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A CRITICAL ANALYSIS OF SECTIONS 44, 45 AND 48 OF THE COMPANIES ACT 71 OF 2008

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ABSTRACT

The doctrine of capital maintenance was part of the South African law and was entrenched in the Companies Act 61 of 1973. According to the doctrine, a company is prohibited from giving financial assistance for the acquisition of shares in the company itself or in its holding company. A company is also prohibited from paying dividends out of share capital or return its share capital to shareholders or make loans not only to its own directors or managers but also the directors and managers of holding company and any company which is subsidiary of its holding company. The justification for the doctrine was that it protects the shareholders, creditors as well as the company itself. The capital maintenance was regarded as an imperfect system to protect the interests of the creditors. Most of the rules in the doctrine were unnecessarily complex and some of these rules have outlived their usefulness. The doctrine of capital maintenance was to a large extent, rendered ineffective and was abolished by the Companies Amendment Act 37 of 1999. The Companies Amendment Act of 1999 permit a company to acquire its own shares from existing shareholders in certain circumstances. Therefore, a company may, if authorized by the articles, approve the acquisition of its issued shares by special resolution. The Companies Amendment Act also permits a company to make payments even out of capital or pay dividends out of capital or to return capital to its members provided that a company is authorised by its articles of association (Memorandum of Incorporation).

The Companies Act 71 of 2008 has now completely done away with the remnant of capital maintenance. The 2008 Act is wholly based on solvency and liquidity and any remnant of the capital maintenance system on which the 1973 Act was based is now removed. Section 44 permit a company to provide financial assistance not only in the holding company but also in subsidiary. Section 45 permits a company to make payments not only to its directors but also to other companies particularly related companies. Section 48 regulates the acquisition of shares by a company of its own or the acquisition of shares by a subsidiary in its holding company. The purpose of this research is to critically analyse sections 44, 45 and and 48 of the Companies Act 71 of 2008.

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CHAPTER 1

INTRODUCTION

1.1 Background of the study

A company will require capital from investors in order in order to exist, continue its existence and carry out its function. The capital rules are developed to protect the capital of a company, in particular the share capital which *inter alia*, give rise to capital maintenance doctrine. According to the rules of common law, a share may not be issued at a discount to their par value,[1] a company may not purchase its own shares[2] and dividends may not be paid out of share capital.[3] The Companies Amendment Act of 1999 effectively abolished the capital maintenance principles. In terms of the Companies Amendment Act, a company is permitted to acquire their own share and shares in the holding company. A company is also permitted to make payments even out of capital or pay dividends out of capital or to return capital to its members provided that a company is authorized by its articles of association (Memorandum of Incorporation). The Companies Act 71 of 2008[4] made a drastic change to the capital rules of a company. The new Act is wholly based on solvency and liquidity test and any remnant of the capital maintenance system on which the Companies Act 61 of 1973[5] was based is now removed.[6]

1.2 Research question

This dissertation considers three of the statutory capital rules which are embodied in sections 44, 45 and 48 of the Act. In particular this dissertation will investigate and ascertain changes made by section 44, 45 and 48.

[1] *Ooregum Gold Mining Company of India v Roper* (1892) AC 125. See also Knight WJL, Capital Maintenance, *Perspective on Company Law* 1 (1995) at 54.
[2] *Trevor v Whitworth* 1887) 12 App Cas 409 (HL).
[3] *Guinness v Land Corporation of Ireland* (1882) 22 Ch D 349 at 356.
[4] (hereinafter the 'new Act'). This Act came into effect on 1 May 2011.
[5] (hereinafter the 'old Act'). This Act came into effect on 1 January 1974.
[6] Delport P *The New Companies Act Manual* (2011) at 31.

1.3 Research objectives

The objective of this research is to investigate the changes made by the new Companies Act to capital rules. In order to achieve this objective, critical analysis of sections 44, 45 and 48 will be done. The research will also compare the position of capital rules in the old Act, Companies Amendment of 1999, new Act and further establish the effect of any changes in the new Act.

1.4 Research Methodology

The descriptive approach will used for the overview of capital rules. A critical study will be conducted to establish the changes that the new Act has brought. The analytical approach will be employed to evaluate the capital rules. Comparative approach will be employed to compare the capital rules in the old Act, Companies Amendment Act of 1999 and the new Act. Lastly in order to achieve the objective of this research, reference will be made to articles, journals, internet-based research and textbooks.

1.5 Scope of research

The research covers the comparison between the capital rules in common law, old Act, Companies Amendment Act of 1999 and the new Act. This research is confined to certain portion of capital rules and it is intended to cover sections 44, 45 and 48 of the Act.

1.6 Overview of chapters

This dissertation is divided into six chapters. Chapter one contains introduction to the research, research question, research objectives, research methodology and chapter review. Chapter two deals with the origin of capital rules. Chapter three contain the essence of the dissertation as it concerns the provision of capital rules specifically financial assistance for the subscription of securities. Chapter four analysis the loans or other financial assistance to directors. Chapter five analysis the acquisition of shares by a company or subsidiary. Chapter six contain the conclusion to the research.

CHAPTER 2

THE ORIGIN OF CAPITAL RULES

2.1 Introduction

Capital rules were developed to protect creditors and both present and future directors, which gave rise to *inter alia* doctrine of capital maintenance.[7] South Africa was one of the few countries that applied the principle of capital maintenance.[8] The English Courts during the last two decades of nineteenth century established the main principle that a share may not be issued at a discount to their par value,[9] a company may not purchase its own shares[10] and dividends may not be paid out of share capital.[11] These principles were inferred from Companies Act of 1862. The purpose of this chapter is to explain in detail the origin and development of capital rules.

2.2 Doctrine of Capital Maintenance

The doctrine of capital maintenance was established by the House of Lords in *Trevor v Whitworth*[12] wherein Lord Watson introduced and formulated the rules governing the maintenance of share capital by a company as follows:

> "The company had purchased, prior to the date of liquidation, no less than 4 142 of its own shares: that is to say, considerably more than a fourth of the paid-up capital of the company had been either paid, or contracted to be paid, to shareholders, in consideration only of their ceasing to be so. I am quite unable to

[7] The business dictionary defines capital maintenance as accounting concept that a profit can be realized only after capital of the firm has either been restored to its original level (called 'capital recovery') or is maintained at a predetermined level. It is therefore necessary to determine the value of capital before the amount of profit can be computed. http://www.businessdictionary.com/definition/capital-maintenance.html
[8] Cilliers *et al Cilliers and Benade Corporate Law* (2000) at 322.
[9] *Ooregum Gold Mining Company of India v Roper* (1892) AC 125. In *Ooregum* the issue of shares at a discount was completely *bona fide* and saved the company. The House of Lords indicated that the allottees to be liable to pay this full nominal amount. Lord Halsbury said the nominal capital of the company is "fixed and certain, and every creditor of the company is entitled to look to that capital as his security". See also Knight WJL, Capital Maintenance, *Perspective on Company Law* 1 (1995) at 54.
[10] *Trevor v Whitworth* 1887) 12 App Cas 409 (HL).
[11] *Guinness v Land Corporation of Ireland* (1882) 22 Ch D349 at 356. At 375 the court per Cotton LJ indicated that *[W]hatever has been paid by a member cannot be returned to him. . . [W]hat is described in the memorandum as the capital cannot be diverted from the objects of the society. It is, of course, liable to be spent or lost in carrying on the business of the company, but no part of it can be returned to a member so as to take away from the fund to which the creditors have a right to look as that out of which they are to be paid.*
[12] *Trevor v Whitworth supra.*

> see how this expenditure was incurred in respect of or as incidental to any of the objects specified in the memorandum. And if not, I have a difficulty in seeing how it can be justified. If the claim under consideration can be supported, the result would seem to be this, that the whole of shareholders, with the exception of those holding seven individual shares, might now be claiming payment of the sums paid upon their shares as against the creditors, who had a right to look to the moneys subscribed as the source out of which the company's liabilities to them were to be met".[13]

Cilliers *et al* state that the passage above indicates that the capital maintenance rule did not develop as independent rule, but rather as an extension of the *ultra vires* rule.[14] Cilliers *et al* further maintains that the act in respect of capital must not be *ultra vires* and must not prefer shareholders above the creditors.[15] Mcgee indicates that two distinct lines of reasoning were employed by the House of the Lords namely, the fact that the Company's Memorandum contained no power to repurchase shares (though the article laid down procedures for making such repurchases) and the purported repurchases were *ultra vires.*[16] Mcgee further argues that the *ratio decidendi* in *Trevor v Whitworth* was the narrow one that a company could not repurchase its shares unless permitted by its memorandum. He also indicates that it was accepted that the repurchase was contrary to the notion of a company. Cassim submits that the theoretical basis of the capital maintenance rule continues to be the protection from the abuse of limited liability by the directors and the shareholders of the company.[17]

2.3 Criticism on the Doctrine of Capital Maintenance

The doctrine of capital maintenance was criticized by several authors. Mcgee states that without a doubt, the doctrine of capital maintenance was attractive in the 19th century when the court were still working out their attitudes to these new-fangled creations, limited companies needed to be severally controlled.[18] He is of the view that it is difficult to accept the doctrine as practical reality at present. He indicates that the companies usually use their share capital in conjunction

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[13] *Idem* at 416. At 423-424, Lord Watson further indicated that *Paid-up capital may be diminished or lost in the course of the company's trading: that is a fact which no legislation can prevent; but persons who deal with, and give credit to, a limited company, naturally rely upon the fact that the company is trading with a certain amount of capital already paid, as well as upon the responsibility of its members for the capital remaining at call; and they are entitled to assume that no part of the capital which has been paid into the conffers of the company has subsequently been paid out, except in the legitimate course of its business.*
[14] Cilliers *et al Cilliers and Benade Corporate Law* (2000) at 322.
[15] *Ibid.*
[16] Mcgee A *Share Capital* (1999) at 2.
[17] Cassim FHI "The reform of company law and the capital maintenance concept" (2005) 283 *SALJ* at 284.
[18] Mcgee A *Share Capital* (1999) at 2.

with their assets and funds for the purpose of operating the business (it would be odd if they did not) and given time - but especially in the early days of new business – it may well happen that the company has no available funds to meet creditors' claims.[19] It is also submitted that the strict adherence of the rule that a company may not repurchase its shares, ultimately came to be seen as inconvenient, not least in small companies, where repurchase of the shares by the company is often the best way of buying out a shareholder who wishes to leave.[20] Van der Linde indicate that *the legislation provided for disclosure of a company's authorised share capital and prescribed the procedure for the reduction of issued share capital, leading the courts to conclude that the share capital could by implication not be returned to shareholders in other ways. The principle that the capital of a company should be devoted to the purpose for which the company was incorporated, confirmed that its return to shareholders would be ultra vires and void.*[21] In particular Van der Linde agree with Mcgee that various capital maintenance rules were not designed in coherent fashion, but the following set of rational objectives can be inferred:

- *To protect existing shareholders from the forced depletion of their interest in the company, either by the dilution of that interest or by its devaluation;*
- *To protect the company as an entity from being looted by unscrupulous shareholders or promoters;*
- *To protect creditors from unjustified diminution of the value of the company's assets against which they would be able to enforce their claims.*[22]

Cassim argues that the capital maintenance rules are not only unnecessarily complex and riddled with obscurities, but worse still, many of these rules outlived their usefulness.[23] Knight expresses the view that what we call "capital maintenance" is up to us, but the rule worth studying is the judge made rule.[24] He finally submit that given the repetition of human behavior, the circumstances in which financial assistance is given are quite likely to offend against other

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[19] *Ibid.*
[20] Farrar *et al Farrar's Company Law* (1998) at 184-185; Mcgee A *Share Capital* 1999 at 3.
[21] Van der Linde K "Aspects of the regulation of share capital and distributions to shareholders" unpublished LLD thesis, University of South Africa (2008) at 20.
[22] Mcgee A *Share Capital* 1999 at 138; Van der Linde K "Aspects of the regulation of share capital and distributions to shareholders" LLD thesis, University of South Africa (2008) at 21.
[23] Cassim FHI "The reform of company law and the capital maintenance concept" (2005) 283 *SALJ* at 284.
[24] Knight WJL Capital Maintenance, *Perspective on Company Law* 1 (1995) at 52.

canons of company lay but the rule against financial assistance are statute-based not judge-made.[25]

2.4 Development of Capital Rules

As indicated above, capital maintenance which was developed by English Courts in the nineteenth century was accepted as part of the South African Company law and taken up and entrenched in the Companies Act 61 of 1973. In particular, the 1973 Act entrenched the rules in doctrine of capital maintenance that a company may not buy back its own shares,[26] may not pay dividends out of capital, may not issue share at discount,[27] and may not provide financial assistance to the company for the purchase of its own shares.

The Companies Amendment Act[28] radically changed the capital maintenance rules and the perceived protection it afforded creditors.[29] In essence the Companies Amendment Act abolished the capital maintenance doctrine which applied in South Africa.[30] The common law rule that dividends may not be paid out of capital was amended by section 90. Section 90 permit a company to make payments even out of capital or pay dividends out of capital or to return capital to its members provided that a company is authorized by its article of association (Memorandum of Incorporation). The company has to show that it has reasonable grounds for believing that it will be able to satisfy the liquidity and solvency test.[31] It is submitted that the purpose of section 90 is to make it easier for the companies to make payments to shareholders, not to remove any existing powers they may have.[32] It therefore stand to reason that the companies will have to amend their articles and those company that do not amend their articles

[25] *Idem* at 57.
[26] Cassim FHI "The right of a company to purchase its own shares" (1985) *THRHR* 318.
[27] Cilliers *et al Cilliers and Benade Corporate Law* (2000) at 322.
[28] 37 of 1999.
[29] *Capitex Bank Ltd v Qorus Holdings Ltd & Others* 2003 (3) SA 302 (W) at 306. Cilliers *et al Cilliers and Benade Corporate Law* (2000) at 322.See also Van der Linde K "Aspects of the regulation of share capital and distributions to shareholders" LLD thesis, University of South Africa (2008) at 252.
[30] See Pretorius *et al Hahlo's South African Company Law Through the Cases* (1999) at 121.
[31] See Cassim FHI "The reform of company law and the capital maintenance concept" (2005) 283 *SALJ* at 285. Section 4 provides that a company satisfies the solvency and liquidity test at a particular time if, considering all reasonably foreseeable financial circumstances of the company at that time (i) the assets of the company, as fairly valued, equal or exceed the liabilities of the company, as fairly valued; and (ii) it appears that the company will be able to pay its debts as they become due in the ordinary course of business for a period of twelve months after the date on which the test is considered.
[32] Van der Linde K "Capital maintenance is dead - long live solvency and liquidity" *JBL* 7 (1999) 155 at 156.

to provide for payments to shareholders, they will be able to declare dividends in terms of common law, but not section 90.[33] Section 90 substituted section 85 of the old Act. In terms of section 90 a company may acquire its own shares under certain circumstances.[34]

In sum, the decision in *Trevor v Whitworth* which prohibits a company to purchase its own share remained part of our law until 30 June 1999 when the Companies Act, 1973 was amended by the Companies Amendment Act 37 of 1999. The common law rule that dividends may not be paid out of capital[35] was supplemented by the rule that dividends could be paid out of profits only.[36] The Companies Amendment Act also permit companies not only to return share capital to their shareholders by buying shares back from them, but also to pay dividends out of shares capital.[37] Section 89 of the Companies Amendment Act further permit a subsidiary companies in accordance to section 85, 86, 87 and 88 to acquire shares in its holding company to maximum of 10 per cent in the aggregate of the number of issued shares of the holding company.[38] Sections 89 shall not apply to the acquisition of shares by a holding company in a subsidiary of itself. The common law prohibition for the purchase of shares by a company, which was extended with a statutory prohibition that precluded a company from giving financial assistance for the purchase of shares,[39] was later repealed by the Companies Amendment Act 37 of 1999, without removing the prohibition in section 38. The legislature incorporated the solvency and liquidity test into the share repurchase provision as a substitute for the capital maintenance principle. The Companies Act 71 of 2008 has now completely done away with the remnant of capital maintenance.[40] The new Act is wholly based on solvency and liquidity and

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[33] *Ibid.*
[34] As indicated earlier, section 90(2) prohibit a company to make any payment in whatever form to its shareholders if there are reasonable grounds for believing that the company is, or would after payment be, unable to pay its debts as they become due in the course of business; or the consolidated assets of the company fairly valued would after the payment be less than the consolidated liabilities of the company.
[35] *Guinness v Land Corporation of Ireland* (1882) 22 Ch D 349 356; *Re Exchange Banking Co, Flitcroft's Case* (1882) 21 ChD 591.
[36] See Davies PL *Gower & Davies' Principles of Modern Company Law* 7ed (2003) at 275; Van der Linde K "Aspects of the regulation of share capital and distributions to shareholders" LLD thesis, University of South Africa (2008) at 23.
[37] Van der Linde K "Capital maintenance is dead- long live solvency and liquidity" (1999) *JBL* 7 155.
[38] Section 85 allows a company to acquire shares issued by it under certain circumstances. Section 86 provides for liability of directors and shareholders under certain circumstances. Section 87 provides for the procedure of acquisition of certain shares by company and section 88 provides for enforceability of contracts for acquisition by certain of certain shares.
[39] Section 38 of the old Act.
[40] Delport P *The New Companies Act Manual* (2011) at 53.

any remnant of the of the capital maintenance system on which the old Act was based is now removed.[41]

2.5 Conclusion

The capital rules which were developed to protect creditors and both present and future directors which gave rise to doctrine of capital maintenance was to a large extent abolished by the Companies Amendment Act 37 of 1999, and later the new Act. The said doctrine was developed by English Courts in the nineteenth century and was accepted as part of South African Company law and later entrenched in the Companies Act 61 of 1973. As indicated above, the capital maintenance was not the only imperfect way to protect the creditors but the rules (mostly English common law) that applied the principle were notoriously imprecise and uncertain. Some authors expressed their view that capital maintenance rules are not unnecessarily complex and riddled with obscurities, but worse still many of these rules have outlined their usefulness.[42]

The rule stated in *Trevor v Whitworth* was to a large extent abolished by the Companies Amendment Act 37 of 1999. The Companies Amendment Act 37 of 1999 allows a company to make payments even out of capital, or pay dividends out of capital or to return capital to its members provided that the company is authorised by its articles (Memorandum of Incorporation). The Companies Amendment Act further permits a subsidiary companies to acquire shares in its holding company to maximum of 10 per cent in the aggregate of the number of issued shares of the holding company. The new Act has completely removed the doctrine of capital maintenance. The new Act is wholly based on solvency and liquidity and any remnant of the capital maintenance on which the old Act was based is now removed.[43]

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[41] *Ibid.*
[42] Cassim FHI "The reform of company law and the capital maintenance concept" (2005) 283 *SALJ* at 284.
[43] Delport P *The New Companies Act Manual* (2011) at 53.

CHAPTER 3

FINANCIAL ASSISTANCE FOR THE SUBSCRIPTION OF SECURITIES

3.1 Introduction

Section 38 of the old Act prohibits a company from giving a financial assistance for the acquisition of shares in the company itself or in its holding company.[44] Section 38 was amended by section 90 of the Companies Amendment Act of 1999. As indicated earlier, the legislature when eliminating the prohibition in section 38 failed to remove the prohibition. The solvency and liquidity test have been incorporated as a substitute for the capital maintenance principle since positive results in terms of the aforesaid test is considered as adequate protection for minority. The new Act allows a company to provide financial assistance provided that provisions of section 44(3) and 44(4) are complied with.[45] In particular the new Act is based on solvency and liquidity tests and any remnant of the capital maintenance on which the 1973 Act was based is now removed.[46] The purpose of this chapter is to analyse section 38 of the old Act and further examine drastic changes made by section 44 of the new Act.

3.2 Section 38 of the Companies Act

As indicated above, a company is prohibited whether directly or indirectly from giving financial assistance for the acquisition of shares in the company itself or in its holding company.[47] Therefore where a company concerned is a subsidiary the prohibition also extends for financial

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[44] Companies Act 61 of 1973. See Cilliers *et al Cilliers and Benade Corporate Law* (2000) at 329; Bernade *et al Entrepreneurial Law* (2008) at 192; See also Blackman *et al Commentary on the Companies Act* (2002) at 4-55.

[45] Section 44(3) provides that despite any provision contrary to the MOI, the Board may not authorise any financial assistance unless is pursuant to an employee share scheme that satisfies the requirements of section 97 or pursuant to a special resolution of the shareholders, adopted within the previous 2 years which approved such assistance. This section further state that the Board must be satisfied that immediately after providing the financial assistance, the company will satisfy the solvency and liquidity test and the terms under which the financial assistance is proposed are fair and reasonable to the company. Section 44(4) imposes duty on the board to ensure that any conditions or restrictions respecting the granting of financial assistance set out in the company's MOI have been satisfied.

[46] Delport P *The New Companies Act Manual* (2011) at 31.

