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## **CAPITALISATION OF PRIVATE COMPANIES**

by

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## TABLE OF CONTENTS

TOPIC	PAGE
Chapter 1 : Introduction	1
1.1 Corporate Law Reform in South Africa	1
1.2 Forms of Ownership in South Africa : Past and Present	2
1.2.1 The Past	2
1.2.1.1 Sole Proprietorship	3
1.2.1.2 Partnerships	3
1.2.1.3 Close Corporations	4
1.2.1.4 Companies	4
1.2.2 The Present	6
1.2.3 Private Company as the Future of Small Business	7
Chapter 2 : Statutory Characteristics of Private Companies Under the 2008 Act	9
Chapter 3 : The Basis of Private Companies	11
3.1 The Origins of the “Private” Concept	11
3.2 The Rationale for Private Companies	12
3.3 Retention of the Origin and Rationale of Private Companies	13
Chapter 4 : Raising Capital Through the Offer of Securities in a Private Company	17
4.1 Introduction	17
4.2 The Private Company Conundrum	17
4.2.1 Proposing Membership : An Offer?	19
4.2.2 By Invitation Only?	21
4.2.3 Offers to Outsiders : Prohibited or Encouraged?	21
4.3 Who is included in the definition of “the public” in relation to a private company?	23
4.3.1 Persons who are “public”	23
4.3.1.1 Multiple definitions of “public” and “offer” at play	23
4.3.2 Non-Public Offers at Common Law	25
4.3.2.1 Focus on Form	25
4.3.2.2 Recognition of Substance	29
4.3.2.3 Conclusion	34
4.3.3 Non-Public Offers at Statute	34
4.3.3.1 Offers that are expressly “non-public”	35
4.3.3.2 Expanding the statutory meaning of “non-public” with the common law	36

4.4 The Interplay Between Section 8 and Chapter 4 of the Companies Act	39
Chapter 5 : Conclusion	42
BIBLIOGRAPHY	44

## 1. Chapter 1 : Introduction

### 1.1. Corporate Law Reform in South Africa

The face of business in South Africa has changed significantly over the past few years. The inception of the Companies Act, 71 of 2008 (“the 2008 Act”) effective from the 1st of May 2011 has not only changed the way we view and work with Companies, but has altered the ambit of registrable entities as well as the nature and usefulness of partnerships. The established “rules of thumb” for choosing a form of ownership for new enterprises have mostly fallen away, leaving behind what is intended to be simplified logical rules directing businesses of all sizes to more obvious and fitting choices.

From the outset, the 2008 Act was intended to reform the South African corporate law rendering it simple, comprehensive and accessible to business people.<sup>1</sup> A clear goal of the reform was to encourage the formation of companies of different sizes with the aim of facilitating access to capital, stimulating innovation and the growth & development of the economy.<sup>2</sup> To achieve these goals, the 2008 Act has either discontinued or amended certain forms of ownership and aims to encourage the use and recognition of a single, more accessible, formal business vehicle.<sup>3</sup> In effect, the legislature has adopted a “single act approach” for the regulation of businesses both small and large.<sup>4</sup> As will be discussed more fully below, this approach means the end of Close Corporations as a readily available form of ownership for entrepreneurs. Whether or not this is the correct approach is debatable and it has been submitted that “*at the root of the development of the Close Corporations Act is the conviction that it is very difficult for a single Act to provide a satisfactory legal form for the large and sophisticated as well as the small and often marginalised entrepreneur*”.<sup>5</sup>

The purpose of this text is to examine the capitalisation of private companies

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<sup>1</sup> See Chapter 3 of the **Corporate Law Reform Policy**, Notice 1183 GG 26493 of 23 June 2004

<sup>2</sup> *Ibid* at Chapter 4

<sup>3</sup> *Id*

<sup>4</sup> JJ Henning “The impact of South African company law reform on close corporations. Selected issues and perspectives” (2010) *Acta Juridica* 456–479 at 464

<sup>5</sup> *Id*

which exist under the 2008 Act as an apparent solution to the want for a unified business entity in place of those entities which were previously available and that is available to small, medium and large enterprises with no artificial distinction. The relevant principles effecting lawful capitalisation of private companies will be discussed and the consequent accessibility of these principles and the law to small businesses will be evaluated.

## 1.2. Forms of Ownership in South Africa : Past and Present

Traditionally, companies both private and public were perceived as intimidating entities reserved for larger businesses who could afford to implement and maintain them. From the standpoint of small businesses, even private companies were arguably complex and costly entities to keep afloat. Additionally, numerous archaic and unnecessary rules, requirements and concepts stood in the way of small businesses, with limited knowledge and resources, choosing private companies as their form of ownership, especially those relating to (*inter alia*) capital maintenance, financial assistance and par value shares. Instead, more affordable and less complicated entities were used, specifically Close Corporations.

Private companies are now in the spotlight where Close Corporations once stood. In light of these dramatic changes and to fully describe where private companies fit into the new corporate regime, a brief discussion of the various forms of ownership and corporate entities both past and present is necessary.

### 1.2.1. The Past

Before the commencement of the 2008 Act, the common law together with the Companies Act, 61 of 1973 (“the 1973 Act”) and the Close Corporations Act, 69 of 1984 were the cornerstones for establishing and regulating business entities as well as unincorporated forms of ownership. The legislation worked in tandem with the common law to establish an interlinked hierarchy of ownership that started with the sole proprietor and ended with the public company. Each step up the ladder of the hierarchy addressed a different element of ownership being *inter alia* risk,

capitalisation, control, perpetuity and tax implications.<sup>6</sup> The existence of juristic personality is undoubtedly one of the most important facets to the choice of enterprise and inevitably has an effect on all of the aforementioned elements.

#### **1.2.1.1. Sole Proprietorship**

The simplest method or form of owning a business was and remains sole proprietorship. There is no juristic personality involved and the sole owner holds all of the risk personally. The drawbacks of the form are obvious in that there is no sharing of risk, no perpetuity and further capitalisation may be impossible. The advantages of sole proprietorship includes complete control, no profit sharing and virtually no regulation at an organisational level through the birth, life and death of the business.

#### **1.2.1.2. Partnerships**

The next step up the hierarchy is the partnership. Much like the sole proprietorship, no juristic personality is involved and there is no perpetuity. The advantages lies in skill sharing, the sharing of risk and greater possibility for further capitalisation due to an increased number of possible owners. Section 30 of the 1973 Act and prior to that, section 4 of the Companies Act, 46 of 1926 (“the 1926 Act”), imposed a limit on the number of partners that could lawfully constitute a partnership.<sup>7</sup> Under the section, no more than 20 persons could constitute a partnership and where an association of persons intended on carrying on business for the acquisition of gain in excess of that number, they would have to incorporate a form of company under the relevant Act.<sup>8</sup> The rationale for this stemmed mainly from

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<sup>6</sup> Although an important consideration in practice, tax is not the focus of this text and will not be dealt with in any detail.

<sup>7</sup> Subject to the exception in section 30(2) of the 1973 Act pertaining to organised professions

<sup>8</sup> Either a company or a close corporation.

considerations of the protection of outsiders.<sup>9</sup> As a partnership or other association of persons acting for gain does not necessarily constitute a juristic person, the identity of parties in attribution of rights, duties and liability proves problematic where the association is large and membership flexible.<sup>10</sup>

### 1.2.1.3. Close Corporations

A more recent and comparably short-lived addition to the hierarchy was the Close Corporation. Close Corporations were incorporated in terms of the Close Corporations Act, 68 of 1984 and provided a solution for small business owners to inexpensively obtain juristic personality<sup>11</sup>. Persons previously trading as sole proprietors with unlimited liability were able to inexpensively limit their liability without introducing partners to their business as a Close Corporation could consist of a single natural person.<sup>12</sup> Close corporations were an extremely popular form of ownership amongst smaller businesses in the formal economy.<sup>13</sup> These entities were affordable and easier to maintain than fully fledged companies. Close corporations were generally not suited for larger enterprises due to the restricted number of members allowed. Only ten natural persons could constitute a Close Corporation<sup>14</sup> limiting access to funds. The limitation on membership to only natural persons also precluded juristic equity financiers from investing in the entities.

### 1.2.1.4. Companies

Companies sat at the very top of the hierarchy. Under the 1973

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<sup>9</sup> *Smith v Anderson* (1880) 15 Ch 247 (CA)

<sup>10</sup> See PM Meskin *et al Henochsberg on the Companies Act, 61 of 1973* (Service Issue 33) 2011 at 48 - 52 for with respect, an insightful discussion on this point.

<sup>11</sup> In terms of section 2(2) of the Close Corporations Act, 69 of 1984

<sup>12</sup> *Id*

<sup>13</sup> See Chapter 2 of the **Corporate Law Reform Policy** *supra*

<sup>14</sup> See s2(1) read with section 29(1) of the Close Corporations Act

Act it was possible to incorporate various types of company, but perhaps the most common types, and the most relevant for present purposes were Public and Private companies.<sup>15</sup>

The benefits of using a company to carry on business lay in ease of transfer of interest, better access to capital and juristic personality & the associated benefits pertaining to risk and perpetuity. The “strength” of juristic personality was also far stronger than that which was available through a close corporation. The nature of a company was and remains such that management is almost entirely separated from ownership, and liability generally only accrues to directors in instances of *inter alia* reckless trading and conflict of interest. Attribution of liability to shareholders required an exercise of “piercing the corporate veil”. Historically, an act of veil piercing in respect of companies was largely regulated by the common law and there were no hard and fast rules as to when and to what extent the veil could be pierced. Furthermore, the courts were not inclined to merely disregard the corporate veil and strived to give effect to and uphold it.<sup>16</sup> Under the Close Corporations Act, less of a distinction between management and ownership was drawn<sup>17</sup> resulting in an increased involvement of the owners in the risk of the venture.

