DEPARTMENT OF MERCANTILE LAW

Forms of Business Enterprise

Study guide for FBE2604

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Preface

INTRODUCTION

This study guide forms an important part of your study material. It is extremely important that you use this study guide because it

- contains the notes that you will require to study for the examination
- places additional information in tutorial letters in context
- explains difficult concepts
- provides practical exercises to assist you in your preparation for the examination

WHAT THIS MODULE IS ALL ABOUT

In this module you will learn about the main South African business forms, namely companies, close corporations, partnerships and trusts. You will see that each business form has its own particular requirements in terms of membership and the way in which it is constituted. There are also very specific consequences attached to each business form.

Every would-be entrepreneur needs to consider the advantages and disadvantages of the various business forms in order to decide which one will best suit the commercial needs of the specific business he or she has in mind. In this module you will learn how to advise such a person, taking into account the relevant legislative provisions, the common-law principles and appropriate case law.

The focus is on profit-oriented businesses. You will be exposed to the law applicable to companies, close corporations, partnerships and trusts.

On completion of this module, you should have acquired sufficient background knowledge of the legal principles governing the main business forms in South Africa. In addition, you should be able to apply the legal principles and solve practical problems that may arise within the context of these business forms. As a law student, it is imperative that you be able to research a topic, analyse material and formulate logical legal arguments. Although you are not expected to access and read cases for this module, learning how to do so will enable you to be effective in your career

HOW TO USE THIS STUDY GUIDE

This study guide includes a discussion of the legislation and some excerpts from and references to cases. You are required to know and be able to refer to the legislation and case law only to the extent that it is discussed in this study guide. You are therefore not expected to access all the legislation and case law that is discussed herein. However, because it is advisable that you start learning how to access cases (for the benefit of your future career), we have indicated a few important cases that you **must** access and read. Please try your best to access these cases and read them. In this module, we would like you to benefit by learning how to access legal resources with more confidence. We also wish to teach you an essential skill, that is, how to read legal material properly.

Activities have been included in the study guide. You should attempt to do the relevant activity after you have studied all the prescribed work in the particular study unit. We suggest that you write your answers to each activity in a notebook so that when you revise the work, you have all the answers at hand. The activities are very important. The examination questions will be similar to these questions. By attempting to answer the activities, you can identify problem areas in your understanding of the study material.

Feedback is provided after each activity. Please note that the feedback provides only guidelines for how to approach the specific question asked in the activity; the feedback is not a model answer to the question. If you do not agree with the feedback provided, please contact a lecturer to discuss it.

HOW TO FIND LEGAL MATERIAL

There are various resources available to enable you to gain access to legal material. Obviously, the law library caters specifically for this and there are library assistants available to help you, if necessary. If you do not have access to the library, the internet provides access to a number of very useful websites, including the following:

- http://heinonline.org/ (journal articles)
- http://www.saflii.org/content/south-africa-index (case law)
- The Companies Act 71 of 2008, Close Corporations Act 69 of 1984 and other legislation referred to can be downloaded from www.gov.za. Choose the "Documents" icon and then "Acts".
- Various forms applicable to the different business forms covered in the module are accessible at http://www.cipc.co.za/.

WHY DO YOU NEED TO READ CASE LAW?

Although you are not expected to access and read all the case law for this module, we believe that it is essential that you know how to read cases so that you can be effective in your career. This will also make the law "come alive", since case law is the application of legislation. If you understand the court's reasoning on the judgments, you should be able to apply the law to practical problems. The more case law you read, the easier it will become to make sense of it. You will thus become aware of the relevant issues and the basis for the court's decision more quickly. You will also be able to apply the law to facts, much like a judge would do in a court case.

When reading case law, it will become apparent that many cases deal with more than one aspect of the law. This is also common in practice. Reading case law will make this clear to you. You will thus be capable of identifying various possible topics within a single set of facts.

The best way to test your knowledge is to think of practical scenarios and then apply the law to them; and the best source of practical scenarios is case law.

In this module we have summarised the principles that you need to study. However, it is very important that you be able to access the information yourself. When you do research on a specific legal topic, you always need to refer to relevant legislation first. This will be your main source. But to see how the legislation has been applied, you should investigate case law.

BASIC GUIDELINES FOR THE EFFECTIVE STUDY OF CASE LAW

(1) Read the entire case.
(2) Identify the main issues (there is usually more than one topic covered in a case). You need to investigate each issue by following the guidelines below.
(3) Consider the relevant legislation, the common law and – possibly – the influence of the Constitution of the Republic of South Africa, 1996 on each topic. Determine what the relevant legislation is by answering the following questions:
   (a) Which facts did the court consider as relevant in the decision dealing with this specific aspect?

(b) Which common-law principles (if any) and legislative principles did the court consider in making the decision? (The court may consider the common law, legislation and international law.)
(c) Why did the court apply these sources (as mentioned in (b))?
(d) How did the court apply the sources in (b) to the issues you identified in (a)?
(e) Did the court apply the sources in (b) correctly to the issues identified in (a)?
(f) If not, why not? Here you may substantiate your answer by referring to similar relevant case law.

(4) Study the facts so that you understand how the law was interpreted and applied to the specific set of facts.
(5) Read the decision carefully so that you understand the presiding officer's reasoning on (rationale for) the decision. The decision is the justification for the interpretation of the relevant legal principle. It is important that you understand the *ratio decidendi* (reason/ground for the decision), as it forms the basis of the argument you would use in answering a factual problem.

We trust that you will enjoy studying this module and that you will benefit greatly from the knowledge you gain.

PART 1

Companies

Contents

IMPORTANT SECTIONS OF LEGISLATION FOR THIS PART

PLEASE NOTE THAT YOU ARE NOT EXPECTED TO ACCESS THESE SECTIONS FROM THE COMPANIES ACT AND THE CLOSE CORPORATIONS ACT. YOU SIMPLY HAVE TO UNDERSTAND THEM AS DISCUSSED HEREIN.

COMPANIES ACT 71 OF 2008:

Section 1 – Definitions
Section 4 – Solvency and liquidity test
Section 7 – Purposes of the Act
Section 8 – Categories of companies
Section 13 – Right to incorporate a company
Section 14 – Registration of a company
Section 15 – Memorandum of incorporation, shareholder agreements and rules of company
Section 16 – Amending the memorandum of incorporation
Section 19(1) – Legal status of companies
Section 19(3) – Personal liability companies

Section 19(4) – Abolishing doctrine of constructive notice and exceptions
Section 20 – Validity of company actions
Section 20(7) – Statutory presumption of compliance with formal and procedural requirements
Section 20(9) – Abuse of juristic personality
Section 21 – Pre-incorporation contracts
Section 38 – Issuing shares
Section 44 – Financial assistance for subscription of securities
Section 46 – Distributions must be authorised by board
Section 48 – Acquisition of company's own shares
Section 57 – Expanded definition of "shareholder" for purposes of Part F of Chapter 2
Section 58 – Shareholder right to be represented by proxy
Section 60 – Shareholders acting other than at meeting
Section 61 – Shareholders' meetings
Section 62 – Notice of meetings
Section 64 – Meeting quorum and adjournment
Section 65 – Shareholder resolutions
Section 66(7) – Consent to serve as a director required for appointment
Section 67 – First director or directors
Section 69 – Ineligibility and disqualification of persons to be director or prescribed officer
Section 71 – Removal of directors
Section 76 – Standards of directors' conduct
Section 76(4) – Business judgment rule
Section 77 – Liability of directors and prescribed officers
Section 78 – Indemnification and directors' insurance
Section 90 – Appointment of auditor
Section 91 – Resignation of auditors and vacancies
Section 92 – Rotation of auditors
Section 93 – Rights and restricted functions of auditors
Section 94 – Audit committees
Section 158 – Remedies to promote purpose of Act
Section 160 – Disputes concerning reservation or registration of company names
Section 161 – Application to protect rights of securities holders
Section 162 – Application to declare director delinquent or under probation
Section 163 – Relief from oppressive or prejudicial conduct
Section 164 – Dissenting shareholders appraisal rights
Section 165 – Derivative actions
Section 166 – Alternative dispute resolution
Schedule 1 – Non-profit companies
Schedule 2 – Conversion of close corporations to companies

CLOSE CORPORATIONS ACT 69 OF 1984:
Section 65 – Abuse of separate juristic personality of corporation

ALL THE CASES IN THIS STUDY UNIT SHOULD BE STUDIED, AS DISCUSSED HEREIN.

IN ADDITION TO THE SELF-ASSESSMENT QUESTIONS AT THE BEGINNING OF EACH STUDY UNIT, YOU MUST DO ALL THE ACTIVITIES IN EACH STUDY UNIT.

INTRODUCTION

The Companies Act 71 of 2008, as amended by the Companies Amendment Act 3 of 2011 (hereinafter the "Companies Act") came into force on 1 May 2011. It repealed and replaced the Companies Act 61 of 1973, except for Chapter 14 of the Companies Act of 1973, which will continue to regulate the winding-up of insolvent companies. (The winding-up of companies is not included in the prescribed work for this module.)

In this part, we deal only with the provisions of the Companies Act and not its predecessor. Some principles of our common law, which will continue to apply in so far as the principles are not repealed by the Companies Act, will also be discussed. Our common law is featured mainly in decided cases of the High Court, the Supreme Court of Appeal and the Constitutional Court. The Companies Act is not a complete codification of our company law. Although the common law will continue to develop under the Companies Act, some important concepts have already been clarified by our courts.

Study unit 1

Legal personality and lifting the corporate veil

Contents

Introduction

In this study unit we will consider the main benefit associated with companies as a business form, namely legal personality.

Laypersons often misunderstand the concept of juristic or legal personality. Hopefully, once you have completed this study unit, you will not think that "a legal person" refers to an attorney or an advocate!

You will know that you understand this study unit if you are able to answer the following key questions:

- What is legal personality? What are its implications for shareholders?
- What does lifting the corporate veil entail? What is its purpose and under what circumstances can it occur?
- Do the branches, divisions and units of a company have their own separate legal personality?

1.1 Legal personality

You need only know the cases referred to, as they are discussed herein.

Important terms:	**Meaning:**
Legal personality	Also known as juristic personality. To be acknowledged in law as a person or bearer of its own rights, with liability for its own debts.
Incorporation	Formation of a company through registration with the Companies and Intellectual Property Commission.
Lifting or piercing the corporate veil	A process used to ignore a company's separate legal personality in order to hold persons inside the company personally liable.

One important aspect that appeals to businesspeople in forming a corporation (company) is the principle of legal personality, which provides for the limitation of their liability. Section 8(3) of the

Companies Act determines that no association of persons formed for the purpose of the acquisition of gain (i.e. to make a profit) will be recognised as a legal person unless it is registered as a company under this Act or formed in terms of another Act.

The registration or incorporation of a company (by the issuance of a registration certificate) confers legal personality upon the new entity. This means that the new entity can acquire its own rights and duties, separate from its shareholders or members. It can enter into contracts in its own name and sue and be sued. Its shareholders or members are not liable for its debts and thus they enjoy limited liability.

In *Salomon v Salomon & Co Ltd* [1897] AC 22 (HL), it was held that the principle of separate legal personality has the following implications:

- The estate of the company is assessed apart from the estates of the individual shareholders or members.
- The debts of the company are the company's debts and are separate from those of its shareholders or members, who thus have limited liability.
- Shares in a company entitle holders to certain interests in the company. However, the profits of the company belong to the company and not to its shareholders, and only after the company has declared a dividend may the shareholders claim that dividend.
- The assets of the company are its exclusive property; the shareholders have no proportionate proprietary rights therein.
- No one is qualified by virtue of his or her shareholding or membership to act on behalf of the company. Only those who are appointed as representatives of the company in accordance with the articles can bind the company. Managerial and executive powers are to be exercised by directors.
- Where a company is wronged, the company must itself seek redress.

From later case law, it is evident that the courts acknowledge the importance of distinguishing between companies and their shareholders *(Dadoo Ltd and others v Krugersdorp Municipality Council* 1920 AD 530).

