

**CAPITAL RULES IN TERMS OF THE COMPANIES ACT NO.71 OF 2008.**

**BY**

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## **TABLE OF CONTENTS**

<b>Declaration of own work</b>	<b>i</b>
<b>Acknowledgements</b>	<b>ii</b>
<b>Dedications</b>	<b>iii</b>
<b>Summary</b>	<b>iv</b>

### **Chapter One**

<b>1. INTRODUCTION AND STATEMENT OF THE PROBLEM</b>	
<b>1.1 Background</b>	<b>1-2</b>
<b>1.2 Introduction</b>	<b>2-3</b>
<b>2. The Research Problem</b>	<b>3-4</b>
<b>3. Delimitations of study</b>	<b>4</b>
<b>4. Research Methodology</b>	<b>4</b>
<b>5. Data and Treatment of Data</b>	<b>4</b>
<b>6. Definition of Concepts and Terms</b>	<b>5-6</b>
<b>7. Chapter summary</b>	<b>6</b>

### **Chapter Two**

#### **CORPORATE PERSONALITY**

<b>2.1 Introduction</b>	<b>7</b>
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<b>2.2.1 The Position in terms of the 1973 Act</b>	<b>8</b>
<b>2.2.2 The Present Position</b>	<b>8-9</b>
<b>2.3 The 'Life' of a Company</b>	<b>10</b>
<b>2.3.1 The Concept of Shares</b>	<b>10-12</b>
<b>2.4 Conclusion</b>	<b>12-13</b>

### **Chapter Three**

#### **CAPITAL RULES IN COMPANY LAW**

<b>3.1 Introduction</b>	<b>14</b>
<b>3.2 The Position under the 1973 Companies Act</b>	<b>15-17</b>
<b>3.3 The Present Position under the Companies Act of 2008</b>	<b>18</b>
<b>3.3.1 The Provision of Financial Assistance</b>	<b>18-20</b>
<b>3.3.2 Acquisition of Own Shares</b>	<b>20-22</b>
<b>3.4 Liability: The Past and Present Position</b>	<b>22-23</b>
<b>3.5 Remedies</b>	<b>24-25</b>
<b>3.6 Conclusion</b>	<b>26-27</b>



## **Chapter Four**

### **OTHER CAPITAL RULES**

<b>4.1 Introduction</b>	<b>28</b>
<b>4.2 Dividend Payment Rules</b>	<b>28-30</b>
<b>4.2.1 Tax Implications on Dividends/Distributions</b>	<b>30-31</b>
<b>4.3 Pre-Emptive Rights</b>	<b>31-32</b>
<b>4.4 Issue of Shares at a Discount</b>	<b>32-33</b>
<b>4.5 Conclusion</b>	<b>34</b>

## **Chapter Five**

<b>5.1 Conclusion and Recommendations</b>	<b>35-38</b>
<b>Bibliography and references</b>	<b>39-41</b>



## DECLARATION

I, BONGIWE G. DLAMINI declare that this paper entitled Capital rules in terms of the Companies Act no.71 of 2008 is my own independent work and all the sources that have been used, quoted, referred to, have been indicated and acknowledged by means of complete references.

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Signature.

(Ms.Bongiwe Dlamini).

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Date.

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## DEDICATIONS

This paper is dedicated to God almighty without whom none of this would have succeeded, to my son, Yenziwe Bandile Tsehlo and my entire Family.

## SUMMARY

This paper entitled Capital Rules in terms of the Companies Act no.71 of 2008 is submitted in partial fulfillment of the requirements for the degree of Master of Laws (LLM) majoring in Corporate Law.

The topic is motivated by the recent change in our company law ushered by the new Companies Act no.71 of 2008. The new Act sets forth to repeal, in the near future, the Companies Act no.61 of 1973. It is trite that the 1973 Act, which has regulated our company law for over thirty (30) years, was old and outdated. Several attempts were made to resuscitate it so as to bring it to par with prevailing international trends in company law. This is evidenced by the numerous amendments to the 1973 Act over the years, particularly between the years 1998 and 1999 when company law trends were experiencing a dimensional shift through out the world. However, these attempts boiled down to 'pouring new wine into an old skin'. Ultimately, it became imperative that the entire Act be reviewed and hence the enactment of the Companies Bill which later became the new Companies Act of South Africa.

The new Act comes with major changes in the company law system. Like any new legislation, some of these changes still need to be revisited while others still need time to settle into our legal system. This paper, as the title depicts, focuses on the changes introduced by the new Act in the sphere of Capital Rules.

To a great extent, the new Act is clear on its position regarding the principle of capital maintenance. Capital rules no longer apply as exceptions to the common law rule as was the case under the 1973 Act. The rules are unambiguously stated in the new Act in sections 45, 46 and 48. The Board of Directors is endowed with power to authorize a company to, *inter alia*,



- provide financial assistance to a related or inter-related company,
- acquire its own shares or those of a related or inter-related company,
- issue shares at a discount and
- declare and pay out dividends.

All things done in terms of the new Act are subject to the company's solvency and liquidity. Any act done that is inconsistent with the Act is void and to be deemed void, the court has to declare such act void (section 218 of the Companies Act no.71 of 2008). This paper seeks to highlight the problems anticipated in light of the changes imported by the new Company law dispensation. Some positive changes have also been observed and these too are highlighted herein. The findings herein are not conclusive as this paper addresses only one specific aspect, Capital Rules, the Act itself is much broader and covers a wide aspect of company law.

It is my wish to see other areas of research develop from this paper and more importantly, to see amendments on the Act being implemented in due course.

## CHAPTER ONE:

### 1. INTRODUCTION AND STATEMENT OF THE PROBLEM

**1.1 BACKGROUND:** The rules and content of Company Law in South Africa has just recently undergone review. This has culminated in the replacement of the 1973 Companies Act with a new Companies Act no.71 of 2008. The former has governed our company law for over thirty (30) years with a number of amendments along the way. Some of these amendments were effected over a short space of time, particularly during the period between 1998 and 1999. During this period, Company Law experienced what **Loubser**<sup>1</sup> termed as a flurry of activity. In just one year, three Companies Amendment Acts were passed (i.e Act no.35 of 1998, Act no. 60 of 1998 and Act no. 125 of 1998) as well as a new Insider Trading Act no.135 of 1998<sup>2</sup>. In 1999, yet another Companies Amendment Act no.37 of 1999 was promulgated<sup>3</sup>. In the following years, the 1973 Act with all its amendments became untenable and somewhat incapable of compliance with international trends in Company Law. It was labelled as unsustainable in the rising era of corporate governance. A reform and review of the 1973 Act (as amended) became a matter of necessity.

The task of reform and review began with an initiative by the Department of Trade and Industry (dti), in consultation with Government and the relevant stakeholders. The process started with the publishing of guidelines for corporate law reform. An input from various Company Law stakeholders was outsourced. The result was the publication of the Companies Bill no. 61 of 2008.

The Companies Bill sought to introduce 21<sup>st</sup> century trends of corporate governance. The main goal was to channel our Company Law with international standards and practices and upholding the spirit of our

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<sup>1</sup> Loubser 'Recent Developments in Corporate Law' (2000) S A MercLJ.

<sup>2</sup> Loubser, *ibid* at 1.

<sup>3</sup> Loubser, *ibid* at 1.

Constitution<sup>4</sup>. The new Bill necessitated formulating a new Code that will align itself with the changes sought to be introduced once the Bill became law. This resulted in the codification of KING III Code and the KING III Report<sup>5</sup>. The Bill was signed by the Minister of Trade and Industry in 2009 and became operative as the new Companies Act no. 71 of 2008 as of the 1<sup>st</sup> July 2010 after being signed by the state President. It is observed that the new Act has done away with the formalistic approach of the 1973 Act. It introduces a simplified version of the Companies Act which is more reader friendly, yet captures new concepts of international standards. It replaces the more than 400 sections of the 1973 Act with 225 sections. It is further observed that the new Act totally decriminalized all conduct that was otherwise criminal under the 1973 Act.

The changes introduced by the new Act have been applauded by academicians, scholars, lawyers and, most importantly, company stakeholders. The changes, in particular, in the area of Capital rules have captured the present writer's interest. This paper seeks to examine these changes and highlight some areas of concern. It is hoped that the highlighted problem areas will form basis for future amendments.

**1.2 INTRODUCTION:** Capital maintenance rules have experienced a dimensional shift in the new Companies Act no. 71 of 2008. The changes have a huge impact in the future outlook of our Company Law milieu and have a fundamental impact in terms introducing changes in the future. These changes themselves provide an interesting point of research which can assist in influencing future amendments and assist also in the interpretation of the not so clear provisions of the new Act. The focus of this paper however remains in examining the changes brought in the area of capital rules.

