

THE RETURN OF CAPITAL TO SHAREHOLDERS BY MEANS OF A REPURCHASE OF SECURITIES

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SUMMARY

Sections 46 and 48 of the Companies Act, 2008, regulates the process for implementing a share repurchase within a company. This study analyses the historical development of the implementation of share repurchase legislation in South African company law, by analysing the capital maintenance rule that existed before 1999, and then following the recent developments through the changes to the Companies Act, 1973 in 1999, under promulgation of the Companies Act, 2008.

The study then analyses the provisions of sections 46 and 48 of the Companies Act, 2008, analysing those provisions from a practical implementation perspective to ascertain the procedural requirements applicable to directors and shareholders, and how the process of implementing a share repurchase may be implemented.

There is then an analysis of the share repurchase provisions in the USA, UK and Australia to compare them at a very high level to the provisions in South Africa mainly to ascertain whether or not the South African requirements are comparable to international best practice.

Finally, a very brief analysis is made of some other factors that may be relevant to a decision to return capital to shareholders by means of a share buy-back, to ascertain to what extent factors may impose higher requirements, influence the decision as to what mechanism to utilise to implement a return of capital to shareholders.

DECLARATION FOR PLAGIARISM

LIST OF ABBREVIATIONS

1973 Act – the South African Companies Act, 1973

2008 Act – the South African Companies Act, 2008

ECA 1981 - English Companies Act, 1981

ECA 1985 - English Companies Act, 1985

ECA 2006 - English Companies Act, 2006

GBP - United Kingdom Pounds

MOI – Memorandum of Incorporation

UK - United Kingdom

USA - United States of America

USD - United States Dollars

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CHAPTER 1

INTRODUCTION

1. BACKGROUND TO THE STUDY

- 1.1. Historically, from a South African common law perspective, the rule imported from English law that a company is required to maintain its share capital, was rigorously applied, not only in South Africa, but also worldwide. In the USA, these restrictions were gradually lifted in the 1980s as companies started to adopt mechanisms, and legislatures allowed measures, to allow companies to repurchase their shares.

- 1.2. Share repurchase activity has become a global phenomenon and after the growth of share repurchases in the USA, share repurchase programs have been widely adopted in Europe, and also in countries such as Japan¹. In 2005 approximately USD400 billion was attributable to share repurchase programs². In fact, in the USA, corporate expenditure in respect of share repurchases, expressed as a percentage of earnings, was 10 times higher in 2005, than it was in the early 1980s. During the late 1990s, US companies started to spend more money on repurchasing shares, than on paying dividends³. In the UK, where repurchases were introduced and legalised in 1981, the annual spend on share repurchases, rose to GBP10 billion in the 1990s, approximately 80 times higher than in the 1980s⁴. Even during the financial crisis of 2007 and 2008, where the volume of share repurchases declined drastically, share repurchases still constitute a significant portion of

¹ Dhanani *Corporate Share Repurchases: The Perceptions and Practices of UK Financial Managers and Corporate Investors* (2009) 1.

² Dhanani 1.

³ Dhanani 1.

⁴ Dhanani 1.

turns to shareholders, and in jurisdictions like the USA, still far exceeds dividend payments⁵.

- 1.3. In South Africa, the rule requiring capital maintenance by companies, was strictly enforced, until the legalisation of share repurchases in 1999⁶. Since then, it has become a valuable tool for returning value to shareholders.
- 1.4. With the promulgation of the 2008 Act, the ability of South African companies to repurchase shares, was retained, although the process to be followed was refined and changed to a certain extent. However, the principle of share repurchase has become part of South African company law, and is now fully incorporated in the structure of the 2008 Act, as a distribution to shareholders.
- 1.5. There are of course a number of methods in which a company may return capital to its shareholders, including a reduction of capital, the issue and subsequent redemption of redeemable preference shares and other distributions from capital, however, the focus of this study, is the return of capital to shareholders through the mechanism of a repurchase of shares by the company.

2. STATEMENT OF RESEARCH PROBLEM

- 2.1. South Africa, as a late adopter of a mechanism to allow share repurchases, has gone through a rapid development progress since 1999, to implement and develop a legal structure to enable such repurchases, and to also align itself with international best practice in this regard.

⁵ Dhanani 3.

⁶ Chapter 3 infra.

- 2.2. The research problem is whether the process prescribed in the 2008 Act facilitates the return of capital to companies in a manageable and sustainable manner, and whether it is aligned with international best practice in comparison to a few selected jurisdictions. It is important to establish whether the South African model, is practically aligned with duties of directors and may be implemented in a manner that obviates an unnecessary administration, and is not overly complex or burdensome on the company.
- 2.3. It should be noted that the use of the term “capital” in this study, is not used in its strict meaning, specifically for tax purposes, but has a wider meaning as including both capital and revenue based returns. Although generally referred to as a return of capital, a repurchase of shares may reduce both the stated capital and retained earnings of a company, and accordingly cannot refer to capital only, in the strict sense. Accordingly, except if the context requires otherwise, a reference to a return of capital in this study, also includes a distribution of profit or retained earnings, through the mechanism of a share repurchase.

3. LITERATURE REVIEW

- 3.1. Due to the fact that the 2008 Act has only been recently promulgated, there is a scarcity of literature specifically on the repurchase procedures under the 2008 Act. However, there is some literature and case law that relates to the 1973 Act which is still applicable, and was utilised in preparing this document.
- 3.2. A number of overseas journals and general publications relating to share purchases and the application thereof were also consulted in a number of jurisdictions, but mainly concentrating on the USA, UK and Australia, being important from a historical perspective, and the USA specifically from the perspective of being a leader in developing a share repurchase environment.

- 3.3. Further guidance was found in contemporary publications on the 2008 Act, and journal articles.

4. AIMS AND OBJECTIVES OF THE STUDY

- 4.1. This study is aimed at analysing the requirements for a repurchase under South African law, as it currently stands under the 2008 Act, with an analysis of the historical position in South Africa insofar as capital maintenance and share repurchases is concerned, the introduction of share repurchase legislation into South African company law, and the current requirements under the 2008 Act insofar as repurchases are concerned, specifically with emphasis on the procedure, and the duties placed on directors and shareholders from a compliance perspective.
- 4.2. In addition to that, the position in specifically the USA and UK was analysed to compare the development in South Africa, with the position in those jurisdictions, and also determining to what extent the procedures in those countries are aligned with, or differ from the position in South Africa, in order to establish to what extent the procedure in South Africa could be regarded as in line with worldwide trends, and also to what extent it creates a practical mechanism to directors to return capital to shareholders of a company.
- 4.3. As a further, but subservient objective, the study also analyses a few ancillary aspects related to share purchases, specifically insofar as its applicability to listed companies, and tax and exchange control requirements are concerned, to ascertain whether a repurchase mechanism, provides any benefits over other mechanisms of returning capital to shareholders, and also, in that context, insofar as returning profits via dividends to shareholders.

5. RESEARCH METHODOLOGY

- 5.1. The research methodology utilised in this study, is mostly a logical-analytical approach, but also includes some legal historical and comparative legal analysis.
- 5.2. The legal historical analysis is utilised to analyse the development of capital maintenance legislation in South Africa, and that, combined with the logical analytical approach, is then utilised to analyse the current provisions of the 2008 Act, to ascertain to what extent, current legislation provides assistance to directors to utilise the mechanism of repurchase to return capital to shareholders. The comparative legal process is utilised to compare the current legislation in South Africa with some selected jurisdictions in an effort to determine whether the South African process, is in line with best practice, and creates a practical mechanism for a return of capital.

6. SCOPE AND LIMITATION OF THE STUDY

- 6.1. The study is presented in four chapters, the first being this introduction, and the other three chapters addressing the historical development, current analytical, and brief comparative analyses of the repurchase process.
- 6.2. The conclusion and summary sets out the conclusions reached, with reference to the research problem, and the objectives stated above, where a conclusion is reached as to the apparent alignment of South African repurchase provisions with international practice, and the extent to which the process facilitates the return of capital to shareholders.

CHAPTER 2

HISTORICAL DEVELOPMENT IN SOUTH AFRICA

1. COMMON LAW POSITION

1.1. South African company law is largely based on English Law and the development in English common law has historically been used as a model for the development of South African company law⁷. Many of the common law principles under English law were accepted by our courts and introduced into South Africa with little or no modification, including the rules relating to the maintenance of share capital⁸. The English legislation in turn, was based on English common law, which was strongly influenced by the principles of the Law of Partnership⁹. In this way numerous principles of English common law found their way into South African law and South African courts were also largely influenced by the interpretation of English courts in respect of South African company law principles¹⁰.

The capital maintenance doctrine established by English courts entailed that:

- 1.1.1 shares may not be issued at a discount to their par value;
- 1.1.2 dividends may not be paid out of share capital; and
- 1.1.3 a company may not purchase its own shares^{11,12}.

⁷ Van Jaarsveld *Suid-Afrikaanse Handelsreg*, (1988) 306.

⁸ Cilliers & Benade *Corporate Law* (2000) 19.

⁹ Van Jaarsveld 306.

¹⁰ Van Jaarsveld 306.

¹¹ Van Der Linde *Aspects of the Regulation of Share Capital and Distributions to Shareholders (LLD Dissertation UNISA 2008)* 20.