Under the 1973 Act, there was little distinction between a public and a private company. The Act required that both entities held mandatory annual general meetings<sup>18</sup> and were subjected to

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<sup>15</sup> See section 19(2) of the 1973 Act

<sup>16</sup> See for example *Cape Pacific Ltd v Lubner Controlling Investments (Pty) Ltd and Others* [1995] 2 All SA 543 (A) at 533

<sup>17</sup> See for example sections 54, 63 and 64 of the Close Corporation Act which all directly or indirectly attribute liability to members (owners) or place members in a position to bind the corporation by virtue of their membership alone.

<sup>18</sup> See section 179 of the 1973 Act

the compulsory appointment of an auditor.<sup>19</sup> The main differences existed in the maximum number of shareholders in the company and restrictions on the offer and transfer of shares. Section 20 of the 1973 Act limited the number of shareholders, irrespective of the number of shares owned by each of them, to fifty.<sup>20</sup> The transferability of shares had to be restricted and offers to the public of shares were prohibited.<sup>21</sup> Private companies therefore existed as a means for a restricted number of persons (ie : fifty) to pool their assets whilst retaining fair certainty of their level of control.

Private companies were not sufficiently suited to the needs of small businesses. Due to the costs associated with the need to audit a private company's financial statements and the increased formalism in carrying on business, smaller businesses gravitated more towards the simpler close corporations, as was initially intended when they were introduced.<sup>22</sup>

### 1.2.2. The Present

As discussed above, the DTI's 2004 Corporate Law Reform Policy aimed to simplify the current business ownership regime by creating what is touted as a single business ownership vehicle, namely a more accessible and simplified company. To encourage the use thereof, certain alternative forms of ownership have been abolished or amended.

The alternatives to companies have always been geared towards smaller businesses. The traditional structures available to larger enterprises remain largely the same. Persons happily trading as sole proprietors

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<sup>19</sup> *ibid* at section 270

<sup>20</sup> *ibid* at section 20(1)(b)

<sup>21</sup> *ibid* at section 20(1)(a) and (c)

<sup>22</sup> See JJ Henning *et al.* **Close Corporations and Companies Service** (Issue 42) 2014 at para 1.01 - 1.03

remain wholly unaffected, but everyone else up the hierarchy now have new opportunities available to them and have also met the end of the option to incorporate close corporations.

A notable change to the formation of partnerships occurred through the repeal of section 30 of the 1973 Act. The limitation on the number of partners has been completely abolished through lack of a similar provision under the 2008 Act. The result is the possibility for the existence of massive partnerships and opens the doors for the quick creation of more informal consortiums. The basic nature of a partnership with respect to lack of juristic personality remains unchanged.

The 2008 Act has amended (but not repealed) various provisions of the Close Corporations Act. Schedule 3 of the 2008 Act amended section 2 of the Close Corporations Act with the effect that no new close corporations could be incorporated past the 1st of May 2011. The same section provides for the continued existence of existing close corporations.

Outwardly, the abolishment of the close corporation as a registrable business vehicle seems to leave a massive gap for smaller businesses wishing to attain the benefits associated with juristic personality. This is where the new and improved private company, which is the focus of this text, finds its footing in the economic landscape.<sup>23</sup>

### 1.2.3. Private Companies As The Future of Small Business

Company law in South Africa was reformed with the goal of making companies more accessible and thereby simplifying the economic landscape. What remains is the hope of an environment regulated purely by company law without the unnecessary rules and confusion of a diverse ecosystem of entities. Whether or not this has been successfully achieved under the 2008 Act is debatable and the focus of this text is to discuss the suitability of the current laws in giving business owners full access to all of

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<sup>23</sup> See **Close Corporation and Companies Service** *supra* at para 10.6 - 10.9 and *Acta Juridica* 456–479 *supra* for a view on the suitability of the Companies Act, 71 of 2008 for small businesses in place of Close Corporations.

benefits that a private company has to offer.

Private companies, as the answer to an accessible business vehicle to businesses of varying sizes, are an entirely new creature that may seemingly operate without much restriction. They exist without a limitation to the number of shareholders and therefore access to potentially unlimited capital.<sup>24</sup> The regulation of these companies is also reduced to an extent rendering them far cheaper and easier to run.<sup>25</sup> Smaller businesses should find such a flexible and dynamic business vehicle attractive, and this was surely the DTI's goal when making recommendations for reform. What is less clear, is to what extent this new dynamism may be flexed whilst keeping within the ambit of the law. There are new, important principles under the 2008 Act that may easily be overlooked by lay persons. These principles are essential to the capitalisation of private companies.

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<sup>24</sup> See **Close Corporations and Companies Service** *supra* at para 1.19 - 1.20 where JJ Henning postulates the existence of "Close Companies" under the New Act, which could be the real replacement for close corporations.

<sup>25</sup> See for example section 90 of the New Act which does not require private companies to appoint auditors; and section 30 which does not generally require private companies to audit their annual financial statements.

## 2. Chapter 2 : Typifying Characteristics of Private Companies Under the 2008 Act

Under section 8 of the 2008 Act, a private company is a profit company that complies with the requirements of the Act to include certain restrictions in its MOI on the dealing in the securities of the company.<sup>26</sup> These restrictions are that the company is prohibited from offering *any* of its securities to the public<sup>27</sup> and that free transferability of its securities must be restricted<sup>28</sup> in some manner.<sup>29</sup> As far as categorisation of companies is concerned, the distinction between public and private companies is embodied in and limited to the above restrictions. Where one of these restrictions is absent or defective<sup>30</sup>, a private company does not come into being and the entity will revert to its default status as a public company.<sup>31</sup>

The restrictions attempt to regulate the issue and sale of securities (ie : dealing on the primary and secondary market). The limitation on the offer of securities to the public attempts regulate to whom a private company may offer its securities on the primary market and the restriction on free transferability attempts to regulate the manner in which securities are sold on the secondary market. Further, unless excluded<sup>32</sup> by the MOI of a private company, section 39 of the Act grants a statutory right of pre-emption in favour of existing shareholders against the company when issuing shares. In essence, the section requires the company to offer shares to existing shareholders before outsiders.

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<sup>26</sup> See the definition of a “private company” in section 1 read with section 8(2)(b)

<sup>27</sup> Section 8(2)(b)(aa)

<sup>28</sup> Section 8(2)(b)(bb)

<sup>29</sup> See PA Delpont *et al Henochsberg on the Companies Act, 71 of 2008* (Service Issue 8) 2014 at page 50 for a discussion of possible methods of limiting transferability of securities

<sup>30</sup> For example, where free transferability of “shares” instead of “securities” is limited. In this regard see **Henochsberg on the Companies Act, 71 of 2008** *supra* at page 50

<sup>31</sup> See section 8(2)(d) which provides that a company will be public in “any other case”. A company is therefore a public company unless it is a state owned company or meets the requirements of a private company. This “default status” appears to have been existence since the 1926 Act which expressly states in s105 that if the limitations in the articles are not present in the case of a private company, it shall be treated as a public company. Section 8(2)(c) provides that a personal liability company is merely a form of private company.

<sup>32</sup> By operation of section 39(3)

The wording of the section 8 of the 2008 Act is extremely important and differs materially from section 20 of the 1973 Act. The 1973 Act required the transfer of shares to be restricted<sup>33</sup> and that the company is prohibited from offering its shares or debentures to the public.<sup>34</sup> The related provisions under the New Act appear to be similar, but the restriction and prohibition on transfer and offering respectively applies to “securities” rather than specifically referring to shares and debentures. The definition of securities in section 1 of the 2008 Act includes “*any shares, debentures or other instruments, irrespective of their form or title, issued or authorised to be issued by a profit company*”. The current restriction on private companies on the transfer and offering of securities is therefore wider and more onerous.

The wording of the provision requiring a restriction on offering securities to the public contains possible ambiguity. The provision (section 8(2)(b)(aa)) requires the MOI to “prohibit [the company] from offering any of its securities to the public” (own emphasis). The word “any” could be interpreted to mean either “all” or “any selection”. The latter interpretation of the restriction conflicts with the rationale for the existence of private companies (discussed in detail below) and would give rise to completely unacceptable and surely unintended consequences. Interpreting “any” to mean less than “all” would mean that a restriction on one class of securities without restriction on all other classes would still qualify the company as “private”. Moreover, restriction on only a few shares of a single class would still clearly qualify as any selection of the securities of the company.

The underlying rationale for private companies is that the company makes exclusive use of private sources of capital.<sup>35</sup> Where “any” is interpreted as “any selection” a company could have a class of shares with one authorised share that is never issued and is restricted from being offered to the public. The same company could then have multiple other classes of securities that may all be offered to the public, resulting in the use of public sources of capital whilst the company remains “private” by definition. It is submitted here that the word “any” must be interpreted to mean “all” for a company to be “private” in both form and substance.

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<sup>33</sup> Section 20(1)(a) of the 1973 Act

<sup>34</sup> *Ibid* at section 20(1)(c)

<sup>35</sup> See the discussion on the rationale of private companies below.