Joubert AJA, in *Ngcwase v Terblanche* at 803 H, held that a corporation is "a statutory juristic person *(persona juris)* ... in law considered to be an abstract legal entity which exists as a juristic reality in the contemplation of law despite the fact that it lacks physical existence".

Our courts have also recognised that a juristic person has the right to a reputation, good name and fame *(Dhlomo v Natal Newspapers (Pty) Ltd* 1989 (1) SA 945 (A)*)*. Companies also enjoy the right to privacy *(Financial Mail (Pty) Ltd v Sage Holdings Ltd* 1993 (2) SA 451*)* and identity *(Universiteit van Pretoria v Tommie Meyer Films* 1979 (1) SA 441).

Access and read the following case:

Manong & Associates (Pty) Ltd v City Manager, City of Cape Town and another 2009 (1) SA 644 (EqC).

The Constitution of the Republic of South Africa, 1996 (hereinafter "the Constitution") vests a juristic person with the rights in the Bill of Rights (Chapter 2) to the extent required by the nature of the rights and the nature of the juristic person. In this case, it was held that a juristic person, like a natural person, could enjoy the right to equality.

Against the backdrop of the Constitution, it is acknowledged that corporations enjoy most of the rights that natural persons enjoy. A juristic person is likewise bound by the duties and obligations flowing from such rights. Separate legal personality ceases when a company is dissolved and deregistered after winding-up.

Legal personality of branches and divisions

A modern company usually operates through various divisions, which – although having a single controlling mind or board – might, in some cases, even compete with one another. Therefore, questions of their separate legal personality might legitimately be raised.

However, if such branches and divisions are not registered entities themselves, but merely operate separately for practical purposes, they do not – for purposes of law – have their own separate legal personality. The branches or divisions of a company are part of the company itself and do not have their own separate legal existence.

1.2 Disregarding separate juristic personality

You need only know the case law, as discussed hereunder.

The exclusion of liability of persons inside business enterprises is not an absolute right. In certain circumstances it is possible to ignore the separation created between companies and their controllers. Likewise, in close corporations, the separate existence of the business can, in certain instances, be ignored so as to hold members personally liable. This can be done in two ways: either in terms of the common-law principle that has been developed in the case law (piercing the corporate veil) or by means of the statutory provisions (section 20(9) of the Companies Act, for purposes of companies, and section 65 of the Close Corporations Act, for close corporations).

Courts have made it clear that they will not allow the use of any legal entity to justify wrong, to conceal fraud or to defend or hide crime. In such cases, the courts may pierce or lift the corporate veil and hold directors and others personally liable for acts committed in the name of the company.

However, to preserve the integrity of the principle of legal personality, the courts have said that they will pierce or lift the corporate veil only in exceptional circumstances, namely where there is no alternative remedy available and piercing the corporate veil will prevent an injustice.

In *Cape Pacific v Lubner Controlling Investments (Pty) Ltd and others* 1995 (4) SA 790 (A), the concept of piercing the corporate veil was described as disregarding the dichotomy between a company and the natural person behind it who controls its activities, and attributing liability to a person who misused or abused the principle of corporate personality. In other words, the reality of the circumstances and substance, rather than the form, must prevail. This measure is used in exceptional circumstances where there is evidence of fraud, dishonesty or improper conduct.

The courts are reluctant to lift the corporate veil as it ignores the concept of separate legal personality and the consequences attached thereto. The court does not have a general discretion to disregard a company's separate existence. A factual investigation must be done in each case to decide whether it would be appropriate to lift the corporate veil. The process involves a balancing of public policy considerations and the importance of the need to preserve the separate corporate identity.

The company need not have been established and run fraudulently or deceitfully for the full course of its existence to justify piercing the corporate veil. If its separate legal personality is abused in a particular instance, then this separate legal personality may be disregarded for purposes of the transaction in question, while still giving effect to its separate legal personality for other purposes.

In *Botha v Van Niekerk & another* 1983 (3) SA 513, a test to determine when the corporate veil should be disregarded was formulated. It was held that only circumstances of an "unconscionable injustice" would result in the court's piercing the corporate veil.

In *Cape Pacific* (supra), this test was held to be too rigid. A more flexible approach was propagated, namely to take the facts of each case into consideration to determine whether or not it is appropriate to pierce the corporate veil. In *Hülse-Reutter v Gödde* 2001 (4) SA 1336 (SCA), the court also held that it has no general discretion simply to disregard a company's separate legal personality.

The corporate veil would be lifted only if there was evidence of misuse or abuse of the distinction between the company and those who control it, and that this enabled those who control the company to gain an unfair advantage (a dual test was introduced by adding the element of unfair advantage). The court further confirmed that much depended on a close analysis of the facts of each case and considerations of policy.

Although piercing the corporate veil is an exceptional remedy in the sense that the courts do not have a general discretion to hold individuals personally liable, this remedy is not necessarily a remedy of last resort. Even if other remedies exist, a person can choose to apply to a court to pierce the corporate veil, despite the other remedies at his or her disposal. However, the existence of another remedy, or the failure to pursue one that was available, may be a relevant factor when policy considerations come into play.

The requirements of company law and close corporations law for the piercing of the corporate veil are similar. Section 20 (9) follows the example of the Close Corporations Act by codifying the general principle of piercing the corporate veil. Section 20(9) of the Companies Act provides that if a court finds that the incorporation of a company or any act by or use of a company constitutes an unconscionable abuse of its juristic personality, the court may declare that the company will be deemed not to be a juristic person in respect of rights, liabilities and obligations relating to the abuse.

The wording is a combination of section 65 of the Close Corporations Act and the judgment in *Botha v Van Niekerk*. It ignores the view expressed in *Cape Pacific Ltd v Lubner Controlling Investments (Pty) Ltd,* which described the test in *Botha v Van Niekerk* as being too rigid.

The first case regarding the interpretation to be given to section 20(9) of the Companies Act was *Ex parte Gore NO* [2013] 2 All SA 437 (WCC), which dealt with a group of companies that was being run as if it were a single company. No distinction was made between the business and finances of the different companies in the group. The court decided that an "unconscionable abuse" – as required in terms of section 20(9) – was not as stringent a requirement as a "gross abuse" – as is needed in terms of section 65 of the Close Corporations Act. The court's view was that the interpretation to be given should be sufficiently wide so as to include "a sham" or "a device". "A sham" or "a device" is where a company is used solely as a vehicle/instrument (the "sham" or "device") for fraudulent, dishonest and improper conduct, and is not being operated as a bona fide company. In the court's opinion, there was no indication that section 20 (9) had to be regarded as a remedy of last resort. In other words, the remedy is available to applicants despite the existence of other legal remedies. Finally, the court held that section 20(9) does not have the effect of nullifying the operation of the common-law principle of piercing the corporate veil. Instead, it supplements the doctrine, and the case law that has been developed (as discussed above) should be used as a guideline by courts when applying the statutory principle.

ACTIVITY 1.1

In 2005, Pat and Tracy Morgan established NetMedia (Pty) Ltd, which offered internet-based news until June 2011, when the company was liquidated as a result of its inability to pay its creditors. During the winding-up of the company, the liquidator discovered that Mr and Mrs Morgan, the only shareholders and directors of NetMedia (Pty) Ltd, had made a loan of R10 million to the company as a start-up cash injection. This loan was secured by a mortgage bond over the immovable property owned by NetMedia. The liquidator argued that there was no real distinction in law between the Morgans and NetMedia (Pty) Ltd and, consequently, the proceeds of the sale of the company's assets must be utilised to settle all debts owed by the company to its other ordinary creditors. Mr and Mrs Morgan believed that NetMedia (Pty) Ltd's separate legal identity entitled them to have their secured claim against the company settled first and vowed to take their fight to the highest court. Advise both parties with regard to their respective positions.

Feedback

You should have advised Pat and Tracy regarding the company's separate legal personality. You could have referred to a number of cases dealing with the rights that companies enjoy, including *Dadoo Ltd and others v Krugersdorp Municipality Council, Salomon v Salomon & Co Ltd* and *Ngcwase v Terblanche*.

The liquidator should be advised regarding the concept of piercing the corporate veil. Therefore, you should have referred to section 20(9) of the Companies Act. In addition, you should have indicated that the court will not easily pierce the corporate veil. In this regard, you could have referred to the case law discussed above (*Botha v Van Niekerk, Cape Pacific* and *Hülse Reutter*).

Considering that the loan was made and secured long before the company was liquidated, it will be very difficult to prove that the Morgans had the intention to defraud creditors when securing the loan.

Reflection

Legal personality entails various rights and privileges. You should be able to say when a company acquires legal personality and what the **nature and implications of legal personality** are. Can you identify instances in which the legal personality of a company will be disregarded and responsible persons within the company will be held personally liable? Keep in mind that you may be asked to discuss either the **common-law** principles pertaining to piercing the corporate veil or the **statutory** principle of disregarding the separate legal existence, or both.

Legal personality is acquired by companies **upon incorporation**. Companies are afforded most of the rights of **natural persons**. It is evident that a company's separate legal existence has many implications for the effective operation of companies.

There are certain instances where the **corporate veil will be lifted** (a common-law principle that developed through case law and which is applicable to both companies and close corporations) or the **legal personality will be disregarded** (the statutory principle, which is made applicable to companies in terms of section 20(9) of the Companies Act, and to close corporations in terms of section 65 of the Close Corporations Act) in order to hold individuals within the company accountable for wrongs committed by them. Furthermore, separate legal personality will cease upon **deregistration** of the company after its dissolution.

REVIEW

You should now understand the concept of separate legal personality. A company acquires separate legal personality upon incorporation. Companies are afforded most of the rights and attributes of natural persons. It is evident that the company's separate existence has many implications for the effective operation of companies.

There are certain circumstances when the corporate veil will be lifted, or the separate legal personality of a company disregarded, to hold individuals within the company accountable for wrongs committed by them. Furthermore, legal personality will cease upon deregistration of the company.

Please ensure that you are able to answer the key questions at the beginning of the study unit.

In the next study unit you will learn about the different types of companies recognised in South Africa, as well as their distinguishing characteristics.

Study unit 2
Types of companies

Contents

Introduction

In study unit 1 you learnt that a company acquires legal personality as soon as the registration certificate has been issued. A legal person is regarded as an entity that can acquire rights and duties that are separate from those of its members.

However, it was stated that this principle of legal personality should not be abused and if it is, the corporate veil can sometimes be lifted.

In this study unit we will highlight the different types of companies that can be incorporated in terms of the Companies Act. There are two types of companies recognised in South Africa, namely profit companies and non-profit companies (NPCs). Profit companies are further divided into public, private, personal liability and state-owned companies. Each of these types of companies has distinguishing characteristics.

You will know that you understand this study unit if you are able to answer the following key questions:

- What types of companies does the Companies Act provide for?
- Through which body are companies registered?
- Which four entities are classified as profit companies? What are their characteristics?
- What is the difference between profit companies and non-profit companies?
- What is an external company?
- What is a domesticated company?

2.1 Profit companies

You need only know the cases referred to, as they are discussed herein.

Important terms:	Meaning:
Domesticated company	A foreign company whose registration has been transferred to South Africa.
External company	A foreign company carrying on business or non-profit activities in South Africa.
Non-profit company	A company incorporated for a public benefit or other object than financial gain for its shareholders.
Profit company	A company incorporated for the purpose of financial gain for its shareholders.
Public company	A profit company that can issue its shares to the public and whose shares can be listed on the Johannesburg Stock Exchange.
Private company	A profit company that prohibits the issue of shares to the public and restricts the transfer of shares in its memorandum of incorporation.
Personal liability company	A profit company in which the directors and previous directors are held personally liable for the contractual debts of the company.
Company secretary	The person who is the chief administrative officer of a company.
Commission	Companies and Intellectual Property Commission (CIPC): a juristic person that functions as an organ of state and replaces CIPRO; this is where companies must be registered.

A profit company has the object of financial gain for its shareholders. A profit company may be incorporated by one or more persons and there is no limit to the number of shareholders that it may have.

Four entities qualify as profit companies, namely

- public companies
- state-owned companies
- personal liability companies
- private companies

Each of these types of companies has distinguishing characteristics.