- 1.2 The most prevalent argument advanced for the capital maintenance doctrine, was that the issued share capital of the company, established a trust fund for creditors of the company to ensure that the company could honor its obligations and liabilities to creditors^{13 14 15}. A further reason for the maintenance of capital, was to prevent a company from trafficking in its own shares to the detriment of its shareholders^{16 17}. Accordingly, the capital maintenance rules provided that share capital may not be returned to shareholders during the existence of the company except if specifically allowed by legislation, which in turn meant that a company could not repurchase its shares or pay dividends out of share capital¹⁸.
- 1.3 In *Trevor v Whitworth*¹⁹ the principles of capital maintenance was confirmed as established under English law, even if it was not expressly contained in the English Companies Act at the time²⁰.
- 1.4 In *Trevor v Whitworth*²¹ a former shareholder claimed the balance of the purchase price of his shares which he had sold to the company before the company went into liquidation²². Lord Herschell could find no legitimate purpose for which the power to repurchase shares could be used, and Lord Watson held that a company could not become a member of itself and that a company could not legally resell the shares, even if purchased, as this would

¹² Cilliers & Benade 322.

¹³ Van Jaarsveld 377.

¹⁴ Van Der Linde 21.

¹⁵ Cassim *Contemporary Company Law*(2011) 268.

¹⁶ Cassim 268.

¹⁷ *The Unisec Group Ltd and others V Sage Holdings Ltd. 1986 (3) SA 259 (T) 265.*

¹⁸ Van Der Linde 21.

¹⁹ (1887) 12 APP CAS 409 (HL).

²⁰ *Unisec v Sage* supra.

²¹ (1887) 12 APP CAS 409 (HL).

²² Pretorius *Hahlo's South African Company Law through the cases* (1953) 122.

be *ultra vires*, or cancel them as this would be a reduction of capital²³. Lord Watson also remarked that he was unable to see how the expenditure that the company had to incur was in respect of, or incidental to any of the objects specified in the memorandum of the company, and therefore had a difficulty in seeing how that can be justified²⁴. This principle, through the import of English law principles into South African law, formed a fundamental part of South African law until 1999²⁵.

2. DEVELOPMENT IN SOUTH AFRICA UNTIL 1999

- 2.1 The principle that a company cannot buy its own shares and that to do so, would be illegal and void came to be regarded as part of South African common law. This principle was so fundamental that the Companies Act, 1926, which followed the English Companies Act very closely, did not even contain any provision expressly prohibiting such purchasers²⁶. The principle was adopted and followed in a string of judgments including *The Unisec Group Limited and others v Sage Holdings Ltd.*²⁷ The principle was considered in respect of a scheme devised to circumvent this principle, and the court re-established the principle and even went as far as finding that the scheme to circumvent the prohibition was in *fraudem legis*²⁸.
- 2.2 The Companies Act, 1973 carried over the principle of capital maintenance although it specifically dealt with aspects of the prohibition²⁹.

²³ Trevor v Whitworth (1887) 12 APP CAS 409 (HL).

²⁴ Cilliers & Benade 322.

²⁵ Cassim 268.

²⁶ *Unisec v Sage* supra.

²⁷ 1986 (3) SA 259 (T) 264.

²⁸ *Unisec v Sage* supra.

²⁹ Par 2.6 infra.

- 2.3 The capital maintenance rule was to a large extent abolished by the Companies Amendment Act, 37 of 1999 in favour of the so-called *American rule*³⁰.
- 2.4 The Companies Amendment Act, 1999 radically changed the capital maintenance rule and perceived protection to creditors. It was accepted that the capital maintenance rule was an imperfect way to protect creditors and the rules that were applied to enforce the principle were imprecise and uncertain³¹. At the time it was abolished, South Africa was one of the very few countries that still applied the principle of capital maintenance and it was also clear that the principle exposed companies in instances where they wanted to protect themselves against the manipulation of share prices³².
- 2.5 Some, but not all the provisions aimed at maintaining the capital maintenance rule, such as the rule that the company may pay dividends only out of the distributable profits and that a company may not purchase its own shares, were abandoned in 1999 and the modern concept of the twin tests of solvency and liquidity were adopted³³.
- 2.6 The 1973 Act (before amendment in 1999) did contain provisions aimed at the reduction of share capital. These were contained in Sections 83 to 90 of the 1973 Act³⁴. The 1973 Act provided for two procedures, set out in Sections 83 and 84. The Section 83 procedure applied to companies which had no creditors, or which could give security for the payment of all its creditors within 12 months of the capital reduction and, under these circumstances, allowed a company to effect a capital reduction by means of a special

³⁰ Pretorius 123.

³¹ Cilliers & Benade 322.

³² Cilliers & Benade 322.

³³ Cassim 10.

³⁴ Van Der Linde 302.

resolution without the intervention of a court application³⁵. The companies' Articles had to authorise the reduction of its capital. A company that could not utilise Section 83 of the 1973 Act, reduced its share of capital with court approval pursuant to the provisions of Section 84 of the 1973 Act. In considering an application for a share reduction under Section 84, the effect of the reduction of capital on the proportionate interest of shareholders was one of the important factors a court had to consider and certain principles of fairness between shareholders, particularly preserving the rights of shareholders to return of capital on the dissolution of the company were also established³⁶. The rights of creditors were protected by their right to object to a reduction of capital involving any payment to shareholders. A court would only sanction a reduction of capital if satisfied that every creditor of a company had either consented to the reduction, or had received payment or security for payment³⁷.

2.7 The 1973 Act, after the amendments in 1999, still contained some provisions that supported the capital maintenance rule³⁸. The South African legislator refrained from using the so-called English model (i.e. the stricter English law approach) and Sections 85 to 90 were largely based on the Canadian Model³⁹.

2.10 The memorandum on the objects of the Companies Amendment Bill, 1999⁴⁰ set out and summarised the reasons for amending the 1973 Act, the most pertinent of these being:

2.10.1 capital maintenance as a concept had undergone significant changes in almost all countries and the modern approach was to allow companies

³⁵ Section 83 of the 1973 Act.

³⁶ Van Der Linde 304.

³⁷ Section 85 of the 1973 Act.

³⁸ Cilliers & Benade 323.

³⁹ Cilliers & Benade 323.

⁴⁰ B17D – 99.

to reduce capital, including the acquisition of their own shares subject to solvency and liquidity provisions. This provided protection to creditors and gave the company flexibility at the same time to achieve sound commercial objectives and this was seen as extremely important for South Africa's re-entry into the global market (this was shortly after the 1994 elections);

- 2.10.2 it was further mentioned that the Johannesburg Stock Exchange and South African Futures Exchange were rapidly expanding and were entering into large scale derivative activities of a complex and sophisticated nature. There are inherent dangers in speculative derivative futures and currency trading activities and if taking place in an unscrupulous way, could easily suppress the price of shares on the stock market. It was perceived that South Africa had become a magnet for trading by such speculators that had, in turn, lead to the decline in the value of most of the leading South African shares. One of the defenses against this negative action in international markets was the ability of strong companies to repurchase and cancel their own shares which leveled the playing field in respect of those speculators;
- 2.10.3 it was seen as a useful tool in respect of employee share schemes enabling the shares of employees to be repurchased when they ceased to be employees;
- 2.10.4 it provides the means to avert a hostile takeover;
- 2.10.5 it provides the means whereby a shareholder or the estate of a deceased shareholder can find a buyer.

- 2.5 Cassim ⁴¹ adds some further advantages to enabling companies to repurchase their own shares:
- 2.5.1 it may be utilised to buy out dissident shareholders;
 - 2.5.2 it will enable a company to return surplus funds to shareholders who can then make other profitable investments;
 - 2.5.2 share repurchases can be used to maintain or achieve what is perceived to be a desirable debt:equity ratio;
 - 2.5.3 where a company has a number of shareholders with small holdings, the administrative overheads that relates to this may be reduced by the company buying out the small holdings without incurring any material costs;
- 2.6 Interestingly, based on a study conducted in the UK, the major motivation for non-investment companies to embark on a share repurchase, is to return cash to shareholders⁴². Accordingly, from a company perspective, it is regarded as one of the most important reasons to embark on a share repurchase.
- 2.7 Although not mentioned in the memorandum on the objectives of the Companies Amendment Bill, 1999⁴³, from a commercial perspective the return of capital, or cash, to shareholders, has become one of the most important mechanisms utilised by companies for this purpose⁴⁴.

⁴¹ Cassim 27.

⁴² Dhanani III.

⁴³ See paragraph 2.10 above.

⁴⁴ Dhanani VIII.

2.8 After the 1999 amendments, the 1973 Act provided three ways in which a company could reduce its paid up capital:

2.8.1 a repurchase of shares under the provisions of Section 85;

2.8.2 a redemption of redeemable preference shares under the provisions of Section 89; and

2.8.2 a repurchase of shares ordered by court pursuant to the provisions of Section 252(3)⁴⁵.

2.9 When a company acquired its own shares under the provisions of Section 85 of the 1973 Act, the repurchased shares were cancelled and then reverted to the status of authorised but unissued shares. Certain adjustments had to be made to the company's share capital account as prescribed under the 1973 Act⁴⁶.

3. DEVELOPMENT IN SOUTH AFRICA UNTIL 1999

Currently, the repurchase of shares by a company is regulated in terms of the provisions of Section 48 of the 2008 Act, which sets out the procedure to be followed, and also bases a decision for repurchase, on the application on the solvency and liquidity tests⁴⁷.

⁴⁵ Blackman *Commentary on the Companies Act 1* (2002) 5 - 15.

⁴⁶ Section 85 of the 1973 Act.