### 3. Chapter 3 : The Basis of Private Companies

The concepts of “private” and “public” are major themes in company law. There are private companies which must prohibit themselves from offering securities to the public, there are public companies that may freely offer securities to the public, there are public offers, non-public offers and so on. The “public” concept has been said to be “*one of the most vexing questions in this area of company law and is the source of most of the reported cases*”.<sup>36</sup> What isn’t given much attention is the meaning of “private” in relation to a private company. This is probably because it’s assumed that if something isn’t public it must be private. The word “private” however, in relation to the name given to the category of company, has more meaning than the mere “leftovers” of the “public” concept. There are important considerations behind the word “private” and these considerations help to unpack the rationale for having two types of profit company.<sup>37</sup>

#### 3.1. The Origins of the “Private” Concept

South African company law originates from the English law. The South African Companies Act, 46 of 1926 was modelled on previous statutes that were based to a large extent on the English Companies Act of 1907 and the subsequent English Companies (Consolidation) Act of 1908.<sup>38</sup>

The English Companies Act of 1907 was the first to introduce the statutory concept of private companies. Prior to enactment, there existed no statutory dichotomy between private and public companies and all companies registered under earlier legislation were subject to the same rights and obligations.<sup>39</sup> Before this statutory separation, the term “private company” was used “*as a convenient expression to describe a company which raised its capital privately and eschewed any invitation to the public to invest in its shares or debentures*”<sup>40</sup> and doing so

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<sup>36</sup> FHI Cassim *et al* **Contemporary Company Law** (2nd Ed) 2012 at 652

<sup>37</sup> For ease of reference, and unless the context indicates otherwise the phrase “public company” includes state owned companies and the phrase “private company” includes personal liability companies.

<sup>38</sup> JT Pretorius *et al* **Hahlo’s South African Company Law Through the Cases** (6th Ed) (1999) Juta at p1 - 2

<sup>39</sup> D Fox **The Law of Private Companies** (1991) Sweet & Maxwell at page 1

<sup>40</sup> *Id*

was entirely voluntary. Irrespective of this voluntary limitation, all companies had to have at least seven members and produce audited accounts.<sup>41</sup>

The 1907 Act defined a private company in terms largely retained by the 1926 and 1973 South African Acts being that the articles of the company must restrict the transfer of shares, a maximum of fifty members were allowed and that *invitations* to the public to subscribe for any shares or debentures should be prohibited.<sup>42</sup> Aside from these characteristics, the 1907 Act granted certain concessions to private companies being that less persons (two instead of seven) were required to found a private company, but more importantly private companies were not required to file an annual balance sheet with the Registrar of Companies.<sup>43</sup> This allowed private companies to keep their financial affairs secret in the same way as sole proprietors and partnerships.<sup>44</sup>

### 3.2. The Rationale for Private Companies

From the origin of the “private” concept briefly outlined above it’s apparent that the “private” element with respect to a private company relates to the source of capital and therefore also to the availability of information to the public. Under the 1907 Act, a public company’s financial affairs were public by law. This was because the source of a public company’s capital was the “public”. The exemption for private companies under the Act made sense as no public person would need access to the public records since they wouldn’t (or shouldn’t) have ever received an offer from a private company. In a private company, capital was raised from “private” sources, and the public therefore had no need for the information. The sourcing of capital and access to information therefore go hand in hand, the latter being contingent on the former.

The concession that only two persons were required to incorporate a private company rather than the seven previously required (and still required at the time for the incorporation of public companies) together with the limitation on the

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<sup>41</sup> *Id*

<sup>42</sup> *Ibid* at p2

<sup>43</sup> *Ibid* at p3

<sup>44</sup> *Id*

number of members indicates that the entities were destined for use by smaller businesses.

### 3.3. Retention of the Origin and Rationale of Private Companies

The Corporate Law Reform Policy places emphasis on differentiating between categories of company in a manner free from artificial distinction.<sup>45</sup> The philosophy of the Policy is that “*the number of shareholders does not provide an adequate basis for differentiation, as some very large companies may have a small number of shareholders*”. The realisation of this philosophy is most easily recognised through the abolishment in the Act of the limit to the number of members in a private company.<sup>46</sup>

In contrast to the principles described in the discussion of the rationale for private companies above, the principles enunciated in the Policy appear to clearly depart from the notion that private companies are destined solely for smaller businesses. The wording of the policy appears to attempt to draw a distinction between companies based on the factual economic size and activity of their business. Interestingly, the paragraph where these principles are first mentioned does not suggest a distinction between private and public companies, but rather that “*perhaps the most important distinction is between a listed and an unlisted company*”.<sup>47</sup> It’s common knowledge that some of the largest companies in South Africa are those listed on the Johannesburg Stock Exchange. Such a distinction, drawn between listed and unlisted companies, appears to mean that a distinction should be drawn between companies of small medium and large sizes on the one hand and on the other, companies that can be described as leviathans.

Private companies would obviously fall into the category of small, medium and large companies. As it stands, private companies are theoretically incapable of listing on a securities exchange<sup>48</sup> and would therefore never fall into the second

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<sup>45</sup> **Corporate Law Reform Policy** *supra* at para 4.2

<sup>46</sup> See paragraph 4.2.2.2 of this text for a discussion of this feature of private companies.

<sup>47</sup> **Corporate Law Reform Policy** *supra*

<sup>48</sup> See the CIPC’s non-binding opinion of 2 April 2012 entitled “Guidance on the interpretation of the Companies Act, 2008, on the limitation on the listing of debt instruments on the JSE by private companies and the consequential effect of such listing”.

category. However, not all public companies are leviathans and it's clearly possible that a private company could be economically stronger and larger than a public company.<sup>49</sup> The New Act appears to have taken this into consideration. Generally only public companies are obliged to have their financial statements audited<sup>50</sup>, to appoint an auditor<sup>51</sup> and to appoint an audit committee.<sup>52</sup> Private companies are generally not obliged to do so as their financial information does not concern the public. Logically, the veracity of a private company's financial statements is questioned to a lesser extent than that of a public company as the public at large is theoretically in less danger of deception in the case of a private company.<sup>53</sup> However, when a private company grows past a certain threshold, based on its annual turnover, the size of its workforce and the nature & extent of its activities, it is obliged to comply with the same audit requirements as a public company.<sup>54</sup> Conversely, there are certain provisions under the Act that allow concessions to extremely small companies.<sup>55</sup> In effect, the Act recognises three distinct sizes of private company : small, medium and large. The larger the company, the more stringent the regulation.

It would appear that the notion that private companies are reserved solely for smaller business has therefore been jettisoned. The 2008 Act accommodates small businesses extensively and goes so far as to support even smaller

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<sup>49</sup> Depending on the success of the business rather than the type of entity.

<sup>50</sup> Section 30(2)(a) of the 2008 Act

<sup>51</sup> *Ibid* at section 90(1)

<sup>52</sup> *Ibid* at section 94(2)

<sup>53</sup> Section 100 of the 2008 Act deals with the content requirements for a prospectus. Subsection (2) (a) requires a prospectus to include information that an investor may reasonably require to assess *inter alia* "the assets and liabilities, financial position, profits and losses, cash flow and prospects of the company in which a right or interest is to be acquired". A logical source of at least some of this information would be the company's financial statements. In such a case the veracity of such statements would be of utmost importance as the public might otherwise be deceived. Traditionally, the issue of a prospectus when offering securities has fallen squarely into the domain of public companies, whether or not this is still the case is explored below.

<sup>54</sup> Section 30(2) read with Regulations 28 and 29 that deal with the calculation of a company's "public interest score" which determines whether the audit requirements apply to it and to what extent.

<sup>55</sup> See for example sections 30(2A), 57(2), 57(3) and 57(4) which all allow leniencies to extremely small companies. See also **Close Corporations and Companies Service** *supra* at para 1.19 - 1.20

businesses than under the 1973 Act, but it's clear that big businesses in the form of private companies are expressly recognised and regulated accordingly.

If size is no longer a major concern and the financial statements of private companies may have to meet similar standards to that of public companies, then the question arises as to what remains, if anything, of the original rationale for the existence of private companies. It is submitted here that the rationale remains largely intact.

As discussed, the size concern is no longer a formal typifying characteristic of a private company.<sup>56</sup> Through operation of the provisions of the 2008 Act, private companies are still a far better option for smaller businesses than public companies, the only difference being that the opposite may no longer be true. The remaining principles, being the source of capital and availability of information, remain largely the same. It is these principles that define private companies to a greater extent than in days gone by. The prohibition on offering securities to the public and the resulting relaxation on the regulation of financial information still exists because of the intended "private source of capital" that private companies are seemingly limited to.

It may appear that the increased regulation imposed on larger private companies creates a flaw in the reconciliation between the past and present rationales for private companies. The increased regulation exists for the benefit of accountability and transparency and is contingent on a company's public interest score. The public interest score is calculated in terms of regulation 26(2) to the 2008 Act and takes into account factors such as the amount owed to creditors, the number of securities holders, the turnover of the company and the number of employees of the company. Greater numbers of securities holders, higher debt to creditors and a larger turnover all require increased transparency and accountability for obvious reasons. The component relating to the number of employees of the company could relate to the principles set out in section 7 of the

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<sup>56</sup> This appears to have become a peripheral characteristic in any event. See for example the statements in the **Corporate Law Reform Policy** *supra* at para 4.2 that "*some very large companies may have a small number of shareholders*".