The capital maintenance concept lies at the very core of corporations. The concept emanates from an old common law principle that a company may not reduce its issued share capital, nor may it return

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<sup>4</sup> Democratic Constitution of 1994.

<sup>5</sup> The KING III Report became effective as of the 1<sup>st</sup> March 2010.

shares to the shareholders or purchase its own shares unless authorised by the Act or common law<sup>6</sup>. The principle was seen as a guarantee or some sort of protection to creditors who look to the company capital for satisfaction of their claims. Capital rules under the 1973 Act were seen as no more than a superfluous means of protecting creditors. **Cilliers and Benade** critique the concept of capital maintenance as not only being an imperfect way to protect creditors but also for the reason that the English common law rules upon which it was based was notoriously imprecise and uncertain<sup>7</sup>. There is a wide and open debate among scholars on whether this area of the law ought to be regulated or not. What is certain however, is that it is regulated and the present Act allows companies to, for instance, buy their own shares or reduce their share capital provided this is done in terms of the Act or authorised by the Constitutive documents of the company. A detailed discussion of the above will follow in the next chapters. What one may point out preliminarily is the level of importance attributed to the concepts of 'solvency' and 'liquidity' under the new Companies Act. Every act by shareholders or directors of the company, whether authorised by the Act or the MoI will be measured against the company's ability to satisfy the solvency and liquidity test as set out in **Section 4(1)** of the 2008 Act<sup>8</sup>.

**2. THE RESEARCH PROBLEM:** This research will attempt to dissect the concept of capital rules in light of the prevailing position. It is a trite principle of company law that a company draws its capital from the sale and purchase of its shares. A shareholder's 'investment' in a company invariably makes him a creditor of that company. Generally, as a creditor one would require some form of security of his investment and surely if the existing milieu does not offer such security, the consequences will be dire to the future existence of companies and hence to our economy. As eluded in the introduction, capital rules have experienced a shift from the previous position under the 1973 Act. The aim of this research is

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<sup>6</sup> Cilliers and Benade *Corporate Law*, 3<sup>rd</sup> Ed (2000), 322.

<sup>7</sup> Cilliers and Benade, *ibid*, 322.

<sup>8</sup> Viz that the assets of the company at the relevant time equal or exceed its liabilities and it appears that it will be able to pay its debts as they become due in the ordinary course of business for at least 12 months after the date on which the test is considered.

to provide an insight of the concept of capital rules from a critical point of view. By the end of the research, the writer hopes to have answered the following questions:

- Has the 2008 Act done justice for corporations through its modern form of capital rules? In particular, do these rules in their modern form provide adequate protection of creditors?
- To what extent does this new Company Law dispensation bring South Africa to alignment with international standards?
- Have we not stretched the new Act too far to the point of rendering some sections academic by trying to incorporate areas that would best be regulated elsewhere?
- Will the approach of establishing quasi-judicial bodies as alternative dispute resolution avenues produce the intended result of avoiding lengthy and costly court processes and speedy remedies?

**3. DELIMITATIONS OF STUDY AREA:** The paper is confined and limited to the topic of Capital Rules under the Companies Act no. 71 of 2008. It does not, as far as possible, include research outside the ambit and scope of the title.

**4. RESEARCH METHODOLOGY:** The research has been conducted through extensive reading of existing texts, articles, journals and case law on the subject. The writer has not merely regurgitated what has already been said but own opinions have been expressed where required. Internet research has been inescapable in this era of cyber information. No interviews or questionnaires have been administered.

**5. DATA AND TREATMENT OF DATA:** The paper focuses on literature relevant to the position in terms of the 1973 Act and the present Companies Act no. 71 of 2008. No quantitative data analysis is taken into account as no questionnaires have been administered. The main emphasis is placed on analysing the Companies Act no.71 of 2008 and its potential effect on the subject matter as well as the projected impact it will have on corporations in the future.

## 6. DEFINITION OF CONCEPTS AND TERMS:

- **‘Corporate Governance’**- the term is commonly used and more often overused to the extent that it sounds like a cliché. For purposes of this work the writer will adopt the meaning given by FARRAR J<sup>9</sup> as “...control of corporations...” and “...systems of accountability by those in control...”. It refers to companies’ legislation but it also transcends the law by looking not only at legal control but also de facto control of corporations, accountability, best practice rules and ethics.<sup>10</sup>
- **‘Corporations’**- means companies and entities incorporated in terms of the Companies Act no.71 of 2008 and the Close Corporations Act no.69 of 1984 and include companies and entities already incorporated in terms of the 1973 Act.
- **‘Companies Act’**- refers to the new Companies Act no.71 of 2008.
- **‘Old Companies Act’**- means Act no.61 of 1973.
- **‘Mol’**-Memorandum of Incorporation as a constitutive document under the Companies Act of 2008.
- **‘dti’**- means the Department of Trade and Industry.
- **‘JSE’**-refers to the Johannesburg Stock Exchange 2939 Limited.
- **‘Board’**- means the directors or board of directors of a company.
- **‘Commission’**- The Companies and Intellectual Property Commission as established by section 185 of the Companies Act of 2008.
- **‘Panel’**- The Take-Over Regulation Panel established in terms of section 196 of the Companies Act of 2008.
- **‘Minister’**- refers to the Minister of Trade and Industry.

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<sup>9</sup> FARRAR J *Corporate Governance-Theories Principles and Practice*, 2<sup>nd</sup> Ed, (2005).

<sup>10</sup> FARRAR, *ibid* 3.

- **'NPA'**-refers to the National Prosecution Authority in its capacity as a national body tasked with prosecution of all criminal matters in the country.
- **'Companies Tribunal'**-means the companies ombud established in terms of section 193 Of the Companies Act no.71 of 2008.

**7. CHAPTER SUMMARY:** The paper is structured into five (5) chapters with topics and sub-topics on the main subject and ancillary matters. The first chapter consists in an introduction and incorporates the salient components of the proposal. The second chapter deals with an introductory discussion of corporate personality, particularly the juristic nature of corporations and how they acquire legal personality. The third chapter is the crux of this paper and discusses corporate capital in depth. More specifically, the third chapter discusses the capital maintenance concept under the Companies Act no. 61 of 1973, and the concept in its present form in terms of the new Companies Act no.71 of 2008. Capital rules, being wide in scope will spread onto the fourth chapter as well. The fifth and final chapter is a summary of the paper, the findings and recommendations.

## **CHAPTER TWO:**

### **CORPORATE PERSONALITY**

**2.1 Introduction:** One of the distinctive factors of corporations is their ability to acquire legal personality upon incorporation. The general company law principle in regards to corporations is that upon formation, a company becomes a separate legal entity. In other words, it acquires its own rights and duties existing separately from its members<sup>11</sup>. This entails a fundamental and important company law principle that lies at the core of corporate entities. Our jurisdiction endorses this principle as landmarked by the case of *Salomon v Salomon And Company*<sup>12</sup>. Briefly, the facts in this case were that Mr Salomon sold his business to a limited company. The shareholders were himself and his family. The business was subsequently wound up. After the sale of its assets the liquidator realised that no funds would be left for payment of ordinary creditors once Mr. Salomon's debentures were paid. The liquidator sought to have him liable to indemnify the company against the claims of the creditors. His argument was that the company was no more than an alias or agent of Mr. Salomon. It was in fact Mr. Salomon in another form. On Appeal, the House of Lords Held that once incorporated legally, a company must be treated like any other independent person with rights and liabilities appropriate to itself<sup>13</sup>.

It is trite that the *Salomon* principle is part of our law and its *ratio decidendi* is often quoted in a number of our landmark judgements in our company law. What follows is an examination of the corporate principle under the 1973 as well as the 2008 Companies Acts.

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<sup>11</sup> Cilliers and Benade, *ibid*.

<sup>12</sup> (1897) AC 22.

<sup>13</sup> Hahlo's *Company Law through the Cases* 5<sup>th</sup> Ed (1991), 14.



**2.2.1 THE POSITION IN TERMS OF THE 1973 ACT:** The Companies Act no.61 of 1973 defines a company as an entity incorporated in terms of the relevant provisions of the Act or any body which was a company in terms of any law which preceded the present Act<sup>14</sup>. I respectfully align myself with the authors **Cilliers and Benade**'s critique of this definition as being incomprehensive<sup>15</sup>. Much reliance in the past has been made on looking at the components of the association to deduce whether it is a company in terms of the Act, e.g the structure of its membership, whether it has a share capital or not, and whether it is limited by guarantee. It is upon examination of, among others, the above features that courts could conclusively find that an association is a corporation in terms of the Act.