⁴⁷ See Chapter 4 below.

CHAPTER 3

SECTION 48 OF THE COMPANIES ACT, 2008

1. INTRODUCTION

The 2008 Act became operational on 1 May 2011⁴⁸, which also introduced the provisions of section 48 of the 2008 Act, introducing with it a modified process for the repurchase of shares by a South African company. For the sake of convenience, the full text of section 48 of the 2008 Act, is reproduced in Schedule 1, as well as the wording of section 46, which applies, by implication, to all share buy backs as well⁴⁹. Section 48 of the 2008 Act, replaced the equivalent provisions in sections 81, 85, 86, 87, 88 and 89 of the Companies Act 1973 Act⁵⁰. In this chapter, all references to a section, are references to the 2008 Act, unless otherwise stated.

2. BASIC REQUIREMENTS

2.1 In a similar way to the 1973 Act, section 48 provides for two forms of share buy backs, namely:

2.1.1 the acquisition by a company of its own shares and;

2.1.2 a subsidiary of shares in its holding company⁵¹.

2.2 The definition of “distribution⁵²” provides specifically, in sub-section (a)(iii) that it includes a direct or indirect consideration for the acquisition:

⁴⁸ Stein & Everingham *The New Companies Act Unlocked* (2011) 7.

⁴⁹ Delpont *Henochsberg on the Companies Act 71 of 2008* (2014) 20, Stein & Everingham 189, Cassim 274.

⁵⁰ Stein & Everingham 189, Delpont 201.

⁵¹ Stein & Everingham 189, Delpont 189.

⁵² Section 1 of the Companies Act 2008.

- 2.2.1 by the company of any of its shares as contemplated in section 48; or
- 2.2.2 by any company within the same group of companies, of any shares of a company within that group of companies.
- 2.3 Accordingly, even though section 48 sets out a procedure for the repurchase of shares by a company, or by a subsidiary within a group structure, the share buy-back itself will also qualify as a distribution under the provisions of the 2008 Act, which means that for any repurchase by a company or its subsidiary, the provisions of section 46 must also be complied with, as a prerequisite⁵³.

3. COMPLIANCE WITH SECTION 46 OF THE COMPANIES ACT 2008

- 3.1 Section 46 regulates distributions of company property to a holder of shares or the holder of a beneficial interest in shares⁵⁴. In basic terms, section 46 requires that a distribution may only be made if it is in terms of an existing legal obligation, or a Court order, alternatively if authorised by a board resolution⁵⁵. The term "distribution" as defined in the 2008 Act, specifically includes a share buy-back by a company or a subsidiary under the provisions of section 48. It should be noted that section 48(2) in turn, also refers to the fact that the decision to implement a share buy-back must satisfy the requirements of section 46. On the face of it, the reference in section 48 to section 46, appears to be superfluous duplication, however, on closer inspection, it does create some difficulties. Section 48 provides that the decision to implement a shares buy-back must satisfy the requirements of

⁵³ Section 48(2).

⁵⁴ Delpont 197.

⁵⁵ Delpont 197.

section 46. However, section 46, which sets out the requirements for distributions, in turn, addresses the requirement for a distribution, and not for a decision⁵⁶. Accordingly, the cross-reference in section 48 seems to imply that, at the time that the decision is made, the company must already comply with the requirements of section 46, whereas section 46 itself, only creates obligations in respect of the actual distribution. According to Cassim⁵⁷, this does not make sense, as the decision in itself can do no harm, and it is the distribution, which, if made contrary to the provisions of section 46, could cause harm⁵⁸. It is submitted that the intention of the legislator was probably to regulate distributions, and not necessarily the decision to make the distribution, and that the cross-reference to section 46 in section 48, is confusingly superfluous and most probably not well considered.

3.2 A distribution under the provisions of section 46 of the Companies Act 2008, must comply with two basic requirements, being:

3.1.1 as set out above, the existence of a legal obligation, Court order or board resolution⁵⁹;

3.1.2 it must reasonably appear that the company will satisfy the solvency and liquidity tests immediately after completing the proposed distribution⁶⁰;

3.1.3 the board of the company, by resolution has acknowledged that it has applied the solvency and liquidity tests and reasonably concluded that

⁵⁶ Cassim 274.

⁵⁷ Cassim 274.

⁵⁸ Cassim 274.

⁵⁹ S46(1).

⁶⁰ S46.

the company will satisfy the solvency and liquidity tests immediately after completing the proposed distribution⁶¹.

- 3.2 The requirement that the directors may approve a distribution, implies that no shareholders approval is required for a distribution⁶². However, whether the memorandum of incorporation of a company may impose such a requirement, is subject to some debate. Cassim argues that section 46 contains nothing that expressly contemplates that the effect of section 46 may be negated, restricted, limited, qualified, extended or otherwise altered in substance. This statement is made with reference to the definition of “alterable provision” in section 1, which provides that an “alterable provision” means a provisions which is expressly contemplated that its effect on a particular company may be negated, restricted, limited, qualified, extended or otherwise altered in substance or effect by that company’s MOI. Accordingly, Cassim argues that due to the fact that section 46 does not contain words to this effect, it effectively means that a provision in the MOI that imposes a restriction on the directors in making a distribution, is ineffective⁶³.
- 3.3 Delpport⁶⁴ conversely argues that in fact, such a restriction may be imposed on the company, based on the fact that section 15(2)(a)(iii) does allow a company to include a provisions in its MOI that imposes a higher standard, greater restriction, longer period of time or similarly any more onerous requirement that would otherwise apply to the company in terms of an unalterable provisions of the 2008 Act. The view of Delpport is to be preferred, as even Cassim acknowledges that it is doubtful whether the legislator intended an MOI to be limited in this way⁶⁵, and clearly, the provision that

⁶¹ S46.

⁶² Cassim 246; Weiner “*The New Companies Act: Peculiarities and Anomalies*” 2009 SALJ 806.

⁶³ Cassim 246.

⁶⁴ Delpport 197.

⁶⁵ Cassim 246.

imposes a higher level of compliance on the company, in this instance specifically requiring shareholders to approve a distribution, would fall into the exception created in section 15(2)(a)(iii). Accordingly, it is submitted that even though the 2008 Act requires a distribution to only be authorised by a board resolution, the MOI of a company may impose a higher standard and require shareholders approval for a distribution as well.

- 3.4 The solvency and liquidity requirements were already introduced in the 1973 Act in respect of certain distributions and other decisions of a company, but has taken a much more central role in the structure of the Companies Act 2008. Section 4 sets out how a company should apply the solvency and liquidity tests and what information should be utilised for that purpose⁶⁶. For purposes of section 46, the company must apply the solvency and liquidity test on two levels. Firstly, it must reasonably appear that the company will satisfy the solvency and liquidity tests immediately after completing the proposed distribution⁶⁷. Section 46 does not indicate to whom it must reasonably appear that the company will satisfy the solvency and liquidity tests, and accordingly it must be assumed that it is intended to be an objective test. Accordingly, if it reasonably appears on an objective basis that the company will be solvent and liquid after completing the proposed distribution, then the first element of the application of the solvency and liquidity tests has been complied with for purposes of section 46⁶⁸. Due to the fact that the company acts through its board, it must be assumed that such a decision will be reflected in a resolution of the board, and the second requirement of section 46, insofar as solvency and liquidity is concerned, then requires a further resolution by the board acknowledging that it has applied the solvency and liquidity tests and that it has reasonably concluded that the

⁶⁶ S4.

⁶⁷ S46(1)(b).

⁶⁸ Delport 198.

company will satisfy the solvency and liquidity tests immediately after completing the proposed distribution. At first glance, it appears to be a repetition of the first requirement, however, in the context, there is a difference, in that in this instance, the board acknowledges, thereby creating a certain level of subjectivity, in applying the solvency and liquidity tests⁶⁹.

3.5 Theoretically, there is a possibility that from a timing perspective, between the time when the distribution is contemplated and the resolution referred to in section 46 is taken, and the time when the distribution is actually made, the financial position of the company may have changed,, at which time, the company is also required to comply with the solvency and liquidity test⁷⁰.

3.6 A distribution, when approved by the board in terms of section 46 must be completed within 120 business days after the board made the acknowledgement referred to, failing which the board must reconsider and reapply the provisions of the solvency and liquidity tests⁷¹.

4. ACQUISITION

Perhaps less material, but still relevant, is the fact that section 48, uses the word “acquiring” in referring to the act of buying-back shares. According to Cassim, the use of the term “acquisition” is a misnomer as it indicates that the company that acquires the shares, holds the shares itself. This is not possible, as a company cannot acquire rights in itself⁷². This is supported by the fact that shares that are acquired by a company, are no longer issued shares, but acquire the status of shares that have been authorised but not issued⁷³. Cassim then seemingly argues that, in instances of

⁶⁹ Delpont 198.

⁷⁰ Delpont 198.

⁷¹ Delpont 198, Cassim 247.

⁷² Cassim 247.

⁷³ S35(5).

a gift or inheritance, it may lead to some absurdity, specifically if it is included in the provisions of section 46. Delport⁷⁴ refers to the same meaning of the term “acquisition” but then points out, in my view correctly, that section 48 cannot apply to a donation or inheritance as the action required to initiate a shares buy-back is a board resolution, which will not be present, if shares are acquired through donation or inheritance. In any event, for purposes of section 48, the exact meaning and application of the term, is less material, as the provisions relating to shares buy-backs are dealt with specifically, and there could hardly be any doubt in respect of its application.