Act and good Corporate Social Responsibility.<sup>57</sup> The end result appears to be a loss of the advantage of the secrecy and privacy of company affairs that has been a hallmark of private companies through the ages.

A specific instance of this apparent loss of secrecy and privacy exists under section 33 of the 2008 Act. The section requires every company (both public and private) to file a yearly annual return with the CIPC. Section 33(1)(a) stipulates that companies that are required to have their annual financial statements audited must file a copy of those financial statements together with their annual returns. This means that large private companies are obliged to file their audited annual financial statements too. The issue with this obligation is that section 186(1)(b) of the Act establishes that one of the objectives of the CIPC is the “*maintenance of accurate, up-to-date and relevant information concerning companies*” and “*provision of that information to the public*”. Further, section 187(5) provides that “*any person, on payment of the prescribed fee, may— (a) inspect a document filed under this Act*”. As a result, unless the document was declared and approved as confidential under section 212, any person may gain access to the financial statements of large private companies.

It is true that the required disclosure certainly erodes the confidentiality of certain private companies, however these larger private companies are still afforded concessions with respect to the level of detail required in their financial statements.<sup>58</sup> The privacy rationale is therefore present albeit in a diminished form with respect to large private companies and the rationale is therefore largely retained.

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<sup>57</sup> See I Esser “Corporate Social Responsibility: A Company Law Perspective”(2011) *SA Merc LJ* 317–335 for a discussion on CSR under the Companies Act, 71 of 2008

<sup>58</sup> See the CIPC’s non-binding opinion of 27 October 2011 entitled “Interpretation of section 30(2) and 30(4) of the Companies Act, 2008, in relation to the disclosure of directors’ remuneration in private companies” where it is stated that private companies are not obliged to comply with section 30(4) of the Act with the result that directors’ remuneration (*inter alia*) does not have to be disclosed. Larger private companies therefore lose their privacy with regards to the content required by section 30(2) being the state of affairs of the business and profit or loss of the company, but at least the sanctity of the directors’ remuneration is retained.

## 4. Chapter 4 : Raising Capital Through the Offer of Securities in a Private Company

### 4.1. Introduction

Chapter 2 of this text briefly discussed the basic characteristics of a private company under the Companies Act, 71 of 2008. This chapter will focus solely on the offer and issue of securities by a private company and will therefore focus on the restriction on offering securities to the public.

Before delving into the issue at hand, it's important to understand that the restriction on private companies relates to an offer of "securities". Under the 1973 Act, the restriction was on "shares and debentures"<sup>59</sup> meaning that only those securities that complied with the definition of a share or a debenture were subject to the restriction. Section 1 of the 2008 Act defines a "security" as "*any shares, debentures or other instruments, irrespective of their form or title, issued or authorised to be issued by a profit company*" and the restriction is therefore theoretically far wider than under the 1973 Act.

### 4.2. The Private Company Conundrum

Aside from the fact that they're cheaper and less burdensome to run, private companies offer many advantages from a strategical and social perspective. Ironically, it's these very advantages that tend to hold back the company by creating other issues stemming from their exclusive nature.

Private companies have a legacy of being smaller, restricted entities as a result of the provisions of the 1926 and 1973 Companies Acts that limited the number of "members" to just fifty,<sup>60</sup> restricted the right to transfer shares<sup>61</sup> and prohibited the offer of shares and debentures to the public.<sup>62</sup> This legacy is somewhat maintained under the 2008 Act in that the offer of securities to the public and the limitation on free transferability has been retained.

The statutory pre-emptive right applicable to private companies embodied in

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<sup>59</sup> Section 20(1)(c) of the 1973 Act

<sup>60</sup> *Ibid* at section 20(1)(b)

<sup>61</sup> *Ibid* at section 20(1)(a)

<sup>62</sup> *Ibid* at section 20(1)(c)

section 39(2) of the 2008 Act also echoes the restricted nature of private companies. Where the right has not been excluded in terms of section 39(3), the Act ensures that a private company maintains a restricted circle of securities holders. These restrictions exist in stark contrast to the free-willed and flexible nature of public companies (which exist as the notional “bigger sibling” to the private company). The undeniable intention of the restrictions on private companies is to ensure that they live up to their designation, specifically that they remain “private”.<sup>63</sup> A public company’s securities are generally purchasable by anyone in the primary<sup>64</sup> or secondary market, the words of Viscount Sumner resonate here that a public offer of securities is one “*open to any one who brings his money and applies in due form*”.<sup>65</sup>

It requires no stretch of the imagination to assume that a public offer relates to a public company and not to a private company. It is submitted that this is the exact intention of the distinction between the two classifications of what are essentially the same type of entity. Public companies afford entrepreneurs the ability to pool large quantities of money and assets obtained from “*any one who brings their money*”, with little regard to where or from whom the money comes from. A public company is largely a means to an end, an effective vehicle for crowd funding on a massive scale.

Private companies are more conservative, sophisticated beings, existing as an “invitation only” club. The limitation on whom may gain membership might be an extremely important feature to a private company’s existing fellowship. The ability to deny access and retain control is surely one of the greatest social and strategical advantages of a private company. The problem, as with most exclusive clubs, exists in the availability of and access to funds for expansion and maintenance. Where there are but a small pool of securities holders, the funding available in the form of internal equity is generally limited to the number of members and the capital they are able to raise in their personal capacities. Where

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<sup>63</sup> See the discussion on the basis of private companies above.

<sup>64</sup> Correctly stated with reference to the primary market, any person may “subscribe for” and not “purchase” shares.

<sup>65</sup> *Nash v Lynde* [1929] AC 158

the amount of capital raised from within is insufficient the exclusivity of the entity may stand in the way of realising the necessary course of action, specifically the issuing of additional securities.

#### 4.2.1. Proposing Membership : An Offer?

There are numerous reasons why a private company may wish to acquire new or additional securities holders. Where it's merely a matter of the inclusion of a specific person in the company (where the underlying reason does not involve raising capital for the company) the inclusion may be effected most simply by a sale of all or a part of the shares of an existing shareholder (ie : a sale on the secondary market). In such a case, the normal principles of purchase and sale will apply between the parties with little or no involvement on the part of the company. Section 101 of the Act requires a written statement to be provided to the purchaser by the seller in such a case.<sup>66</sup>

Where a company is a party to the transaction (meaning that new securities will be issued) the process becomes far more complex. There obviously needs to be consensus between the parties that securities are to be issued for some sort of consideration.<sup>67</sup> This entails an offer and an acceptance. An "offer" is defined by both the common law and the Companies Act, the latter definition finding no application for present purposes.<sup>68</sup> Under common law an offer is defined as "*a declaration of the will of one party which is of such nature, and in such form, that acceptance thereof will be sufficient to constitute an agreement*".<sup>69</sup>

Generally a company will offer securities to a prospective investor to

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<sup>66</sup> In the context of private companies, section 101(4) does not require the written statement to be registered with the CIPC. Section 101(6) contains the content requirements for written statements.

<sup>67</sup> Section 40 requires that shares may only be issued for adequate consideration as determined by the board of directors.

<sup>68</sup> See para 4.3.1.1 for a discussion in this regard.

<sup>69</sup> See PA Delpont "Offers' and the Companies Act 71 of 2008" (2011) *THRHR* 280–286 at 284 referring to Joubert *General principles of the law of contract* (1987) 37

subscribe for those securities on certain terms and for certain consideration (acceptance of which will constitute an agreement). In such a construction, the result is that the company is the offeror and the investor is the offeree. The obvious and complex issue arises in determining whether the offeree constitutes a section of the “public” (discussed below in more detail).

A possibly easier point to address (disregarding the “public” component of the offer for the time being) is whether an offending “offer” has occurred. The Act aims to prohibit the construction where the company is the offeror. The wording of section 8(2)(b) expressly states that the company’s MOI must prohibit “*it from offering any of its securities to the public*” (emphasis added). The provision therefore only works to prohibit a positive act on the part of the company. What isn’t prohibited, is the company accepting an offer from any other person, be it a “private” person or a person constituting a section of the “public”. In such a case it would appear that the prohibition embodied in section 8(2)(b) is completely overcome when restricted to the common law definition of an offer. It is possible, however, that the above mentioned principles, with respect to an issue of shares, become wholly irrelevant if the application of section 39 is required.

With respect to the issue of shares only, section 39(2), if not excluded in the MOI of a private company requires that where the company intends issuing shares, existing shareholders may be offered those shares before persons who are not shareholders. Section 39(4)(b) provides that those shares not subscribed for by existing shareholders must then be offered to an outsider. The effect of this section is that where an outsider makes the offer for a certain number of shares, the company is forced to first make an offer to its existing shareholders and then make a counter offer to the outsider, the content of the offer being that the number of shares to be issued is what remains after the compulsory offer to existing shareholders is complete. If the wording of the section was : “*shares not subscribed for by a shareholder within the reasonable time contemplated in subsection (2), may be issued to other persons*” the problem would be overcome, but as it stands the section requires that the shares be “*offered to other*

*persons*” and the making of an offer on the part of the company therefore seems unavoidable under the circumstances.

#### 4.2.2. By Invitation Only?

Neither the common law nor the Companies Act includes an “invitation” in the definition of an offer.<sup>70</sup> An invitation is used “*to exercise a choice in respect of the counter-party and also to communicate additional terms to the other party before finally concluding the contract*”.<sup>71</sup> A private company making an invitation for an offer for the subscription of securities will therefore not be restricted by the prohibition of section 8(2)(b) of the Companies Act.