[47] Section 38(1) of the Companies Act 61 of 1973. See Cilliers *et al Cilliers and Benade Corporate Law* (2000) at 329; Bernade *et al Entrepreneurial Law* (2008) at 192; See also Blackman *et al Commentary on the Companies Act* 2002 at 4-55; Oelofse AN "Artikel 38 van die maatskappywet" (1980) *TSAR* 47 on the scope and application of section 38.

assistance in respect of the purchase or subscription of shares in its holding company.[48] Section 54 of the English Companies Act, 1948 is identical to section 38(1). The court in *Lipschitz v UDC Bank*[49] indicated that the prohibition in section 38 comprises two main elements namely, the giving of financial assistance and the purpose for which it is given (or the 'in connection with' provision). In *Lewis v Oneanate (Pty) Ltd*[50] the court indicated that the following propositions could be extracted from *Lipschitz* with regard to financial assistance:

> 1. The prohibition against the giving of financial assistance is couched in very wide terms. It relates to 'any' financial assistance, whether given 'directly or indirectly' and it relates to such assistance not only when it is given for the purpose of the purchase of or subscription for any shares in the company, but also when it is given 'in connection with' such purchase or subscription (at 797D-E)
> 2. The prohibition contains two main elements - the giving of financial assistance, and the purpose for which it is given. Although the two elements are linked to form a single prohibition, they are vitally different in concept (at 799E)
> 3. There is no comprehensive definition of 'financial assistance' in the section or elsewhere in the Act. From time to time various tests have been formulated by the courts as a guide to a proper answer to the question whether what a company has done in a given case constitutes the giving of 'financial assistance' within the meaning of the section (at 789C-E)
> 4. One such test is the so-called 'impoverishment test', which asks the question, has the company become poorer as a result of what it did for the purpose of or in connection with purchase of its shares? (at 798C-E)
> 5. The application for the impoverishment test is not always appropriate. In some cases the test may be a helpful guide and may often yield a clear and decisive answer to the problem. In other cases it may not only unhelpful but irrelevant (at 801D-E)
> 6. The section provides in terms that the giving of a guarantee or the provision of security constitutes the giving of financial assistance. In such cases, if the giving of the guarantee or the providing of the security is shown to be for the purpose of or in connection with the purchase of the company's shares, the section would be contravened, whether or not such guarantee or security actually renders or is likely to render the company poorer (at 800-801)
> 7. Although the section does not in terms prohibit the conclusion of a contract for the sale of shares in which there is a provision for the giving of financial assistance, if a contact provides for the future financial assistance which if actually given would be in contravention of the section, it is invalid and unenforceable (at 802B-803C)".[51]

[48] *Armour v Hick Northern Ltd v Armour Trust Ltd* [1980] 3 All ER 833 (Ch); *Belmont Finance Corporation v Williams Furniture* [1980] 1 All ER 393 (CA).
[49] 1979 (1) SA 789 (A) at 799. See De Bruin R "Artikel 38(1) van die maatskappywet" (1979) *De Rebus* 361 and also *Lewis v Oneanate (Pty) Ltd* 1992 (4) SA 811(A); Cilliers *et al Cilliers and Bernade Corporate Law* (2000) at 331; Pretorius *et al Hahlo's South African Company Law Through the Cases* (1999) at 131.
[50] 1992 SA (4) 811 (A) at 816-817.
[51] *Ibid.*

It is submitted that the purpose of section 38 is to ensure that corporate funds are used for proper corporate purposes.[52] Cassim submit that section 38 simply ensures that persons who purchases shares in a company do so out of their own funds and not by the plundering the resources of the company to the prejudice of creditors and minority shareholders.[53]

3.3 Section 38 and subsidiary

Section 38 does not permit subsidiary to provide financial assistance to any person for the purchase or subscription of shares in its holding company.[54] In other words, where a company concerned is a subsidiary, the prohibition for giving financial assistance in section 38 also extends to financial assistance in respect of purchase or subscription of shares in its holding company.[55] It is submitted that the extension of section 38(1) to include subsidiary ignores, for policy reasons, fundamental principles of company law namely the concept of legal personality established by the court in *Salomon v Salomon & Co Ltd*[56] where the court held that subsidiary, like any other company is to be regarded as a separate and distinct entity from its holding company.[57] However Cassim expresses his view that section 38(1) does not forbid provision of financial assistance for the purchase or subscription for shares in a subsidiary of the company.[58] He is of the view that there is less likelihood of prejudice to other shareholders and creditors.[59] Gower indicate that section 151-3 of the Companies Act of 1985 which prohibit the giving of financial assistance by a company for the purchase of shares do not apply where financial

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[52] Blackman *et al Commentary on the Companies Act* (2002) at 4-57; Cassim FHI "The reform of company law and the capital maintenance concept" (2005) 283 *SALJ* at 292.

[53] Cassim FHI "The reform of company law and the capital maintenance concept" (2005) 283 *SALJ* at 292.

[54] Cassim FHI "Unravelling the obscurities of section 38(2)(d) of the Companies Act" (2005) *SALJ* at 494.

[55] Cilliers *et al Cilliers and Benade Corporate Law* (2000) at 329; *Armour v Hick Northern Ltd v Armour Trust Ltd* [1980] 3 All ER 833 (Ch); *Belmont Finance Corporation v Williams Furniture* [1980] 1 All ER 393 (CA). See Cassim FHI "Unravelling the obscurities of section 38(2)(d) of the Companies Act" (2005) 493 *SALJ*.

[56] [1897] AC 22(HL).

[57] Cassim FHI "Unravelling the obscurities of section 38(2)(d) of the Companies Act" (2005) 493 *SALJ* at 493. See *Adams v Cape Industries Plc* [1991] ALL ER 927 (ChD and CA) at 1019 and *Acatos and Hutcheson Plc v Watson* [1995] 1 BCLC 218 (ChD) at 223 e-f) where Slade LJ indicated that *Our law for better or worse, recognizes the creation of subsidiary companies, which though in one sense the creatures of their parent companies, will nevertheless fall to be treated as separate legal entities with all the rights and liabilities which would normally attach to separate legal entities.*

[58] Cassim FHI "Unravelling the obscurities of section 38(2)(d) of the Companies Act" (2005) 493 *SALJ* at 494; Parker GB & Buckley M *Buckley on the Companies Act* 14ed (1981) vol 1 at 156 in relation to section 54 English Companies Act, 1948 which is identical to section 38.

[59] Cassim FHI "Unravelling the obscurities of section 38(2)(d) of the Companies Act" (2005) 493 *SALJ* at 494.

assistance is given by the holding company for the acquisition of shares in its subsidiary company.[60]

Section 38(2)(d) provides that the provision of financial assistance in section 38(1) shall not be construed as prohibiting the acquisition of shares in a company by the company or its subsidiary in accordance with the provisions of section 85 for the acquisition of such shares. There are few interpretation regarding section 38(2)(b). Blackman *et al* indicate that the meaning of section 38(2)(d) is not obvious and 'it is unclear how a company can give itself financial assistance to purchase its own shares or the shares of its holding company.[61] They further indicate that '[p]erhaps it was intended that section 38(2)(d) should refer, not to section 85 but section 89.[62] Cilliers *et al* also describe the provisions of section 38(2)(d) as curious exception because it is the company that acquires shares and it is therefore impossible for the company to provide itself with financial assistance.[63] Delport indicate that *What bedeviled the exclusions in section 38(2)(b) was that the reference was not to s 85(4), which contains the solvency and liquidity requirements, but to the whole of s 85, which provides for the power of the company to acquire its own shares.*[64] Delport further states that there are two possible interpretations. He states that one is that the financial assistance is given by the company to its subsidiary for the acquisition of shares in the company by the subsidiary.[65] In light of this interpretation, he submit that it seem to be logical as the subsidiary may now hold shares in the holding company (section 39 and 89).[66] He indicate that the second interpretation appears to be more problematic, because it may be that the exclusion covers instances where the financial assistance is provided by the subsidiary for the acquisition of shares of the holding company by the holding company in terms of section 85.[67] He concludes that due to these uncertainties, the exclusion contained in section 38(2)(b) is therefore virtually useless.[68] The view expressed by Delport is rejected by Van der Linde.[69] In particular, Van der Linde disagree with the view that the exclusion allow or purports to allow the giving of financial assistance by the company itself. She beliieves that section 38(2)(b) has the following effect:

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[60] Davies PL *Gower and Davies Principle of Modern Company Law* 7ed (2003) 261 (n52).
[61] Blackman *et al Commentary on the Companies Act* (2002) Act vol 1 para 4-66.
[62] *Ibid.*
[63] Cilliers *et al Cilliers and Benade Corporate Law* (2000) at 330 (n52).
[64] Delport PA "Company groups and the acquisition of shares" (2001) *13 SA Merc LJ* 121 at 125-126.
[65] *Ibid.*
[66] *Ibid.*
[67] *Ibid.*
[68] *Ibid.*
[69] Van der Linde K "Financial assistance for the acquisition of shares in accordance with s 85 of the Companies Act – A reply to Delport" (2001) *SA Merc LJ* 437 at 438.

- "A subsidiary may give financial assistance (to its holding company or any other person) in connection with the acquisition by the holding company of its (the holding company's) own shares;
- A holding company may render assistance to its subsidiary company or to any other person) in connection with the acquisition by the subsidiary of shares in the holding company;
- A co-subsidiary of a subsidiary acquiring shares in its holding company may give assistance (to the subsidiary or any other person) in connection with the acquisition by the subsidiary of shares in the holding company".[70]

Cassim is of the view that in order to explain the meaning and effect of section 38(2)(b) it will be useful to go back to its origin in 1999 as well as the origins of section 38(1).[71] He further disagree with the Blackman *et al* and Delport when they expressed the view with reference to section 38(2)(b) that the person who acquires the shares is the company, so the exclusion applies to financial assistance given to the company by the company.[72] Cassim concludes by stating that the consequence of section 38(2)(d) is that financial assistance may only be given to its subsidiary or fellow subsidiary will be subject to approval by special resolution, authorization in the articles of association of the company and compliance with the tests of 'liquidity and solvency'.[73] He further states that the *net result of second part of section 38(2)(b) is that it facilitates, subject to vital safeguard, the injection of capital into a subsidiary by its holding company to enable the subsidiary to acquire the shares of its holding company without any fear that this would constitute indirect financial assistance contrary to section 38(2)(d).*[74]

4. The Companies Amendment Act 37 of 1999

Section 38 was amended by section 3 of the Companies Amendment Act of 1999 by insertion of section (2)(d) in order to provide for further exemption to the prohibition. In particular when amending section 38, the legislature failed to remove the prohibition in section 38. Only the solvency and liquidity test was incorporated into share repurchase provision as a substitute for the capital maintenance and are considered to be adequate

[70] Van der Linde K "Financial assistance for the acquisition of shares in accordance with s 85 of the Companies Act – A reply to Delport" (2001) *SA Merc LJ* 437 at 442.
[71] Cassim FHI "Unravelling the obscurities of section 38(2)(d) of the Companies Act" (2005) 493 *SALJ* at 495, 496.
[72] See PA Delport "Company groups and the acquisition of shares" (2001) *13 SA Merc LJ* 121 at 125-126; Blackman *et al Commentary on the Companies Act* (2001) Act vol 1 para 4-66.
[73] Cassim FHI "Unravelling the obscurities of section 38(2)(d) of the Companies Act" (2005) 493 *SALJ* at 500.
[74] *Ibid.*

safeguard for minority shareholders and creditors.[75] As indicated earlier, liquidity tests prohibits a company from making any payment to acquire shares that it has issued if it appears that the company is, or would after payment be unable to pay its debts in the ordinary course of business. The solvency tests prohibits a company from making any payment to acquire shares that it has issued if it appears that the consolidated assets of the company fairly valued would, after the payment , be less than the consolidated liabilities of the company.