A public company (Ltd)

- Shares may be offered to the public and are freely transferable.
- This company can be listed on the JSE Limited.
- It can be formed by one person.
- It must have at least three directors.
- It is obliged to hold annual general meetings.
- It is obliged to appoint an auditor.
- It is obliged to appoint a company secretary.
- It is obliged to appoint an audit committee.

A state-owned company (SOC Ltd)

- It is registered in terms of the Companies Act and either listed as a public entity in Schedule 2 or 3 of the Public Finance Management Act of 1999 or owned by a municipality.
- Examples include ACSA, Denel and South African Airways.
- The majority of the provisions applicable to public companies apply to state-owned companies, except if an exemption has been granted by the Minister.

- It is obliged to appoint a company secretary.
- It is obliged to appoint an audit committee.
- Chapter 3 of the Companies Act applies, except to the extent that the company has been exempted by the Minister.

A personal liability company (Inc or Incorporated)

- It must meet the criteria for a private company; it is mainly used by professional associations (such as attorneys).
- The memorandum of incorporation must state that it is a personal liability company.
- Directors are jointly and severally liable – along with the company – for debts and liabilities **contracted** during their term of office.

  Note: Section 19(3) uses the word “contracted” and not “incurred”, which was held by the court in *Fundtrust (Pty) Ltd (In Liquidation) v Van Deventer* 1997 (1) SA 710 (A) to limit directors’ liability to contractual debts and to exclude delictual and statutory liabilities.

  A provision that the directors and past directors will be jointly and severally liable, together with the company, for debts and liabilities of the company that were contracted during their periods of office must be included in the memorandum of incorporation of a personal liability company. The effect of the inclusion of such a clause is that creditors would be able to hold the directors jointly and severally liable for the company’s contractual debts and liabilities. Also, a director who had paid the debts will have a right of recourse against his or her fellow directors for their proportionate share (*Sonnenberg McCloughlin Inc v Spiro* 2004 (1) SA 90 (C)).
- It can be formed by one person.
- It must have at least one director.
- The doctrine of constructive notice applies in terms of section 19(5) of the Companies Act.

A private company ((Pty) Ltd)

- Its memorandum of incorporation prohibits the offering of any securities to the public and restricts the transferability of its securities.
- Private companies are no longer limited to 50 shareholders, as was the case under the Companies Act of 1973.
- In terms of section 8(2)*(b)* of the Companies Act, a private company’s memorandum of incorporation must contain a prohibition against the offering of its securities to the public and restrict the transferability of its securities.
- It can be formed by one person.
- It must have at least one director.

2.2 Non-profit companies (NPCs)

- A non-profit company is a company that is not formed with the aim of making a profit for its members (note that a non-profit company has members and not shareholders like profit companies).
- Its objects must relate to social activities, public benefits, cultural activities or group interests.
- A non-profit company must be formed by at least three persons who will be the company’s first directors.
- It must have at least three directors, but they are not allowed to obtain any financial gain from the company other than remuneration for the work they perform.
- A non-profit company does not have to have members. If these companies have members, some members may enjoy voting rights, while others may not.
- The income and property of non-profit companies are not distributable to its incorporators, members, directors, officers or persons related to any of them. Upon liquidation, income and

assets must be paid over to another non-profit company, voluntary association or trust with a similar purpose.

2.3 External and domesticated companies

An external company is a "foreign company" conducting business or non-profit activities in South Africa. It must always have at least one office within the Republic (see the definition in section 1 of the Companies Act). It can be registered as either a profit or non-profit entity.

A foreign company is required to register as an "external company" with the **Companies and Intellectual Property Commission (hereinafter "the Commission")** within 20 days after it first begins to conduct business or non-profit activities in South Africa. To do so, form CoR 20.1 must be lodged with the Commission.

Section 23(2A) of the Companies Act includes a list of activities that will not be regarded solely as conducting business, such as establishing a bank account in South Africa or acquiring any interest in any property within the Republic.

Foreign companies may, in terms of the Companies Act, transfer their registration to South Africa from the foreign jurisdiction. A foreign company that has transferred its registration will be deemed to have been originally so registered. These companies are referred to in the Act as "domesticated companies".

Exercise:

Candy Ltd is a … company.

Rand Water SOC Ltd is a … company.

Front End (Pty) Ltd is a … company.

Dandala and Associates Inc is a … company.

Estcourt View Home Owners' Association NPC is a … company.

ACTIVITY 2.1

Answer the following questions:

- What types of companies does the Companies Act provide for?
- Through which body are companies registered?
- Which four entities are classified as profit companies? What are their characteristics?
- What is the difference between profit companies and non-profit companies?
- What is an external company?
- What is a domesticated company?

Feedback

You need to know all the types of companies that the Companies Act provides for and the abbreviation behind each company's name.

You also need to know the two types of companies – profit companies and non-profit companies. You should know the four entities that qualify as profit companies (i. e. public companies, state-owned companies, personal liability companies and private companies) and the distinguishing characteristics of each of these types of companies.

Note that a profit company is established with the goal of obtaining a profit for its shareholders, while a non-profit company has a social, cultural or other public goal.

A private company may not issue its shares to the public and its shares are not freely transferable, whereas a public company's shares may be offered to the public and are freely transferable.

An external company is a "foreign company" conducting business or non-profit activities in South Africa. It can be registered as either a profit or non-profit entity.

A domesticated company is a foreign company whose registration has been transferred to South Africa.

REVIEW

In this study unit, the different types of companies and their distinguishing features were highlighted. Two main types of companies may be formed, namely **profit companies** and **non-profit companies**.

The goal of a profit company is to make a profit for its shareholders, whereas a non-profit company is incorporated for a social, cultural or other public purpose.

There are four types of profit companies: public companies, private companies, personal liability companies and state-owned companies. Each of these companies has distinguishing characteristics. A private company, for instance, may not issue its shares to the public and its shares are not freely transferable, while a public company's shares may be offered to the public and they are freely transferable. Make sure that you know the abbreviations that are written after the names of each of these types of companies. This can be used as a simple tool to identify the type of company depicted in a set of facts.

A foreign company that is carrying on business or non-profit activities in South Africa must be registered with the Commission and is called an external company.

A foreign company that has transferred its registration to South Africa will be deemed to have been originally registered in South Africa. Such a company is referred to as a domesticated company.

You should be able to identify the type of company that you are dealing with and the distinctive characteristics of such a company. This should enable you to advise a client on the requirements that need to be adhered to in order to form a specific type of company.

Please ensure that you are able to answer the key questions at the beginning of the study unit.

In the next study unit you will learn about the process of incorporation of a company.

Study unit 3

Company formation

Contents

Introduction

In study unit 2 you learnt about the different types of companies that may be formed in terms of the Companies Act. Before a company is recognised as a legal person, there are various steps that need to be taken. Both the company and the company's name need to be registered. Moreover, there may be a need to conclude pre-incorporation contracts. In this study unit we will explain the process of incorporation of a company

> You will know that you understand this study unit if you are able to answer the following key questions:
>
> - What documents have to be filed to inform the Companies and Intellectual Property Commission of the intention to register a company?
> - How flexible is the memorandum of incorporation?

- What may be included in the memorandum of incorporation?
- What is the legal status of the memorandum of incorporation and the rules developed by the board of directors?
- How are third parties dealing with a ring-fenced company affected by the fact that the company is a ring-fenced company?
- How are alterations, amendments and translations to the memorandum of incorporation made?

3.1 The right to incorporate a company

Important terms:	**Meaning:**
Memorandum of incorporation	The sole registration document of a company.
Notice of incorporation	The document filed with the Companies and Intellectual Property Commission alongside the memorandum of incorporation to show the company's intention to register as a business.
Alterable provision	A provision of the Companies Act in which it is expressly contemplated that its effect on a particular company may be negated, restricted or limited in terms of the company's memorandum of incorporation.
Unalterable provision	A provision that may not be altered in substance in the memorandum of incorporation.
Registration certificate	The document issued by the Commission when all formalities for registration are in order.
Company rules	Rules that may be adopted by the board of directors after incorporation of a company; these rules enjoy the same legal status as the memorandum of incorporation.

Before a company is recognised as a legal (juristic) person, the company and its name must be registered.

Key objectives of the Companies Act, as found in section 7 *(b),* include the promotion of the development of the South African economy through

- the creation of flexibility in the formation and maintenance of companies
- simplicity in the formation and maintenance of companies
- the encouragement of corporate efficiency
- the encouragement of transparency
- the provision of a predictable regulation of companies

When dealing with the formation of companies, the objectives of flexibility and simplicity are clear. The Companies Act makes it possible to incorporate both simple business structures and very complex business structures.

ACTIVITY 3.1

Muofhe and Tau wish to start a business. They do not want to form a partnership, as they prefer a business that will have its own legal personality.

They consider forming a company, but they are worried because they want the simplest business structure. They have been told that if they want a simple structure, they must forget about the possibility of incorporation as (1) the incorporation of a company is a privilege that is reserved for certain people only and (2) a company must have a complex business structure. They want to know why the law makes it impossible for them to form a company.

Feedback

When advising Muofhe and Tau, you should consider

- the Companies Act's objectives of simplicity and flexibility, which would allow them to form a company
- the fact that we all have the right to incorporate a company
- that the incorporation of a company with the simplest business structure is possible

3.2 Procedure for incorporation of companies

NB: The registration documents are available online at http://www.cipc.co.za/.

To register a company, a notice of incorporation and a copy of the memorandum of incorporation must be lodged at the Commission and the prescribed registration fee paid.

The notice of incorporation is "the notice to be filed in terms of section 13 (1), by which the incorporators of a company inform the Commission of the incorporation of that company, for the purposes of having it registered" (section 1).

It serves as notification to the Commission of the incorporation of the company. It is therefore the way in which promoters of a company let the Commission know about the company being formed and the fact that they wish to register the company.

The notice of incorporation (form CoR 14.1), which must be lodged together with memorandum of incorporation, contains the following information:

- type of company
- incorporation date
- financial year end
- registered address (main office)
- number of directors
- company name
  - whether the company's name will be the registration number
  - the reserved name and reservation number
  - a list of four names to be checked by the Commission

The memorandum of incorporation is the document that sets out rights, duties and responsibilities of shareholders, directors and others within and in relation to a company and other matters. Provisions in the memorandum of incorporation may be amended from time to time.

One or more persons may incorporate a profit company. For the formation of a non-profit company, three or more persons are required. Each of these people must complete and sign the memorandum of incorporation.

Use of the standard form *(pro forma)* for a memorandum of incorporation (CoR 15.1A– E) is optional. Companies are allowed to draft their own unique memorandum of incorporation, as long as it includes the required information.

3.3 The memorandum of incorporation

The memorandum of incorporation contains the following information:

- details of incorporators
- number of directors and alternate directors
- share capital (maximum issued)
- content of memorandum of incorporation

Alterable and unalterable provisions of the memorandum of incorporation

The Companies Act imposes certain specific requirements on the content of a memorandum of incorporation in order to protect the interests of shareholders of the company. A number of default company rules or alterable provisions are provided for.

Companies may accept or alter the following alterable provisions, as long as the alteration remains consistent with the Companies Act.

3.3.1 Alterable provisions

- A company enjoys all the legal powers and capacity of an individual, except to the extent that a juristic person is incapable of exercising any such powers, or having any such capacity, or the company's memorandum of incorporation provides otherwise (e.g. it may determine that the company's activities will be limited to a specific business).
- Private, non-profit and incorporated companies may elect to comply with the extended accountability requirements of Chapter 3 (section (2)).
- Shares within the same class have the same rights, limitations and terms, unless the memorandum of incorporation provides otherwise (section 37(1)).
- The memorandum of incorporation may exclude the right of first refusal of current shareholders of a private company in respect of shares issued by the company (section 39(3)).
- The memorandum of incorporation may forbid the board to render financial assistance to parties wanting to acquire shares in the company (section 44(2)).
- The memorandum of incorporation may provide for longer minimum notice periods for meetings.
- Electronic notice and electronic participation in meetings are allowed, unless the memorandum of incorporation prohibits it (section 63(2)).
- Companies may determine a higher number of minimum directors than what the Companies Act prescribes (section 66(2)).