The requirements of section 39 discussed above may however force the company to make an offer when the issue of shares is the subject of the invitation. The discussion of this section in paragraph 4.2.1 therefore applies equally here and may be entirely catastrophic to the successful operation of such an invitation.

#### 4.2.3. Offers to Outsiders : Prohibited or Encouraged?

As discussed above, section 39(2) grants existing shareholders a pre-emptive right to be offered shares (excluding other securities) before non-shareholders (“outsiders”). The section provides that when a private company issues shares, it must offer its existing shareholders shares in proportion to their general voting power immediately before the offer was made. It is important to note that securities other than shares may also have voting rights<sup>72</sup>, but this section relates only to shares and only actual shareholders will be granted the right. Section 39(3) states that the company’s MOI may limit, negate, restrict or place conditions on the pre-emptive right. Section 39(4) provides that the MOI may state that the company may not offer shares to outsiders if all the shares subject to the

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<sup>70</sup> See *THRHR* 280–286 *supra* at 284 and **Henochsberg on the Companies Act, 71 of 2008** *supra* at 364

<sup>71</sup> *Id*

<sup>72</sup> Section 43(3)(a)

offer are not subscribed for.<sup>73</sup>

The consequence of section 39(3) and (4) outlined above is that three scenarios exist. The **first** scenario is that the pre-emptive right is completely excluded by the MOI meaning that shares may be offered to outsiders immediately without a proportionate offer to the existing shareholders. The **second** scenario is that the shares may be offered to outsiders if they weren't subscribed for by the existing shareholders. The **third** and final scenario is that the shares may never be offered to outsiders.

In the first two scenarios, it is clear that statutory recognition and facilitation is given to a private company issuing shares to persons who are not at present a part of the company. This indicates that the prohibition on offering securities to the public was not intended to prohibit a private company from issuing any further securities (especially shares) to third parties. There is also obviously the possibility that an offer made only to the existing securities holders of a company is renounceable. The question therefore arises as to whom the company, as a private company subject to the above-mentioned restrictions on capacity, may validly offer securities and if the offer is renounceable, to whom the offer may be renounced. This is where the "public" concept becomes relevant. Assuming that making an "offer" cannot be sidestepped as discussed in paragraph 4.2.1 and 4.2.2 above, there is clearly a restriction on from whom the company may source additional share capital.

The remainder of this chapter will explore the question of to which outsiders a private company may make an offer for the subscription of securities.

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<sup>73</sup> See also **Henochsberg on the Companies Act, 71 of 2008** *supra* at 174. Where this is the case and not all of the shares offered are subscribed for, the company may offer the shares to its existing shareholders again in accordance with section 39(2). This process could be repeated until all or a sufficient number of the shares offered have been subscribed for.

### 4.3. Who is included in the definition of “the public” in relation to a private company?

#### 4.3.1. Persons who are “public”

A private company’s capacity is restricted to offering its securities to persons who are not “public”. It is therefore essential to determine what persons are “non-public” or “private” in relation to a private company. What is of relevance here is not necessarily to determine a holistic view of what persons are public and non-public in terms of the Companies Act, but rather what persons are private or non-public in relation to a private company for the purposes of section 8 of the 2008 Act.

##### 4.3.1.1. Multiple definitions of “public” and “offer” at play

When approaching the issue of identifying what “public” means when determining who a private company is precluded from offering securities to in terms of section 8, the most obvious starting point is section 1 which contains the definitions applicable throughout the Act. Interestingly, no definition of “public” or “offer” exists in section 1.

The next logical step would be to examine Chapter 4 of the Act which bears the title “Public Offerings of Company Securities”. The first section under Chapter 4, section 95, contains a set of definitions including a definition for “offer” as well as “offer to the public”.<sup>74</sup> Section 96 which also falls into Chapter 4 lists offers that are not public. At first glance, the definitions in section 95 read with the title of Chapter 4 appear to cover the circumstances in which a private company would and would not be offering securities to the public for the purpose of section 8. However, section 8 falls into Chapter 1 of the Act. Section 95(1) begins by stating that “*in this Chapter, unless the context indicates otherwise*” and then lists words and their meanings for the purpose of Chapter 4 alone.

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<sup>74</sup> Section 95(1)(g) and (h) respectively.

The definitions under section 95 are therefore restricted to use in Chapter 4 and therefore cannot apply to Chapter 1.<sup>75</sup> The result is that the common law definitions of “public” and “offer” apply to section 8 and it appears that it is these definitions that must be used to determine who is “private” in relation to a “private” company. As alluded to earlier, this also means that only the common law definition of “offer” applies when determining whether an offer has been made for the purposes of section 8 as there is no definition of an “offer” in section 1. This is not to say that private companies escape the requirements of Chapter 4, as will be discussed in more detail below, the two definitions of “public” and “offer” under the Act and common law apply separately and for different purposes.

Studying the contents of Chapter 4, it is evident that the provisions therein seem to work together not to regulate or prohibit offers in general and for all purposes, but determine the circumstances and to what extent disclosure is required when certain offers for securities are made. The section therefore does not determine what a “public offer” is for every other purpose under the Act. Chapter 4 could be described as a self-contained mechanism or an “Act-within-an-Act” by which all offers should be judged for the purposes of issuing a prospectus.

Unlike the 1926 Act, the 1973 and 2008 Acts do not have a universal definition of “public”. A similar issue arose under the 1973 Act where the meaning of “offer to the public” in Chapter 5 of the Act existed for a different purpose to the meaning of “offer to the public” under Chapter 6 (Chapter 6 being the equivalent of Chapter 4 under the 2008 Act). It has been submitted that the definition of “offer to the public” in section 141 (Chapter 5) of the 1973 Act has no application to section 142 (Chapter 6) and vice

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<sup>75</sup> See **Henocheberg on the Companies Act, 71 of 2008** *supra* at 49 - 50

versa.<sup>76</sup>

Where “public” is defined for a specific purpose, it does not necessarily become an umbrella definition for the term throughout the rest of the Act. In the decisions of *S v Rossouw*<sup>77</sup> and *Vlakspruit Landgoed v J Mentz*<sup>78</sup> it was held that the intention of the offeror plays a major role in determining whether or not the offer is “public” for a particular purpose.<sup>79</sup> It is submitted that the purpose of the use of the word “public” in section 8 is different from the purpose in Chapter 4. Where section 8 deals with the a specific source of capital, Chapter 4 deals with disclosure requirements for certain offers.

#### 4.3.2. Non-Public Offers at Common Law

The question of “who is public” under the common law is a rather complex issue. There appears to be a battle for relevance between form and substance. In the context of private companies, the question revolves around *who* you may offer securities to (being the substance), but at times, case law seems to focus more on *how* the securities are offered (being the form).

##### 4.3.2.1. Focus on Form

In *Nash v Lynde* (supra), one of the earliest cases dealing with the issue, the court dealt with the situation where a private company intended issuing additional shares to raise capital. A document marked “strictly private and confidential” containing certain particulars of the company was prepared by the managing director and addressed to a fellow director. Attached to this document was a statement that was intended to convey

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<sup>76</sup> **Henochsberg on the Companies Act, 1973** supra at 255

<sup>77</sup> 1971 (3) SA 575 (T)

<sup>78</sup> 1977(1) SA 780 (T)

<sup>79</sup> See the discussion of these cases in **Henochsberg on the Companies Act, 1973** supra at 255 and **Henochsberg on the Companies Act, 2008** at 384

the company's intention to the public at large, but that was originally addressed only to the directors of the company (the wording of the document made this apparent). The documents were delivered to the director who then forwarded them to his attorney with the intention of locating prospective subscribers (without any specific person in mind). As an eventual result of the dissemination of these documents, certain shares were subscribed for. At a later stage a dispute arose (the merits of which are not relevant for present purposes) and two fundamental questions arose. The first was whether the two documents forwarded by the director constituted an "offer of shares made by the company to the public", and the second was whether those documents were in fact "issued to the public".

The question of whether an offer of securities was made to the public was contingent on whether the "prospectus" (the two documents) was in fact transmitted to the subscriber with the intention of "issuing the prospectus to the public". The House of Lords placed much emphasis on the question of intention and ultimately came to the conclusion, in light of the facts, that there was no intention to "issue the prospectus to the public" in this specific instance. The truth of the matter was that the documents were transmitted via the grapevine to the eventual subscriber who was a family member of a friend of the attorney of the director who initially received the "strictly confidential" documents. The documents reached the subscriber with the intention of merely indicating the state of affairs of the company to him for the purpose of evaluating prospective salaried employment. What transpired was that the subscriber ultimately didn't subscribe for any of the shares that were "offered" in the document, but rather accepted employment after establishing a relationship with the company and simultaneously subscribed for other shares not included in the offer. On this basis, it could not be proved that any offer was "issued" with the intention of

offering any securities.

This is entirely unhelpful in determining whether an offer is one made to the public. In this instance that question was entirely sidestepped by studying the intention of the transmission of the documents. If the subscriber in question had subscribed on the strength and terms of the documents received, the question of whether he was “public” in relation to the company would have been dealt with, however this was not the case. The facts do not assist in determining whether the offer was public in form or in substance.