5. REQUIREMENTS FOR A SHARE BUY-BACK

- 5.1 Section 48(2) is the enabling section that sets out the formal requirements for implementing a shares buy-back. It provides, subject to the provisions of sections 48(3) and 48(8) that the board of a company may determine that the company will acquire a number of its own shares⁷⁵ and the board of a subsidiary company may determine that it will acquire shares of its holding company subject to certain restrictions^{76 77}.
- 5.2 These requirements are essentially the same as for the 1973 Act, except that the requirements for a special resolution and authorisation by the articles have been abolished⁷⁸. Accordingly, approval of a share buy-back by shareholders is no longer required and approval by the board of a company or the board of a subsidiary is the only requirement. This seems to be a relaxation of the strict requirements of the English model, and a move to the

⁷⁴ Delport 204.

⁷⁵ S48(2)(a).

⁷⁶ S48(2)(b).

⁷⁷ Stein and Everingham 189.

⁷⁸ Stein and Everingham 190.

less restrictive American model⁷⁹. From an abuse and control perspective, this approach is open to some criticism, specifically as the acquisition may be in respect of selected shareholders and not pro-rata to all shareholders, which increases the possibility of potential abuse⁸⁰. The one obvious way in which to address this, would obviously be to consider amending the MOI to include a requirement for shareholder approval, whether by ordinary resolution or by special resolution. For example, the concept of a “general” and “specific” approval for a shares buy-back that existed in the 1973 Act, could be reinstated into the company’s MOI.

5.3 A possible technical argument around the amendment of a MOI to require shareholder approval, could be raised in the same manner as an amendment for purposes of requiring shareholder approval for a distribution, in respect of section 46⁸¹. Section 48 is an unalterable provision, in the same manner that section 46 is an unalterable provision and accordingly its provisions may not be amended. However, it is doubtful that the legislator intended a MOI to be nullified in this way⁸². Accordingly, it is suggested that in the same way as the provisions of section 15(2)(a)(ii) may be utilised to impose higher standards or greater restrictions on distribution, the same may be applied for share buy-backs⁸³, paving the way for shareholders to exercise such a level of control, to the extent required.

5.4 A further difficulty that is also faced, is the fact that section 48 does not contain any provisions aimed at informing shareholders of an offer to acquire shares in a company by the company or its subsidiary as was required by section 87(1) of the 1973 Act⁸⁴. No circulars have to be sent to shareholders

⁷⁹ See chapter 4 *infra*.

⁸⁰ Delpont 201.

⁸¹ See paragraph 3.3 above.

⁸² Cassim 275.

⁸³ Stein & Everingham 190, Cassim 275.

⁸⁴ Stein & Everingham 190.

when an offer for their shares is made and no distinction is made between general and specific offers, and no safeguards have been included to address an abuse of power where selective offers are made⁸⁵. Some commentators are even of the view that relying solely on the common law duties of a director to act within the scope of their fiduciary duties, is insufficient protection in this regard⁸⁶, although specific provisions aimed at protecting minorities, and requiring shareholder approval where repurchases involve directors, have been included in the 2008 Act.

5.5 Section 48⁸⁷ requires that the board of a company may acquire a number of its own shares, and requires a resolution by the board for that purpose. However, due to the fact that a repurchase of shares also constitutes a distribution, it seemingly requires an additional resolution to the resolution envisaged in section 46 insofar as the making of a decision for a distribution is concerned. Put differently, section 46, requires a decision by the board to make a distribution, whereas section 48, in addition to the requirements of section 46, also requires a decision (in fact a decision which satisfies the requirements of section 46), leaving it unclear as to exactly what the formality requirement is, that the board must comply with⁸⁸. It is submitted, from a practical perspective, that the resolution to implement an acquisition of own shares, should comply both with the provisions of section 46 and 48, and that the repurchase decision be drafted as a distribution at the same time.

5.6 As stated above, were a subsidiary wishes to acquire shares in its holding company, the board of the subsidiary must take the decision to acquire such shares⁸⁹. Such a decision is similarly subject to the provisions of sections

⁸⁵ Cassim 276, Cassim SALJ 287.

⁸⁶ Cassim SALJ 288.

⁸⁷ S48(2)(a).

⁸⁸ Delpont 203.

⁸⁹ S48(2)(b) of the Companies Act 2008.

48(3) and 48(8), and must also satisfy the requirements of section 46. It may be argued that the board of a subsidiary company, is indirectly controlled by the board of its holding company, which effectively means that the board of the holding company takes the decision to acquire the shares in itself. It may even be that the board of the holding company influences such a decision, although it is expected that the directors of the subsidiary company will act within their fiduciary duties in taking a decision to acquire shares in its holding company⁹⁰. This may be particularly relevant in respect of shares acquired in this way as treasury shares.

5.7 Section 48⁹¹ provides that where a subsidiary acquires shares in its holding company:

5.7.1 not more than 10% in aggregate of the number of issued shares in the holding company may be held by or for the benefit of, all of the subsidiaries of that company taken together; and

5.7.2 no voting rights attached to those shares may be exercised while the shares are held by the subsidiary and it remains a subsidiary of the company whose shares it holds.

5.8 It is interesting that the reference is to “hold”, as opposed to “acquire”, where the 10% limit is referred to. This firstly makes it clear that existing holdings of the subsidiary will be taken into account in calculating the 10% aggregate, which was not clearly stated in section 89 of the 1973 Act⁹². It is also not clear whether the limit of 10% applies to each class of shares or to 10% of the total shares irrespective of the class of shares, i.e. to the extent that more than 10% of any particular class of shares are acquired, but the

⁹⁰ Delpont 203.

⁹¹ S48(2)(b).

⁹² Delpont 203.

total number of shares held, is below 10% of the total number, would that still comply with the requirements of section 48⁹³? It is submitted, that the reference to class of shares, was intended to qualify the reference to 10%, otherwise it would not have had a purpose for its inclusion in section 48(2)(b)(i), and accordingly that the limit applies specifically to each class of shares. As a further comment, the fact that reference is made to “hold”, does imply that the subsidiary may acquire in excess of the 10% limit, as long as it does not hold those shares, and accordingly it would be possible for a subsidiary to enter into an arrangement where it in fact acquires in excess of 10% of shares in its holding company, but then does so on behalf of a third party.

5.9 The voting rights attached to the shares held by a subsidiary, may not be exercised by the subsidiary, while it is so held⁹⁴. An interesting anomaly appears to be that the way in which section 48(2)(b)(ii) is drafted, applies the restriction on exercising voting rights, only in respect of shares acquired while that company was in fact a subsidiary. However, shares acquired before it became a subsidiary, is not specifically addressed, and just on the wording of section 48, it may be argued that such shares will not be subject to the voting exclusion, and that only shares acquired while that company was a subsidiary, will be subject to such an exclusion. It may have been unintended, but still creates a drafting anomaly insofar as the voting rights of such a subsidiary is concerned⁹⁵.

5.10 Should a subsidiary hold in excess of the limit of shares in its holding company, such holding will not be void, based on the provisions of section 218. Under the provisions of section 218 nothing in the 2008 Act renders void any agreement that is prohibited, voidable or that may be declared unlawful,

⁹³ Cassim 283.

⁹⁴ Delpont 203.

⁹⁵ Cassim 285.

unless the 2008 Act specifically declares such an agreement void, or a Court has made a declaration to that effect⁹⁶. Accordingly, as section 48(2)(b) does not declare a holdings share of the prescribed limited to be void, such holding by a subsidiary in excess of the limit, will not be invalid, unless it is set aside by a Court.

6. ADDITIONAL REQUIREMENTS

- 6.1 Section 48(2) refers to three additional requirements that must be adhered to, namely sub-sections 3 and 8, under certain specific circumstances.
- 6.2 Firstly, section 48(3) provides that an acquisition to which section 48 applies, may not have the result that the company in respect of which the shares are acquired, would no longer have any shares in issue other than shares held by one or more subsidiaries, or convertible or redeemable shares⁹⁷. Section 48(3) also makes it clear, that the company's MOI may not contain a contrary provision and by definition, section 48(3) is in itself an unalterable provision. The intention is clearly to avoid a situation where a company is wholly owned by a subsidiary or only has shares that may be redeemed or converted. It also implies that a company must at least have an ordinary share in issue after the proposed acquisition of shares by itself or a subsidiary. However, there is no provision in the 2008 Act that prohibits a company from repurchasing its shares, and after it has completed the repurchase, convert the remaining ordinary shares into redeemable shares⁹⁸.
- 6.3 This is in line with the requirement that a company may not issue shares to itself⁹⁹ and may also not own shares directly in itself¹⁰⁰.

⁹⁶ Delpont 203.

⁹⁷ S48(3)(a)(b).

⁹⁸ Delpont 203.

⁹⁹ S35(3).