Section 15 (2) *(b)* provides that the memorandum of incorporation of a company may contain special conditions applicable to the company and requirements in addition to those stipulated in the Act, for the amendment of such conditions.

Section 15(2)*(c)* also allows the memorandum of incorporation to prohibit the amendment of any particular provision in the memorandum of incorporation. If the memorandum of incorporation of a company contains the provisions allowed by section 15 (2) *(b)* or *(c),* the name of the company must be followed by the abbreviation "(RF)". This is an abbreviation for the words "ring fencing" and is intended to warn outsiders dealing with the company that there are special conditions contained in the memorandum, which they should check.

The notice of incorporation filed by the company must also contain a prominent statement drawing attention to each such provision and where it is located in the memorandum of incorporation (section 13(3)).

3.3.2 Unalterable provisions

Unalterable provisions are provisions of the Companies Act that a company's memorandum of incorporation may not change, except to impose a higher standard, greater restriction, longer period of time or any similar more onerous requirement than contained in an unalterable provision of the Companies Act. For instance, directors' duties and responsibilities and accountability requirements for public and state-owned companies cannot be excluded in the memorandum of incorporation. The Companies Act allows for companies to add provisions to deal with matters that are not covered in the Companies Act itself. However, all provisions included in the memorandum of incorporation must be consistent with the Act (section 15(1)*(a)* and *(b)*).

ACTIVITY 3.2

Draft a memorandum of incorporation in which you include ten issues that may be included in a memorandum of incorporation. Ensure that the provisions of the memorandum of incorporation provide clarity on all the different issues.

Feedback

See section 15 of the Companies Act. This activity is intended to familiarise you with issues that are usually included in the memorandum of incorporation. Did you check the provisions to ensure that they are consistent with the Companies Act?

3.4 The role of the Commission

Once the notice of incorporation and a copy of the memorandum of incorporation have been filed with the Commission and the prescribed fee paid, the Commission may either accept or reject the notice of incorporation.

The notice of incorporation may be rejected by the Commission under the following circumstances:

- if it has not been completed in full (section 13(4)*(a)*)
- if it has not been properly completed (section 13(4)*(a)*)

The notice of incorporation must be rejected by the Commission under the following circumstances:

- if the initial number of directors is less than the prescribed minimum number (section 13(4)*(b)*)
- where, as a result of a director's disqualification, the initial number of directors becomes less than the prescribed minimum number (section 13(4)*(b)*)

In terms of section 66(2) of the Companies Act, a private company must have at least one director and a non-profit company must have a minimum of three directors, in addition to the minimum number of directors that the company must have to satisfy any requirement to appoint an audit committee or a social and ethics committee.

If the Commission realises that one of the directors does not qualify to be a director, this will reduce the number of directors. If the reduction leads to the number of directors being less than the prescribed number, the Commission has no choice but to reject the notice of incorporation.

Where there is a deviation from the design or content of the prescribed form, the deviation will invalidate the actions of the person only if it affects the substance of the notice of incorporation negatively and materially, or if such deviation would reasonably mislead someone who reads the notice of incorporation (section 6(8)*(b)*(i) and (ii)).

ACTIVITY 3.3

Vanitha and Sandra have just moved to a new town. There they meet a mutual friend, Wilma, from their days in boarding school. The town has many orphans, who are homeless. Vanitha, Sandra and Wilma have decided to form a non-profit company that will provide food and shelter to the orphans. They have completed drafting the memorandum of incorporation for the company to be registered as Hayani NPC. They want to start operating before the winter season arrives. The directors are Vanitha, Sandra and Wilma. A day before filing their documents with the Commission, Vanitha finds out that Sandra has been prohibited by a court of law from becoming a director. She discusses this with Wilma and together they decide to proceed with the process of incorporation, since looking for someone to replace Sandra as a director will cause unnecessary delays. They agree that they will look for someone to replace Sandra after incorporation. They proceed to file a copy of the memorandum of incorporation and the notice of incorporation, together with the prescribed fee, with the Commission.

How must the Commission deal with this notice of incorporation?

Feedback

Although the Companies Act allows for flexibility, there are circumstances in which the Commission is compelled to reject the notice of incorporation. Read section 13(4)*(b)* together with section 69(8) of the Act.

3.5 Registration of a company

In terms of section 14 of the Companies Act, once the notice of incorporation has been filed, the Commission

- assigns a unique number to the corporation
- enters prescribed information regarding the company in the companies register
- issues and delivers a registration certificate to the company, if all the other requirements have been complied with

The date stated on the registration certificate is the date on which the company acquires legal personality. If the promoters have stipulated a specific date on the notice of incorporation, the date on the registration certificate will be the later one of that date and the date on which the certificate is issued by the Commission.

3.6 Rules made by the board of directors

In terms of section 15 of the Companies Act, where both the Companies Act and the memorandum of incorporation are silent regarding certain matters that have to do with the governing of the company, the board of directors of a company is generally allowed to

- make rules
- amend any existing rules
- repeal any rules

Such rules must not be in conflict with the memorandum of incorporation of the company nor with the Companies Act. In terms of section 15(4)*(a)*, where there is a conflict between a rule made by the board of directors and the Companies Act or the memorandum of incorporation, the rule will be void, but only to the extent of its inconsistency.

Before the rules of the board become effective, the following must occur:

- A copy of the rules must be published (section 15(3)*(a)*).

- Rules made by the board must be published in the manner stated in the memorandum of incorporation. If the manner of publication is not stated there, the rules must be published in the manner stated in the rules themselves.
- A copy of the rules must be filed with the Commission (section 15(3)*(b)*).
- The rules must be filed as required by the Companies Act.

Ten business days after filing of the rules or on the date stated in the rules (if any), the rules become effective. As soon as the rules become effective, they are binding on an interim basis, until put to the vote at the next general shareholders' meeting. For a rule to become permanent, it must be ratified by an ordinary resolution at the general meeting. Note that if a rule is rejected by the majority of the shareholders, the board is not allowed to make a similar rule until a period of 12 months has lapsed. The board may make a similar rule within 12 months only if this is approved in advance by ordinary resolution at the shareholders' meeting.

3.7 The legal status of the memorandum of incorporation and the rules developed by the board of directors

In terms of section 15, the memorandum of incorporation and the rules are binding

- between the company and each shareholder (s 15(6)*(a)*)
- between or among the shareholders of the company (s 15(6)*(b)*)
- between the company and each director or prescribed officer of the company (s 15(6)*(c)*(i))
- between the company and any other person serving the company as a member of a committee of the board (s 15(6)*(c)*(ii))

The relationship created in terms of section 15 of the Companies Act seems to be of a contractual nature. The Companies Act 71 of 2008 entails fewer criminal offences than its predecessor, but there is a greater risk of personal liability arising from action in contravention of a company's memorandum of incorporation and rules.

ACTIVITY 3.4

You are a member of the board of directors of Regona (Pty) Ltd. At the last meeting of the board, it became clear that the memorandum of incorporation was silent regarding certain issues relating to the governance of the company. After lengthy discussions, three rules concerning the governance of the company were made. They were filed with the Commission a month ago. The next general shareholders' meeting has not taken place yet.

You decide to read the rules thoroughly and you realise that one of the rules has already been dealt with in the Companies Act. You also realise that another rule is actually inconsistent with the memorandum of incorporation of the company.

You mention this to the other members of the board. You are then requested to find out if these rules are valid or not. You are also requested to find out when they will become permanent and on whom they will be binding.

Feedback

- The board of directors has the power to make rules concerning the governance of the company, provided that they are not dealt with in the Companies Act or in the memorandum of incorporation.
- A rule made by the board that is inconsistent with the memorandum of incorporation or with the Companies Act will be void, but only to the extent of its inconsistency.

- Although the rule becomes effective ten business days after publication, ratification by an ordinary resolution at the next shareholders' general meeting is important.

3.8 Amending the memorandum of incorporation

In terms of section 16 of the Companies Act, changes may be made to the memorandum of incorporation, unless the amendment of a provision is prohibited by the memorandum itself in terms of section 15(2)*(c)*. Such amendments may be in the form of

- a new memorandum of incorporation; or
- amendments to the existing provision(s) of the memorandum of incorporation

Note that if changes are in the form of a new memorandum of incorporation, the new memorandum of incorporation will replace the existing memorandum of incorporation.

A company's memorandum of incorporation may be amended

- in compliance with a court order (An amendment in terms of a court order is given effect via a board resolution and there is no need for a shareholders' special resolution.)
- by the board in terms of section 36(3) and (4), which allows the board to amend the authorised share capital of the company, unless the memorandum of incorporation provides otherwise
- by a special resolution of the shareholders proposed by
  - the board of directors; or
  - shareholders who collectively exercise not less than 10% of the voting rights

  There is no need to convene a shareholders' meeting to adopt this special resolution. As it is sometimes difficult for some shareholders to attend meetings, the proposal to amend the memorandum of incorporation may be submitted to shareholders who are entitled to vote.

  The proposal will be adopted if approved by the required majority who voted in writing within 20 days after the resolution was submitted to them (section 60).
- in terms of the procedure set out in the company's memorandum of incorporation

To effect the amendment, a form CoR 15.2 must be filed.

Unless the amendment is made by a company that existed before the Companies Act came into operation and the amendment is pursuant to compliance with the Companies Act, a filing fee must be paid.

A copy of the special resolution (if such is required in terms of a company's memorandum of incorporation) or a copy of the amended memorandum must accompany the notice.

An amendment may result in a profit company's not meeting the criteria for that category of profit companies. When this happens, the name and the abbreviation after the name must also be amended in such a way that it reflects the new category that the profit company falls under.

If an amendment to the memorandum of incorporation of a personal liability company has the effect that the company falls into another category of company, the company must give at least ten days' prior notice of the filing of the notice of amendment to any professional or industry regulatory authority that has jurisdiction over the business of the company and to any person who may have relied on the personal liability of the directors in dealings with the company and could suffer prejudice if that liability is terminated.

3.9 Alteration of the memorandum of incorporation

Section 17 of the Companies Act allows for changes or alterations to be made to the company's rules and to the memorandum of incorporation. These may be made with a view to correcting minor errors such as grammar, punctuation, spelling and references.

Note that it is the board of a company – or an individual who has been given authority to do so by the board – that may make these changes.

For an alteration to be effected,

- a notice of alteration must be published in accordance with the memorandum of incorporation and the rules;
- a notice of alteration (form CoR 15.3) must be filed; and
- a filing fee must be paid.

3.10 Translations of a memorandum of incorporation

In terms of section 17(3) and (4) of the Companies Act, a company that has filed a memorandum of incorporation has the right to file a translation thereof. The translation may be in any official language, or more than one official language, of the Republic of South Africa. A notice of translation (form CoR 15.4), a copy of the translated memorandum of incorporation and a sworn statement by the translator confirming that the translation is a true, accurate and complete translation of the memorandum of incorporation must be filed.

A filing fee is payable.

Note that in the event of a conflict between the memorandum of incorporation and the translated version, the original memorandum of incorporation prevails.

ACTIVITY 3.5

After Exit (Pty) Ltd was incorporated, the memorandum of incorporation was translated into Afrikaans and Tshivenda. The English, Tshivenda and Afrikaans copies were kept together. There is now confusion regarding the provision that deals with the frequency of meetings, as the three versions state different things. Which version of the memorandum of incorporation should prevail and why?

Feedback

In the event of a conflict between a provision in the memorandum of incorporation and a provision in the translated version, the provision in the original memorandum of incorporation prevails.

3.11 Consolidation of a memorandum of incorporation

In terms of section 17(5) and (6) of the Companies Act, after filing the memorandum of incorporation, a company may make amendments or alterations to it. Anytime thereafter, the company may file a consolidated revision of its memorandum of incorporation indicating all the new changes. The Commission may also require the company to consolidate its memorandum of incorporation by sending a form CoR 15.6 request.