However, Lord Viscount Sumner discussed the concepts of what “communications” would have constituted an offer to the public. Sumner argued that the attorney who received the documents for dissemination did so as an agent of the company and his receipt could therefore not have constituted an “issue”. He went on to state that in sending it on, the attorney would have affected the “issue” of a single offer and that such an issue could not constitute an issue to the public *“otherwise any private letter, written by a person engaged in forming a company and advising his correspondent to take shares, would become an issued prospectus if other letters were written by him asking others to do the same”*.

Lord Sumner found that for such an “issue” to be public, it must be disseminated to the public and that no particular number of persons was required to constitute an offer to the public, or to a section of the public. If the offer is open to anyone who brings his money and applies in due form, whether the prospectus was addressed to him or not, it shall be a public offer.

The notion that someone is “private” in relation to a private company is not addressed here. The substance of the offer is therefore entirely ignored. What is addressed (in part) is the

form of the offer. As far as the concepts of public and private are concerned, the focus in this case was not on the identity of the offeree, but rather the manner in which the offer was made, namely : was it acceptable by the “public at large” or only those to whom it was addressed? The problem with such an approach is that an offer may be made to an arbitrary selection of offerees that would otherwise be public. Theoretically, if this approach were followed, one could page through the telephone directory and address offers to those specific persons listed therein without those offers being to the “public”.

The form of the offer was also given preference in *S v National Board of Executors Ltd and Others*<sup>80</sup> where an offer for an “issue by private placing” of securities was made under cover of a brochure that was marked “strictly private and confidential - for the information of addresses only” and “strictly private and confidential: not for publication”. In this case, the court had to decide whether contraventions of various sections of the 1926 Act had occurred in offering securities to the public. The real question was whether the brochure was an invitation to subscribe which “*can properly be regarded, in the circumstances, as not being calculated to result, directly or indirectly, in the shares or debentures becoming available for subscription or purchase by persons other than those receiving the offer or invitation*”.<sup>81</sup> The facts of the case were that the company had disseminated hundreds of the brochures supposedly only to doctors in the Durban area. What resulted was the subscription by seemingly unrelated parties who had obtained copies of the invitation. The Defence argued that the requirement did not state that the invitation must be received by an applicant from the issuer, and that applicants who received the invitation from *anyone* could therefore apply without the

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<sup>80</sup> [1971] 4 All SA 104 (D)

<sup>81</sup> Subsection (2) of section 84*bis* of the 1926 Act

offer being public.<sup>82</sup> This argument (together with other factors<sup>83</sup>) was accepted by the court and it was found that the invitation was not one to the public.<sup>84</sup>

Although the decision in the present case dealt with an offer by a public company, the same problem arises here as with the decision in *Nash v Lynde*. If the principles enunciated in this decision are applied in the context of a private company, the rationale of the private source of capital for private companies is lost. The decision in *S v National Board of Executors Ltd and Others* is testament to the fact that a determination of what constitutes a “public” offer in respect of a private company (with specific reference to the requirements of section 8 of the 2008 Act), cannot be approached on the basis of form alone.

#### 4.3.2.2. Recognition of Substance

A far more realistic set of requirements that balances form and substance was established in *Corporate Affairs Commission (South Australia) v Australian Central Credit Union*.<sup>85</sup> The meaning of “public” in context of the Australian Companies Act of 1961 was discussed and the court found that for an offer to be “non-public” there must exist, as a pre-condition, either: (i) some subsisting relationship between the offeror and the members of the offeree group; or (ii) some rational connection

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<sup>82</sup> At 112

<sup>83</sup> At 116 - 119

<sup>84</sup> Beuthin criticises this decision in RC Beuthin “By Invitation Only : The Public are not invited” (1972) *SALJ* 8–15 where he submits that the court’s decision was not line line with either the ‘actual intention’ of the Millin Company Law Amendment Enquiry Commission 1947-1948 or with the ‘presumed intention’ of the legislature. The basis for his argument is founded on an interpretation supported by LCB Gower *The Principles of Modern Company Law* 3 ed (1969) at 259 - 7 where it is proposed that the requirements of section 84*bis* could never be met in circumstances where it is likely that someone else might purchase the shares from the recipient of the original offer.

<sup>85</sup> 10 ACLC 59 at 63

between the common or identifying characteristics<sup>86</sup> of the members of the group and the offer made to them.<sup>87</sup>

Once one of the two preconditions is met, the determination of whether the offer was to “the public” would depend on a variety of factors<sup>88</sup> including : (a) the number of persons comprising the group; (b) the subsisting relationship between the offeror and the members of the group; (c) the nature and content of the offer; (d) the significance of any particular characteristic which identified the members of the group; and (e) any connection between that characteristic and the offer. Selected elements of this test were applied in the South African case of *Gold Fields Limited v Harmony Gold Mining Company Limited*<sup>89</sup> (discussed later).

In identifying a “private source of capital” that is wholly compatible with the rationale for private companies, the above requirements appear to be an ideal point of departure. The first leg of the test establishes some sort of relationship between the issuing company and the offerees or between the offerees *inter se* in relation to the offer. These two requirements work in the alternative and identify scenarios where, for example, shares are issued to a person who already has a relationship with the company, or shares are issued in pursuance of the acquisition of an asset through a rights offer or share swap. In both instances the purpose and intention of the issue is not to offer securities to the public for the acquisition of public capital.

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<sup>86</sup> Brennan J, delivering the minority judgement required that the common characteristics between the group must be as a result of the relationship with the offeror. See PA Delpont “Offer to the ‘Public’ : Even More Disharmony” (2005) *SA Merc LJ* 388–394 at 393

<sup>87</sup> MF Cassim “Gold Fields v Harmony : A lost opportunity to clarify section 145 of the Companies Act” (2005) *SALJ* 269–283 at p276

<sup>88</sup> *Id*

<sup>89</sup> (2005) 2 SA 506 (SCA)

The second leg of the test balances form and substance by considering the subjective circumstances of the specific offer. The factors for consideration listed are not exhaustive but the examples outlined above show a study of the form of the offer based on the number of persons involved and the nature and content of the offer (which may or may not hinge on whether the offer is renounceable and to whom) as well as a study of the substance in considering subjective characteristics of the actual offerees and their relation to the offeror. Clearly the more restricted the offer and the closer the relations, the less likely that the offer will be found to be “public”.

This leg of the test is supported by a variety of case law. In the American case of *SEC v Sunbeam Gold Mines Co*<sup>90</sup> the court held that it is essential to examine the circumstances under which the distinction is sought to be established and to consider the purposes sought to be achieved by such distinction. In *S v Rossouw* (supra) the court found that the phrase “member of the public” could not be equated with “member of the community” and that an “offer to the public” does not mean “an offer to any person” for the reason that it is possible that a member of the community or a person that would otherwise be “public” may be connected to the offeror in a manner that could not truly designate them as such. The court went on to find that whether or not the offer was one “to the public” would depend on the facts of each case. In both of the above cases, it is clear that the subjective circumstances of the offeror and offeree and their relation to one another must be scrutinised.

With respect to the considerations relating to the latter part of the first leg of the test, the court found in *Vlakspruit Landgoed v J Mentz* (supra) (considering a matter concerning the sale of shares on the secondary market under the 1973 Act) that the

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<sup>90</sup> 95 F2d 699 (CA 9th Cir Wash 1938)

intention of the offeror was decisive<sup>91</sup> and drew a distinction between trafficking in securities and transferring ownership of an asset via the sale of shares.<sup>92</sup> In essence, the question was : “*did he wish to sell the shares or something else by way of shares?*”.<sup>93</sup> In relation to a private company issuing shares, the question might rather be “*did the company wish to ‘sell’<sup>94</sup> shares, or acquire something else by way of shares?*”.

In *Gold Fields Ltd v Harmony Gold Mining Co Ltd* (supra) (referring to *Corporate Affairs Commission (South Australia) v Australian Central Credit Union* (supra)) the court had to decide whether an offer was to the “public” and therefore whether a prospectus was required. The court found that the offer of securities by one company to existing shareholders of another company was not public as it was made only to persons in the “peculiar capacity” as the owners of certain private property.<sup>95</sup> This is an obvious exercise of the second part of the first leg of the test in *Corporate Affairs Commission (South Australia) v Australian Central Credit Union* (supra), however, this decision has been the subject of much criticism.<sup>96</sup>

It has been submitted that the second part of the first leg of the test cannot be read in isolation from the first part.<sup>97</sup> Brennan J, delivering the minority judgement in *Corporate Affairs Commission (South Australia) v Australian Central Credit Union* (supra) stated that “*when an antecedent relationship exists*

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<sup>91</sup> See also **Henochsberg on the Companies Act, 71 of 2008** at 385

<sup>92</sup> *Id*

<sup>93</sup> Cilliers, Benade *et al.* **Corporate Law** 2000

<sup>94</sup> ie : issue shares to raise capital

<sup>95</sup> See Delpont *SA Merc LJ* (2005) 388–394 *supra* at 390 and **Henochsberg on the Companies Act, 71 of 2008** *supra* at 366

<sup>96</sup> See Delpont *SA Merc LJ* (2005) 388–394 *supra* and Cassim (2005) *SALJ* 269–283 *supra*

<sup>97</sup> Delpont *SA Merc LJ* (2005) 388–394 *supra* at 393

*between the offeror and a group of offers and, by reason of that relationship, the offers have a special interest in the subject matter of the offer, there is a ground for distinguishing the group from the public*". The effect of this is that the common characteristics between the group (ie : the second part of the first leg) must be as a result of the relationship with the offeror (ie : as a result of the first part of first leg). Without this subsisting relationship, an offer could be made only to persons who have R1 million in cash, which might comply with the reasoning of the judgement. In such a case it would appear that the offer was made to persons in the peculiar capacity, not shared by the public at large, as owners of specific limited property.<sup>98</sup> This would clearly not be a private offer.