5. Corporate Laws Amendment Act 24 of 2006

Section 38 was further amended by section 9 of the Corporate Laws amendment Act by insertion of subsection 2(A) and (B). The Corporate Laws Amendment Act permit a company to provide financial assistance for the purpose of purchase or subscription of shares provided that the approval by special resolution is made and the transaction will pass the liquidity and solvency test.[76]

6. Section 38 and BEE (Broad-Based black economic empowerment)

As indicated above, section 38 prohibit financial assistance for the purchase of company's share by the company itself or by a subsidiary. BEE aims to fund the acquisition by an empowerment group of a subsidiary stake in an existing South African private corporate vendor. Financing remains a preferred option.[77] Accordingly, the term vendor financing is used to derive financing provided either by the target company or its shareholders to an empowerment group to finance the acquisition of equity in the target company.[78] It should be noted that a vendor financing is restricted by section 38. Miller & Mgudlwa submit that *the target company may not provide security, loans, guarantees or the like to the empowerment group which typically lacks collateral to raise finance from commercial banks on normal commercial terms. Consequently, vendor financing in the context of BEE transaction is*

[75] *Ibid.*
[76] See section 38(2A) of the Act 61 of 1973 and section 9 of the Corporate Laws Amendment Act 24 of 2006.
[77] Miller H & Mgudlwa M Financial empowerment - "The implication of section 38 of the Companies Act" (2003\037\BEE\CR) at 1, http://www.docstoc.com/docs/19871618/UPdate-Financing-empowerment---The-implications-of-Section-38-of
[78] *Ibid.*

limited to, for example, share incentive schemes for employees. And this seldom results in black persons owning a substantial stake in the target.[79]

7. Section 44 of the Companies Act 71 of 2008

Section 44 regulates the situation where a company provides financial assistance for the acquisition of company's securities.[80] Section 44(2) provides that:

> "Except to the extent that the MOI provides otherwise, the board may authorise the company to provide financial assistance by way of loan, guarantee, the provision of security or otherwise to any person for the purpose of, or in connection, the subscription any option, or any securities, issued or to be issued by the company or a related or inter-related company, or for the purchase of any securities of the company or a related or inter-related company, subject to subsections (3) and (4)".

Delport states that it is not clear how the Board can authorise the company (represented by the Board) to provide financial assistance.[81] He is of the view that the correct construction should be that the company authorises the Board (as agents of the company) because the contracting party, with rights and obligations, remains the company.[82] He further refers to the section 66 which appear to change the ultimate organ in the company.[83] According to him financial assistance is norm, unless the MOI excludes or limits it and if MOI is silent, the company/Board has the power to provide financial assistance. He concludes by stating that the authorization must obviously be by the Board resolution.[84]

Section 44(3) provides that despite any provision of the Company's MOI to the contrary, the Board may not authorise any financial assistance in section 44(2) above, unless the particular of financial assistance is:

- Pursuant to an employee share scheme that satisfies the requirements of section 97; or

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[79] *Ibid.*

[80] Section 1 of the Companies Act 71 of 2008 stipulates that securities has the meaning set out in section 1 of the Securities Services Act 36 of 2004 and includes shares held in private company. Section 1 of the Securities Services Act 36 of 2004 define securities as any shares, debentures or other instruments, irrespective of their form or title, issued or authorised to be issued by a profit company. Delport indicate that this is much wider definition than was previously the case. He also indicate that securities include shares but shares does not include securities, Delport P *The New Companies Act Manual* (2011) at 29 (n1).

[81] Delport P *The New Companies Act Manual* (2011) at 54 (n6).

[82] *Ibid.*

[83] *Ibid.*

[84] *Ibid.*

- Pursuant to a special resolution of the shareholders, adopted within the previous two years, which approved such assistance either for a specific recipient, or general for a category of potential recipients, and the specific recipient falls within that category; and
- The Board is satisfied that-

  -immediately after providing the financial assistance, the company would satisfy the solvency and liquidity test; and

  - the terms under which the financial assistance is proposed to be given are fair and reasonable to the company.[85]

Section 44(4) imposes duty on the Board to ensure that any conditions or restrictions respecting the granting of financial assistance set out in the company's MOI have been satisfied. Section 44(5) provides that a decision by the Board to give financial assistance will be void if such decision is inconsistent with section 44 or is inconsistent with a prohibition, condition or requirement of section 44(4). In terms of section 44(6) a director who were present and did not vote against the resolution, can be held liable for any loss, damage or costs sustained by the company if the resolution has been declared void under section 218. Delport states that although the resolution or the agreement in contravention of section 44 or the provision in the MOI is void (Section 44(5)), it must still be declared void by the court in terms of section 218(1) or 77(5)(a) and that is only when non-compliance will result in the director's civil liability under section 77(3)(e)(iv).[86] He further indicate that the general liability provision (section 77(3)(e)(iv)) does not require this.[87]

7.1 The meaning of financial assistance

Section 44(1) provides that "financial assistance" does not include lending of money in the ordinary course of business by a company. Section 44(2) state that financial assistance include loan, guarantee, the provision of security or otherwise. Like section 44, section 38 of the old Act also covered financial assistance 'by means of loan, guarantee, the provision of security or

[85] See Delport P & Vorster Q *Henochsberg on the Companies Act 71 of 2008* (2011) at 190 in which they states that there is no indication what fair and reasonable in this context would be. They submit that the provisions of section 37(3)(c) of the Act 61 of 1973 could be indicative.
[86] Delport P *The New Companies Act Manual* (2009) at 33 (n11).
[87] *Ibid.*

otherwise.[88] The Act does not define the term financial assistance .The court in *Anglo Petroleum Ltd v TFB (Mortgages) Ltd*[89] indicated that it is unwise for the legislature to lay down a precise definition of the term and this can give rise to uncertainties and ambiguities.[90] Delport state that since the Act does not define the term financial assistance, the common law definition in terms of the Act 61 of 1973 Act will be used to determine whether there was a financial assistance.[91] In *Gradwell v Rostra Printers Ltd*[92] the court formulated test called "impoverishment" and this was always used by the court to determine whether financial assistance was given. The test involves the question whether the company had become poorer in consequences of what it did for the purpose of or in connection with the purchase or subscription of shares.[93] In other words, it entails financial assistance before and after the transaction is evaluated.[94] It therefore follows that if a company is in a worse financial situation by the transaction it is impoverished.[95] Delport state that this will happen for example if the company registers a bond over its property to secure a bank loan made by the buyer of the shares,[96] or if the company creates a fictitious debt (not based on *bona fide* transaction) in favour of the seller.[97]

7.2 For the purpose of, or in connection with

The court in *Lipschitz* held that the prohibition in section 38 comprises two main elements, one is the giving of financial assistance, the other is the purpose for which it is given (or the "connection with" provision). The court further indicated that the word "in connection" is an alternative to "for the purpose of" and in the context of the section its connotation was greatly affected by the concept to which is an alternative.[98] In *Brandy v Brandy*[99] the House of the Lords

[88] Cassim *et al Contemporary Company Law* (2012) at 316.
[89] [2008] 1 BCLC 185 (CA) at para 26 pp 190-1.
[90] *Ibid.*
[91] Delport P *The New Companies Act Manual* (2011) at 55.
[92] 1959 (4) SA 419 (A).
[93] See Cilliers *et al Cilliers and Benade Corporate Law* (2000) at 331. In *Sterileair (Pty) Ltd v Papallo* (1998) 29 ACSR 461 at 466 the court indicated that assistance involves something in nature of aid or help. The court went on to state that assistance cannot exist in vacuum, it must therefore be given to someone. The assistance must be financial (*Armour Hick Northern Ltd v Armour Trust Ltd* [1980] 3 All ER 833 (Ch) at 837-8; *London Ranch (Pty) Ltd v Hyreb estate* (Pty) Ltd 1963 (2) SA 570 (E).
[94] Delport P *The New Companies Act Manual* (2011) at 55.
[95] *Ibid.* See para 3.2 above for the decision of *Lewis v Oneanate (Pty)* 1992 (4) SA 811 (A) 816-817 for the propositions that was extracted by the court *from Lipschitz NO v UDC Bank Ltd* 1979 (1) SA 789 (A) with regard to financial assistance.
[96] *Karroo Auctions v Hersman* 1951 2 SA 33 (E).
[97] *Albert v Papenfus* 1964 2 SA 713 (E); Delport P *The New Companies Act Manual* (2011) at 55.
[98] *Lipschitz supra* at 805. Cilliers *et al Cilliers and Benade Corporate Law* (2000) at 333.

drew a distinction between the 'purpose' and the 'motive' or 'reason' why a purpose is formed. The House of the Lords said:

> "the purpose and the only purpose of the financial assistance is and remains that of enabling the shares to be acquired and the financial or commercial advantages flowing from the acquisition, are a by-product of it rather than independent purpose of which the assistance can properly be considered to be an incident".[100]

The court in *Lipschitz* indicated that where the purpose of the company in performing the act complained of is established, and that purpose is for something other than the purchase of the company's shares, there will be a little or no room for finding that for purpose of section 38 the Act was nevertheless performed in connection with the purchase of shares.[101] The court gave the following example:

> "Company A, for its own business purposes, guarantees B's overdraft at a bank so as to enable B to carry on his business as manufacturing certain equipment which the company necessarily requires for its business and which equipment it purchases from B. Company A knows full well at the time of giving guarantee that B, who has confidence in its stability and management, intends to invest in shares in the company A the surplus profits he will make as a result of being able to continue is manufacturing business by reason of the overdraft facilities made available to him by virtue of A's guarantee. B in fact thereafter uses such profits for the purchase of shares in A. The guarantee given by A clearly amounts to the giving of financial assistance to B, but not at all for the purpose of the purchase of the company's shares; its purpose, clearly established, was to enable B to continue producing the equipment required by A for its business. In such a case there would surely be no room for finding that, because A knew of B's ultimate intention regarding the purchase of shares in the company, the financial assistance given by A, although not given for the purpose of purchase but for a different purpose, was nevertheless given in connection with the purchase of shares and was therefore in contravention of the section".[102]

In sum, the word "for the purpose of, or in connection with" appears in section 44 and therefore the decision of *Lipschitz* will apply to the new Act.

7.3 The requirements to provide financial assistance

In terms of section 44(3) the following requirements must be complied with before the company provide financial assistance.