**2.2.2 THE PRESENT POSITION:** The new Companies Act no. 71 of 2008 received Presidential assent on the 1<sup>st</sup> of July 2010. Effectively it is our new Law but it is expected to come into operation on a date not earlier than one year following the date on which the President assented to it<sup>16</sup>. The new Act has attempted to do away with the formal definition of the 1973 Act and has simplified and elaborated the definition as follows:

'A company is a *juristic person registered* in terms of this Act or a juristic person that immediately before the effective date-

- a) was registered in terms of the Companies Act of 1973..., or
- b) Close Corporations Act no.69 of 1984...

and recognized as an 'existing company' in terms of the 1973 Act...'<sup>17</sup>

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<sup>14</sup> See Definitions section of the 1973 Act.

<sup>15</sup> Cilliers and Benade, *ibid*.

<sup>16</sup> Section 225 of the Companies Act no. 71 of 2008.

<sup>17</sup> See Chapter 1 Part A of the Companies Act no.71 of 2008.

The legal effect of this juristic personality is a demarcation between the assets, liabilities and estate of the company from its members. Consequently, as stated by **Cilliers and Benade**, the sequestration of the estates of members will not lead to liquidation of the company, and conversely, the liquidation of a company will not necessarily result in the sequestration of estates of its members<sup>18</sup>. Incorporation confers the status of legal personality to the company. It has been argued under the common law that prior to incorporation, the company does not exist therefore any acts purportedly done by the company prior to its incorporation are not binding to the company. Our company law clearly states that a person may enter into an agreement in the name of, or on behalf of an entity that is contemplated to be incorporated but does not yet exist<sup>19</sup>. The contract must however be ratified or rejected completely, partially or conditionally by the company within three months of incorporation<sup>20</sup>.

The above summarizes the concept of legal personality and its legal effect. One must mention that the new Act has created what is referred to as 'personal liability company'. In terms of section 8(2) (c) and (d) of the new Act, it is a private or a public company which states in its Mol that it is a personal liability company. It is identified by the words 'Incorporated' or 'Inc' at the end of its name. It is submitted that this class of company is similar to the section 53 private companies under the 1973 Act where liability of directors is jointly and severally for all debts and liabilities of the company contracted during the director's term of office. Effectively, the subscribers or shareholders of a personal liability company acquiesce to personal liability for the debts of the company. Under the 2008 Act, present and past directors will be jointly and severally liable for the contractual debts of the company<sup>21</sup>.

Having mentioned how corporations acquire the status of legal personality and what the status implies in terms of the law, we may now look into how the company maintains its livelihood.

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<sup>18</sup> Cilliers and Benade, *ibid*, 10.

<sup>19</sup> Section 21 (1) of the Companies Act no.71 of 2008.

<sup>20</sup> Section 21 (4) of the Companies Act no.71 of 2008.

<sup>21</sup> KING III Report on Corporate Governance.

**2.3 THE 'LIFE' OF A COMPANY:** To enable a company to function properly, it must have capital.

Once it has been legally incorporated, the company may carry out its functions in terms of the Act and in accordance with its objects as contained in its Mol. Our company law provides for distinctive ways in which capital may be raised in a public and private company. As already pointed out above, private companies are prohibited from offering their shares to the public and transferability of those shares is restricted by its Mol<sup>22</sup>. With regards to public companies, it all depends on whether the shares are being offered to the public and whether the company is listed with the Johannesburg Stock Exchange Ltd. If the offer is made to the public, the offer must be accompanied by a prospectus<sup>23</sup>. In the case of a listed company, the JSE Rules regulate the issue and acquisition of such shares.

Capital acquisition by the different types of companies will be discussed in more detail in chapter three (3). However, it may be noted that the common denominator between the various types of companies is that all require some form of capital to maintain their livelihood and this capital is generated through the issue and purchase of shares. What are these shares?

**2.3.1 The Concept of Shares:** The question 'what is a share' is more often asked than answered by scholars, and it is still not judicially settled. The definition most quoted in our jurisdiction is that of FARWELL J in *Borland's Trustees v Steel*<sup>24</sup> which states as follows;

“ A share is the interest of a shareholder in a company measured by a sum of money for the purpose of liability in the first place, and of interest in the second , but also consisting of a series of mutual covenants entered into by all the shareholders *inter se*.... A share is not a sum of money...but it is an interest measured by a sum of money and made up of various rights contained in the contract, including the right to a sum of money of more or less amount.”

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<sup>22</sup> Section 8 (2) (b) (ii) of the Companies Act no.71 of 2008.

<sup>23</sup> Section 99 (2) of the Companies Act no. 71 of 2008.

<sup>24</sup> [1901] 1 CH 279 at 288.

**Gower and Davies** opine that the often quoted definition in *Borland's Trustees* places emphasis on the contractual nature of shareholders rights. They argue that the theory seems to be that the contract constituted by the articles of association defines the nature of these rights. They contend further that these rights are not purely personal rights but confer some form of proprietary interest in the company. The company, they continue to argue, is treated not just as a person (a *subject* of the rights and duties) but also as the *object* of these rights and duties<sup>25</sup>.

CORBETT JA in *Standard Bank of South Africa Ltd v Ocean Commodities Inc*<sup>26</sup> describes shareholders' rights as a bundle or conglomerate of personal rights entitling the holder thereof to a certain interest in the company, its assets and dividends.

**HAHLO** simply defines a share as a share in the capital of a company. It is clear from the foregoing that there is no settled definition of a share and attempting to comprehensively define the concept only takes one in circles. My considered view is that it all boils down to the components of the share in relation to the rights it confers upon the holder thereof.

My summarised definition of a share is that it is;

- A share in the capital of a company,
- Representing a shareholders monetary interest in the company, and
- Attaches a series of personal rights (to the holder thereof) in the company and its assets, which are regulated by the Mol.

The new Companies Act has attempted to remedy this problematic definition of shares and provides in section 35(1) that a share is *movable property transferrable* in any manner provided by the Act or other legislation. With much respect, this is but the simplest version of what a share is. However, this much is

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<sup>25</sup> Gower and Davies, *Principles of Modern Company Law*, (2008).

<sup>26</sup> 1983 (1) SA 279 (A) at 288.

true of shares; they are recognized *de lege* (in law) as well as *de facto* (in fact) as objects of property capable of being sold, bought, mortgaged and bequeathed.

**2.4 CONCLUSION:** The *Salomon v Salomon* principle has remained firmly entrenched in our law and has been maintained throughout the wave of changes since the first Companies Act of 1926. It has remained unaltered in the 2008 Act. The KING III Report hails the introduction of the new Act as a positive step towards economic growth and aligning the country with international standards and practices<sup>27</sup>. The KING Code suggests that the new Act will bring corporations to compliance with the Constitution of the country as it abolishes the notion of a corporate structure that can pursue its course to realise profits at the expense of human rights. South Africa is now in a position to provide a framework within which corporation can operate whilst upholding fundamental provisions in the Bill of Rights as outlined in our Constitution<sup>28</sup>.

The new Act endeavours to, *inter alia*, provide for;

- The incorporation, registration, organisation and management of companies;
- Capitalisation of profit companies;
- Define relationships between the companies and their respective shareholders or members and directors;
- Efficient rescue of financially distressed companies;
- Appropriate legal redress for investors and third parties with respect to companies;
- The establishment of bodies such as the Companies and Intellectual Property Commission and the Takeover Regulation Panel to administer the Act;
- The establishment of alternative dispute resolution forums such as the Companies Ombuds;

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<sup>27</sup> King III Report on Corporate Governance at para. 23.

<sup>28</sup> KING III Report on Corporate Governance, *ibid*.

- The repeal of the Companies Act no.61 of 1973 and amend the Close Corporations Act no.69 of 1984<sup>29</sup>.

A lot of effort is put into implementing the submissions of the relevant stakeholders and drafting an Act of Parliament that will uphold the Constitution of the country, international standards and still adapt to the prevailing economic and social climate. The legislator must achieve a certain balance, and that is the most challenging aspect of a new law. The true test of the success in achieving the above is revealed when that particular Act is tested in court. It is within that forum that cracks and shortfalls will be revealed. It will be interesting to see how the courts will apply the new Act in practical situations come date of operation of the 2008 Act.

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<sup>29</sup> See Preamble to Companies Act no.71 of 2008.

## **CHAPTER THREE:**

### **CAPITAL RULES IN COMPANY LAW.**

**3.1 INTRODUCTION:** The **Trevor v Whitworth**<sup>30</sup> principle has been the cornerstone of our capital maintenance rules in South African Company Law<sup>31</sup> for over two decades. It was adopted into our legal system by the Transvaal High Court in the case of **Jacobs v African Agricultural and Finance Corporation Ltd**<sup>32</sup> and again reaffirmed in a later case of **Sage Holdings Ltd v Unisec Group Ltd**<sup>33</sup>.