The decision has also been criticised for largely ignoring the second leg of the test, being the variety of factors studied once the precondition in the first leg is satisfied.<sup>99</sup> Although none of the factors of the second leg are determinative on their own<sup>100</sup>, the court may have realised that one of the factors is "the subsisting relationship between the offeror and the members of the group" which is a repetition of the wording of the first leg.

The criticism of the *Goldfields* decision is accepted here for present purposes as it conforms with the rationale of private companies. An offer made to an anonymous section of the public defined by whatever means cannot be considered a "private" source of capital, nor could such an offer constitute a "private" affair. Such an offer could easily be made in the newspaper which is certainly not a private document.

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<sup>98</sup> *Ibid*

<sup>99</sup> Cassim (2005) *SALJ* 269–283 *supra* at 277

<sup>100</sup> *Id*

#### 4.3.2.3. Conclusion

It is currently impossible to be dogmatic about what constitutes an offer to the “public” for the purposes of section 8 of the Act. The principles of *Corporate Affairs Commission (South Australia) v Australian Central Credit Union* (supra) are a fantastic point of departure and the application of those principles may surely be guided by existing case law. A reasonable summary of the position might be that where securities are offered to a restricted number of persons, who have an existing relationship with the company, or the company has an interest in something other than mere acquisition of capital and that binds those persons as a group, and the offer is of such a nature that the intention is not to bring those securities into public circulation, such an offer will not be one to the public for the purposes of section 8. Such a determination must be judged on the facts of each case.

#### 4.3.3. Non-Public Offers at Statute

The determination of who a private company may offer securities to is a separate affair to the determination of what constitutes an “offer to the public” for the purpose of disclosure. All companies, private and public included have to issue a prospectus if an offer contemplated in Chapter 4 of the Act is made.<sup>101</sup>

Section 95 of the Act regulates the definitions in respect of offers to the public and applies to all companies including foreign companies.<sup>102</sup> An “offer” is defined as an offer made in any way, by any person in respect of the acquisition of securities in a company, for consideration. It is therefore clear that private companies issuing securities fall within the wide ambit of the section. Section 95(1)(h)(i) and (ii) defines an “offer to the public” and begins by stating that an offer is one to the public even if made to a

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<sup>101</sup> Section 99(3)(a) of the Act prohibits the offer to the public of unlisted securities unless that offer is accompanied by a registered prospectus. As discussed earlier in this text, a private company is currently incapable of listing its securities on an exchange.

<sup>102</sup> Section 95(1)(a) read with the definition of a company in section 1

section of the public selected by some criteria. The wording serves to exclude the *Gold Fields* decision (supra) where the court found that an offer to existing shareholders was not public as it was made only to persons in the “peculiar capacity” as the owners of certain private property.<sup>103</sup> The word “public” (aside from the sections of the public included by section 95(1)(h)(i)) is assigned its meaning as the term is ordinarily understood.<sup>104</sup>

The “sections of the public” included by section 95(1)(h)(i) includes persons selected by any criteria<sup>105</sup> but specifically includes *inter alia* existing holders of the company’s securities<sup>106</sup> and the holders of any class of property.<sup>107</sup> The definition of public under section 95 is extremely wide and would appear to cover almost any instance of offering securities. Section 95(1)(h)(ii)(aa) provides a necessary exception to the above rules by excluding offers made in the circumstances listed under section 96.

#### 4.3.3.1. Offers that are expressly “non-public”

Section 96 of the Act creates statutory exceptions to what constitutes offers made to “the public” in terms of section 95. The exceptions under section 96 include offers made to certain institutions or persons whose ordinary business is to deal in securities<sup>108</sup>, where the acquisition cost of the securities for a single addressee is above a certain value<sup>109</sup>, where the offer is made only to existing securities holders or persons related to

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<sup>103</sup> See Delport (2005) *SA Merc LJ* 388–394 supra at p390 and **Henochnberg on the Companies Act, 71 of 2008** supra at 366

<sup>104</sup> **Henochnberg on the Companies Act, 71 of 2008** supra at 365 discussing the *Goldfields* case supra

<sup>105</sup> Section 95(1)(h)(i)(dd)

<sup>106</sup> Section 95(1)(h)(i)(aa)

<sup>107</sup> Section 95(1)(h)(i)(cc)

<sup>108</sup> Section 96(1)(a)

<sup>109</sup> Section 96(1)(b) - This exception is often referred to as the “sophisticated investor” exception.

them<sup>110</sup>, where the offer is a specific type of rights offer<sup>111</sup>, where the offer is made only to directors or persons related to them<sup>112</sup>, if the offer pertains to a specific type of employee share scheme<sup>113</sup> and where the offer is pursuant to a small issue meeting the requirements of the Act.<sup>114</sup>

#### 4.3.3.2. Expanding the statutory meaning of “non-public” with the common law

Section 95(1)(h) defines “offer to the public” and includes non-exhaustive exclusions to what constitutes such an offer.<sup>115</sup> This creates the possibility for the existence and application of a common law “non-public” category.<sup>116</sup> It has been submitted that where legislation allows for such a category, the test for “public” or “non-public” must comply with the philosophy that “non-public” includes “those who are able to fend for themselves” (*SEC v Ralstron Purina infra*) as allowance for the levels of exclusion<sup>117</sup> such as those possible through *Goldfields* (*supra*) are unacceptable.<sup>118</sup>

The precise meaning of the word “public” has been considered in a number of cases, but its content is still uncertain.<sup>119</sup> The term is problematic in determining what constitutes an “offer to the public” due to the inherent uncertainty as to its exact

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<sup>110</sup> Section 96(1)(c)

<sup>111</sup> Section 96(1)(d)

<sup>112</sup> Section 96(1)(e)

<sup>113</sup> Section 96(1)(f)

<sup>114</sup> Section 96(1)(g)

<sup>115</sup> PA Delpont “About Offers of Securities to the Public” (2011) *THRHR* 668–676 at 675

<sup>116</sup> *Id*

<sup>117</sup> Note that the specific exclusions possible through the *Goldfields* decision are not possible under the 2008 Companies Act due to the express inclusion under s95(1)(h)

<sup>118</sup> Delpont (2005) *SA Merc LJ* 388–394 *supra* at 394

<sup>119</sup> **Corporate Law** *supra* at 262, para 16.3

meaning in the context of company law.<sup>120</sup> The issue is simply that if the offer constitutes an “offer to the public”, it falls into the purview of the legislative restrictions and requirements governing such offers.<sup>121</sup> Due to these uncertainties, it is useful to examine the common law where it is possible that “non-public” categories have been established.<sup>122</sup>

The US developments of the term are helpful.<sup>123</sup> In *SEC v Ralston Purina Co*<sup>124</sup> the court stated that an offering to those who are shown to be able to fend for themselves is a transaction “not involving any public offering”. This concerns the concept of the “sophisticated” investor and an offer to such persons does not constitute an “offer to the public”.<sup>125</sup> The rationale behind excluding such persons from the ambit of “the public” appears to hinge on the concept of who does and does not require “protection”. The less sophisticated investor would need different, possibly more information than one with a higher aptitude for assessing prospective investments.<sup>126</sup>

In *Gold Fields* (supra at 12), the court attached the ordinary meaning of the term to the meaning of “public” in the context of the Companies Act. The court accepted the “ordinary meaning”<sup>127</sup> to be that an offer to be public would at least “*need to be capable of being offered to and accepted by the public at*

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<sup>120</sup> Delpont (2011) *THRHR* 668–676 at 671

<sup>121</sup> **Contemporary Corporate Law** supra at 652

<sup>122</sup> Delpont (2011) *THRHR* 668–676 at 671

<sup>123</sup> *Ibid* at 675

<sup>124</sup> (1953) 346 US 119 at 125

<sup>125</sup> Delpont (2011) *THRHR* 668–676 supra at 674

<sup>126</sup> See Delpont (2011) *THRHR* 668–676 supra at 671 for a discussion on the historical development of the term “public”

<sup>127</sup> Delpont (2005) *SA Merc LJ* 388–394 at 389

*large*".<sup>128</sup> The court went on to define “*at large*” as an offer that would “*enable it to be made to and accepted by the public at large, and it could thus be made with indifference to any random section of the public*”.