- 6.4 Section 48(8)(a) provides that a decision by the board to acquire shares in itself, must be approved by a special resolution of the shareholders if the shares that are to be acquired, are acquired from a director or prescribed officer of the company, or a related person to a director or prescribed officer. This requirement is clearly aimed at preventing directors from abusing their position or benefitting from a repurchase themselves¹⁰¹.
- 6.5 Section 48(8)(b) provides that a decision by the board of a company to repurchase shares in that company, is subject to the requirements of sections 114 and 115 of the Companies Act 2008, if considered alone, or together with other transactions in a integrated series of transactions, it involves the acquisition by the company of more than 5% of the issued shares of any particular class of the company's shares. Section 114 sets out the requirements for implementing a scheme of arrangement, and section 115, which must be read together with section 114, sets out the approvals required for a scheme of arrangement, section 114 in turn classifying a reacquisition by a company of its securities, as a scheme of arrangement¹⁰². Such a proposal (i.e. a scheme of arrangement) requires a special resolution and is subject to Court review if more that 15% of shareholders vote against it, and also gives appraisal rights to minority shareholders¹⁰³.
- 6.6 The interaction between sections 48(8)(a) and (b) creates a number of anomalies. Firstly, the use of the word "and" between sub-sections (a) and (b) implies that those paragraphs must be interpreted conjunctively, which means that the provisions of section 42(a) could only apply if the acquisition

¹⁰⁰ Stein & Everingham 190.

¹⁰¹ Cassim 277.

¹⁰² S114(1)(e).

¹⁰³ Cassim 277.

is from directors and it forms part of a scheme of arrangement¹⁰⁴. However, if that interpretation is followed, it does create some anomalies, for instance, the requirement of a special resolution in both sub-sections. It would also undermine the individual aims of each of those sub-sections, which would indicate that these sub-sections should probably not be interpreted conjunctively, but separately.

- 6.7 Section 48(8)(b) on its own, creates even more anomalies. The intention of inserting section 48(8)(b) seems to have been to avoid a conflict between the provisions of section 48 and section 114, and it appears that the distinction between the application of section 48 and section 114 is that section 48 is designed to deal with casual or once-off decisions to acquire shares whereas section 114 is designed to address wholesale fundamental changes to the company's capital structure¹⁰⁵. However, if that is the intention, the distinction is not clearly expressed, creating a potential for arbitrage. It is possible that a company can misuse section 48 to avoid the more onerous standards of section 114¹⁰⁶.
- 6.8 Section 48(8)(b) could also be interpreted in two different ways. The one interpretation is that, if 5% or more of the shares of a particular class are acquired by the company, it must be done by way of an acquisition in terms of both sections 114 and 115, whereas a second possible interpretation is that section 115 will apply in all instances where the 5% threshold is reached, but that section 114 will only apply if the acquisition is done by way of section 114¹⁰⁷. This lack of clarity unfortunately does provide some room

¹⁰⁴ Delpont 204(1).

¹⁰⁵ Cassim 277.

¹⁰⁶ Cassim 277.

¹⁰⁷ Delpont 204(1).

for abuse, and the possibility that a company could misuse section 48 to avoid the onerous standards of section 114¹⁰⁸.

- 6.9 The purpose of section 48(8) is clearly intended to protect minority shareholders against abuse by the directors of their powers¹⁰⁹. Even though it does have a number of anomalies in respect to its interpretation, it does provide some mechanism to protect shareholders from abuse of power by directors. This is particularly true in off-market situations where the unequal treatment of shareholders and the abuse of power by directors are realities¹¹⁰.
- 6.10 Section 48(8) does not apply to the acquisition by a subsidiary of shares in its holding company¹¹¹.

7. EXCEPTIONS

- 7.1 Section 48(1)(a) provides that section 48 does not apply to the making of a demand, tendering of shares and payment by a company to a shareholders in terms of a shareholder's appraisal rights as set out in section 164 and it also does not apply to the redemption by a company of any redeemable securities in accordance with the terms and conditions of such securities¹¹².
- 7.2 Section 48(1)(a) is effectively restated in section 164(19), presumably for the sake of clarity. A payment by a company pursuant to the exercise of an appraisal right, is also not a distribution, and the reason for these exclusions is that the solvency and liquidity test need not be satisfied to enable a person

¹⁰⁸ Cassim 277.

¹⁰⁹ Stein & Everingham 191.

¹¹⁰ Delpont 204(1).

¹¹¹ Stein & Everingham 191.

¹¹² Stein & Everingham 192.

to exercise appraisal rights. For this reason, section 164(17) deals specifically with the inability of a company to comply with the exercise of appraisal rights, because it has insufficient cash¹¹³.

- 7.3 The exemption in respect of the redemption of redeemable securities, flows from the distinction that is usually drawn in company legislation between redemptions and repurchases. Both involve the return to a company of shares issued to shareholders, however, with respect to a redemption, it is regulated through a contract between the shareholders and the company, usually through the MOI, whereas a repurchase of shares, does not rely on pre-existing contractual arrangements¹¹⁴. Accordingly, the exemption insofar as redeemable securities, speaks for itself from that perspective.

8. TREASURY SHARES

Treasury shares are shares acquired by a company in itself, which instead of being cancelled on reacquisition, are held by the company until reissue or resale. The Companies Act 2008 does not permit the direct holding by a company of treasury shares¹¹⁵, as is the case with a number of other jurisdictions ¹¹⁶. However, South African companies may, to a limited extent, create treasury shares through the mechanism of procuring a subsidiary to acquire the shares in its holding company. The acquisition of shares for this purpose does not reduce the number of issued shares in the company and the sale of such shares, does not increase the number of issued shares in the company. They carry no voting rights or rights to dividends and do not participate in the distribution of assets on a winding up ¹¹⁷. Being resaleable, treasury shares appear to be assets of the company, but they are in actual fact no

¹¹³ Stein & Everingham 192.

¹¹⁴ Cassim 272.

¹¹⁵ Cassim 280.

¹¹⁶ See chapter 2.

¹¹⁷ Cassim 280.

more assets of the company than authorised but unissued shares of the company, and therefore cannot properly be taken into account in calculating net assets of the company or profits available for distribution as dividends. The purpose of treasury shares, are not intended to be a corporate asset, but actually provides an opportunity for the company to manage, to a limited extent, its corporate structure and possible future opportunities that it may want to pursue¹¹⁸.

9. ENFORCEABILITY OF AGREEMENTS

9.1 Section 48(4) provides that an agreement with a company providing for the acquisition by it of its own shares is enforceable against it, subject to compliance with the provisions of sections 48(2) and (3)¹¹⁹. In other words, provided that the company does not fall foul of the solvency and liquidity requirements or if the acquisition would result in there no longer being ordinary shares of the company in existence, then that agreement would be enforceable against the company¹²⁰. This provision (and the provisions of sub-section (5)) do not seemingly apply to a subsidiary acquiring shares in the holding company¹²¹, although the reason for excluding a subsidiary from these provisions is not clear¹²².

9.2 To the extent that the company alleges that it is unable to fulfill its obligations in terms of such an agreement, the company must apply to a Court and prove that the fulfillment of its obligations would be a breach of the requirements of section 48¹²³. If the Court is satisfied that the company is prevented from fulfilling its obligations, the Court may make an order that:

¹¹⁸ Cassim 280.

¹¹⁹ Stein & Everingham 190.

¹²⁰ Cassim 279.

¹²¹ Delpont 203.

¹²² Cassim 285.

¹²³ S48(5).

- 9.2.1 is just and equitable having regard to the financial circumstances of the company¹²⁴; and
- 9.2.2 ensures that the person to whom the company is required to make payment in terms of the agreement, is paid at the earliest possible date that is compatible with the company satisfying its other financial obligations as they fall due and payable¹²⁵.

The principle applied under these circumstances, is to maintain liquidity (as defined), and it does not appear as if solvency requirements need to be taken into account by a Court under these circumstances¹²⁶.

- 9.3 Section 48(5) only applies to situations where the requirements of sections 48(2) and (3) are not complied with, and cannot be utilised for other purposes, such as for instance the situation where a subsidiary acquires shares in excess of the limit of 10% in its holding company¹²⁷.
- 9.4 The provisions of sections 48(4) and (5) are similar to section 88 of the 1973 Act except for the obligation of a company to apply to Court under these circumstances¹²⁸.
- 9.5 If a company acquires shares contrary to the provisions of sections 46 or 48, the company must, not more than two years after such acquisition, apply to a Court for an order reversing that acquisition¹²⁹. The Court may order that the previous shareholders return the amount paid by the company and the company issue the same number of shares and in the same class that were

¹²⁴ S48(5)(c)(i).

¹²⁵ S48(5)(c)(ii).

¹²⁶ Delport 204.

¹²⁷ Delport 204.

¹²⁸ Stein & Everingham 191.

¹²⁹ S48(6).

acquired¹³⁰. However, the section does create some anomalies in its application. The actions by the company and previous shareholder can only apply in respect of shares acquired by the company, and not those acquired by a subsidiary, even though the sub-section specifically provides that it is applicable to instances where a subsidiary acquired the shares. Secondly, it does not contemplate the position where the shares were acquired for a consideration other than cash and it may be impossible to return assets which may no longer exist. Finally, even though a shareholder is involved in the process, the original action was taken by the board, and the shareholders whose shares were acquired, would not have been part of the process, nor to the application of the solvency and liquidity requirements, or any other facts, for that matter. Accordingly, such a *bona fide* shareholder, may be confronted by an order for repayment, irrespective of whether or not the shareholder was privy to the information, or has the cash available for the restitution¹³¹.

10. DIRECTORS LIABILITY

10.1 If a director was present at a meeting where the board approved an acquisition of shares pursuant to the provisions of section 48 and failed to vote against the acquisition of such shares, despite knowing that the shares acquired was contrary to the provisions of section 46 or section 48, such director will be liable for any loss, damage or costs sustained by the company as a direct or indirect consequence of that decision¹³². Due to the fact that an acquisition by the company of its own shares, also by definition constitutes a distribution, the acquisition can also give rise to liability on the part of such a director, in terms of the provisions of section 77(3)(e)(vi).