The facts of these cases will not be mentioned here. What is important for the present discussion are the principles stated in these cases. In the *Whitworth* case, His Lordship SMITH J held that an agreement by the company to purchase its own shares is bad in law on the grounds that such an agreement would in effect be a reduction of capital. His Lordship COETZEE J in the *Unisec* case describes such a transaction as *fraudem legis*, devised to carry out an unlawful object which is to use company funds of the holding company to purchase its own shares.

The rationale for disallowing the above has always been that the capital of the company constitutes a fund to which creditors of a company look up to for satisfaction of their claim and hence ought to be maintained. This notion has come under severe criticism and dissenting opinions have been expressed about its practicality<sup>34</sup>. This so-called protection afforded by the capital maintenance rule is superfluous since a company may, in the ordinary course of business lose its capital<sup>35</sup>. In any event, it is my opinion that any form of business transaction has an inherent risk of loss and creditors inevitably assume that

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<sup>30</sup> (1887)12 App. Case 409 (HL).

<sup>31</sup> Loubser 'Recent Developments in Corporate Law' (2000) SA MercLJ 5.

<sup>32</sup> (1905) TH 47.

<sup>33</sup> 1986 (3) SA 259 (T).

<sup>34</sup> See the following articles: Van Der Linde 'Financial assistance for the acquisition of shares in accordance with section 85 of the companies act- a reply to Delpport' (2001) SA MercLJ 437 and Delpport 'Capital rules in south African company law' De Jure 406.

<sup>35</sup> Loubser, *ibid*.

risk the minute they enter into a share purchase transaction. Van Der Linde<sup>36</sup> additionally opines that creditors can be protected in other ways other than insisting on maintenance of share capital.

**THE POSITION UNDER THE 1973 COMPANIES ACT:** Until recently, the position maintaining in our company law has always been that;

‘No company shall give, whether directly or indirectly, and whether by means of a loan, guarantee, the provision of security or otherwise, any financial assistance for the purpose of or in connection with a purchase or subscription made or to be made by any person of, or for any shares of the company or where the company is a subsidiary company; or its holding company’<sup>37</sup>.

It was provided further by the 1973 Act<sup>38</sup> that section 38(1) shall not be construed as prohibiting the provision of financial assistance for the purpose of acquisition of shares in a company by a company or its subsidiary in accordance with section 85. In other words, the acquisition by a company of its own shares was possible provided it was done in accordance with section 85. For a summarized version and the clarity with which the section is articulated, the writer will quote, with respect, Van Der Linde’s summary of the requirements of section 85<sup>39</sup>. She states that the following have to be met; Firstly, there must be a special resolution taken to approve the acquisition. The resolution (special) can be a specific approval for a particular acquisition or a general approval. Secondly, payment by the company for the acquisition of shares can only be made if there is no reasonable ground for believing that;

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

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<sup>36</sup> Van Der Linde ‘A Company’s Purchase of its Own Shares’(1999) JBL 68.

<sup>37</sup> Section 38(1) of the Companies Act no.61 of 1973.

<sup>38</sup> Section 38(1) (d) of the Companies Act no.61 of 1973.

<sup>39</sup> Van Der Linde ‘A Company’s Purchase of its Own Shares’ *ibid*.



Thirdly, where par value shares are required by the company, the issued capital has to be decreased by an amount equal to the nominal value of the acquired shares. This provision, Van Der Linde states, ensures that creditors are not misled into believing that the issued or paid up capital is higher than it actually is. If par value shares are acquired at premium, the later may be paid out of the reserves of the company (that is, the share premium account and the capital redemption reserve fund). Fourthly, where no- par value shares are acquired, the stated capital account must be decreased with reference to the average issue price of all the shares of that class.

Fifthly, the shares acquired by the company have to be cancelled as issued shares and regarded as authorized but unissued shares. Lastly, after the acquisition, there must still remain shares in issue other than convertible or redeemable shares. Van Der Linde<sup>40</sup> states that this is to ensure that a company cannot acquire *all* its shares or be able to *convert* or *redeem* all its issued shares as this would effectively amount to informal self-liquidation.

The notion of what *providing financial assistance* is has itself been a subject of jurisprudence. Our courts have on two occasions provided us with important precedents in this respect.

The first is the case of **Gradwell v Rostra Printers**<sup>41</sup> where the court applied the ‘impoverishment test’ as the determinant of whether the sale of all issued shares to the second respondent company (Printing House Limited) amounted to the provision of financial assistance. The relevant question in *casu* was whether the company has been left poorer in consequence of what it did in relation to the transaction<sup>42</sup>. Once the company’s financial position is adversely affected by the transaction then the company has impoverished itself therefore has given *financial assistance*.

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<sup>40</sup> Van Der Linde ‘A Company’s Purchase of its Own Shares’, *ibid*.

<sup>41</sup> 1959 (4) SA 419 (A).

<sup>42</sup> Gower and Davies, *ibid*, 164.

The second case is that of *Lipschitz v UDC Bank Ltd*<sup>43</sup>. In this case, the Appellate Division (as it was called then) stated that the impoverishment test ought not to be the only test used to determine whether financial assistance has been given. Financial assistance includes other acts which do not necessarily involve the impoverishment of a company or even the use of its pecuniary resources at all<sup>44</sup>. The provision of security or a guarantee by the company, for instance, (which is covered by section 38(1)(d))<sup>45</sup> does not necessarily involve a direct depletion of the company resources<sup>46</sup>.

It is submitted that the position under the 1973 Act was clouded with controversies. **Van Der Linde**<sup>47</sup> suggests that this was caused by the way in which the entire section 38 was couched. It reads like an exception to the section 38(1) prohibition. Nonetheless, it became a very useful provision which effectively made it possible for a subsidiary to give financial assistance to its holding company for the acquisition of the latter's own shares and *vice versa*<sup>48</sup>. Had it not have been for subsection (d) such would remain prohibited<sup>49</sup>.

The capital rules as they were under the 1973 Act placed much emphasis on the question of direct depletion of company resources. It is submitted that as the courts observed in the *Lipschitz* case, the issue whether the company is left poorer (impoverished) or not does not assist much, in particular if the financial standing of the company is substantial enough to countervail any depletion of resources. It is submitted that the same yardstick ought to be used for both small entities and large conglomerates to measure whether financial assistance has been given, *so long as they are in the same class of companies*.

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<sup>43</sup> 1979 (1) SA 789 (A).

<sup>44</sup> Gower and Davies, *ibid*, 164.

<sup>45</sup> Companies Act no.61 of 1973.

<sup>46</sup> Gower and Davies, *ibid*.

<sup>47</sup> Van Der Linde 'Financial Assistance for the Acquisition of Shares in Accordance with Section 85 of the Companies Act- A Reply to Delpport' (2001) MerclJ, 437.

<sup>48</sup> Van Der Linde, *ibid*, 442.

<sup>49</sup> Van Der Linde, *ibid*, 442.

### **3.3 THE PRESENT POSITION UNDER THE COMPANIES ACT OF 2008:**

**3.3.1 Provision of Financial Assistance** - Whereas the 1973 Act dealt with the provision of financial assistance and acquisition by a company of its own shares in a single section<sup>50</sup>, the 2008 Act has attempted to separate the two<sup>51</sup>. This is done presumably in the spirit of clarity and to remedy the problems of the 1973 Act. For purposes of continuity of the discussion, sections 45 and 48 will be tackled simultaneously as done in the discussion of the position under the 1973 Act.

The position prevailing under the New Act is that the Board, unless otherwise provided by the Mol may authorise a company to provide, inter alia, direct or indirect financial assistance to a related or inter-related company or corporation<sup>52</sup>. The requirements under the new Act are that such financial assistance must be pursuant to a special resolution adopted two (2) years previous to the action. Additionally, the Board must be satisfied that after providing the financial assistance, the company would satisfy the solvency and liquidity tests<sup>53</sup>. The Act further requires that the financial assistance be fair and reasonable to the company.

The first novelty under the new Act is the manner of authorization. The Board which is supposedly the 'agent' of the company is empowered to authorize its principal (the company). This is an inversion of the normal agency rules where the principal gives a mandate to an agent in order to clothe him with power to act on his behalf. It is submitted that this position is quite anomalous and ought to be amended accordingly.

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<sup>50</sup> Section 38 of the Companies Act no.61 of 1973.

<sup>51</sup> Provision of financial assistance is dealt with in section 45 while acquisition by a company of its own shares is dealt with in section 48.

<sup>52</sup> Section 45 (2) of the Companies Act no 71 of 2008.

<sup>53</sup> Section 45 (3) (b) (i) of the Companies Act no. 71 of 2008.