The consolidated revision has to be filed together with a notice of consolidation of Memorandum of Incorporation (form CoR 15.5)and a sworn statement made by a director of the company or by an attorney or notary confirming that it is a true, accurate, updated and complete representation of the memorandum of incorporation. The payment of a filing fee is required.

ACTIVITY 3.6

Punch (Pty) Ltd has made alterations to its memorandum of incorporation three times within the past year. The Companies and Intellectual Property Commission is concerned about the number of documents that have to be handled each time a person has to read Punch (Pty) Ltd's memorandum of incorporation. How can the problem be resolved?

Feedback

The Commission may request the company to file a consolidated revision of its memorandum of incorporation. Remember that a sworn declaration must accompany this consolidated revision.

3.12 Authenticity of versions of the memorandum of incorporation

In terms of section 18, in the event of a conflict between the memorandum of incorporation and its translated versions, the memorandum of incorporation, as altered or amended, prevails. The same applies to a conflict between the memorandum of incorporation, as altered or amended, and its filed consolidated version. The consolidated version may prevail only if it has been ratified by special resolution at a general shareholders' meeting of the company.

In the event of a conflict between the latest version of the memorandum of incorporation endorsed by the Commission and any other document purporting to be a memorandum of incorporation, the latest version – as endorsed by the Commission – will prevail.

ACTIVITY 3.7

Exit (Pty) Ltd has made several alterations to and translations of its memorandum of incorporation. Some of the alterations were made in respect of the same provisions.

One of the directors approaches you as he is worried that the memorandum consists of too many documents. He is already confused and does not know which version should prevail in the event of a conflict and why. Advise him accordingly.

Feedback

Where there is a conflict between various versions of the memorandum of incorporation, the latest version that has been endorsed by the Commission prevails.

As you advise the director, you may inform him about the possibility of consolidating the memorandum of incorporation.

3.13 Shareholders' agreements

In terms of section 15(7) of the Companies Act, shareholders may enter into agreements with one another regarding any matter concerning the company. Such agreements must be consistent with the Companies Act and the company's memorandum of incorporation.

Where a provision of the agreement is inconsistent with the Act or with the memorandum of incorporation, it is void to the extent of its inconsistency.

ACTIVITY 3.8

Ryno has been appointed as a director of a private company. He becomes aware of an agreement between the shareholders of the company. As he reads the agreement, he realises that two of the ten provisions contained in the agreement are not consistent with the company's memorandum of incorporation. He is concerned about the validity of the agreement. Advise Ryno accordingly.

Feedback

Although shareholders are allowed to enter into agreements on matters concerning the company, such agreements must be consistent with the Companies Act and with the memorandum of incorporation. Provisions that are inconsistent are void to the extent of the inconsistency.

3.14 Anti-avoidance

In terms of section 6 of the Companies Act, the Commission or Takeover Regulation Panel may apply to court to declare an agreement void if it is intended to defeat or reduce the effect of any prohibition or requirement established by or in terms of an unalterable provision of the Companies Act. Shareholders' agreements regulating voting rights may conflict with this provision.

REVIEW

In this study unit you learnt about the procedure for incorporation of companies. You should be able to advise a person wishing to start a company of the procedure.

The purpose of the Companies Act is to simplify the process for incorporation of companies. Only one constitutive document, namely the memorandum of incorporation, is required to register a company.

The board of directors that is responsible for managing the company's business may, however, adopt rules to regulate internal processes.

Please ensure that you are able to answer the key questions at the beginning of the study unit.

In the next study unit we will look at the options available to companies for the conclusion of contracts prior to registration that will become binding upon the company after incorporation.

Study unit 4

Pre-incorporation contracts

Contents

Introduction

The common law does not allow a person to act as an agent for a principal who does not exist. This means that under the common law, no person can act as an agent for a company that has not yet been incorporated, because the company does not exist before incorporation. Section 21 of the Companies Act allows for pre-incorporation contracts to be entered into on behalf of a company that has yet to be incorporated.

Section 21 does not exclude the common law, which means that a promoter may also use the common-law alternatives.

In this study unit we will start off by looking at the requirements and consequences of concluding a contract under the Companies Act, whereafter the common-law alternatives will be briefly considered.

You will know that you understand the study unit if you are able to answer the following key questions:

- What is a pre-incorporation contract?
- What are the formal requirements for a contract to be binding upon a company under section 21 of the Companies Act?
- Who is liable for performance if a pre-incorporation contract is concluded under section 21 of the Companies Act and the company is subsequently not registered?
- Who is liable for performance in terms of a pre-incorporation contract concluded under section 21 of the Companies Act if the company subsequently rejects the contract?
- List the common-law alternatives to conclude a pre-incorporation contract.
- Explain the process for the conclusion of a contract to the benefit of a third party *(stipulatio alteri)*.

- Explain the process of nomination of a company to be bound by terms of an agreement under the common law.
- Explain what is meant by cession and delegation. What is the risk attached to this alternative means of conclusion of a pre-incorporation contract?
- What are the benefits of concluding a pre-incorporation contract under the common law instead of under section 21 of the Companies Act?

Important terms:	**Meaning:**
Common law	Also known as case law or precedent; law developed by judges through decisions of courts and similar tribunals, rather than through legislative statutes or executive branch action.
Pre-incorporation contract	A contract entered into by a person who is acting on behalf of a company that does not exist yet.
Promoter	The catalyst for the conclusion of a pre-incorporation contract. This is a more apt description than an "agent", since common-law agency is impossible for the conclusion of pre-incorporation contracts.
Delegation	The transfer of duties.
Cession	The transfer of rights.
Option agreement	An agreement between two parties that provides one of the parties with the right – but not the obligation – to buy, sell or obtain a specific asset at an agreed-upon price at some time in the future.
Stipulatio alteri	A contract that is concluded to the benefit of a third party.

4.1 Statutory method of conclusion of a pre-incorporation contract (section 21 of the Companies Act)

The common law does not allow a person to act as an agent for a principal who does not exist. This means that under the common law, no person can act as an agent for a company that has not yet been incorporated, because the company does not exist before incorporation.

This may result in the companies losing the chance to enter into beneficial contracts that present themselves prior to incorporation. To avoid this state of affairs, section 21 of the Companies Act allows for pre-incorporation contracts to be entered into on behalf of a company that has yet to be incorporated.

Section 1 of the Companies Act describes a pre-incorporation contract as "a written agreement entered into before the incorporation of a company by a person who purports to act in the name of, or on behalf of, the proposed company, with the intention or understanding that the proposed company will be incorporated, and will thereafter be bound by the agreement".

In terms of section 21 of the Companies Act, a pre-incorporation contract will be binding on a company if

(1) it is concluded by a person in the name of, or purporting to act in the name of or on behalf of a company yet to be incorporated in terms of the Companies Act;
(2) the contract was concluded in writing; and
(3) the board of that company ratifies the transaction or does not reject the contract within the stipulated three-month period after its incorporation. In other words, if the above two formal requirements are complied with and after the company's incorporation, the board "does nothing" about the transaction (i.e. neither ratifies nor rejects it), the contract will become binding on the company.

However, section 21 provides for joint and several liability of the person or persons who concluded the contract on behalf of the company for liabilities created in terms of the pre-incorporation contract if

- the company is not incorporated; or
- the board rejects the contract partially or in full. In such a case, the person who acted on behalf of the company may claim any benefit from the company that it receives in terms of the contract, but may apparently not claim any benefit from the other contracting party.

There are some other common-law alternatives (except for agency, which is impossible) that could be used more effectively and safely to avoid possible personal liability.

These are the contract for the benefit of a third party *(stipulatio alteri),* option, nomination or cession and delegation.

These common-law methods of concluding contracts prior to the incorporation of a company are briefly discussed below.

4.2 Alternative common-law methods of concluding pre-incorporation contracts

The common-law constructions have a major advantage over the statutory method because in terms of the common law, the person acting on behalf of the proposed company is not automatically liable if the company is not incorporated or fails to ratify the contract completely.

4.2.1 Cession and delegation

Cession is the transfer of rights, whereas delegation is the transfer of duties or liabilities. When using this method to conclude a pre-incorporation contract, a person concludes a contract in his or her own name. After the company has been registered, this person cedes the rights and delegates the obligations under the contract to the company. The risk associated with this method is that the consent of all three parties is required for delegation of duties.

In other words, the company and the other contracting party must agree to the substitution of the company as the new debtor. All rights and duties not accepted by the company will remain with the original person, unless it is specifically agreed otherwise.

4.2.2 Nomination

A person concludes the pre-incorporation contract subject to a term that he or she will have the option to nominate a third party in his or her place within a specified period.

Upon incorporation of the yet-to-be-formed company, this person then nominates the company to become a party to the contract in his or her place. The risk is that the company may refuse the nomination or not be able to comply with the obligations in terms of the agreement. Under such circumstances, the original debtor will incur liability only if it is specifically agreed upon.

4.2.3 Option

The option granter (offerer) undertakes to keep the substantive offer open for a period of time. The option is then ceded to the company upon its incorporation.

If the company accepts the offer, a contract comes into being. Otherwise, the person who concluded the option agreement will remain personally liable only if the option agreement provides for liability.

4.2.4 Contract for the benefit of a third party (*stipulatio alteri*)

A person concludes a contract with another contracting party in terms of which the latter will offer certain benefits to the company to be formed. If the company is formed, it may accept the offer or decline it. The risk is that the company may not come into existence or not accept the offer. The person who concluded the contract will incur liability under the contract only if specifically so provided.

ACTIVITY 4.1

John and Jane want to incorporate a catering company, De-lish Pty (Ltd), together. Before the company is registered, Jane sees a delivery vehicle that would be perfect for use in their catering business.

(a) Advise Jane regarding the formal requirements to conclude a contract on behalf of the yet-to-be-formed company in terms of section 21 of the Companies Act.
(b) If De-lish (Pty) Ltd is never incorporated, would Jane incur liability for performance in terms of the contract?
(c) Advise Jane of alternative common-law methods of concluding the contract to avoid possible personal liability.

Feedback

To conclude a binding contract under section 21 of the Companies Act, the following formal requirements must be met:

- The contract must be concluded in writing.
- The person concluding the contract on behalf of the yet-to-be-formed company must act or profess to be acting as an agent for a company that is not yet registered.
- The board of the company must, within three months of its incorporation, ratify the contract.

Section 21 of the Companies Act provides for joint and several liability of the person or persons who concluded the contract on behalf of the proposed company. In other words, should the company fail to ratify the contract completely or reject it, or should the company not be registered, this person or persons will incur liability toward the other contracting party for liabilities created in terms of the agreement.

To avoid possible personal liability, an option agreement; cession of rights and delegation of duties; a nomination; or a contract to the benefit of a third party could provide a safer option. The promoter must, however, ensure that the contract is properly formulated to specifically exclude personal liability.

REVIEW

In this study unit you were introduced to the statutory position where contracts are concluded prior to the incorporation of a company, in other words pre-incorporation contracts. Keep in mind that the various common-law options remain available for the conclusion of pre-incorporation contracts. The possible personal liability of the promoter that is effected by the Companies Act might be more risky than some of the common-law alternatives.

Please ensure that you are able to answer the key questions at the beginning of the study unit.

In the next study unit we will look at registration of company names and the important role company names play in providing corporations with an identity.

Study unit 5

Registration of company names

Contents

Introduction

Company names play an important role in providing corporations with an identity. The public often associates a name with a specific product and good or bad service.

Therefore, it is imperative that there be rules to regulate what names may be chosen. The Companies Act provides for name reservations. If a proposed name is rejected, the company may usually still be registered and the registration number then becomes the name of the company at incorporation, until such time as an appropriate name has been reserved or approved.

Note that non-profit companies are not allowed to use registration numbers as their names.

In this study unit, the process for the reservation of a company's name will be considered. In addition, the situation that arises when a company's name is objectionable will be set out.

> You will know that you understand this study unit if you are able to answer the following key questions:
>
> - What are the criteria for the names of companies under the Companies Act?
> - Who can order a name change where a name to be registered is similar to an existing company's name?
> - What factors are considered in order to ascertain whether or not a name is objectionable?
> - How should the name and registration number of a company be used?