¹³⁰ S48(6)(a) and (b).

¹³¹ Delpport 204.

¹³² S48(7).

10.2 The liability for directors under subsections (vi) and (vii) of section 77(3)(e) are essentially the same, except for two differences:

10.2.1 in the case of an acquisition the liability of the director is wider as there is the requirement that the company must not be left without any ordinary shares¹³³; and

10.2.2 in the case of an acquisition the limit for liability set out in section 77(4)(b) does not apply, whereas it will apply in the case of a distribution. That limit essentially caps the liability of the director to the difference between the amount by which the value of the distribution exceeded the amount that could have been distributed without causing the company to fail to satisfy the solvency and liquidity test, and the amount recovered by the company from persons to whom the distribution was made¹³⁴.

SUMMARY

In summary, it is clear that the 2008 Act has streamlined the measures for implementing a share buy-back, although, unfortunately, the way in which the provisions of sections 46 and 48 are drafted, does not necessarily provide greater clarity from an implementation perspective. The fact that a shareholder resolution is no longer required in most instances, is a move towards the more relaxed regulatory position in the USA, although there are still a number of requirements to comply with which probably places the South African system somewhere in between the strict English law system, and the system in the USA¹³⁵.

¹³³ S48(3).

¹³⁴ S77(4)(b).

¹³⁵ See chapter 4.

From a management and director perspective, the new procedures in the 2008 Act facilitates implementation of a share buy-back, and the more consolidated approach for applying the liquidity and solvency tests, does bring the provisions of the 2008 Act more in line with international best practice. However, there are still instances where shareholder intervention is required, specifically where directors are involved, which should provide some relief to directors abusing their powers. Shareholders who are concerned about their position, could also implement provisions in a MOI to refer decisions for a share buy-back, back to shareholders.

CHAPTER 4

BRIEF ANALYSIS OF THE POSITION IN OTHER JURISDICTIONS

1. INTRODUCTION

As indicated above, South African only introduced variations to the capital maintenance rule, at a fairly late stage¹³⁶. Below are set out a brief analysis of the position in some selected jurisdictions, to establish how the legal framework in those jurisdictions differ from that in South Africa, and to what extent the process is utilised for the return of capital to shareholders.

2. UK

2.1 In UK, the rule as set out in *Trevor v Whitworth*¹³⁷ was already relaxed in 1985¹³⁸. Sections 159 to 181 of the 1985 Companies Act in UK permitted both public and private companies to redeem and purchase their own shares, provided that their Articles authorised it¹³⁹.

2.2 The Companies Act, 1981 introduced a general power to companies to purchase their own shares for the very first time¹⁴⁰. In 2003 the ECA 1981 was further changed to allow public companies to retain such shares, without cancelling them, and thereby creating the possibility for companies in UK to hold treasury shares¹⁴¹.

¹³⁶ Chapter 3 supra.

¹³⁷ *Trevor v Whitworth* (1887) 12 APP CAS 409 (HL).

¹³⁸ Pretorius 123.

¹³⁹ Pretorius 123.

¹⁴⁰ Morse 160.

¹⁴¹ Morse 160.

- 2.3 The provisions of the ECA 1981 were consolidated into the ECA 1985 and is now contained in ECA 2006¹⁴². The ECA 2006 applies to the whole of the UK and not only UK¹⁴³. Share repurchases in the UK are also governed by the UK Listing Rules¹⁴⁴.
- 2.4 Both private and public companies may repurchase shares out of distributable profits or the proceeds for a new issue of shares. Only fully paid shares may be repurchased, and a company may not repurchase shares if, after the repurchase, only redeemable shares will remain in the company. Any premium payable on a repurchase of shares must generally be paid out of distributable profits¹⁴⁵.
- 2.5 Where private companies repurchase shares out of capital, certain requirements must be met aimed at protecting both creditors and shareholders. There are:
- 2.5.1 whether the company will, immediately after payment has been made, be able to pay its debts; and
- 2.5.2 whether it will be able to continue carrying on business as a going concern in the year following payment¹⁴⁶.
- 2.6 The directors are also required to issue a formal solvency statement that has to be reported on by the auditors of the company. It is accordingly clear that

¹⁴² Dhanani & Roberts (*Corporate Repurchases: The perception and practices of UK Financial Managers and Corporate Investors*) 6..

¹⁴³ Van Der Linde 38.

¹⁴⁴ Dhanani 6.

¹⁴⁵ Van Der Linde 83.

¹⁴⁶ Section 714 (3) of the ECA 2006.

both the directors and the auditors have an active duty to enquire into and report on the affairs of the company¹⁴⁷.

- 2.7 The Articles of a company wishing to repurchase its shares must specifically allow it to do so¹⁴⁸.
- 2.8 Shareholder approval is required for a repurchase of shares¹⁴⁹. For market purchases, the company has to be authorised by an ordinary resolution of shareholders that must specify the maximum number of shares that may be acquired, the maximum and minimum prices, the date upon which the authority expires, which expiration date may not be later than 18 months after the passing of the resolution¹⁵⁰. Where private companies wish to repurchases shares out of capital, a special resolution must be taken, which resolution will not be valid unless the statutory solvency declaration by the directors and the auditors are available for inspection by the members at the meeting called for the passing of the resolution. The resolution must be passed within a week of the date of the statutory declaration¹⁵¹. For repurchases out of capital, strict timing provisions apply to ensure that the resolution taken is based on recent financial information and that the payment takes place when the situation is not likely to have changed. Creditors and shareholders are also given a right to object to the proposed repurchase out of capital¹⁵².

¹⁴⁷ Van Der Linde 85.

¹⁴⁸ Van Der Linde 89.

¹⁴⁹ Dhanani 8.

¹⁵⁰ Dhanani 8.

¹⁵¹ Van Der Linde 94.

¹⁵² Van Der Linde 96.

- 2.9 Unlisted companies must retain a prescribed minimum shareholding after a share repurchase, and listed companies may not repurchase more than 15% of any class of equity¹⁵³.
- 2.10 Repurchase regulation in the UK is regarded as amongst the most stringent globally¹⁵⁴. Generally speaking, a company in the UK may acquire its own shares through three procedures, which are set out in sections 164 to 166 of the ECA 2006¹⁵⁵, namely off market purchases, through option agreements, or through an on market purchase.
- 2.11 Repurchase regulation in the UK is regarded as amongst the most stringent globally¹⁵⁶. Generally speaking, a company in the UK may acquire its own shares through three procedures, which are set out in sections 164 to 166 of the ECA 2006¹⁵⁷, namely off market purchases, through option agreements, or through an on market purchase.
- 2.12 As a result of the stringent controls in the UK, repurchase activity in the UK tend to emphasise the return of capital to shareholders, and not to increasing earnings per share¹⁵⁸.
- 2.13 The concept of treasury shares was introduced in the UK in 2003, and allows the company to hold certain shares as treasury shares pending disposal or cancellation¹⁵⁹. It is seen as advantageous for a company to be able to hold some of its shares as treasury shares, as it may be used as a mechanism to

¹⁵³ Dhanani 7.

¹⁵⁴ Dhanani 10.

¹⁵⁵ Morse 163.

¹⁵⁶ Dhanani 10.

¹⁵⁷ Morse 163.

¹⁵⁸ Dhanani XIV.

¹⁵⁹ Dhanani 8.

manage their capital structures, for instance their debt in equity ratios, and setting up employee share schemes. Listed companies may hold up to 10% of any class of listed shares as treasury shares, although regulatory and disclosure requirements are extensive¹⁶⁰.

3. USA

- 3.1 American Company Law allows companies to repurchase their own shares subject to strict safeguards designed to protect creditors¹⁶¹. Of particular interest in the USA, is that the corporate laws fall within the jurisdiction of each individual state and accordingly each state has its own corporate laws and approaches to the repurchase of shares. There is significant difference in the way in which different states regulate companies, and also the way in which contributions and distributions to shareholders are managed¹⁶².
- 3.2 In marked contrast to the position in the UK, there are few regulations and restrictions for share repurchases, in the USA¹⁶³. Generally, there are no restrictions on timing, volume or levels at the time of repurchase¹⁶⁴.
- 3.3 In Delaware, a state that is probably the most well know for establishing companies in the USA¹⁶⁵, companies are allowed to purchase or otherwise acquire or deal with their own shares¹⁶⁶.
- 3.4 The laws in Delaware contain no specific procedure for a repurchase of shares and there are no requirement that shareholders should approve a

¹⁶⁰ Dhanani 8.

¹⁶¹ Pretorius 123.

¹⁶² Van Der Linde 155.

¹⁶³ Dhanani 9.

¹⁶⁴ Dhanani 9.

¹⁶⁵ Van Der Linde 161.

¹⁶⁶ Delaware *General Corporation Law S160(a)*.

repurchase or that repurchases should be proportioned. It has, in fact, been held that a corporation may purchase its own shares privately without making an offer to shareholders of the same class¹⁶⁷. In addition, the term *repurchase* has a very wide meaning which includes any type of acquisition by the company for consideration¹⁶⁸.