Section 45(2) provides for the giving of financial assistance to a *related or inter-related company or corporation*. A juristic person is said to be related to another juristic person if either of them directly or indirectly controls the other or the business of the other, or is a subsidiary of the other<sup>54</sup>. Juristic persons are said to be inter-related if three or more of them are connected to each other in an unbroken link, that is, the first and second such persons are related to the second and third such persons and so forth, in an unbroken series<sup>55</sup>.

The 2008 Act authoritatively incorporates the concepts of solvency and liquidity. It provides that financial assistance ought not to be given unless the Board is satisfied that after providing the financial assistance, the company would satisfy the two tests<sup>56</sup>. One of the problems anticipated in this respect is that the determination has to be made two (2) years *prior* to the action. This may be problematic practically as the financial position of the company may have plunged within the course of the period. It is submitted that this *waiting period* is too long. It is my humble view that it would make better sense if a one (1) year period was provided so as to coincide with the company's annual financial reporting.

Additional to the above requirements, the Board must ensure that any restrictions in the company's Mol regarding the provision of financial assistance are adhered to and the resolution is not inconsistent with both the Mol and the Act. If there is found to be such inconsistencies, the Act states that the resolution will be *void*<sup>57</sup>. One anticipates a lot of controversy around section 45 (6) in light of section 218 of the same Act which states categorically that nothing in this Act renders void any agreement, resolution or provision of an agreement, resolution, Mol or rules of a company...void, voidable or unlawful unless declared void by the court.

Effectively, this means that even if the Board adopts a resolution that is otherwise void in terms of section 45(6), it will cease to be void until the court has declared it void. This voiding and un-voiding of

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<sup>54</sup> Section 2 (1) (c) of the Companies Act no.71 of 2008.

<sup>55</sup> Section 2 (1) (d) of the Companies Act no.71 of 2008.

<sup>56</sup> Section 45 (3) (b) (i) of the Companies Act no. 71 of 2008.

<sup>57</sup> Section 45 (6) of the Companies Act no.71 of 2008.

acts that are otherwise void under the Act is bound to create an uproar in Company Law jurisprudence. This will also saddle companies with costs of court applications as the court cannot issue an order in vacuum; it has to be formally approached by application. The burning question is who will approach the court? To me it is nonsensical that a company should approach the court to declare its own resolution void. The new Act goes on to further define what is regarded as financial assistance. It states under section 45 (1) that financial assistance includes lending money, guaranteeing a loan or other obligation and securing any debt or obligation. The section goes on further to create exclusions such as the lending of money in the ordinary course of business by a company whose primary business is the lending of money<sup>58</sup>.

The above summarizes the present position with regards to the provision of financial assistance under the new Act. In terms of effect, the position is similar to that under the 1973 Act, save that what the new Act has done is separate the transactions into different sections.

**3.3.2 Acquisition of Own Shares-** In regards to the acquisition by a company of its own shares, the new Act regulates it separately under section 48. In terms of this section, a company may acquire its own shares. A subsidiary can acquire up to 10% of the shares in its holding company. It is not clear however whether the 10% is of each class of shares or relates to the total shares across the classes. The 1973 Act clearly stated that it was 10% of each class of shares<sup>59</sup>. Clarity is necessary here because the effect of the 10% differs in the sense that if, for instance, it is 10% of three classes of shares, then the 10% becomes 30%.

Nonetheless, it is clear under the new Act that the notion of strict non-acquisition common-law position is abolished. It appears that the only prohibition is if after the acquisition, the company no longer has shares other than convertible or redeemable shares or shares held by its subsidiary. The rationale

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<sup>58</sup> Section 45 (1) (b) (i) of the Companies Act no.71 Of 2008.

<sup>59</sup> Section 89 of the 1973 Act.

behind this prohibition is *firstly*, to prevent a company from disposing of all its shares and leaving only redeemable or convertible shares as this would amount to self-liquidation<sup>60</sup>. *Secondly*, to limit the ability of a holding company to traffic its own shares through its subsidiary<sup>61</sup>. It is noted however that the later would not be easy in light of section 35 (5) which provides that shares issued by a company and subsequently acquired by that company as contemplated in section 48 have the same status as shares that have been authorised but not issued.

An acquisition that is inconsistent with section 46 and section 48 can be reversed by the company on application to the court and the court has the discretion to order either of the following;

- A return of the amount paid by the company, or
- An issue of an equivalent number of shares of the same class as those acquired.

It is submitted that the later order will open room for abuse by companies since they will be able to re-issue the same number of shares of the same class over and over. It is interesting as well to note that an inconsistent acquisition is not void but may be *voidable* under section 218.

Under the 2008 Act, distributions are dealt with as part of acquisitions of own shares by a company. This is inferred from the definition of a distribution under the new Act. A distribution is defined as; *inter alia*...a transfer of the consideration for the acquisition by a company of its own shares or an acquisition by any company within the same group of companies of any shares within that group<sup>62</sup>.

The solvency and liquidity applies *mutatis mutandis* in acquisitions as it does in provision of financial assistance. **Jooste**<sup>63</sup> however suggests that it is possible for companies to by-pass the solvency and liquidity test in acquisitions. He suggests that this is so where the consideration takes the form of a

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<sup>60</sup> See Van Der Linde 'A Company's Purchase of its own Shares, *ibid*.

<sup>61</sup> Van Der Linde 'A Company's Purchase of its Own Shares' *ibid*.

<sup>62</sup> Section 1 (a) (iii) of the Companies Act no.71 of 2008.

<sup>63</sup> Jooste 'Issues Relating to the Regulation of 'Distributions' by the 2008 Companies Act' (2009) SALJ 627.

company incurring debt on behalf of a selling shareholder (surety or guarantee). I respectfully disagree with this view as an acquisition, whatever form it takes directly or *indirectly* results in some payment of a consideration. The Act could not have intended what is suggested by this writer. The shortfall of the solvency and liquidity test is in regards to satisfaction of the test in a group of companies. It implies that the test is satisfied if the aggregate assets of the company exceed the aggregate liabilities of the company<sup>64</sup>. This will create a false impression to creditors because the holding company will rely on assets that are owned by other companies in the group, giving an amplified version of the financial status of the holding company. The test, ideally, should be applied for each individual company in order to protect creditors who might otherwise be misled.

**3.4 LIABILITY: THE PAST AND PRESENT POSITION-** The new Act seems to attach the least liability to directors. In fact, it appears to do all that is possible to absolve directors of liability. This is a major shift from the past position under the 1973 Act where liability was firmer. In fact, criminal prosecution was possible under the old Act. Directors (including directors of the holding company) were jointly and severally liable to restore to the company any amount so-paid and not otherwise recovered by the company<sup>65</sup>. Directors could also face liability for breach of fiduciary duties. Liability under the 1973 Act also included any other liability for breach of duties under the common law. The courts reserved the right to absolve any person from liability if it is shown that he acted honestly and reasonably and in the circumstances ought to be excused<sup>66</sup>.

Conversely, under the new Act, the position is that a director will only be liable for a resolution or an agreement to provide financial assistance contrary to the Act once such resolution or agreement is

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<sup>64</sup> Jooste, *ibid*, 627.

<sup>65</sup> Section 86 (1), Companies Act no.61 of 1973.

<sup>66</sup> Section 248, Companies Act no.61 of 1973.

declared void by the court in terms of section 218<sup>67</sup>. Liability does not attach to a director at all *unless* he was;

- Present at the meeting when the resolution was taken, and
- Failed to vote against the provision of financial assistance despite *knowing* (own emphasis) that it was inconsistent with the Mol.

The same applies to breach of section 45, section 46 and section 48. Under the foregoing sections, directors are only liable if they were present at the meeting when the resolution was taken and participated but failed to vote against the adoption of the resolution despite knowing that it was inconsistent with the Mol.

It is apparent that under the new Act, directors will be liable *firstly*, once the resolution has been declared void by the court. *Secondly*, if they were present at the meeting when the resolution was adopted and failed to object to its adoption. By inference from the foregoing, a director who objects to the adoption of the resolution will not be liable. *Thirdly*, the director must have knowledge that the resolution is inconsistent with the company's Mol. This entails a *subjective test* which may be difficult to prove. In fact, it places an onerous burden on the aggrieved party to prove that the director knew that the resolution was inconsistent with the company's Mol.

Furthermore, the present position under the new Act is that the period of prescription of any action against directors or the company is three years<sup>68</sup>. At face value, the Act is in harmony with the Prescription Act no.68 of 1969<sup>69</sup>. The point of inconsistency is that under the Prescription Act, the three year prescription period for the extinction of a debt runs as soon as the debt is due, and a debt is said to be due when the creditor has knowledge of the debtor and the facts from which the debt arose. Given

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<sup>67</sup> See Section 77 (e) (iv) of the Companies Act no.71 of 2008.