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[99] [1988] 2 All ER 617 (HL) at 633.
[100] *Ibid.*
[101] *Lipschitz supra* at 805.
[102] *Ibid.*

7.3.1 Memorandum of Incorporation (MOI)

The MOI must permit the company to provide financial assistance. It must state clearly that the company can give financial assistance.[103]

7.3.2 Employee share scheme or special resolution

Section 44(3) provides that the Board may not authorise any financial assistance unless the particular provision of the financial assistance is pursuant either to an employee share scheme that satisfies the requirements of section 97 or to a special resolution of the shareholders adopted with the previous two years.

7.3.3 Solvency and liquidity test

Section 44(3)(b) stipulates that the Board may authorise the company to provide financial assistance , if the Board is satisfied that immediately after providing financial assistance, the company would satisfy the solvency and liquidity test. Delport argues how the Board can authorise the company. He indicate that the company should authorise the Board.[104] He put it as follows:

> "It is not clear how the Board can authorise the company (represented by the Board) to provide financial assistance. The correct construction should be that the company authorizes the Board (as agents of the company) because the contracting party, with the rights and obligations, remains the company".[105]

Delport further refers to section 66 and indicate that it appears to change the ultimate organ in the company.[106] He is of the view that financial assistance is now the norm, unless the MOI excludes or limits it. He indicates if the MOI is silent, the company or Board has the power to

[103] Company Law (MSR812) - Prof Delport's lecture on capital Rules (27 May 2009).
[104] Delport P *The New Companies Act Manual* (2011) at 54 (n6).
[105] *Ibid.*
[106] Section 66 stipulate that the business and affairs of a company must be managed by or under the direction of its Board, which has the authority to exercise all of the powers and perform any of the functions of the company, except to the extent that this Act or the company's MOI provides otherwise. See Delport P & Vorster Q *Henochsberg on the Companies Act 71 of 2008* (2011) at 189 where Delport and Vorster argues that the concept Board as organ or agent of the company can "authorise the company" is foreign to the common law but is now possible under section 66(1).

provide financial assistance. Finally he expresses his view that the authorisation must obviously be by the Board resolution.[107]

Section 4(1) stipulates that the company satisfies solvency and liquidity test at a particular time if considering all reasonably foreseeable financial circumstances of the company at that time, the assets of the company as fairly valued equal or exceed the liability of the company and it appears that the company will be able to pay its debts as they become due in the ordinary course of business for the period of 12 months from the date on which the test is considered or in the case of distribution 12 months following that distribution. Therefore financial assistance to be considered by the company must be based on accounting records that satisfies the requirements of section 28, and financial statements that satisfy the requirements of section 29.[108] Van der Linde states that the test imposes an objective test rather than a subjective test.[109] She indicates that the determining factor is the existence of reason or ground upon which a conclusion could reasonably be reached. She further indicate that a resolution by the board that it has "reasonably concluded" that the company will satisfy the test is a set as an additional requirement in certain instances.[110] Delport is of the view that the test in respect of solvency is objective as well as subjective in that it appears that it will remain liquid for the following 12 months.[111]

7.4 Exception

Section 44(1) provides for the exception to the application of section 44. In particular section 44(1) stipulates that "financial assistance" does not include lending money in the ordinary course of business by a company whose primary business is the lending of money. Therefore a person who wish to purchase or subscribe shares in a company whose primary business is the lending of money, he or she will have to approach such company for a loan.

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[107] Delport P *The New Companies Act Manual* (2011) at 54 (n6).
[108] Section 4(2).
[109] Van der Linde K "The solvency and liquidity approach in the Companies Act 2008" (2009) 2 *TSAR* 224 at 235.
[110] *Ibid.*
[111] Delport P *The New Companies Act Manual* (2011) at 54. See Delport P & Vorster Q *Henochsberg on the Companies Act 71 of 2008* (2011) at 191 in which they further indicate that the word "Board is satisfied" is subjective test, but qualified by the objective "reasonably foreseeable circumstances" in section 4.

7.5 Liability and validity of contracts

Section 44(5) provides for the consequences for non-compliance with section 44(2). It stipulate that a decision by the Board of a company to provide financial assistance or an agreement with respect to the provision of any such assistance is void if it is inconsistent with the section 44 or a prohibition, condition or requirement in the MOI. Section 44(6) provides that if a resolution or agreement is void in terms of section 44(5), a director of a company will be liable in terms of section 77(3)(e)(v) if he was present at that meeting when the Board approved the resolution or agreement or participated in the making of such decision in terms of section 74 and failed to vote against such resolution or agreement despite knowing that the provision of financial assistance was inconsistent with section 44 or a prohibition, condition or requirement of section 44(4). The directors who were present at the meeting and did not vote against the resolution can be held liable only for loss, damage or costs sustained by the company.[112]

8. Comparison of section 38 and 44.

Section 38 contains a strict prohibition on the company to provide financial assistance.[113] This is confirmed by the words "no company shall give". In terms of section 38 a company is not allowed to provide financial assistance. Section 44 permit a company to provide financial assistance. This is confirmed by the words "a company may" whereas it was not possible in terms of section 38.[114]

Section 38 further provides that "you will be guilty" of an offence if you do not comply with it, whereas section 44 does not indicate anything like an offence that you will be guilty of. Section 44 only stipulates that the directors will be liable as in section 38.

Section 38 will not apply if financial assistance is given is given by holding company to buy shares in the subsidiary or "related company". Section 44 provides for financial assistance for the purpose of buying shares not only in the holding company, but also in a subsidiary (or related company). A holding company that provides financial assistance to subsidiary must comply with section 44.

[112] Delport P *The New Companies Act Manual* (2011) at 56; Section 77(3)(e)(iv).
[113] Company Law (MSR812) - Prof Delport's lecture on capital Rules (27 May 2009).
[114] *Ibid.*

9. Conclusion

It is evident from this chapter that section 38 which prohibit a company to give financial assistance for the acquisition of shares in the company or in its holding company was amended by 90 of the Companies Amendment Act 37 of 1999. It is further notable that that the legislature failed to remove the prohibition in 1999 and only incorporated the solvency and liquidity test. Section 38 further prohibit a subsidiary to provide financial assistance to any person for the purchase or subscription of shares in its holding company. It is further apparent that the exception in section 38(2)(d) was subject to many interpretation and it is suggested that it is unclear,[115] containing curious exception[116] and because of uncertainties is virtually useless.[117] Section 44 of the new Act permit a company to provide financial assistance for the acquisition of or subscription of company's securities. It further provides for financial assistance for the purpose of buying shares not only in the holding company, but also in a subsidiary (or related company).[118] The new Act does not define the term "financial assistance" and as such Delport indicate that the common law definition of financial assistance should be used and in this regard the decision of *Lipschitz* should be taken into consideration. For the company to provide financial assistance in terms of the new Act, the MOI must permit the company to provide such financial assistance, secondly the Board may not authorise any financial assistance unless the particular provision of the financial assistance is pursuant either to an employee share scheme that satisfies the requirements of section 97 or to a special resolution of the shareholders adopted with the previous two years, and thirdly the Board must be satisfied that immediately after providing financial assistance, the company would satisfy the solvency and liquidity test. The word "Board may authorise the company" to provide financial assistance as indicated in section 44(3) appears to be incorrect and as such the writer hereof agree with Delport that the correct construction should be "the company that authorises the Board" to provide financial assistance.[119]

[115] Blackman *et al Commentary on the Companies Act* (2002) Act vol 1 para 4-66.
[116] Cilliers *et al Cilliers and Benade Corporate Law* (2000) at 330 (n52).
[117] Delport PA "Company groups and the acquisition of shares" (2001) *13 SA Merc LJ* 121 at 125-126.
[118] *Idem* 27.
[119] Section 44(3); Delport P *The New Companies Act Manual* (2011) at 54 (n6).

CHAPTER 4

LOANS OR OTHER FINANCIAL ASSISTANCE TO DIRECTORS

4.1 Introduction

The doctrine of capital maintenance prohibited a company to return its share capital to shareholder. It also prohibited a company to pay dividends out of profits. Directors and management are in a powerful position in a company. Therefore section 226[120] was enacted to prevent directors or managers of the company acting in their own interest and against the interest of the shareholders by burdening the company with the obligations which are not its benefit but for the benefit of another company and/or for the benefit of its directors or managers.[121] In particular section 226 is designed to protect the members of the company.[122] The Companies Amendment Act[123] made it possible for the company to buy back shares from their shareholders and in the process return share capital to them,[124] and pay dividends out of share capital.[125] It is submitted that a company may pay dividends out of share capital as long as it remains solvent and liquid.[126] Section 45 amended 226 with regard to loans or other financial assistance to directors of a company by a company. Section 45 stipulates that the Board may authorise a company to provide financial assistance subject to section 45(3) and 45(4). In terms of section 45(3) financial assistance must be pursuant to an employee share scheme or to a special resolution, secondly the solvency and liquidity test must be satisfied and thirdly if the Board adopts a resolution to provide financial assistance, the company must provide the written notice to shareholders and any trade union representing its employees. The purpose of this chapter is to identify and explain changes made by section 45 of the new Act with regard to loans or other financial assistance to directors. Reference will be made to section 226 of the old Act and section 37 of the Companies Amendment Act 37 of 1999.