5.1 Reservation process

In terms of section 12 of the Companies Act, in order to reserve a name, a form CoR 9.1 must be completed and a filing fee paid.

The criteria for acceptance of names have been reformed to give maximum effect to the constitutional right to freedom of expression.

In terms of section 11, the Companies Act restricts a company name only as far as necessary to

- protect the public from misleading names, which falsely imply an association that does not exist;
- protect the interest of the owners of names and other forms of intellectual property (such as trade marks) from other persons passing themselves off, or coat-tailing, on the owner's reputation and good standing; and
- to protect the public from names that would fall within the ambit of expression that does not enjoy constitutional protection because of its harmful or other negative nature.

  To avoid deception of the public, the name of a company may not

  – be the same as the name of another company, external company, close corporation or co-operative; or the name of a business that has already been registered in terms of the Business Names Act 27 of 1960; or a trademark that has been filed for registration in terms of the Trade Marks Act 194 of 1993; or a mark, word or expression protected in terms of the Merchandise Marks Act of 1941;
  – be confusingly similar to a name, trademark, mark, word or expression as described above (subject to a few specific exceptions);
  – give the false impression that the company is associated with the government, or with a particular person or government office, etc; and
  – may not include any word, expression or symbol that may constitute propaganda for war, incitement of imminent violence or advocacy of hatred based on race, ethnicity, gender or religion, or incitement to cause harm.

- The Companies Act does not make provision for the registration of a shortened or translated name.
- A name reservation in a foreign language must be accompanied by a certified translation and certificate of translation.
- In terms of the Consumer Protection Act 68 of 2008, members of the public are required to register their business/trading name/sole proprietorship/partnership names with the Commission.
- Where, according to the Commission, there is a possibility that the name is similar to the name of another company or another business undertaking or trademark, or that the name gives an impression that there is a connection between the company that is applying and another entity or state organ, the Commission may compel the applicant to inform parties that may be interested by serving them with a copy of the application and name reservation. If the company's name is to be associated with another existing business, the Commission will require proof from the applicant company that the associated company was thus made aware before registration of a similar name is to be allowed.
- The Companies Act also allows any person who has an interest in the name of a company to apply to the Companies Tribunal for it to determine whether or not the name is in accordance with the requirements of the Companies Act.

5.2 Effect of a name reservation

A name reservation is valid for six (6) months. It is possible to apply for an extension of a name reservation for an additional 60 business days by lodging a form CoR 9.2 and paying a filing fee.

In terms of section 12 of the Companies Act, a name may be reserved for use at a later stage, to be used for a newly incorporated company or to be used as a replacement for an existing name of a company.

Someone who has applied for reservation of a name may transfer the reserved name to another person by lodging a form CoR 11.1.

Disputes regarding names may be referred to the Companies Tribunal or the Human Rights Commission in terms of section 160 of the Companies Act.

5.3 Change of name

You need only know the cases referred to, as they are discussed herein.

Where a name that is to be registered is the same as another name as described above, the Commission may make use of the registration number of the company as an interim name.

The company will be provided with another opportunity to file a notice of incorporation containing an acceptable name. Upon receipt of the notice of incorporation with the amended name, the Commission has to enter the new name in the companies register. It must also issue an amended registration certificate reflecting the amended name.

In *Peregrine Group (Pty) Ltd v Peregrine Holdings Ltd* 2001 (3) SA 1268 (SCA), the seven applicant companies and eleven respondent companies were all registered under names with the word "Peregrine" as the first and dominant word. The applicants sought an order directing the first to eighth respondents to change their names by excluding the word "Peregrine" and restraining them from passing off their businesses as those of the applicants or as associated in the course of trade with those of the applicants.

The Registrar of Companies (who was also a respondent) stated that he did not, as a matter of principle, "allow the monopoly of an ordinary generic word". He had thus permitted the registration of no fewer than 29 entities bearing some designation of the name "Peregrine".

The court looked at the activities that the companies engaged in to decide whether the similarity in the names would cause confusion.

In addition, the client bases of the applicants and the respondents were considered to see whether there was an overlap. It was made clear that a court may direct a company to change its name if the name is undesirable and calculated to cause damage to the applicant.

It was held that the court enjoyed wide discretion to hold that a company's name is undesirable. Where the names of companies are the same or substantially similar and where there is a likelihood that members of the public would be confused in their dealings with the competing parties, these would be important factors to be taken into account in deciding whether or not a name was undesirable. However, the mere fact that the names of companies are the same or similar is not a conclusive factor in determining whether or not a name is objectionable. The court also considered whether or not "Peregrine" could be described as generic or descriptive of the services they offered. If so, the name could be subject to a monopoly. The court, however, held that "Peregrine" is an ordinary English word with no secondary meaning that could be associated with the companies' functions.

In determining whether or not there was a likelihood of confusion that would have the effect of deceiving or misleading the public, the type (degree of sophistication) of customer catered for by the businesses of the respective parties and the extent and ambit of the competing activities of the applicants and the respondents had to be considered. In this latter regard, it was held that the absence of a common field of endeavour was not conclusive.

The date of registration of the companies would also play a role. The company that registered the name first would enjoy preference over companies that registered their names later.

In order to prove passing off, it has to be proven that the applicant had acquired a reputation in the services that it offered with the name and that the respondent had made a representation that would lead members of the public to associate the respondent's business with the applicant's.

5.4 Use of name and registration number

Section 32 of the Companies Act requires that a company provide its full name or registration number to any person on demand. It further prohibits the misstating of the name or registration number and the stating of the name in such a way that it may mislead or deceive a person. A company must use its registered name at all times, and not a modified version of such name. In the case of a profit company, the name may consist of a registration number only, followed by the words "South Africa".

Where the registration certificate is issued with an interim name by the Commission, the company is obliged to use its interim name. The interim name is used until the company's name has been amended.

ACTIVITY 5.1

Suppose that John, who was previously a franchisee of McTucky's Ltd, wants to incorporate a company with the name MacTuckies Ltd. The new company will run substantially the same business as McTucky's Ltd, namely selling fried chicken. Consider whether or not McTucky's Ltd has grounds to object to the registration of the name.

Feedback

Restrictions have been placed on names that companies are permitted to register. A proposed name is not permitted to be confusingly similar to another existing one. In looking at the specific facts provided in this question, it is clear that the names are confusingly similar. John was previously a franchisee of McTucky's. It therefore seems that he has chosen this name with the intention of making people confuse his business with that of McTucky's Ltd.

The factors laid down in *Peregrine Group (Pty) Ltd v Peregrine Holdings Ltd* should also be considered.

In this scenario, the business conducted is similar and the clients are not very sophisticated. Therefore, it may be concluded that the proposed name is objectionable.

REVIEW

In this study unit you have learnt that there are prescribed criteria for company names. Although it is not always required of companies to reserve a name, it is preferable since the Commission may require a company to change its name if it is too similar to another existent company's name or is objectionable for some other reason. There are measures in place to protect a company's goodwill and avoid deception of the public resulting from the registration of undesirable names.

Please ensure that you are able to answer the key questions at the beginning of the study unit.

In the next study unit we will discuss the capacity of companies and the authority of representatives to participate in the management of companies and to conclude binding contracts on behalf of the company.

Study unit 6

Capacity and representation of a company

Contents

Introduction

A company's capacity is the sphere of actions that a company may legally perform. Representation occurs when somebody acts on behalf of or in the name of a company. In this study unit you will learn what actions a company may legally perform or what capacity the company enjoys.

In addition, you will be introduced to the corporate-law principles applicable to representation in companies. Therefore, this unit deals with the validity of company actions and the authority of a person to act on behalf of the company.

You will know that you understand this study unit if you are able to answer the following key questions:

- What is meant by the "capacity" of a company?
- What is the *ultra vires* doctrine?
- In which circumstances does a person have the authority to represent a company and bind it to an agreement?
- What is the purpose of the Turquand rule and how does it operate under the Companies Act?

6.1 Capacity of a company

Important terms:	**Meaning:**
Legal capacity	A person's authority under the law to engage in a particular undertaking or maintain a particular status. It is the power provided under the law to a natural person or a juridical person to enter into binding contracts and to sue and be sued in his or her or its own name.
Representation	Occurs when somebody acts on behalf of or in the name of a company.

Important terms:	Meaning:
Ultra vires doctrine	Any act that lies beyond the authority of a corporation to perform. The rules pertaining to the consequences of a company's acting outside the scope of its powers and competency.
Estoppel	The legal principle that prevents someone who made a representation from subsequently denying the truth of such a representation if certain requirements are met. The representor is therefore estopped from denying the truth of the representation.
Turquand rule	The rule established in *Royal British Bank v Turquand* in terms of which an outsider dealing in good faith with a company may assume that all aspects of the company's internal management have been duly complied with.

A company's capacity is determined by the **sphere of actions that it may legally perform**. Representation occurs when somebody acts on behalf of or in the name of a company. You will learn what actions a company may legally perform or what capacity the company enjoys. In addition, you will be introduced to the corporate-law principles applicable to representation in companies. Therefore, this unit deals with the **validity of company actions** and the **authority of a person** to act on behalf of the company.

Section 19(1)*(b)* of the Companies Act provides that a company has all the legal capacity and the powers of a natural person, except to the extent that a juristic person is incapable of exercising any such power, or the company's memorandum of incorporation provides otherwise. Therefore, the capacity of a company is no longer limited by its main or ancillary objects or business, and these objects need not even be stated in the memorandum of incorporation. Although the company's memorandum of incorporation may limit, restrict or qualify the purposes, powers or activities of the company (in other words, impose restrictions on the legal capacity of the company) in terms of section 19(1)*(b)*(ii), any such restrictions would not render any contract invalid that conflicts with these restrictions (section 20(1)*(a)*). **Therefore, the contract remains valid and binding on the company and the other party to the contract, even if it is an *ultra vires* transaction.**

The *ultra vires* doctrine

You need only know the cases referred to, as they are discussed herein.

In terms of our **common law**, a contract is *ultra vires* the company when the conclusion of the transaction is beyond its legal capacity. In other words, if a company's principal business is, for instance, catering, it would be outside the company's capacity to buy an expensive yacht on behalf of the company. The *ultra vires* doctrine is based on the understanding that a company exists in law only for the purpose for which it was incorporated. According to the *ultra vires* doctrine, when an act on behalf of the company falls outside its main and ancillary objects, the company does not exist in law and, consequently, such an act is not binding on the company. Such an act is described as an *ultra vires* act. In the catering example mentioned above, it would be within the scope of the principal business (*intra vires*) for the company to purchase a refrigerator that it needs for catering.

In *Attorney-General v Mersey Railway Co*, the court explained that whether a particular contract falls within the capacity and powers of the company is a question of fact. If the main purpose of the company was to carry on the business of a hotel, it is clear that acts necessary to achieve this purpose, for example the purchasing of furniture and the hiring of staff, are *intra vires*.

In terms of section 19(1)(*a*) of the Companies Act, a company becomes a separate legal person upon incorporation. This legal personality continues until the name of the company is removed from the companies register. One of the main advantages of incorporation is that a company enjoys perpetual existence. A company does not die like a natural person, and the business is unaffected by a change in the shareholders or members of the company. A company can be terminated only by means of a legal process, deregistration and dissolution.

Section 19(1)*(b)* of the Companies Act provides that a company has all the legal capacity and the powers of a natural person, except to the extent that a juristic person is incapable of exercising any such power, or the company's memorandum of incorporation provides otherwise. Therefore, the capacity of a company is no longer limited by its main or ancillary objects or business, and these objects need not even be stated in the memorandum of incorporation. Although the company's memorandum of incorporation may limit, restrict or qualify the purposes, powers or activities of the company (in other words, impose restrictions on the legal capacity of the company) in terms of section 19(1)*(b)*(ii), any such restrictions would not render any contract invalid that conflicts with these restrictions (section 20(1)*(a)*). **Therefore, the contract remains valid and binding on the company and the other party to the contract, even if it is an *ultra vires* transaction.**

Furthermore, the Companies Act no longer requires that a company's principal business be stated in its memorandum of incorporation, as was the case under the previous legislation. Although the company's memorandum of incorporation may restrict the company's legal capacity, such restriction will not, in terms of section 19(1)*(b)*(ii), invalidate a contract that is in conflict with the restrictions (section 20(1)*(a)*). Thus the contract will remain valid and binding on the company and the other contracting party.