<sup>68</sup> Section 77 (7) of the Companies Act no. 71 of 2008.

<sup>69</sup> Section 12 of the Prescription Act no.68 of 1969.



the procedures that must be followed prior to the institution of action and the two year waiting period of the resolution under the new Act<sup>70</sup>, the action may prescribe before it goes to court. It is submitted with respect that the new Act should have followed the 1973 position which provided that an action to enforce liability must be instituted within *three* years after completion of the acquisition. It is submitted that *completion of the acquisition* runs concurrently with the *debt being due* as envisaged by the Prescription Act.

**3.5 REMEDIES:** It is imperative to begin this discussion on the remedies available to an aggrieved creditor or shareholder with a brief narration of the legal effect of the constitutive documents of a company. The reason is simply that it is these documents that regulate the legal relationship with the company. Under the 1973 Act, the constitutive documents comprised of the Memorandum and Articles of Association. In terms of section 65(2) of that Act, the Memorandum and Articles bound the company and its members as if they had been signed by each member respectively. In other words the relation was contractual in nature,<sup>71</sup> in a peculiar way. It was peculiar in the sense that it was regulated not by the ordinary law of contract but by the common law as well as the Companies Act<sup>72</sup>.

Under the present Act however, the only constitutive document of a company is its Mol<sup>73</sup>. The new Act states simply that the Mol is binding between;

- The company and each shareholder.
- Shareholders of the company.
- The company and each director or prescribed officer of the company as well as any other person serving the company as a member of the audit committee or the Board<sup>74</sup>.

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<sup>70</sup> See Section 45 (3) (a) (ii) of the Companies Act no.71 of 2008.

<sup>71</sup> Morajane 'The Binding Effect of the Constitutive Documents of the 1973 and the 2008 Companies Acts of South Africa' Potchefstroom Electronic Law Journal (2010) 6.

<sup>72</sup> Morajane, *ibid*, 6.

<sup>73</sup> See Sections 13 (1) and (2) of the Companies Act no.71 of 2008.

Our courts will have to assist us in the interpretation of section 15 (6) of the new Act as it is not clear whether it retains *qua* membership contract as the previous Act or not<sup>75</sup>. It is anticipated that a common law rule will be developed to ascertain the rights conferred by the Mol.

Having given the above background, one can then move on to discuss the remedies under the specific capital rules. For the sake of relevance, the discussion will be confined to the 2008 Act, and only brief mention will be made to the 1973 Act. **Jooste**<sup>76</sup> observes the problems created by hip-hopping between sections 46 and 48 in the new Act. He contends that there will be a problem of enforceability in the following respect; section 48(4) provides that an agreement with a company providing for the acquisition by a company of shares issued by it is enforceable against the company subject to subsections (2) and (3). The course of action which must be followed is stipulated in section 48 (5), but the later applies to buy-backs, not acquisitions.

Furthermore, a company has the right to approach the court where it has engaged in an acquisition contrary to section 46. It can therefore be inferred that creditors and shareholders can avail themselves the remedy of derivative action in terms of section 165 of the 2008 Act. The statutory derivative action under the new Act provides that any other remedy available at common law is abolished<sup>77</sup>.

Additionally, creditors or shareholders are required to serve a demand upon the company prior to the institution of any action<sup>78</sup>. A waiting period of fifteen (15) days then ensues before they can then approach the court for *leave* to institute the action on behalf of the company<sup>79</sup>. The court has the discretion whether to grant leave or not and will only be persuaded to do so if it is satisfied that the

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<sup>74</sup> Section 15 (6) of the Companies Act no.71 of 2008.

<sup>75</sup> Morajane, *ibid*.

<sup>76</sup> Jooste, *ibid*, 627.

<sup>77</sup> Section 165 (1) of the Companies Act no.71 of 2008.

<sup>78</sup> Section 165 (2) of the Companies Act no. 71 of 2008.

<sup>79</sup> Section 165 (3) of the Companies Act no. 71 of 2008.

applicant is acting *bona fide* and in the interests of the company<sup>80</sup>. It may be argued that the present position firmly entrenches the common law proper- plaintiff rule as expounded in *Foss v Harbottle*<sup>81</sup> - *albeit* without the common law exceptions to that rule.

**3.6 CONCLUSION:** It is evident that our capital rules have undergone major transition from the 1973 position to the present 2008 Act. The new Act has completely displaced the common law. The present Act is clear and unambiguous in its position that an acquisition by a company or its subsidiary of its own shares is permissible; so also is the provision of financial assistance for the purpose of such acquisition. Despite some criticism around the acquisition by companies of their own shares, there are as many advantages for allowing such acquisitions as there are disadvantages. **Gower and Davies**<sup>82</sup> name but a few of these such as:

- Companies enjoying more flexibility to exercise greater control over the entity.
- Increase in capital mobility in the form of redirecting capital to achieve more efficient investments.
- Harmony within the membership through the option of buying out dissident members.

On the negative however, acquisitions of this nature may open room for market price manipulation, share trafficking by a holding company through its subsidiary and promotion of insider trading<sup>83</sup>. The new Act places utmost faith in the strength of the solvency and liquidity test. While this is an accepted international concept, the Act lets us down by applying the test across the board, resulting in a false reflection of the financial standing of companies within a group.

The issue of voiding and un-voiding of resolutions under the New Act is also another disappointing aspect. *Prima facie*, a resolution that is inconsistent with the Mol is void. However there is still the

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<sup>80</sup> Section 165 (5) of the Companies Act no.71 of 2008.

<sup>81</sup> (1843) 2 Hare 461.

<sup>82</sup> Gower and Davies, *ibid*.

<sup>83</sup> Gower and Davies, *ibid*.

section 218 voiding by the court. Effectively this means that an otherwise void resolution is not void until declared void by the court. The question then is whilst it has not been so declared by the court; does it remain valid and enforceable?

On the issue of liability, the new Act has the least liability attachments than any other Company Act that has ever been in force in the country. While it does make provision for the payment of exorbitant amounts of fine, it has totally removed all forms of criminal liability. Directors will enjoy the least form of liability under the new Act. Directors have taken over the powers of the Mol. They have the power to ratify acts that are otherwise outside the scope of their powers as outlined in the Mol. Such ratification has *retroactive* effect. This means that directors can engage in acts *ultra vires* their scope of power then ratify their otherwise unlawful act through a resolution.

In summary, there are a lot of discrepancies in the new Act not just for the Capital Rules but various other areas of our Company Law. A lot of these can be corrected by regulating the different aspects such as buy-backs, distributions, acquisition of shares by companies, acquisition by subsidiaries separately. This will aid in clarity and consistency as opposed to having to gallivant between the sections. It is submitted that there is still much room for amendments in the 2008 Act.

## **CHAPTER FOUR:**

### **OTHER CAPITAL RULES.**

**4.1 INTRODUCTION:** Other capital rules that will form part of this discussion are;

- a) Dividend payment rules.
- b) Pre-emptive rights.
- c) Issue of shares at a discount.

The above are also said to be capital rules in the sense that they too entrench the principle of protection of creditor's interests by ensuring that there is no depletion of the capital of a company.

**4.2 DIVIDEND PAYMENT RULES:** It has been argued that the legal rules relating to the computation of divisible profits (dividends) was the most archaic part of our Company<sup>84</sup>, until its amendment by the Companies Act of 1999. The Companies Act of 1973 did not regulate the manner in which dividends were to be declared and paid. The practice had been that the company's articles of association regulated how this was to be done. Much reliance was placed on the common law until the introduction of section 90 of the Companies Act of 1999.

At common-law, dividends could only be paid from the distributable profits of the company and never from the share capital<sup>85</sup>. This rule was firmly entrenched in English law as far back as the nineteenth century through the case of **Re Exchange Banking Company (1882)21 ch 519 (CA)**<sup>86</sup> and re-affirmed in a later case of **Ooregum Gold Mining Company v Roper [1892] AC 125 (HL)**<sup>87</sup>. It followed therefore that the position was later incorporated in the English Companies Act of 1985, which is pro- capital

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<sup>84</sup> Delpont 'Capital rules in S.A Company Law' De Jure 412.

<sup>85</sup> Pretorius 'Capital maintenance doctrine in S.A corporate law' [www.accaglobal.com/student](http://www.accaglobal.com/student) (visited on 14<sup>th</sup> September 2010).

<sup>86</sup> Pretorius, *ibid*.

<sup>87</sup> Benade, Henning, du Plessis, Delpont, de Koker and Pretorius, *Enterprenueral law incorporating the new Companies Act Manual* (2009)191.

maintenance. Under the English regime, capital is viewed as a matter of accounting principle, that is, as a liability of the company<sup>88</sup>.