[120] Act 61 of 1973.
[121] *Standard Bank of SA Ltd v Neugartem* 1988 (1) SA 652 (W) at 658.
[122] *Ibid.*
[123] 37 of 1999.
[124] Van der Linde K "A company purchase of its own shares" (1999) 7 *JBL* 68.
[125] See Van der Linde K "Capital maintenance is dead-Long live solvency and liquidity" (1999) 7 *JBL* 155.
[126] *Ibid.*

4.2 Section 226

Section 226(1) prohibit a company to make a loan to any director or manager of the company or its holding company or any other company which is a subsidiary to its holding company. Section 226(1) further prohibit a company to make a loan to any other company or other body corporate controlled by one or more directors or managers of the company or of its holding company or of any company which is a subsidiary of its holding company. It is submitted that an extension of prohibition beyond a loan to its own directors or managers as well as directors and managers of its holding company is understandable as it is intended to prevent the potential abuse which the holding company has over the directors and managers of its subsidiaries.[127] Section 226(1)(a) provides that the provisions do not apply in respect to the making of a loan to, or the provision of security for the company's own director or manager or a company or body corporate controlled by one or more of its directors or managers, with the prior[128] consent of all the members of the company or in terms of a special resolution relating to the specific transaction. In particular the prohibition lays down that no company shall 'make a loan' or 'provide any security' in the stated circumstances without the prior consent.[129] In *Standard Bank of SA v Neugarten*,[130] Goldblatt AJ stated that:

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

Jooste states that section 226 is recognition of the powerful position held by directors or managers of a company. He is of the view that such power may be potentially abused by directors, managers specifically for their benefit and to the detriment of the company including

[127] Jooste R "Loans to directors - An analysis of section 226 of the Companies Act" (2000) 12 *SA Merc LJ* 273.
[128] The word 'prior' was inserted by section 6 of the Companies Amendment Act 82 of 1992.
[129] In *Standard Bank of SA Ltd v Neugartem & others* 1988 (1) SA 652 (W) Goldblatt held that ratification was permissible in respect of the similar provisions of section 226. The Appellative Division in *Neugartem v Standard Bank of SA Ltd* 1989 (1) SA 797 (A) rejected Goldblatt J decision to the effect that shareholder consent at any stage is sufficient to comply with section 226(2)(a). The Appellative Division held that when consent is required in terms of section 226(2)(a) the lack of it before or at the time the loan was made (or the security was provided) is fatal to the validity of the transactions. See also Blackman *et al Commentary on the Companies Act* (2002) at 8-312. The reason for amendment is section 6 of the Companies Amendment Act 82 of 1992 is the decision of the Appellative Division.
[130] 1988 (1) SA 652 at 658.

but not limited to the shareholders.[131] When incorporating 226 it is important to take cognizance of approach by the court in *Bevray Investments (Edms) Bpk v Boland Bank en andere*,[132] wherein Grosskopf JA indicated that:

> "Die bree oogmerk of oogmerk of oogmerke van die bepaling is natuurlik duidelik. Maatskappye bestuur deur direkteure en bestuurders. Hierdie direkteure en bestuurders kan hul bevoegdhede misbruik vir hul eie voordeel. Daarbenewens kan die direkteure of bestuurders van houermaatskappye hulself onbehoorlik bevoordeel deur hul beheer oor fifiaalmatskappye. Die wetgewer wou die moontlikheid van sulke wanpraktyke beperk. Die wetgewer het egter nie hirdie oogmerk prober verwesenlik deur 'n algemene of absolute verbod te plaas op alle transaksies tussen 'n bestuurder of direkteur en 'n betrokke maatskappy waardeur die bestuurder of direkteur bevoordeel kan word nie. Klaarblyklik sou so 'n verbod onprakties wees. Daar moet noodwendig baie omstandighede wees waarin dit nie onbehoorlik is vir 'n derekteur of bestuurder om geldelike voordele te ontvang van die maatskappy wat hy bestuur of wat deur sy maatskappy beheer word nie. Die wetgever het himself dus beperk tot 'n verbod op sekere bepaalde transaksies wat as *prima facie* onaanvaarbaar beskou is nl die maak van sekere lenings en die voorsiening van sekere sekuriteite. Selfs hier is die verbod egter nie absoluut nie – sekere transaksies wat binne die trefwydte van die vebod val, was nogtans vir die wetgeveer onaanvaarbaar. Om vir sulke transaksies voorsiening te maak, bevat subart (2) 'n langerige lys uitsonderings op die verbodsbepalings in subart (1). Die wetgewer se spesifieke oogmerk met art 226 was dus om sekere bepaalde vorms van van geldelike bystand te verbied onderhewig aan bepaaldeuitsonderings. Met die een hand verbied hy; met die ander hand veroorloof hy. Daar was dus nie 'n eenvoudige of ongekwalifiseerde oogmerk wat as toetssteen by die uitleg van die artikel gebruik kan word nie".[133]

4.3 Section 90 of the Companies Amendment Act 37 of 1999

Section 90(1) permit a company to make payment to its shareholders if authorised by its articles (MOI). It is not clear as to whether the authorisation in the articles should specifically refer to the making of payments in terms of section 90 or whether the general power to make payment will be sufficient, but certainly payments out of capital cannot be made if the articles provides that dividends may be paid only out of profits.[134] According to section 90(1) companies are allowed to return share capital to their shareholders by buying back from them.[135] Therefore section 90 abandons common law concept of capital maintenance as well as the principle that dividends

[131] Jooste R "Loans to directors - An analysis of section 226 of the Companies Act" (2000) 12 *SA Merc LJ* 269
[132] 1993 (3) SA 597 (A).
[133] *Idem* at 623.
[134] Van der Linde K "Capital maintenance is dead-Long live solvency and liquidity" (1999) 7 *JBL* 156.
[135] Van der Linde K "A company purchase of its own shares" (1999) 7 *JBL* 68.

may only be paid out of distributable profits.[136] Section 90(2) provides that a company shall not make any payment to its shareholders if there are reasonable grounds for believing that a company is, or would after payment be unable to pay its debts as they become due in the in the ordinary course of business or the consolidated assets of the company fairly valued would after the payment be less that the consolidated liabilities of the company. Van der Linde states that the requirement above must be complied with when the actual payment is made.[137] She further indicate that if the company declared dividends at a stage when it is still solvent and able to pay its debts, it may not pay it over to the shareholders if it has since the date of declaration become insolvent or unable to pay its debts.[138] If the requirements of the liquidity and solvency are not met, the shareholder who received payment will be liable to pay money back to the company.[139] In terms of section 90 payment includes any direct or indirect payment or transfer of money or other property to a shareholder of the company by virtue of the shareholder's shareholding in the company, but excludes an acquisition of shares in terms of section 85, a redemption or redeemable preference shares in section 98, any acquisition of shares in terms of an order of court and the issue of capitalization shares in the company.

4.4 Section 45 of the Companies Act 71 of 2008

In terms of section 45(2) the Board may except to the extent that the MOI provides otherwise, authorise the company to grant loan to, or secure a debt or obligation or otherwise provide direct or indirect financial assistance to the following people subject to section 45(3) and 45(4) of the Act:

- Director or prescribed officer; or
- A director or prescribed officer of the related or inter-related company; or
- A related or inter-related company or corporation;
- Member of a related or inter-related company;
- To a person related to any such company, corporation, director, prescribed officer or member.[140]

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[136] Cassim FHI & Cassim R "The capital maintenance concept and share repurchases in South African law" (2004) http://www.bowman.co.za/LawArticles/Law-Article~id~-639353216.asp
[137] Van der Linde K "Capital maintenance is dead-Long live solvency and liquidity" (1999) 7 *JBL* 156.
[138] *Ibid.*
[139] Section 90(2).
[140] Section 45(2). See Delport P *The New Companies Act Manual* (2011) at 57.

4.4.1 Financial assistance

In terms of section 45(1)(a) financial assistance includes lending of money, guaranteeing a loan or other obligation and securing any debt or obligation. In terms of section 45(1)(b) financial assistance does not include the following:

- Lending money in the ordinary course of business, by a company whose primary business is the lending of money;
- An accountable advance to meet legal expenses in the relation to a matter concerning the company or anticipated expenses to be incurred by the person of the finally;
- An amount to defray the person's expenses for removal at the company's request.

Delport and Vorster indicate that there is clear overlap with section 44 if the financial assistance is to the named persons to subscribe for or purchase securities or options, and the requirements of section 45 are more extensive than that of section 44.[141] They further indicate that financial assistance will include any "direct or indirect" provision of financial assistance.[142]

4.4.2 The requirements of section 45

The Board may not authorise financial assistance unless the following requirements are met:

- The provision of financial assistance is pursuant to an employee scheme that satisfies the requirements of section 97;
- The provision of financial assistance is pursuant to a special resolution;
- The Board is satisfied that immediately after providing financial assistance, the company would satisfy the solvency and liquidity test[143] and the test under which financial assistance is proposed to be given are fair and reasonable to the company.[144]

[141] Delport P & Vorster Q *Henochsberg on the Companies Act 71 of 2008* (2011) at 193.
[142] *Ibid.*
[143] Delport and Vorster states that *the solvency and liquidity test appears to require that the Board must not be satisfied that the company is solvent and liquid, but that it is satisfied that it will comply (satisfy) the test as in section 4, which requires, inter alia, that the solvency and liquidity is based on "reasonably foreseeable circumstances" which is not an absolute test. The "Board is satisfied" means that the particular Board is satisfied, which is a subjective test, but qualified by the objective "reasonably*

Section 45(5) imposes duty upon the Board to ensure that any conditions or restrictions respecting the granting of financial assistance set out in the MOI has been complied with.

4.4.3 Written notice of resolution

If the Board adopts resolution to provide financial assistance in terms of section 45(2), the company must provide written notice of that resolution to all shareholders unless every shareholder is also a director of the company and to any trade union representing its employees. The said notice must be given within 10 business days after the Board has adopted resolution, if the total value of all loans, debts, obligations or assistance in that resolution, together with any previous such resolution during the financial year, exceeds one-tenth of 1% of the company's net worth at the time of resolution or within 30 business days after the end of financial year.[145]

4.4.4 Consequences of non-compliance

A resolution taken by the Board to provide financial assistance in terms of section 45(2) or an agreement with respect to provision any such assistance will be void if it is inconsistent with section 45 or a prohibition, condition or requirements of section 45(4). Section 45(6) provides that if a resolution or agreement is void in terms of section 44(5), a director of company will be liable in terms of section 77(3)(e)(v) if he was present at that meeting when the Board approved the resolution or agreement or participated in the making of such decision in terms of section 74 and failed to vote against such resolution or agreement despite knowing that the provision of financial assistance was inconsistent with section 44 or a prohibition, condition or requirement of

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foreseeable circumstances", Delport P & Vorster Q *Henochsberg on the Companies Act 71 of 2008* (2011) at 195.

[144] Delport submit that should the Board misdirects itself, also in respect of the test that the financial assistance must be 'fair and reasonable' to the company, section 45 is not complied with and the resolution and financial assistance could be void. He further states that this could result in the breach of the fiduciary duties with the liability as in terms section 77. He also indicates that the requirement is that the terms of financial assistance must be fair and reasonable to the company as opposed to the transaction which could be for the benefit of the company. He maintains that the said distinction is important, Delport P *The New Companies Act Manual* (2011) at 57 (n21).

[145] Delport is of the view that giving notice to shareholders is odd as they will be required to pass the special resolution, Delport P *The New Companies Act Manual* (2011) at 57 (n20).

section 45(4). The directors who were present at the meeting and did not vote against the resolution can be held liable only for loss, damage or costs sustained by the company.[146]

4.5 Comparison of section 226, 90 and 45

Section 226 prohibit a company to make loan to any director, managers of the company or its holding company or any other company which is subsidiary of its holding company. Section 90 permit a company to make payments to its shareholders provided that it is solvent and able to pay its debts subject to section 90 and to its disclosure in the financial statement of the company. Section 45 permit the company to provide to provide direct or indirect financial assistance to a related or inter-related company. It broaden the scope of the provision of financial assistance by a company not only to its directors but also to other companies particularly related companies.