Using this logic, the court found that where shares are offered only to a class of persons as owners of specific property, this would fall outside of the meaning of “*at large*” and would therefore not qualify as an “offer to the public” meaning that no prospectus is required. The court stated that an offer will not be to “the public” where the intention is to acquire specific private property (see also *Vlakspurit supra*). The court expressly agreed with the test in *Corporate Affairs Commission (South Australia) v Australian Central Credit Union* (*supra* at 14) in stating “*that there is a ‘rational connection’ between the offer and the characteristic that sets the group apart ... hardly needs saying for the characteristic is inherent in the offer itself.*”

As discussed above it has been submitted that a mere “rational connection” is insufficient, and the other factors mentioned in *Corporate Affairs Commission* (*supra*) are necessary requirements.<sup>129</sup> Acknowledgement of the presence of the “rational connection” only satisfies the first leg of the test as a precondition to the second and in this case the court failed to fully analyse the latter.<sup>130</sup> The mere fact that the group of persons were selected as owners of a particular type of “private property” as in *Goldfields* (*supra*) would not satisfy the *Corporate Affairs Commission* test in absence of the criteria listed in the second leg of the test and would therefore not qualify as “non-public”.<sup>131</sup>

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<sup>128</sup> at 13

<sup>129</sup> **Henochsberg on the Companies Act, 71 of 2008** *supra* at 366

<sup>130</sup> Cassim (2005) SALJ 269–283 *supra* at 277

<sup>131</sup> **Henochsberg on the Companies Act, 71 of 2008** *supra* at 366 - 367

As discussed in 4.4 below, the existence of a common law “non-public” category for the purposes of disclosure would greatly assist in offering of securities in a private company. Whether such a category for the purposes of disclosure under Chapter 4 exists remains to be seen. The non-public category established in *Gold Fields* (supra) has been eliminated through the provisions of section 95(1)(h) of the Act. It has been submitted that the test for “public” and “non-public” for the purposes of disclosure identified in *SEC v Ralstron Purina Co* (supra) must be applied in that the determination must comply with the basic philosophy that a “non-public” category of persons must be shown to be able to fend for themselves.<sup>132</sup>

#### 4.4. The Interplay Between Section 8 and Chapter 4 of the Companies Act

From the foregoing chapters and paragraphs it is clear that an “offer to the public” has no consistent meaning throughout the Act. The definitional requirements under section 95 that include the wording “*made in any way, by any person*”<sup>133</sup> and “*to any section of the public*”<sup>134</sup> cast a wide net that is minimally reduced by the exceptions in section 96. The concept of “non-public” is therefore far wider under section 8 where the common law may certainly include a section of the public selected by some means not included in the exceptions in section 96.

The two definitions are therefore somewhat contradictory, yet both must apply simultaneously. When a private company intends offering securities to *anyone*, it is under a duty to comply with the limitations imposed under section 8 to ensure that it does not act beyond its capacity limited by the compulsory provisions in its MOI. It is then under a further duty to identify whether the offer is caught by the prospectus requirements of Chapter 4 of the Act. The only method of doing so is to determine whether the offer falls squarely into one of the exceptions listed in

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<sup>132</sup> Delport (2005) *SA Merc LJ* 388–394 *supra* at 394

<sup>133</sup> Section 95(1)(g)

<sup>134</sup> Section 95(1)(h)

section 96.

These considerations are most easily brought to life through a hypothetical set of facts. Consider a scenario where a private company has only one client. Imagine that this private company produces a patented chemical that is essential to its sole client's manufacturing process. The parties would clearly have an intimate relationship and the client would be in the position to have a very good understanding of the supplier company's state of affairs. Suppose the client forms the intention of subscribing for shares in the supplier company to enable it to expand and increase its output. If one now considers the requirements for such a transaction, it becomes apparent that all of the principles outlined in this text would find immediate and possibly unintended application.

Firstly, the supplier company would have to comply with the requirements of section 8 of the Act. Applying the requirements of *Corporate Affairs Commission (South Australia) v Australian Central Credit Union* (supra) it is clear that there is a subsisting relationship between the offeror and the offeree meaning that the pre-conditions for a "non-public" offer have been met. Application of the second leg of the test confirms that the offer is private seeing that (a) there is only one offeree; (b) there is a strong subsisting relationship between the parties; (c) the nature of the offer is not aimed at circulating the securities in the public sphere (see also the requirements in *Vlakspruit Landgoed v J Mentz* supra); (d) the significant characteristic of the offeree identifying it as such is that it is the sole client of the offeror (see also the requirements of *SEC v Sunbeam Gold Mines Co* supra); and (e) there is a strong connection between that characteristic of the offeree and the offer. The requirements of *S v Rossouw* (supra) are also met in that the offer is not made to any "member of the community" or "any person". It is clear that the offer is certainly not public and may safely be designated as "private" for the purposes of section 8 of the Act.

Secondly, the supplier company would have to comply with the requirements of Chapter 4 of the Act. A cursory study of section 95 would result in the identification of section 95(2) which specifically includes a "purchaser of goods from the company" as a "member of the public". Unless the offer is exempted by section 96, a prospectus would therefore be required.

In this instance, the offer is not made to a particular type of institution envisaged in section 96(1)(a), nor is it made to an existing shareholder or director (or person related to them), nor is it a qualifying rights offer or pertaining to an employee share scheme. What remains are the exceptions set out in section 96(1)(b) and (g) relating to the size and value of the offer. Section 96(1)(b) simply states that the offer is not public if the total acquisition cost for a single addressee (in this instance the sole client) is equal to or greater than R1million.<sup>135</sup> This exception is clearly an option under the circumstances. The supplier company could raise millions from the issue to its client without having to issue a prospectus. Where the intended capital injection is below R1million however, this exception could not apply. Instead, it may be possible to use the exception under section 96(1)(g) which may only be used to raise in total R1million<sup>136</sup> or less, through an offer to a maximum of fifty persons and where no selling expenses are incurred.<sup>137</sup> The issue of the securities subject to the offer would also have to be finalised within six months.<sup>138</sup> The requirements under this exception are interesting in that the maximum number of persons by whom the offer may be accepted is the same as the maximum number of members allowed in a private company under the Old Act.<sup>139</sup> The prescribed maximum value also appears to be geared towards small to medium sized businesses. It would appear that these exceptions are ideal for private companies.

However, it is obviously possible that the aforementioned exceptions will not be applicable to all private companies rendering them fully susceptible to the disclosure requirements of Chapter 4. Assume for example that the subscribers are two shareholders of the client company who can each only contribute less than R1 million but the total capital required is more than R1 million. In such a case, neither of the two exceptions considered above find application.

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<sup>135</sup> Regulation 45(2)

<sup>136</sup> Regulation 45(2)

<sup>137</sup> Section 96(1)(g)(i). Such an offer would only be possible where no similar offer was made within the previous 12 months (section 96(1)(g)(v) read with regulation 45(2)).

<sup>138</sup> Section 96(1)(g)(ii)

<sup>139</sup> Section 20(1)(b) of the Old Act

It is clear that the existence of a common law “non-public” category under Chapter 4 of the Act would assist private companies here. The result is that private companies may indeed have to issue a registered prospectus when offering securities. The facts might show that the securities aren’t being offered to the public for the purposes of Section 8, but are indeed offered as such for the purposes of Chapter 4.

## 5. Chapter 5 : Conclusion

The crux of this text is that a private company offering securities that are “public” for the purpose of Chapter 4 might not be “public” for the purpose of section 8. The mere fact that a private company is caught by the provisions of Chapter 4 does not by implication mean that it is acting in contravention of section 8. The instance of a private company possibly having to issue a prospectus under certain circumstances is a fairly new turn of events which may or may not have been an intended consequence of the new laws. The provisions governing the concepts of “public” and “private” are clearly more complicated than they appear and the cost implications of preparing a prospectus may be problematic for smaller companies who are unable to circumvent Chapter 4. Furthermore, the necessity of determining whether an offer requires a prospectus and then having to go through the processes of preparing and registering the document also limits the flexibility of private companies, driving an even deeper divide between the private company and its predecessor, the Close Corporation.

One of the goals of the most recent round of corporate law reform in South Africa was to render company law accessible to a greater audience by simplifying not only the wording of the governing Act, but by streamlining the landscape of registrable entities going forward. The landscape has certainly been streamlined, but the wording is not as clear cut as it could be. As far as accessibility is concerned, smaller business owners may be perplexed and intimidated by the somewhat confusing restriction on offering securities to the public. If the difference between section 8 and Chapter 4 is understood, the complexity involved with and the liability flowing from prospectuses may also serve as a deterrent to further capitalisation and expansion of a business.

It is submitted that despite the above concerns, private companies are sufficiently simple and accessible for use by small businesses even in the absence of resources

and knowledge. Section 96 (especially section 96(1)(b) and (g)) fairly balances the opportunities to raise capital without necessitating the preparation, registration and issue of a prospectus. In most cases, the exceptions are compatible with the common law notion of “public” and “private” that apply under section 8. The interplay between section 8 and Chapter 4 is not perfect, but it is submitted that if Chapter 4 of the Act requires the company to issue a prospectus, it is likely that the offer is “public” for both purposes. If a small business trading in the form of a private company makes an offer that is truly private, even if no active consideration is given to Chapter 4, it is likely that the offer will fall into one of the exceptions under section 96 by coincidence. The common law concept of “public” under section 8 is wider than the Chapter 4 definition rendering a breach of section 8 unlikely, but as the limitation exists as a restriction on capacity, such a breach could merely be ratified in any event.

Consideration must also be given to the intention of the legislature. Transparency and accountability are major themes under the Act and it follows that these themes are reinforced by a requirement to issue a prospectus where large quantities of money or many persons are at risk. It is reasonable to state that persons who want to solicit capital from the public should be forced to disclose adequate information irrespective of that company’s classification. The mere fact that one may call his company “private” should not allow total relaxation of the protections afforded to the investing public. The liability attached to untrue statements in prospectuses<sup>140</sup> also protects those who “cannot fend for themselves” which may include persons who are otherwise “private” in relation to the company at common law.

(14690 Words)

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<sup>140</sup> Section 104

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