By virtue of our Company law amendment, a company was able to make payments to shareholders subject to;

- a) the Act, and
- b) the company's articles.

'Payment' in this section included any direct or indirect payment or transfer of money or other property to a shareholder in a company by virtue of his shareholding in the company. The acquisition of shares in terms of section 85 or the redemption of preference shares under section 98 was excluded. The only requirements for such payment under this section were that firstly, there had to be reasonable ground for believing that after payment, the company will satisfy both the solvency and liquidity tests; secondly, the payment had to be authorised by ordinary resolution and lastly, the payment had to be stipulated in the company's articles.

Although some writers view the introduction of section 90 by the Companies Act of 1999 as an alteration of the common law rule, it is my observation that there were some remnants of the common law in this section. I respectfully concur with **Henning, du Plessis, Delpport, de Koker and Pretorius's** view that section 90 did not necessarily render the common law redundant<sup>89</sup>.

The Companies Act of 2008 on the other hand alters the common-law entirely. In the first instance, it changes the meaning of payments made to shareholders in their capacity as such from being referred to as 'dividends' and refers to such as 'distributions'<sup>90</sup>. Under the new Act, a company may not make a distribution unless it is pursuant to an existing legal obligation or an order of court<sup>91</sup>. The authorisation

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<sup>88</sup> Palmer's Company law manual (2000) 331.

<sup>89</sup> Henning, du Plessis, Delpport, de Koker and Pretorius, *ibid*.

<sup>90</sup> See Section 46 of the Companies Act no.71 of 2008.

<sup>91</sup> Section 46 (a) of the Companies Act no.71 of 2008.

to make a distribution must be pursuant to resolution by the Board as opposed to the ordinary resolution. There is no prescription for a majority vote under the previous company law regime. Before the Board may authorise the payment of a distribution, the Board is required by the new Act to acknowledge that it has applied the solvency and liquidity tests and has reasonably come to the conclusion that the company will satisfy both tests immediately after completing the proposed distribution<sup>92</sup>. In so far as liability for effecting a distribution contrary to the terms of section 46 is concerned, a director will only be liable to the extent of section 77 (e) (vi) *if* (own emphasis);

- He was present at the meeting when the board approved the distribution or participated in the approval of the resolution, and
- Failed to vote against the distribution despite *knowing* (own emphasis) that the distribution was in contravention of the section.

Liability under section 77 extends up to the loss, damage or costs sustained by the company as a result of a distribution that was in contravention of section 46.

**4.2.1 Tax Implications on Dividends/Distributions:** The Secondary Taxation on Companies (STC) Act of 1993 read together with the Income Tax Act no.52 of 1962 (ITA), regulates the issue of taxes payable by companies, particularly, the issue of taxes on dividends. Section 64B of the ITA imposes a secondary tax on all companies resident in the country based on the net amount of dividends declared during a dividend cycle<sup>93</sup>. In order for a dividend declared by, or accrued to, a company to be subjected to secondary tax, it must be a dividend as defined for income tax purposes<sup>94</sup>. 'Dividend' is defined in the ITA as any amount distributed by a company to its shareholders<sup>95</sup>. It must be noted that in some parts, section 64B and section 64C also refer to 'profits'. Typically, these are 'profits available for distribution'

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<sup>92</sup> See section 46 (b) and (c) of the Companies Act no.71 of 2008.

<sup>93</sup> David C 'Income Tax in S.A' (April 2010).

<sup>94</sup> David C, *ibid*.

<sup>95</sup> See section 1 of the Income Tax Act n o.52 of 1962.

or 'profits out of which dividends may be declared'<sup>96</sup>. The current tax rate is 10% of the net amount deduced from subtracting the dividend accrued to the company per cycle from the dividend declared<sup>97</sup>. STC is payable by the company in addition to the normal tax liability of the company.

**4.3 PRE-EMPTIVE RIGHTS:** In essence, pre-emptive rights refer to the right of first refusal over the shares on offer<sup>98</sup>. The doctrine seeks to ensure that no allotment of shares to the detriment of existing shareholders (in their individual capacity) takes place<sup>99</sup>. The rationale behind this doctrine is that a shareholder must be able to protect his portion of the total equity<sup>100</sup>. He must be given 'first preference' to subscribe for any new issue of shares or securities.

Under the South African company law system, the term 'pre-emptive rights' is regarded as a common law restriction on the transfer of shares<sup>101</sup>. The restriction on the right to transfer shares in a private company is viewed as a distinguishing feature in private companies<sup>102</sup>. Under the 1973 Act, section 20(1) specifically stated that a private company was one which in its articles restricted the right of transfer of its shares. This restriction however applied only in respect of transfers through sale.

In terms of the current legislation, pre-emptive rights have been statutorily entrenched in section 39. The statutory pre-emptive right in terms of the new Act applies to private companies or personal liability companies and relates only to the issue of shares<sup>103</sup>. The issue of options, conversion rights, capitalisation shares or shares issued for a future consideration are excluded from the right of pre-emption<sup>104</sup>. A private or personal liability company will now be able to circumvent the restriction on

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<sup>96</sup> David C, *ibid*, 3.

<sup>97</sup> David C, *ibid*, 1.

<sup>98</sup> Gower and Davies, *ibid*, 835.

<sup>99</sup> Gower and Davies, *ibid*.

<sup>100</sup> Gower and Davies, *ibid*.

<sup>101</sup> Van Der Linde 'Pre-emptive Rights in Respect of Share Issues' (2008) SA MerLJ, 510.

<sup>102</sup> Van Der Linde 'Pre-emptive Rights in Respect of Share Issues' *ibid*.

<sup>103</sup> See Section 39(b) of the Companies Act no.71 of 2008.

<sup>104</sup> Section 39 (b) of the Companies Act no. 71 of 2008.



transferability of its shares by simply issuing the shares for future consideration thus excluding the operation of the pre-emption principle<sup>105</sup>.

**4.4 ISSUE OF SHARES AT A DISCOUNT:** Another common-law rule on the maintenance of share capital is that shares cannot be issued at a discount<sup>106</sup>. However; statutory exceptions to the common law were introduced by section 81 of the 1973 Act. By virtue of this section, the issue of shares at a discount was permissible under the following conditions;

- 1) The shares issued at a discount must be of a class already issued by the company;
- 2) At least one year must have elapsed since the date on which the company commenced business or since the date of the first issue of that class of shares;
- 3) The issue must be authorized by special resolution, specifying the maximum rate of discount;
- 4) The issue must be sanctioned by the court and the court has the discretion to make an order on such terms and conditions as it deems fit;
- 5) The shares in question must be issued within one month of the date on which the court sanctioned the issue or such period as the court may allow<sup>107</sup>.

The 1973 Act made a distinction between par-value (PV) and no-par value (NPV) shares. PV shares issued at a discount were regarded as equity while the discount allowed was shown as a fictitious asset<sup>108</sup>. If companies had PV shares, this meant that the fixed value and amount of issued shares had to

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<sup>105</sup> Van Der Linde 'Pre-Emptive Rights in Respect of Share Issues, *ibid.*

<sup>106</sup> Pretorius 'Capital Maintenance doctrine in S.A corporate law' [www.accaglobal.com](http://www.accaglobal.com) (visited on the 14<sup>th</sup> September 2010).

<sup>107</sup> Pretorius, *ibid*, 4 and 5.

<sup>108</sup> Cilliers and Benade, *Corporate Law* (2000),327

be indicated in the memorandum of association<sup>109</sup>. In the case of NPV shares, the memorandum of association only indicated the amount of issued shares and these shares did not have a fixed value<sup>110</sup>. The 1973 Act further required that discounted shares be shown in every subsequent prospectus issued by the company. Non-disclosure in the prospectus warranted an offence in terms of section 441(g). NPV shares discount was required to be authorised only by special resolution. Directors were further required to make a report stating the reasons why the shares were issued at a discounted value<sup>111</sup>.

A major change from the 1973 position has been introduced by the new Act. Shares will no longer have a fixed or nominal value (par-value), but will be fixed in number only (i.e. will have no par value)<sup>112</sup>. In terms of section 35(4) of the Act, no nominal value or par-value is attached to a share. No rights attach to shares until they are issued<sup>113</sup>. Problems however, are likely to arise when companies which had PV shares phase them out or convert them to NPV shares. Ultimately, companies will be required to make that transition to NPV shares<sup>114</sup>. The new Act specifies that the Minister of Trade and Industry( hereafter referred to as ‘the Minister’) has to issue regulations providing for the conversion of PV shares into NPV shares<sup>115</sup>. Until the Minister publishes these regulations, it is unclear how the transition will occur<sup>116</sup>. Nonetheless, one finds solace in the provision that the rights of PV shareholders will be preserved in so far as possible or else the company must compensate the shareholders for any loss of their rights<sup>117</sup>.