4.6 Conclusion

Section 226 prohibited a company to make loans not only to its own directors and managers but also to the directors and managers of the lending company's holding company and any other company which is a subsidiary of its holding company. It is notable that the purpose of section 226 was to prevent the directors and managers to abuse their power to the detriment of the company. Section 90 of Companies Amendment Act permit a company to make payments to its shareholders provided that it is solvent and able to pay its debts subject to section 90 and to its disclosure in the financial statement of the company. Section 45 of the new Act permit a company to provide to provide direct or indirect financial assistance to a related or inter-related company. It is submitted that section 45 broaden the scope of the provision of financial assistance by a company not only to its directors but also to other companies particularly related companies.

[146] Delport P *The New Companies Act Manual* (2011) at 56; Section 77(3)(e)(iv).

CHAPTER 5

ACQUISITION OF SHARE BY A COMPANY OR SUBSIDIARY

5.1 Introduction

Section 48 of the Companies Act 71 of 2008 regulates the acquisition of shares by a company of its own or the acquisition of shares by a subsidiary in its holding company. In particular the acquisition by a company of its own shares is a distribution which must comply with the requirements of section 46 and is affected usually by the Board.[147] Therefore acquisition by the company of its own share must comply with the solvency and liquidity test in terms of section 46. According to section 85 of the old Companies Act, the acquisition by a company of its own share must comply with the requirements of approval by special resolution and authorisation by the company's articles. The purpose of this chapter is to ascertain the difference between section 85 and 48 and further analyses the solvency and liquidity test as required by section 46.

5.2 Section 85 of Companies Amendment Act 37 of 1999

Section 85(1) stipulates that subject to the provision of section 85 and any other applicable law, a company may by means of special resolution if permitted by its articles (MOI) approve the acquisition of shares issued by the company. Section 85(1) places the requirements before acquisition of shares namely special resolution and authorisation by articles (MOI). Section 85(2) provides that such approval of special resolution can be either a general approval or specific approval for a particular acquisition. A general approval shall be valid only until the next annual general meeting of the company, but it may be varied or revoked by special resolution at any general meeting of the company at any time prior to such meeting.[148]

Section 85(4) prohibit a company to make any payment in whatever form to acquire any share by the company if there are reasonable grounds for believing that the company is, or would after the payment be, unable to pay its debts as they become due in the ordinary course of business or the consolidated of the company fairly valued would after the payment be less than the consolidated liabilities of the company.[149] Section 85(9) prohibit a company to acquire shares if

[147] Section 48(2). See Delport P *The New Companies Act Manual* (2011) at 60.
[148] Section 85(3).
[149] Section 86 deals with liability of directors and shareholders under certain circumstances. Section 87 provides for the procedure of acquisition of certain shares by a company. Section 88 deals with

as a result of such acquisition there will no longer be any share other than convertible or redeemable shares.

5.3 Section 48 of the companies Act 71 of 2008

Section 48 regulates the acquisition of shares by a company of its own shares as well as acquisition by subsidiary in holding company. As indicated above the acquisition by a company of its own share is a distribution which must comply with the requirements for section 46.[150] Van der Linde submit that giving of consideration for the acquisition by one company in a group of shares in any other company in the group is a distribution and such acquisition are not regulated by section 48 except where a subsidiary is acquiring shares in its holding company.[151] Delport and Vorster indicate that section 48, is for various reasons, including drafting uncertainties, particularly problematic.[152] They further indicate that section 48 is not intended to provide an exhaustive compilation of the problems or to give definitive answers.[153]

5.3.1 The requirements for distributions

5.3.1.1 Authorisation by the Board

A company is prohibited to make any proposed distribution unless the distribution is authorised by the Board of a company by resolution[154] or is pursuant to an existing legal obligation of the company or a court order,[155] and it reasonably appears that the company will satisfy the

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enforceability of contracts for acquisition of certain shares by company. Section 89 permit subsidiaries to acquire certain shares in holding company.

[150] Delport expresses the view that *an acquisition in terms of a shareholder's dissenting rights is not subject to the requirements of section 48, nor is a redemption by the company of any redeemable securities in accordance with the terms and conditions of those securities (s 48(1). Section 37(5)(b) provides expressly that redeemable shares are subject to section 48. Redemption of securities other than shares should not be covered by section 48, but the exclusion of redeemable shares (as species of 'securities') seems to be an unwarranted exclusion which is open to abuse, as section 35(4) states that shares acquired by the company cease to exist. The effect on solvency and liquidity is patent*, Delport P *The New Companies Act Manual* (2011) at 60 (n40).

[151] Van der Linde K "The regulation of distributions to shareholders in the Companies Act 2008" (2009) 3 *TSAR* 484 at 487, 488.

[152] Delport P & Vorster Q *Henochsberg on the Companies Act 71 of 2008* (2011) at 200.

[153] *Ibid.*

[154] Section 46(1)(a)(ii).

[155] Section 46(1)(a)(i).

solvency and liquidity test immediately after completing the proposed distribution.[156] It is therefore evident that a company that acquires shares for consideration has to comply with section 48 as well as the requirements of distributions in section 46.[157]

5.3.1.2 Solvency and liquidity

Section 46(1)(c) permit the company to make distribution if the Board of a company by means of resolution has acknowledged that that it has applied the solvency and liquidity test and reasonably concluded that the company will satisfy the solvency and liquidity test immediately after completing the proposed distribution. If distribution has not been completed in 120 business days after the Board has made acknowledgement in terms of section 46(1)(c) or after a fresh acknowledgement, the Board must reconsider the solvency and liquidity with respect to the remaining distribution to be made pursuant to the original resolution order or obligation and the company must not proceed with or continue with any such distribution unless the Board adopts a further resolution as indicated in section 46(1)(c).

5.3.1.3 Financial restrictions

It stands to reason that compliance with solvency and liquidity test is required for all distributions. Therefore the test is divided into solvency and liquidity of which both must be satisfied immediately after the distribution is complied with.

[156] Section 46(1)(b).

[157] Van der Linde states that *unfortunately section 48 contains an unnecessary and confusing cross-reference to section 46 by requiring that the 'decision' to acquire shares should satisfy the requirements of section 46. Section 46 states the requirements for 'distributions' as such and not for 'decisions'. In fact, two of the requirements are decisions or resolutions in their own right. It is thus unclear whether a separate decision to acquire shares is envisaged or whether the 'decision' refers the authorization of the distribution by the Board under clause 46. The impression is created that, in contrast with any other resolution under clause 46 to make a distribution, a repurchase resolution can be taken only if the company is solvent and liquid at the time of the resolution. But a decision is unlikely to have any effect on a company's solvency and liquidity and the requirements as to an acknowledgement (and especially consideration of the solvency and liquidity test and a subsequent acknowledgement under 120-days rule) will usually follow rather than precede to acquire shares. It is contrary to the scheme of the Act to require compliance with the solvency and liquidity requirements at the time of the decision to acquire shares rather than at the time of completion of the distribution. If the intention is to deviate from this general principle and require an additional consideration of solvency and liquidity, this should be stated clearly.* She therefore submit that *uncertainty can be removed by doing away with the reference in section 48 to section 46 or alternatively by substituting 'payment of any consideration' for the current' decision*, Van der Linde K "The regulation of distributions to shareholders in the Companies Act 2008" (2009) 3 *TSAR* 484 at 492,493.

It should be noted that section 48(2) authorises the company to acquire its own shares subject to section 48(3) and 48(8) and if the decision to do so satisfies the requirements of section 46. Section 48(2)(b) also permit subsidiary to acquire shares of its holding company but 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 subsidiaries of the company and no voting rights attached to those shares may be exercised while the shares are held by subsidiary. A company or subsidiary acquiring shares should also comply with the above requirements for distribution. Delport indicate that as long as such subsidiaries remain subsidiaries, no voting rights attached to those shares may be exercised in respect of the shares held.[158] He further state that this has the effect on the percentage shareholding of other shareholders, but it is not addressed in this section.[159] He provide the following example "if A holds ten shares out of one hundred issued shares and a subsidiary acquires ten of the remaining shares, A will now have 11% of the votes instead of the previous 10%".[160] He further indicate that "the existing problem with the subsidiary acquiring its own share other than in terms of the Act, by for example a dividend *in specie* declared by the holding company, is also not addressed".[161] Section 48(3) stipulates that subject to the MOI, provision of any law, agreement or order, a company and subsidiary may not acquire shares of that company if there will no longer be any shares of the company issue other than shares held by one or more subsidiaries of the company or convertible or redeemable shares.

5.4 Enforceability of contract to acquire shares

An agreement with a company providing financial assistance for the acquisition by the company of shares issued by it, is enforceable against the company subject to the provision of section 48(2) and 48(3). It appears that non-compliance of any of the requirements for repurchase, including but not limited to those in section 48(3) will render the contract unenforceable.[162] It is submitted that this is a departure from section 88(1) of the old Companies Act where non-enforcement with the solvency and liquidity requirement is the only basis for unenforceability.

[158] Delport P *The New Companies Act Manual* (2011) at 60.
[159] Delport P *The New Companies Act Manual* (2011) at 60 (n44).
[160] *Ibid.*
[161] *Ibid.*
[162] Van der Linde K "The regulation of distributions to shareholders in the Companies Act 2008" (2009) 3 *TSAR* 484 at 494.

5.5 Court order

If a company alleges that as a result of acquisition of its own share or acquisition of share by subsidiary to its holding company it is unable to fulfill its obligation in terms of the agreement for acquisition of share, the company must apply to a court for order.[163] If the court is satisfied that the company is prevented from fulfilling its obligation pursuant to an agreement it may make an order that-

- Is just and equitable, having regard to the financial circumstances of the company; and
- 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 compatible with the company satisfying its other financial obligations as they fall due and payable.

5.6 Acquisition of share contrary to section 46 or 48

According to section 48(6) a company that acquires shares in contravention of section 46 or 48, it must not more than 2 years after the acquisition, apply to a court for an order reversing the acquisition. The court may order:

- The person from whom the shares were acquired to return the amount paid by the company; and
- The company to issue that person an equivalent number of shares of the same class as those acquired.