- 3.5 There are also very few financial restrictions applicable to companies in acquiring their own shares, although it is provided that a company may not purchase its own shares when its capital will be impaired after the transaction, or is already impaired. The capital impairment test does not rely on a published balance sheet, and leaves the way clear for a company to revalue its assets and liabilities in establishing whether a repurchase is possible¹⁶⁹.
- 3.6 To protect shareholders, courts in Delaware have formulated certain restrictions in the right of directors to repurchase shares, the most important being the proper purpose doctrine. The proper purpose doctrine provides that a repurchase must be for the benefit of the company and a repurchase made, for instance, for the benefit of directors, would be regarded as improper. There are, however, also exceptions to this doctrine, including a reliance on the business judgement rule, and where directors act in the wake of a sudden emergency to protect the company from suffering damages¹⁷⁰. The holding of treasury shares and the way in which a company may dispose of or deal with treasury shares, are however regulated¹⁷¹.

¹⁶⁷ Van Der Linde 180.

¹⁶⁸ Van Der Linde 179.

¹⁶⁹ Van Der Linde 179.

¹⁷⁰ Van Der Linde 181.

¹⁷¹ Van Der Linde 179.

3.7 Another relevant jurisdiction is that of California. It was the first state in the USA to move away from the capital maintenance regime¹⁷². The California Corporations Code of 1977 introduced a single definition of distribution which encompasses both dividends and repurchases. Distributions may be made out of retained earnings or alternatively when the corporation's assets exceed its liabilities by 25% and its current assets are at least equal to its current liabilities. The Code applies to all corporations in California¹⁷³.

4 AUSTRALIA

4.1 Until 1998, Australian companies were prohibited from undertaking share buy-backs, and capital maintenance rules were applied. In 1987 the Companies and Securities Law Review Committee published a report in which it recommended that the law be amended to allow share buy-backs. This was done in 1989, but at that stage the law was very rigid in its regulation of share buy-backs. Only certain types of share buy-backs were allowed, and a mandatory requirement, until 1995, was that a company had to change its constitution before initiating a buy-back program, linked to detailed disclosure requirements and shareholder approvals¹⁷⁴. In December 1995, the company laws were changed to substantially reduce mandatory requirements for share buy-backs including the following:

4.1.1 there is no longer a need for companies to have buy-back authorisations in their constitutions;

¹⁷² Van der Linde 188.

¹⁷³ Van der Linde 189.

¹⁷⁴ Lamba and Ramsay *Comparing Share Buy-backs in Highly Regulated and Less Regulated Market Environments* 262.

- 4.1.2 directors are no longer required to sign a solvency statement under which they may be liable for a period of twelve months should the company become insolvent;
- 4.1.3 a public company may acquire more than 10% of its shares in a twelve month period, provided it obtains the approval of more than 50% of shareholders who vote on the resolution;
- 4.1.4 an audit is no longer required to provide a report in relation to a buy-back;
- 4.1.5 for selective buy-backs, shareholder approvals have been lowered and only 75% of shareholders voting are required to approve such a resolution¹⁷⁵.

SUMMARY

The analysis above probably contrasts the two most divergent system of share repurchase against each other, that of the USA which is very progressive and requires very little regulatory supervision, and that of the UK, which is regarded as very strict. The UK model certainly requires more shareholding intervention than the South African model whereas the USA model is much more open. From this perspective, the ease with which share repurchases in South Africa may be implemented, is probably not as easy as in the USA, directors do have more power insofar as implementing a repurchase than in the UK. On balance, the 2008 Act seems to endeavour to move away from very strict regulation, and specifically, shareholder approval, whilst still maintaining some form of regulation by position of

¹⁷⁵ Lamba 264.

solvency and liquidity requirements, as well as the necessity to have shareholder approval under certain circumstances.

CHAPTER 5

ADDITIONAL MATTERS FOR A COMPANY TO CONSIDER

1. INTRODUCTION

Although the 2008 Act sets out the formalities to be complied with by a company for implementing an acquisition of its own shares, there are also some external factors to consider, most notably that of exchange control, tax, and the JSE listing requirements.

2. EXCHANGE CONTROL

2.1 South Africa enforces an exchange control system through the provisions of the Currency and Exchanges Act¹⁷⁶. The current control measures were introduced by way of the Exchange Control Regulations¹⁷⁷ and which are updated from time to time by the South African Reserve Bank. For purposes of the Exchange Control Regulations, the term “securities” includes South African stocks, shares, warrants, debentures and rights as well as unlisted shares in public companies and shares in a private company¹⁷⁸. A “controlled security” is defined as any security registered in the name of a non-resident of which the non-resident is the owner or in which the non-resident has an interest and any security acquired from a non-resident by any person irrespective of the residents of such a person¹⁷⁹. Accordingly, for exchange control purposes, the acquisition by a company of its own shares, from a non-resident, would constitute the acquisition of a controlled security for

¹⁷⁶ Act No. 9 of 1933.

¹⁷⁷ Promulgated by Government Notice R1111 of 1 December 1961.

¹⁷⁸ South African Reserve Bank *Exchange Control Manual* paragraph 6.2.4.1.

¹⁷⁹ South African Reserve Bank 6.2.4.1.

exchange control purposes, which would fall under the control of the Financial Surveillance Department of the South African Reserve Bank.

2.2 The control over controlled securities, relates to certain transactions by non-residents, which includes the acquisition of, or disposal of any controlled security¹⁸⁰. As such, the acquisition by a company of its own shares from a non-resident, would fall within the category of control for exchange control purposes. The control is exercised by placing the endorsement “non-resident” on all securities owned by non-residents, or in which non-residents have an interest. The effect of this endorsement is to ensure that payment of the sale proceeds of securities belonging to non-residents, only are transferred abroad or credited to a non-resident. Accordingly, from the perspective of a company acquiring its own shares, it will have to ensure that shares acquired from a non-resident, is duly endorsed for exchange control purposes, failing which it will not be able to remit the purchase consideration to the non-resident shareholder¹⁸¹. Similarly, if such shares are acquired by a company, the securities must be presented to an authorised bank for exchange control purposes, to cancel the endorsement. The endorsement will only be cancelled upon presentation to the authorised bank of:

2.2.1 evidence by a broker or auditor confirming the value of the security;

2.2.2 payment to the bank for transfer abroad of the amount to the credit of the non-resident¹⁸².

2.3 Accordingly, to the extent that a company has non-resident shareholders, it will have to ensure that those share certificates are duly endorsed “non-

¹⁸⁰ South African Reserve Bank 6.2.4.2.

¹⁸¹ South African Reserve Bank 6.2.4.3.

¹⁸² South African Reserve Bank 6.2.4.5.

resident” to enable it to implement a share buy-back, and it will have to take the necessary steps to cancel such endorsement, once the acquisition has been implemented and the proceeds paid to the non-resident.

3. TAX CONSIDERATIONS

- 3.1 On the repurchase of shares by a company, the proceeds realised, would, depending on the circumstances, either be regarded as a dividend for tax purposes, or a return of capital to the shareholder¹⁸³.
- 3.2 Paragraph (b) of the definition of “dividend”¹⁸⁴ includes a share buy-back as a dividend, except to the extent that it results in a reduction of contributed capital, or it is a buy-back by a South African listed company of its own shares in terms of certain JSE listing requirements.
- 3.3 To the extent that the repurchase is a dividend, the proceeds of the repurchase will be subject to dividends tax levied at a rate of 15%¹⁸⁵. Although dividends tax is a tax on the shareholder, it must withheld by the company which pays over the dividend on behalf of the shareholder to the tax authorities¹⁸⁶.
- 3.4 To the extent that the proceeds of a share repurchase results in the reduction of the contributed tax capital of the company, that portion of the purchase consideration, will be regarded as a return of contributed tax capital, which will be subject to capital gains tax in the hands of the shareholder to the extent that it exceeds the amount paid by the shareholder in subscribing for

¹⁸³ Huxham (*Notes on South African Income Tax*) (2012) 467.

¹⁸⁴ S1, Income Tax Act, 1962.

¹⁸⁵ 64(E), Income Tax Act, 1962.

¹⁸⁶ 64(E), Income Tax Act, 1962.

such share, at the applicable rate of capital gains tax for that particular shareholder¹⁸⁷.

- 3.5 A company embarking on a share buy-back accordingly has to ensure that it complies with the obligation to withhold dividends tax, where applicable and account to the authorities accordingly.

4. JSE LISTING REQUIREMENTS

- 4.1 Although the 2008 Act does provide a procedure for the repurchase of shares by a company, companies who have shares listed on the JSE Limited, must also comply with the requirements of the JSE listings requirements¹⁸⁸.
- 4.2 The Listings Requirements distinguishes between a specific repurchase and a general repurchase. A specific repurchase is defined as a specific offer to security holders who are specifically named, or which includes the grant of an option in terms of which a company may well be required to purchase its securities in the future¹⁸⁹, and a general repurchase, although not specifically defined, would constitute a repurchase which is not a specific repurchase¹⁹⁰.
- 4.3 In respect of both a special and a general repurchase, the Listings Requirements require that the MOI of the company making the repurchase, should authorise the repurchase. This requirement seems odd, as section 48, is an unalterable provision which by implication means that it must apply to all companies whether included in their MOI's or not. Conversely, a company does not have to specify in its MOI that it may repurchase its own shares, as section 48 provides that authority in any event.

¹⁸⁷ Huxham 749.

¹⁸⁸ JSE Limited *JSE Listings Requirements*.

¹⁸⁹ JSE Limited 5.69.

¹⁹⁰ JSE limited 5.72.