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<sup>109</sup> ‘Getting to grips with the new Companies Act’(September 2010),[www.bowmangilfillanattorneys/articles.co.za](http://www.bowmangilfillanattorneys/articles.co.za) (visited on 15 October 2010).

<sup>110</sup> ‘Getting to grips with the new Companies Act, *ibid.*

<sup>111</sup> Pretorius, *ibid.*, 5.

<sup>112</sup> ‘Getting to grips with the new Companies Act’, *ibid.*

<sup>113</sup> See Section 35(4) of the Companies Act no.71 of 2008.

<sup>114</sup> ‘Getting to grips with the new Companies Act’, *ibid.*

<sup>115</sup> Schedule 7, item 6 (3) of the Companies Act no.71 of 2008.

<sup>116</sup> ‘Getting to grips with the new Companies Act’, *ibid.*

<sup>117</sup> Schedule 7, item 6(3) of the Companies Act no.71 of 2008.

**4.5 CONCLUSION:** The new companies Act has made it possible for a company to issue shares for, among others, future services to be provided to the company<sup>118</sup>. Under the 1973 Act, companies insisted on receiving a consideration for their shares before they could be issued<sup>119</sup>. In contrast, the present Act provides that on entering into an agreement for future services, the company must immediately issue the shares<sup>120</sup>. In the case of private companies; the concept of pre-emptive rights has been retained by the new Act. Whilst the new Act makes incorporation much simpler and easier, this will not affect our tax revenues as the ITA has ensured that there are no loop-holes when it comes to STC's.

When one goes through the regulation of the capital rules discussed in this chapter, one observes considerable flexibility in the structuring of finances by companies. It is projected that in the future, companies will take advantage of this flexibility and be able to structure their capitalisation to suit their needs<sup>121</sup>. Creditors are expected to utilise, in addition to the remedies discussed in chapter three(3), the statutory turquand rule as envisaged in section 20 (7) of the Act. The section entitles any person who is neither shareholder, director nor prescribed officer of the company to redress; provided he deals with the company *bona fide*. In essence, the statutory turquand rule entitles such person to presume compliance by the company with all formal and procedural requirements of its Mol and the Act. This is an improvement from the previous reliance on the common-law turquand rule, though the rationale of the principle has remained the same.

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<sup>118</sup> 'New companies Act offers relief to struggling businesses' (2009), [www.bowmangifillanattorneys.za](http://www.bowmangifillanattorneys.za) (visited on 15<sup>th</sup> October 2010).

<sup>119</sup> 'New companies Act offers relief to struggling businesses' (2009), [www.bowmangifillanattorneys.za](http://www.bowmangifillanattorneys.za).

<sup>120</sup> The shares are caused to be held in trust pending fulfilment of the obligation in terms of the agreement. No voting rights or pre-emptive rights attach to the shares whilst they are held in trust: see 'New companies Act offers relief to struggling businesses' (2009), [www.bowmangifillanattorneys.za](http://www.bowmangifillanattorneys.za).

<sup>121</sup> 'New companies Act offers relief to struggling businesses' (2009), [www.bowmangifillanattorneys.za](http://www.bowmangifillanattorneys.za).

## **CHAPTER FIVE:**

### **CONCLUSION AND RECOMMENDATIONS.**

At the beginning of this research, the writer highlighted the following hypothetical questions which were sought to be answered by the end of this research. The questions were as follows:

- Do the capital rules in their modern form provide adequate protection to creditors?
- Has the new Companies Act done justice for corporations by introducing the modern form of capital rules?
- To what extent does the new Act bring South Africa to alignment with international standards of companies' rules?
- Has the Act not overstepped its boundaries by incorporating issues which would best be regulated elsewhere?
- Will the alternative dispute resolution measures introduced by the new Act work in practice?

It is accepted that the 1973 Act was in dire need of reform. These sentiments are expressed in almost every article that deals with the introduction of the new Companies Bill B61 OF 2008 which has subsequently become our new Companies Act no. 71 of 2008. It was imperative for our country to effect changes that will adopt international practices. We have seen an introduction of some corporate governance standards in the new Act. Concepts of transparency, accountability, solvency and liquidity are evident throughout the Act. As a developing country, we certainly have tried to align with standards maintaining in the United Kingdom and the United States of American. There is still a lot of improvement as we currently do not have all the structures necessary for effective implementation of the new Act. But, we must be applauded for the effort we have done which has placed our country ahead of its counterparts, particularly in the SADC region.

The new Act has rightfully preserved the notion of corporate legal personality. It is my conclusion that we ought to continue to uphold the *Salomon*<sup>122</sup> principle in order maintain our corporate revenue. It is submitted that this concept is fundamental in corporations and sits at the very core of their existence. In regards to the protection of creditors, it is my submission that we have not done so great, in particular in relation to providing adequate remedies for aggrieved creditors. It is submitted that the Act should not have taken away the common-law remedies completely. It is conceded that shareholders stand at a better footing with the introduction of the statutory derivative action and dissenting shareholders appraisal rights<sup>123</sup>. Creditors on the other hand will inevitably have to resort to the turquand rule in its statutory form<sup>124</sup>.

In relation to the capital rules in their present form, there has been an improvement and the present Act has adopted a more flexible approach when it comes to companies regulating their capitalization. This approach however has its pros and cons. On the positive, the company is able to exercise a measure of control over the purchase and sale of its shares. Should a company be in need of more capital injection, it can sell its shares in- house to existing shareholders or its subsidiary. This way it remains in control of the shareholding and it is easier to influence decisions with very little or no dissent from its shareholders. On the negative however, the capital rules open room for trafficking of shares from a holding company to its subsidiary.

When it comes to the secondary and most important issue of declaring dividends, again the new Act is not as strict as the 1973 Act. While the 1973 Act maintained that the issue of when, how and at what rate dividends were paid had to be specifically set out in the articles of association, the present Act entrusts this to the Board of Directors. It is my submission that the question of authorisation on the issue of distributions ought to be amended *pronto*. The company must remain the principal and the

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<sup>122</sup> *Salomon v Salomon and Company*, *ibid*.

<sup>123</sup> Section 164 and 165 of the Companies Act no.71 of 2008.

<sup>124</sup> Section 20 (7) of the Companies Act no.71 of 2008.

Board its agent. We cannot maintain a system where the Board authorises the company instead of the other way round.

The new Act places too much reliance on the solvency and liquidity tests. While this is an internationally accepted concept, it appears that whenever certain measures of control are to be exercised, the Act relies on the solvency and liquidity test. It is applied to distributions, purchase and buy-backs of shares, mergers and amalgamations, loans to directors etc. This will present problems in the future, particularly on the question of liability for failure to apply the solvency and liquidity test. In some instances the issue may not necessarily be failure to apply the tests but it may be that at the time of the relevant transaction, the company did satisfy the tests. In the later instance, the directors should rightfully be absolved from liability.

Another issue that requires urgent attention in the new Act is the number of inconsistencies presented by section 218. Given that in a number of sections there are specific provisions relating to certain acts being void, section 218 ought to be removed. It is my submission that if the Act has declared certain conduct void, then there is no need to have the same conduct declared void by the court before the consequences of that conduct apply.

Another aspect which deserves mention is the decriminalisation of conduct in the new Act. While the previous Act made certain conduct criminal, the NPA will breathe a sigh of relief at being relieved from the responsibility of prosecuting company law transgressions. The new Act has introduced quasi-judicial bodies to deal with company law violations such as the Companies Ombud, the Panel and the Commission<sup>125</sup>. *Locus standi* under the new Act is much wider and accommodates associations and

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<sup>125</sup> Section 157 of the Companies Act no.71 of 2008.

groups (including trade unions), persons acting in the public interest as well as those acting on behalf of the person directly contemplated in that particular provision. These bodies are endowed with a wide scope of powers and discretion and whatever decision is reached by either the Panel or the Commission has the force equivalent to a court order. Criminal sanctions have now been replaced by administrative fines imposed by these organs. While the notion of introducing alternative dispute resolution measures is noble, there is in my opinion too much red-tape when it comes to putting these measures into practice. A lot of preliminary procedures have to be complied with, not to mention privileged information expected to be supplied by the informant. The entire process of initiating proceedings before these organs is lengthy and cumbersome and that alone is a factor which will result in aggrieved parties desisting from reporting *bona fide* cases. It is suggested that the process be simplified so as to make it more accessible.

The problems highlighted above are in no way comprehensive. The new Act has been broken down and is simpler, shorter and easier to understand. It is projected that for at least the next few years, the new Act, just like any other law will experience a number of punches until it is eventually amended. Company law stakeholders need to attend to those mishaps that are so glaring that they do not need to wait for the courts intervention.

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