Delport indicate that the *bona fide* third party could be prejudiced by the said reversal if he does not have the capital to pay back.[164] He further indicate that besides ascertaining if there are restrictions in the MOI, the third party cannot ascertain whether the other requirements such as solvency and liquidity under section 46 have been complied with.[165] He submit that the internal requirements could be covered under the modified *Turquand* rule and/or section 20(7)-(8).[166] Delport and Vorster submit that section 48(6) raises three issues that may be problematic.[167] They indicate that *in the first instance it implies that the shares will have been reacquired for*

[163] Section 48(5)(a).
[164] Delport P *The New Companies Act Manual* (2011) at 61 (n49).
[165] *Ibid.*
[166] *Ibid.*
[167] Delport P & Vorster Q *Henochsberg on the Companies Act 71 of 2008* (2011) at 202, 203.

cash. Returning assets which may not exist anymore may be impossible. Secondly, the actions by the company and the previous shareholder obviously can only apply in respect of shares acquired by the company, and not those acquired by the subsidiary in the holding company, but section 48(6) expressly makes it applicable to both situations by a reference to (the whole of) section 48. Thirdly, it should be noted that the action is taken by the Board and that the shareholder whose shares are acquired is not privy to the information about the solvency and liquidity of the company or any other internal (board) matters.[168]

5.7 Liability for unlawful acquisition of share / Directors liability

In terms of section 48(7) a director of a company will be liable to the extent set out in section 77(3)(e)(vii) if he was present at the meeting when the Board approved an acquisition of shares or participated in the making of such a decision in accordance with section 74 and failed to vote against the acquisition of shares, despite knowing that the acquisition was contrary to section 46 or 48. According to section 46(6) a director will be liable to the extent set out in the section 77(3)(e)(vi) if he was present at the meeting when the Board approved distribution or participated in the making of such decision in terms of section 74 and failed to vote against the distribution, despite knowing that the distribution was contrary to section 46. Van der Linde states that this implies that either section 77(3)(e)(vi) or section 77(3)(e)(vii) could be used when a company makes a distribution with regard to acquisition of shares contrary to the distribution requirements because "distribution" and an "acquisition of shares" are involved.[169]

5.8 Section 85 and 48

As indicated above, acquisition by a company of its own share in terms of section 85 must comply with the requirements of approval by a special resolution and authorisation by the articles. In terms of section 48 acquisition by a company of its own share and acquisition of share by a subsidiary in its holding company needs to comply with distribution in section 46 which also includes the satisfaction of solvency and liquidity test. It is therefore submitted that section 48 requires the compliance with section 46 (distribution) whereas section 85 requires

[168] *Ibid.*
[169] Van der Linde K "The regulation of distributions to shareholders in the Companies Act 2008" (2009) 3 *TSAR* 484 at 495.

approval by a special resolution and authorisation by the articles. It therefore stands to reason that section 48 imposes less requirements than section 85.

5.9 Solvency and liquidity test

Measures have been taken to safeguard creditors and minority shareholders of a company by requiring the directors not to make any proposed distributions unless it reasonably appears that the company will satisfy the solvency and liquidity test immediately after completing the proposed distribution.[170] The test for solvency and liquidity restricts the funds available for a repurchase of shares to the net assets of the company. This tests must also be satisfied immediately after providing financial assistance in terms of section 44.[171]

Section 4(1) stipulates that the company satisfies solvency and liquidity test at a particular time if considering all reasonably foreseeable financial circumstances of the company at that time, the assets of the company as fairly valued equal or exceed the liability of the company and it appears that the company will be able to pay its debts as they become due in the ordinary course of business for the period of 12 months from the date on which the test is considered or in the case of distribution 12 months following that distribution. Therefore financial assistance to be considered by the company must be based on accounting records that satisfies the requirements of section 28, and financial statements that satisfy the requirements of section 29.

Van der Linde states that the test imposes an objective rather than a subjective test.[172] She indicates that the determining factor is the existence of reason or ground upon which a conclusion could reasonably be reached. She further indicate that a resolution by the board that it has "reasonably concluded" that the company will satisfy the test is set as an additional requirement in certain instances. Delport is of the view that the test in respect of solvency is objective as well as subjective in that it appears that it will remain liquid for the following 12 months.[173] Cassim *et al* states that an analogy can perhaps be drawn with test as to whether a

[170] Section 46(1)(b).
[171] See chapter 3.
[172] Van der Linde K "The solvency and liquidity approach in the Companies Act 2008" (2009) 2 *TSAR* 224 at 235.
[173] Delport P *The New Companies Act Manual* (2011) at 54. See also Delport P & Vorster Q *Henochsberg on the Companies Act 71 of 2008* (2011) at 191 in which they further indicate that the word "Board is satisfied" is subjective test, but qualified by the objective "reasonably foreseeable circumstances" in section 4.

director has acted with due care and diligence in particular respect.[174] In this regard they refers to section 76(3)(c)(ii) in which they concludes by stating that the test in this regard is purely objective. They also indicated that if the legislature intended that the subjective factors should be taken into account, it would have said so.[175]

With regard to the requirement for the consideration of all reasonably foreseeable financial circumstances as indicated in section 4, Van der Linde submit that this involve a measure of prediction. She states that "this requirements, which fits in well with the liquidity element that necessarily involves a forecast, is not appropriate for the solvency element.[176] The solvency element does not state that it should 'appear' that the assets 'will' exceed the liabilities but is formulated objectively with reference to a particular point in time".[177] She finally indicates that "it would have been preferable to insert the reference to reasonably foreseeable circumstances in these provisions rather than the main solvency test".[178] With regard to the meaning of the aggregate Van der Linde opines that the drafters intended to refer to the aggregate assets of the group, rather than that of the company.[179]

In sum, the liquidity and solvency test appears to be different in the Companies Amendment Act of 1999 and the new Act. The Companies Amendment Act of 1999 imposes negative duty on the company and its Board whereas in the new Act the Board has a positive duty to consider the test.[180] Van der Linde argues that with regard to *distribution, the Board has to adopt a resolution acknowledging that it has applied the test and concluded that that the company will satisfy it.*[181] In terms of Companies Amendment Act of 1999, the solvency test must be complied with subsequent to the transaction and liquidity test must be met before providing financial assistance and for the duration of the transaction whereas, the new Act provide that the test must be met 12 months after the date in which the test is considered.[182]

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[174] Cassim *et al Contemporary Company Law* (2012) at 273.
[175] *Idem* 250.
[176] Van der Linde K "The solvency and liquidity approach in the Companies Act 2008" (2009) 2 *TSAR* 224 at 227.
[177] *Ibid.*
[178] *Ibid.*
[179] *Ibid.*
[180] Van der Linde K "The solvency and liquidity approach in the Companies Act 2008" (2009) 2 *TSAR* 224 at 237.
[181] *Ibid.*
[182] Section 4(b)(i).

5.10 Conclusion

It is evident from section 48(2) that acquisition by a company of its own shares is a distribution which must comply with the requirements of section 46 (distribution). Section 85 old Act places the requirement before the acquisition namely special resolution and Authorisation by the articles. It is notable that section 46 stipulates the requirements for distribution namely, authorisation by the Board, compliance with liquidity and solvency tests as well as financial restrictions. It is submitted that section 48 imposes less requirements than section 85. The most serious problem with the new Act is the reference to section 46 (distribution) and the writer hereof agree with Delport and Vorster that section 48 is for various reasons, including drafting uncertainties, particularly problematic.

CHAPTER 6

CONCLUSION

It is evident from the research that capital rules which were developed to protect creditors and both present and future directors was to a large extent abolished by the Companies Amendment Act 37 of 1999, and later the new Act. The doctrine of capital maintenance was part of South African Company law and later entrenched in the Companies Act 61 of 1973. According to the doctrine, a company may not issue share at discount to their par value,[183] a company may not purchase its own shares[184] and dividends may not be paid out of share capital.[185] The capital maintenance was regarded as imperfect system to protect the interest of the creditors. The writer is in favour of the view expressed by some authors that capital maintenance rules are not unnecessarily complex and riddled with obscurities, but worse still many of these rules have outlined their usefulness.[186] What is interesting is that the Companies Amendment Act of 1999 allow a company to make payments even out of capital, or pay dividends out of capital or to return capital to its members provided that the company is authorised by its article (Memorandum of Incorporation). The Companies Amendment Act also permits subsidiary companies to acquire shares in its holding company to maximum of 10 per cent in the aggregate of the number of issued shares of the holding company. As indicated earlier the legislature failed to remove the prohibition in 1999 and only incorporated the solvency and liquidity test. Section 44 of the new Act permit a company to provide financial assistance for the acquisition of or subscription of company's securities. It further provides for financial assistance for the purpose of buying shares not only in the holding company, but also in a subsidiary (or related company).[187] The new Act is wholly based on solvency and liquidity and any remnant of the capital maintenance on which the old Act was based is now removed.

Section 38(2)(b) was subject to interpretation and the writer agree with the authors that it is unclear,[188] containing curious exception[189] and because of uncertainties is virtually useless.[190]

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[183] *Ooregum Gold Mining Company of India v Roper* (1892) AC 125.
[184] *Trevor v Whitworth* (1887) 12 App Cas 409 (HL).
[185] *Guinness v Land Corporation of Ireland* (1882) 22 Ch D349 at 356.
[186] Cassim FHI "The reform of company law and the capital maintenance concept" (2005) 283 *SALJ* at 284.
[187] *Idem* 27.
[188] Blackman *et al Commentary on the Companies Act* (2002) Act vol 1 para 4-66.
[189] Cilliers *et al Cilliers and Benade Corporate Law* (2000) at 330 (n52).
[190] Delport PA "Company groups and the acquisition of shares" (2001) *13 SA Merc LJ* 121 at 125-126.

For the company to provide financial assistance in terms of the new Act, the MOI must permit the company to provide such financial assistance, secondly the Board may not authorise any financial assistance unless the particular provision of the financial assistance is pursuant either to an employee share scheme that satisfies the requirements of section 97 or to a special resolution of the shareholders adopted with the previous two years, and thirdly the Board must be satisfied that immediately after providing financial assistance, the company would satisfy the solvency and liquidity test. In light of the above the writer agree with Delport that the word "Board may authorise the company" to provide financial assistance as indicated in section 44(3) appears to be incorrect and the correct construction should be "the company that authorises the Board" to provide financial assistance.[191]

The test for solvency and liquidity restricts the funds available for a repurchase of shares to the net assets of the company. This test must also be satisfied immediately after providing financial assistance in terms of section 44.

Section 226 which prohibited a company to make loans not only to its own directors and managers but also to the directors and managers of the lending company's holding company and any other company which is a subsidiary of its holding company was amended by section 90 of the Companies Amendment Act. Section 90 permit a company to make payments to its shareholders provided that it is solvent and able to pay its debts subject to section 90 and to its disclosure in the financial statement of the company. According to section 45 of the new Act a company is permitted to provide direct or indirect financial assistance to a related or inter-related company. It is therefore submitted that section 45 broaden the scope of the provision of financial assistance by a company not only to its directors but also to other companies particularly related companies.

More pertinently section 48(2) provides that acquisition by a company of its own shares is a distribution which must comply with the requirements of section 46 (distribution). Section 85 of the old Act stipulates the requirement before the acquisition namely special resolution and Authorization by the articles, whereas section 46 stipulates the requirements for distribution namely, authorisation by the Board, compliance with liquidity and solvency tests as well as financial restrictions. It is therefore submitted that section 48 imposes less requirements than section 85. It is further submitted that serious problem with the new Act, particularly section 48

[191] Section 44(3); Delport P *The New Companies Act Manual* (2011) at 54 (n6).

is the reference to section 46 (distribution) and the writer hereof agree with Delport and Vorster that section 48 is for various reasons, including drafting uncertainties, particularly problematic.

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