4.4 Furthermore, the Listings Requirements also require, in respect of both types of repurchase, that a special resolution be taken by the shareholders of the particular company, authorising the repurchase. Accordingly, it creates an additional requirement over and above that set out in section 48. It is submitted that listed companies will accordingly have to amend their MOIs to reflect the requirement for a special resolution for a repurchase of their shares, on the basis that it is an additional requirement as envisaged in section 15 of the 2008 Act. The Listings Requirements also require confirmation and resolutions from the directors, which are materially the same as the resolutions set out in section 48(2), although requiring more detail. In respect of a specific repurchase, the directors must also state that the company will be able in the ordinary course of business to pay its debts for a period of twelve months after the date of approval of the circular for the repurchase, that the assets of the company will be in excess of the liabilities of the company for a period of twelve months after the date of approval of the circular and also that the share capital, reserves and working capital of the company will be adequate for ordinary business purposes for a period of twelve months¹⁹¹. Insofar as a general repurchase is concerned, the requirements are less onerous, but it also requires a resolution by the board that there have been no material changes to the financial position of the group¹⁹².

SUMMARY

From a practical perspective, there are some additional requirements that directors have to comply with in implementing a share repurchase, which will affect the decision on a return of capital to shareholders. From an exchange control perspective, although the regulation is fairly light, the process of share repurchases,

¹⁹¹ JSE Limited 5.69.

¹⁹² JSE Limited 5.72.

where non-resident shareholders are involved, does require more administration than merely declaring a dividend. Accordingly, that may influence a decision on the return of capital to non-resident shareholders. To the extent that tax considerations are considered, the position between a share repurchase and declaring a dividend, is almost exactly the same, and accordingly there is very little difference from an administration perspective, in implementing a return of capital via share repurchase, as opposed to a declaration of dividends. Obviously, to the extent that the company is listed, the JSE listings requirements do impose a number of additional requirements, which is to be expected for shares that are publicly listed. However, this does increase the administrative burden for implementing a share repurchase, as opposed to merely declaring a dividend to shareholders, which may very well have an effect on the decision as to the method to apply in returning capital to shareholders.

CHAPTER 6

SUMMARY AND CONCLUSION

The aim of this study was to analysis the procedure of share repurchase in South Africa, with emphasis on it as a method of returning capital to shareholders, specifically comparing it from an international perspective with other jurisdictions, and also analysing the obligations on directors insofar as the procedural aspects are concerned.

As stated, South Africa historically implemented a system of capital maintenance as was followed in the UK, and it was only in 1999 that South Africa moved towards a system where share repurchases as a mechanism to return capital to shareholders, was allowed. Before that, capital could be reduced, through a court process, which did not leave the decision within the hands of directors and shareholders.

Under the 1973 Act, the provisions relating to share repurchases, were introduced, and it also introduced with it the requirements for the company to remain solvent and liquid after a share repurchase. However, under the 1973 Act, shareholder intervention was required, which did make the process more administratively burdensome than the process that currently exists under the 2008 Act. Although the provisions in the 2008 Act are not always that clear, and there are a number of drafting anomalies, the process itself does appear to have become less restricted, and in line with international standards.

An analysis of the share repurchase systems applied in the USA, UK and Australia, indicates that South Africa has aligned itself with international best practice by implementing a system of share repurchase, and the way in which it is currently implemented in the 2008 Act, certainly does place it in line with the jurisdictions analysed. It is probably fair to say that the system in South Africa falls somewhere between the USA model, which is fairly unregulated, and the UK model, which is very regulated. The Australia model also seems to fall somewhere in between.

In analysing other factors that may be relevant to a share repurchase, such as exchange control, tax and requirements for listed companies, it does appear that implementing a share repurchase as a method of returning capital to shareholders, is a viable and practical option, although from an exchange control perspective and the requirements for listed companies on the JSE, more regulatory approval is required, than would necessarily be the case if a dividend is merely declared. However, in line with international practice, share repurchase provisions does provide a viable alternative to companies in considering a return of capital to shareholders.

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46. Distributions must be authorised by board

- 1) *A company must not make any proposed distribution unless—*
 - a) *the distribution—*
 - i) *is pursuant to an existing legal obligation of the company, or a court order; or*
 - ii) *the board of the company, by resolution, has authorised the distribution;*
 - b) *it reasonably appears that the company will satisfy the solvency and liquidity test immediately after completing the proposed distribution; and*
 - c) *the board of the company, by resolution, has acknowledged that it has applied the solvency and liquidity test, as set out in section 4, and reasonably concluded that the company will satisfy the solvency and liquidity test immediately after completing the proposed distribution.*
- 2) *When the board of a company has adopted a resolution contemplated in subsection (1)(c), the relevant distribution must be fully carried out, subject only to subsection (3).*
- 3) *If the distribution contemplated in a particular board resolution, court order or existing legal obligation has not been completed within 120 business days after the board made the acknowledgement required by subsection (1)(c), or after a fresh acknowledgement being made in terms of this subsection, as the case may be—*
 - a) *the board must reconsider the solvency and liquidity test with respect to the remaining distribution to be made pursuant to the original resolution, order or obligation; and*
 - b) *despite any law, order or agreement to the contrary, the company must not proceed with or continue with any such distribution unless the board adopts a further resolution as contemplated in subsection (1)(c).*
- 4) *If a distribution takes the form of the incurrance of a debt or other obligation by the company, as contemplated in paragraph (b) of the definition of ‘distribution’ set out in section 1, the requirements of this section—*
 - a) *apply at the time that the board resolves that the company may incur that debt or obligation; and*
 - b) *do not apply to any subsequent action of the company in satisfaction of that debt or obligation, except to the extent that the resolution, or the terms and conditions of the debt or obligation, provide otherwise.*
- 5) *If, after considering the solvency and liquidity test as required by this section, it appears to the company that the section prohibits its immediate compliance with a court order contemplated in subsection (1)(a)(i)—*
 - a) *the company may apply to a court for an order varying the original order; and*
 - b) *the court may make an order that—*
 - i) *is just and equitable, having regard to the financial circumstances of the company;*

- and*
- ii) *ensures that the person to whom the company is required to make a payment in terms of the original order is paid at the earliest possible date compatible with the company satisfying its other financial obligations as they fall due and payable.*
- 6) *A director of a company is liable to the extent set out in section 77(3)(e)(vi) if the director—*
- a) *was present at the meeting when the board approved a distribution as contemplated in this section, or participated in the making of such a decision in terms of section 74; and*
- b) *failed to vote against the distribution, despite knowing that the distribution was contrary to this section.*

48. Company or subsidiary acquiring company's shares

- 1) *This section does not apply to-*
- a) *the making of a demand, tendering of shares and payment by a company to a shareholder in terms of a shareholder's appraisal rights set out in section 164 ; or*
- b) *the redemption by the company of any redeemable securities in accordance with the terms and conditions of those securities.*
- 2) *Subject to subsections (3) and (8), and if the decision to do so satisfies the requirements of section 46—*
- a) *the board of a company may determine that the company will acquire a number of its own shares; and*
- b) *the board of a subsidiary company may determine that it will acquire shares of its holding company, but—*
- i) *not more than 10%, in aggregate, of the number of issued shares of any class of shares of a company may be held by, or for the benefit of, all of the subsidiaries of that company, taken together; and*
- ii) *no voting rights attached to those shares may be exercised while the shares are held by the subsidiary, and it remains a subsidiary of the company whose shares it holds.*
- 3) *Despite any provision of any law, agreement, order or the Memorandum of Incorporation of a company, the company may not acquire its own shares, and a subsidiary of a company may not acquire shares of that company, if, as a result of that acquisition, there would no longer be any shares of the company in issue other than—*
- a) *shares held by one or more subsidiaries of the company; or*
- b) *convertible or redeemable shares.*
- 4) *An agreement with a company providing for the acquisition by the company of shares issued by it is enforceable against the company, subject to subsections (2) and (3).*
- 5) *If a company alleges that, as a result of the operation of subsection (2) or (3), it is unable to fulfil its obligations in terms of an agreement contemplated in subsection (4)—*
- a) *the company must apply to a court for an order in terms of paragraph (c);*
- b) *the company has the burden of proving that fulfilment of its obligations would put it in breach of subsections (2) or (3); and*

- c) *if the court is satisfied that the company is prevented from fulfilling its obligations pursuant to the agreement, the court may make an order that—*
 - i) *is just and equitable, having regard to the financial circumstances of the company; and*
 - ii) *ensures that the person to whom the company is required to make a payment in terms of the agreement is paid at the earliest possible date compatible with the company satisfying its other financial obligations as they fall due and payable.*
- 6) *If a company acquires any shares contrary to section 46, or this section, the company must, not more than two years after the acquisition, apply to a court for an order reversing the acquisition, and the court may order—*
 - a) *the person from whom the shares were acquired to return the amount paid by the company; and*
 - b) *the company to issue to that person an equivalent number of shares of the same class as those acquired.*
- 7) *A director of a company is liable to the extent set out in section 77(3)(e)(vii) if the director—*
 - a) *was present at the meeting when the board approved an acquisition of shares contemplated in this section, or participated in the making of such a decision in terms of section 74; and*
 - b) *failed to vote against the acquisition of shares, despite knowing that the acquisition was contrary to this section or section 46.*
- 8) *A decision by the board of a company contemplated in subsection (2)(a)-*
 - a) *must be approved by a special resolution of the shareholders of the company if any shares are to be acquired by the company from a director or prescribed officer of the company, or a person related to a director or prescribed officer of the company; and*
 - b) *is subject to the requirements of sections 114 and 115 if, considered alone, or together with other transactions in an integrated series of transactions, it involves the acquisition by the company of more than 5% of the issued shares of any particular class of the company's shares.*