Even though an *ultra vires* transaction will be binding on the company, the shareholders are provided with recourse to claim back their losses from the person who acted beyond the scope of the company's capacity. **Section 20(6) of the Companies Act** provides that each shareholder has a claim for damages against any person who fraudulently, or due to gross negligence, causes the company to do anything inconsistent with the Companies Act or a limitation, restriction or qualification on the powers of the company as stated in its memorandum of incorporation, unless ratified by special resolution in terms of section 20(2). This is in addition to the remedy provided in section 165.

If the company or directors have not yet performed the planned action (e. g. concluded the contract) that is inconsistent with a limitation or qualification of the company's powers contained in the memorandum of incorporation, one or more shareholders, directors or prescribed officers of the company may obtain a court order restraining (i.e. preventing) the company or directors from doing so. A third party who did not have actual knowledge of this limitation or qualification and acted in good faith will, in such a case, have a claim for any damages suffered as a result. In terms of section 20(4), shareholders, directors, prescribed officers and a trade union representing employees of the company may also institute proceedings to prevent the company from doing anything inconsistent with the Act. Note that it is only in the last-mentioned case that a trade union may prevent the company from acting.

ACTIVITY 6.1

The memorandum of incorporation of ToyZ Ltd states that the company has the power to sell only toys. The board of directors of ToyZ Ltd decides to buy a luxury yacht on behalf of the company.

- Will the contract of purchase and sale be valid?
- Do the shareholders have any remedies against the board of directors?

Feedback

Although the company's memorandum of incorporation may limit the legal capacity of the company in terms of section 19(1)*(b)*(ii), any such restrictions would not render any contract invalid that conflicts with these restrictions (section 20 (1) *(a)*). Thus the contract remains valid and binding upon the company and the other party to the contract.

If the board of directors has not yet completed the transaction, one or more shareholders, directors or prescribed officers of the company may obtain a court order restraining (i.e. preventing) the company or directors from doing so.

Section 20 (6) of the Companies Act provides that each shareholder has a claim for damages against any person who fraudulently or due to gross negligence causes the company to do anything inconsistent with the Companies Act or a limitation, restriction or qualification on the powers of the company as stated in its memorandum of incorporation, unless ratified by special resolution in terms of section 20(2). This is in addition to the remedy provided in section 165.

6.2 Representation

Representation relates to a person's acting under the company's authority. Authority can be given expressly (in writing or orally) or by implication. Whether authority has been conferred is a question of fact. Section 20(1)*(a)* of the Companies Act 71 of 2008 provides that the contract will be valid only if the directors had no authority to authorise the action by the company only as a result of the limitation, restriction or qualification on the capacity of the company. Therefore, if there is a lack of authority on any other basis, section 20(1)*(a)* does not apply and the company is not bound by the contract, even if the third party acted in good faith. The common-law principles of authority do not allow the company to give authority for something that is outside its capacity, because the rights and duties from the contract go to the principal. If the memorandum of incorporation contains a provision that directors do not have the authority to conclude contracts beyond the capacity of the company, this is regarded as a restriction on authority.

A company cannot participate in the legal sphere as a legal subject on its own; it therefore depends on its agents to conclude contracts on its behalf. If a company gives an agent authority to act on its behalf, the agent possesses **actual authority** and will bind the company in acts that fall within the scope of the mandate given to him or her. The agent has the consent to act on behalf of the principal; however, if the agent acts outside his or her mandate, the principal is not bound by that action/contract.

Sources of actual authority:

- memorandum of incorporation
- rules of the board
- express mandate

A company may also be bound by a contract on the basis of estoppel, where the person purporting to conclude the contract on its behalf lacked actual authority, express or implied, but the other party to the contract had been misled by the company into believing that he or she did have authority. This is referred to as **ostensible or apparent authority**. In other words, a company may be liable to a bona fide third party if it is represented by someone who does not have actual authority, but where the company allows such a person to represent the company as if that person did have authority.

6.2.1 The doctrine of constructive notice

The doctrine of constructive notice provides that third parties dealing with a company are deemed to be fully acquainted with the contents of the public documents of the company. **Section 19(4) of the Companies Act** partly abolishes this doctrine. Therefore, third parties contracting with the company will no longer be deemed to have had notice of the contents of the public documents of a company merely because they have been filed with the Commission or are accessible for inspection at the office of the company.

However, **section 19(5) of the Companies Act** provides for **two exceptions**: firstly, a person is deemed to have knowledge of any provision of a company's memorandum of incorporation in terms of section 15(2)*(b)* (relating to special conditions applicable to the company and additional requirements regarding their amendment).

This is subject to the condition that the name of the company includes the abbreviation "RF" and that the company's notice of incorporation contains a prominent statement drawing attention to such a provision, as required by section 13(3). In other words, the **doctrine of constructive notice still applies to "ring-fenced" companies**.

Section 15(2)(*b*) of the Companies Act determines that a company may include restrictions and conditions in its memorandum of incorporation pertaining to the company's capacity. Before a third party dealing with the company would be required to acquaint themselves with these restrictions and conditions, certain requirements must be met in terms of the Companies Act:

1. There must be a restriction or conditions in the memorandum of incorporation of the particular company.
2. A prohibition against amendment of the restriction or condition must be included in the memorandum of incorporation.
3. The company's name must be followed by "RF" to warn the third party of the special restrictions or conditions.
4. The notice of incorporation that is lodged together with the memorandum of incorporation must include a provision that draws attention to the fact that special restrictions or conditions apply to the company.

The second exception applies to a **personal liability company**. A person is also regarded as having received notice and having knowledge of the effect of section 19(3) on a personal liability company. Section 19(3), in turn, provides that the directors and past directors of a personal liability company are jointly and severally liable, together with the company, for any debts and liabilities of the company contracted during their respective periods of office.

6.2.2 The Turquand rule

You need know only the cases referred to, as they are discussed herein.

Common-law Turquand rule

The Turquand rule was derived from the case of *Royal British Bank v Turquand* (1856) 6 E & B 327, 119 ER 886. According to the common-law Turquand rule, if the person acting on behalf of the company has the authority to do so, but this is subject to an internal formality, such as approval by the board, an outsider contracting with the company in good faith is entitled to assume that this internal requirement has been complied with. The company will be bound by the contract even if the internal formality has not been complied with. The exceptions are if the outsider was aware that the internal formality had not been complied with, or if the circumstances in which the contract was concluded were suspicious.

The Turquand rule was formulated to keep an outsider's duty to inquire into the affairs of the company within reasonable bounds. To elicit the protection provided by the Turquand rule, there must have been an internal requirement present.

In Wolpert v Uitzigt Properties (Pty) Ltd 1961 (2) SA 257 (W), the articles of the company provided that the board of directors could authorise a person to sign promissory notes on its behalf. Therefore, the board could authorise anyone to sign promissory notes on its behalf. One of the company's ordinary directors signed promissory notes on behalf of the company without authorisation and the question arose whether the outsider was entitled to assume that the director was authorised to do so.

The court found that an outsider with express or constructive notice of the articles could assume that someone was authorised to sign the notes, but not that a specific person was so authorised.

For the Turquand rule to come into operation, the person who acted must have possessed actual authority that was subject to an internal formality. In *Tuckers Land and Development Corporation (Pty) Ltd v Perpellief* 1978 (2) SA 11, the court held that third parties may not automatically assume that a branch manager or an ordinary director has authority to act on behalf of the company. The company may still escape liability on the grounds that the person had no authority.

Statutory Turquand rule – section 20(7) of the Companies Act

Section 20(7) of the Companies Act now contains a provision that in some respects resembles the Turquand rule by providing that a person dealing with a company in good faith is entitled to presume that the company, in making any decision in the exercise of its powers, has complied with all the **formal and procedural requirements** in terms of the Act, the company's memorandum of incorporation and any rules of the company, unless the person knew, or reasonably ought to have known, of any failure by the company to comply with any such requirement.

However, this provision does not replace the common-law Turquand rule, because section 20(8) provides that subsection (7) must be interpreted concurrently with, and not in substitution for, any relevant common-law principle relating to the presumed validity of the actions of a company.

- A company's memorandum of incorporation determines who has authority to act on behalf of the company.
- The Turquand rule applies where the authority is subject to an internal requirement.

> **Example:** Company A's memorandum of incorporation determines that the board of directors has authority to conclude all contracts on behalf of the company. **<u>If the amount of the transaction exceeds R50 000, consent must be obtained from the shareholders at a general meeting</u>.**

The underlined part in the block above is an internal requirement. Even though the memorandum of incorporation is registered and available to the public, a third party contracting with the company would have to conduct a further investigation to ascertain whether or not consent was obtained from the shareholders.

The Turquand rule makes this unnecessary, as, in terms of this rule, third parties who act in good faith may assume that such internal requirement has been complied with.

The exceptions to the application of the statutory rule are not expressed in exactly the same way as the common-law exceptions: section 20(7) determines that the rule will not apply if the third party knew or **reasonably ought to have** known that the internal requirement had not been complied with. In *Nieuwoudt v Vrystaat Mielies* 2004 (3) SA 486, the court confirmed that the common-law Turquand rule applies only if it is clear that a person has actual authority. This means, *inter alia*, that if the memorandum of incorporation provides that the board can appoint a person to conclude a contract for the company, the common-law Turquand rule cannot be used by the bona fide third party.

Practical effect of the Turquand rule:

A company cannot escape liability under an otherwise valid contract on the ground that some internal formality or procedure was not complied with.

The Turquand rule does not protect

- directors, prescribed officers, shareholders or anyone who should have been aware whether the internal requirements had been complied with, or
- a third party who has relied on a forged document.

However, the Turquand rule does not convey ostensible authority such as when estoppel may be used. The person who represented the company had to have had **actual authority, which was subject to an internal requirement,** in order to rely on the Turquand rule.

ACTIVITY 6.2

Steelbelts Railway Carriages (Pty) Ltd's memorandum of incorporation provides that only the board of directors, or any person authorised by the board, has the power to conclude contracts on behalf of the company. In addition, any transaction that exceeds R100 000 must first be authorised by the company in a general meeting by way of ordinary resolution.

Mr Buckley, one of the directors, is authorised by the board of directors to act on behalf of the company. Mr Buckley concludes a contact with Mr Matthews for the purchase of equipment that will be used in the process of manufacturing railway carriages to the value of R150 000, without the authorisation of the company in a general meeting. Mr Matthews knows about this provision because he has dealt with the company before.

However, he assumes that the approval of the general meeting has been obtained, since it had always been obtained for previous transactions.

Is the company bound by the contract concluded by Mr Buckley?

Feedback

The company is bound by the contract concluded because of the operation of section 20(7) of the Companies Act. It provides that a person dealing with a company in good faith is entitled to assume that the company has complied with all of the formal and procedural requirements in terms of the Companies Act and the company's memorandum of incorporation and rules, unless the person knew or reasonably ought to have known of any failure by the company to comply with its formal and procedural requirements. There is no indication from the facts that Mr Matthews knew or reasonably ought to have known that Mr Buckley failed to comply with the procedural requirement in terms of the memorandum of incorporation.

There is also no indication that Mr Matthews was aware of the fact that Mr Buckley did not comply with the procedural requirement and had acted in bad faith. Based on these facts, the company is bound by the contract.

The contract will also be binding because of the common-law Turquand rule, since Mr Buckley is authorised to act on behalf of the company, but this is subject to an internal formality. Although Mr Mathews knew about the internal formality, he was entitled to presume that it had been complied with and there is no evidence that he knew it had not been complied with or that there was anything to raise his suspicion. In some instances, both the Turquand rule and section 20(7) of the Companies Act will apply, as in this case. This is not always the case, however.

6.2.3 The doctrine of estoppel

You need only know the cases referred to, as they are discussed herein.

