount paid by the company and that the company must return an equivalent number of shares of the same class as those acquired.¹⁷⁶ This provision might have a very unsatisfactory affect on the shareholder from whom the shares were acquired, as that person might not be in a financial position to return those funds. If the initial transaction, which did not comply with the provisions of section 48 of the 2008 Act, was due to the negligence of one or more directors, the shareholder who is affected will be able to hold the director or directors personally liable in terms of sections 77(3)(e)(vii) of the 2008 Act for any damages that the shareholder might have suffered because of the non-compliance.

A director will be held liable¹⁷⁷ if he or she was present at the meeting when the board approved an acquisition of shares, or participated in the making of such a decision and the director failed to vote against the acquisition of the shares,

¹⁷⁴ S 48 (3)(a)-(b).

¹⁷⁵ S 46 (5)(a)-(b).

¹⁷⁶ S 48 (6)(a)-(b).

¹⁷⁷ S 77 (3)(e)(vii).

despite the fact that he knew that the acquisition of the shares was not in compliance with the provisions of sections 46 or 48 of the 2008 Act.¹⁷⁸

10. Conclusion

The 2008 Act will introduce significant changes into company law in South Africa. This is a very important step, since the Act is outdated, defective and lacks technical quality. In navigating the various provisions of the 2008 Act it will have to be determined what relevance historic precedents, including decided cases both in South Africa and in foreign jurisdictions, will have in the interpretation of the 2008 Act.¹⁷⁹

The objectives of the provisions of the 2008 Act are to recognise the changes which have occurred in the South African economy since 1973 as well as to update South African company law in accordance with current international standards. The legal framework in South Africa has changed considerably over the last ten years with the introduction of the Constitution and numerous other statutes (such as the Competition Act) which affected business and the way in which it is conducted. These legislative changes need to be recognised in South African company law.

The new alterable provisions and the provisions of section 40 of the 2008 Act, read together with the concept of 'contribution', are likely to have a significant impact on the structuring of black economic empowerment transactions. The new definition of 'distribution' will be important in the context of capital maintenance, as will be the tests for solvency and liquidity, which are set out in section 4 of the 2008 Act.

¹⁷⁸ S 48 (7)(a)-(b).

¹⁷⁹ Michael Katz *A practical guide to the implications of the new Companies Act – an introduction* – De Rebus, January/February 2010.

The 2008 Act seems to be predicated on the concept of concerted parties concluding an enforceable agreement.¹⁸⁰ This is narrower than the Act, where arrangements and understandings that may not necessarily create a binding agreement between the parties fall within the concert party definition.¹⁸¹ If this view is correct, it is an example of transactional arbitrage between the two Acts.¹⁸²

The new Act will come into force as from July 2010, and every company as well as company lawyer will await its enforcement with eager anticipation.

¹⁸⁰ *New Companies Act: who is related to whom and why?* – Business Report June 30, 2009

¹⁸¹ See vn 179.

¹⁸² See vn 179.

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