Estoppel applies only when the **agent did not have actual authority** to bind the company. Take particular note of the fact that the misrepresentation (i. e. that the agent had the necessary authority when, in fact, he or she did not) must have been made by the **company** as principal.

Based on such misrepresentation, the company will be prevented (estopped) from denying liability if the third party can prove that

(a) the company misrepresented, intentionally or negligently, that the agent concerned had the necessary authority to represent the company
(b) the misrepresentation was made by the company
(c) the third party was induced to deal with the agent because of the misrepresentation
(d) the third party was prejudiced by the misrepresentation

In *Freeman and Lockyer v Buckhurst Part Properties (Mangal) Ltd* [1964] *2* QB 480 [103], the court decided that estoppel could arise not only from the articles (note that this would be the memorandum of incorporation in terms of the current Companies Act), but also because the company, with full knowledge and approval, allowed an ordinary director to act as the managing director and, in this manner, culpably represented that he or she was entitled to act.

Reflection

Despite the fact that companies enjoy separate legal personality, it is still necessary for individuals to act on their behalf. Only individuals with some type of authority may represent companies. This authority need not always be expressed authority.

ACTIVITY 6.3

The memorandum of incorporation of Concord Ceramics (Pty) Ltd (RF) provides that the board of directors has authority to contract on behalf of the company, subject to the condition that if the value of a contract exceeds R1 million, the approval of shareholders by special resolution is required.

The memorandum of incorporation further provides that this last-mentioned provision may be amended only by unanimous approval of all the shareholders.

(a) Are third parties deemed to be aware that the consent of the general meeting is required for transactions in excess of R1 million?
(b) To what extent is the doctrine of constructive notice still applicable to this company?

(c) Suppose that Mike, a site manager on one of the company's plants, regularly contracts on behalf of the company without having a mandate to do so. The board of directors takes note of this behaviour, but never takes any steps to caution Mike against contracting on behalf of the company. Mike enters into a contract with Timothy for the purchase of raw materials. The company now argues that Mike did not have authority to enter into the contract and that it is not bound by the contract. Advise Timothy on whether the company can be held to be bound by the contract.

Feedback

The doctrine of constructive notice has been partially abolished by section 19(4) of the Companies Act. Third parties contracting with the company are not deemed to have had notice of the contents of the public documents of a company merely because they have been filed with the Commission. Section 19(5) of the Companies Act provides for two exceptions: "ring-fenced" (RF) companies and personal liability companies are still subject to the doctrine of constructive notice.

In casu, the company is a "ring-fenced" company. A person is deemed to have knowledge of any provision of a company's memorandum of incorporation relating to special conditions applicable to the company and additional requirements regarding their amendment.

This is subject to the condition that the name of the company includes the letters "RF" and that the memorandum of incorporation contains a prominent statement drawing attention to such a provision, as required by section 13(3) of the Companies Act. Therefore, a third party dealing with the company will be deemed to be aware of the requirement of approval in a general meeting for contracts in excess of R1 million.

Where a director is allowed to contract on behalf of the company without actual authority, under certain circumstances the company may nevertheless be bound by such a contract.

This would be the case if the requirements for estoppel can be proven, that is, that the company negligently or intentionally created a misrepresentation that the director did in fact have the necessary authority, the third party was induced to deal with the agent because of the misrepresentation and was subsequently prejudiced by the misrepresentation. Reference should be made to *Freeman and Lockyer v Buckhurst Park Properties (Mangal) Ltd.*

Reflection

Despite the fact that companies enjoy separate legal personality, it is still necessary for individuals to act on their behalf. Only individuals with some type of authority may represent companies. This authority need not always be express authority.

This would be the case where the requirements for estoppel can be proven, that is, that the company negligently or intentionally misrepresented that a director did in fact have the necessary authority, the third party was induced to deal with the agent because of the misrepresentation, and the third party was prejudiced by the misrepresentation. Reference should be made to *Freeman and Lockyer v Buckhurst Part Properties (Mangal) Ltd*.

REVIEW

You have now learnt that companies are able to conclude any contract, whether it falls inside or outside the scope of their business. As long as the person who is representing the company has authority to do so, any act performed by him or her on behalf of or in the name of the company will usually bind the company.

The doctrine of constructive notice has largely been abolished by the Companies Act. Now only third parties dealing with **"ring-fenced" companies** and **companies with personal liability** are deemed to know about these special restrictions in their memorandum of incorporation.

Although a company may set restrictions on the scope of its actions in its memorandum of incorporation, such restrictions will not influence the validity of its actions unless the other contracting party (third party) is aware of the situation or reasonably should have had knowledge thereof. The Turquand rule also protects third parties against the possible invalidity of contracts. In terms of this rule, a third party may assume that the internal requirements have been complied with if he or she is acting in good faith and is unaware of any failure to comply with such internal requirements.

There are circumstances in which a company will be bound even if the person acting on behalf of the company did not have actual authority to conclude the contract, that is, when the elements of **estoppel** can be proven.

You should now understand the concept of legal capacity and representation. A company's capacity is determined by the **sphere of actions that it may legally perform**. Representation occurs when somebody acts on behalf of or in the name of a company. You should also understand that the doctrine of constructive notice provides that third parties dealing with a company are deemed to be fully acquainted with the contents of the public documents of the company. Section 20(7) of the Companies Act provides that a person dealing with a company in good faith is entitled to assume that the company has complied with all of the formal and procedural requirements in terms of the Companies Act and the company's memorandum of incorporation and rules, unless the person knew or reasonably ought to have known of any failure by the company to comply with its formal and procedural requirements. In terms of the common-law Turquand rule, if the person acting on behalf of the company has the authority to do so, but this is subject to an internal formality, such as approval by the board, an outsider contracting with the company in good faith is entitled to assume that this internal requirement has been complied with. Estoppel applies only when the **agent did not have actual authority** to bind the company.

Please ensure that you are able to answer the key questions at the beginning of the study unit.

In the next study unit you will be introduced to the corporate finance structure and will learn about shares, debentures and company distributions.

Study unit 7

Corporate finance: shares, debentures and distributions

Contents

Introduction

One of the main advantages of running a business in the form of a company is that a company has separate legal personality from its shareholders. This means that a company is the owner of its own assets and liable for its own obligations.

Another major advantage of the company as a business form is that it affords the opportunity to raise money from a wide range of investors. In this study unit we will explain the different ways in which a company can raise money. You will also learn how dividend payments work.

In certain circumstances, a company may buy back shares it previously issued; it may also assist a person financially to buy shares in that company.

A company obtains the funds it needs for its business through two possible means, namely equity financing and debt financing. Equity financing means that the company issues shares in return for some form of consideration paid to the company, which makes up the company's share capital.

Debt financing takes the forms of loans and can be either bank loans or debt securities. Debt securities are issued in a similar way to shares. The traditional debt security is called a debenture.

The providers of equity financing are the company's shareholders. They receive a return on their investment in the form of dividends. If the company is wound up, after all the company's creditors have been paid, the shareholders are entitled to the balance of the company's assets.

The providers of loan capital are called company creditors. The return on their investment is interest plus the principal amount of the loan, which must be paid back at a specified time as agreed.

In this study unit we will highlight the characteristics of shares and debentures, the procedure for issuance of shares and also the procedure for making distributions.

You will know that you understand this study unit if you are able to answer the following key questions:

- What is the legal definition of a share?
- What types of preference shares may be issued by a company?
- When must the board of directors obtain the approval of the shareholders before issuing shares?
- What are the differences between shares and debentures?
- What is meant by the pre-emptive rights of shareholders in private companies?
- What is solvency and liquidity test and when is it applicable?

7.1 The definition of a "share"

You need only know the cases referred to, as they are discussed herein.

Important terms:	**Meaning:**
Distribution	Any direct or indirect transfer of money or other property of the company, whether out of capital or profits, to shareholders in their capacity as shareholders.
Share	Incorporeal, movable property transferable in the manner provided by the Companies Act.
Deferred shares	A class of shares commonly issued to the founders of the company. The right of the holder to receive dividends is deferred (delayed) until dividends have been issued to all the holders of other classes of shares in the company.
Debenture	A document issued by a company acknowledging that it is indebted to the holder in the amount stated therein.
Dividend	A distribution (payment) by a company to its shareholders.
Ordinary shares	The residual category of a company's shares that does not carry any special class rights, such as special voting rights or preferential rights to payments of dividends.
Preference shares	A class of shares that provides a preferential right, including a preference to receive dividends when declared, to its holder.

The Companies Act defines a "share" as "one of the units into which the proprietary interest in a profit company is divided" (section 1). A shareholder is essentially one of the contributors of the fund that sets up a company. This fund is the share capital of the company. A share is the unit of the contribution made to the share capital. It is property in itself and can be traded.

The number of shares must be authorised in the memorandum of incorporation. The memorandum of incorporation of a company must set out the classes of shares and the number of each class that a company is authorised to issue. This is referred to as the "authorised share capital" of a company.

A company may issue shares only that are authorised by the memorandum of incorporation.

However, unless the company's memorandum of incorporation limits or excludes this power, a company's board of directors may increase or decrease the authorised share capital. They may further reclassify any shares authorised but not issued.

If a company issues 100 shares and the price per share that a shareholder pays is R1, the company will have a share capital of R100. In other words, the company will have raised R100 to use in its business. After the initial issue, the share will be worth what the market is willing to pay for it.

In Standard Bank of SA Ltd v Ocean Commodities Inc 1983 (1) SA 276 (A), the court held that a share usually entitles its holder to vote at a shareholders' meeting, to share in dividends if declared by the board and to share in any assets of the company after it has been wound up. It is therefore clear that there are personal rights attached to shares. The extent of these rights depends on the class of shares held.

7.2 Classes of shares

A company may divide its shares into different classes of shares.

Shares are divided in classes according to the specific rights that a share confers on its holder. The rights that differ among the various classes can usually be divided into the following:

- the right to vote
- the right to information
- the right to receive a dividend when one has been declared
- the right to share in the assets that are left upon the winding-up of a company after the company's creditors have been paid

The classes of shares most commonly found are preference shares, ordinary shares and deferred shares.

7.2.1 Preference shares

Preference shares provide their holders with a preference over other shareholders to dividends, and/or the right of return of capital on winding-up. You need to consult the memorandum of incorporation of the company, as well as the terms of issue of the preference shares, to find out in which respect they confer a preference on their holders. If the preference shareholders have the right to receive dividends first, this right is subject to a dividend being declared. In other words, if no dividend has been declared, the preference shareholders do not have a right to demand a dividend payment. The amount of the dividend is usually fixed at a specified percentage of the issue price paid for these shares or a stipulated amount, for example 5% preference shares.

In return for the preferential right to dividends, the right of preference shareholders to vote is usually curtailed in the memorandum of incorporation. However, even if the memorandum of incorporation provides that preference shareholders do not have the right to vote, the Companies Act provides that they have an irrevocable right to vote on any proposal to amend the preferences, rights, limitations and other terms associated with their shares.

There must always be at least one class of shareholders of the company that can vote at a meeting of shareholders and at least one class of shareholders that is entitled to the net assets of the company upon its liquidation. In other words, a company is not allowed to issue only preference shares that do not grant their holders the right to vote.

The following types of preference shares can be distinguished:

- *Cumulative preference shares:* Holders enjoy a right of priority in respect of both arrear dividends and current dividends. If a dividend is not declared in a specific year, the shareholder's right to a dividend is carried over to the next year. When a dividend is declared the next year, the preference shareholder will have to be paid two years' dividends before the ordinary shareholders can receive their dividends.

- *Participating preference shares:* After receiving their preference dividends, preference shareholders may be given the right to also receive normal dividends along with the ordinary shareholders, or just after the ordinary shareholders.
- *Preferential right to capital on winding-up:* Preference shareholders could be given the preferential right to receive repayment of the capital they contributed to the company on its winding-up. Additionally, they could be given the right to share in any surplus assets of the company upon its winding-up, after receiving their capital contributions, but this is the exception rather than the rule.
- *Convertible preference shares:* There is a right to convert the preference shares to shares of another class after a certain date.

7.2.2 Ordinary shares

The amount of the dividend paid fluctuates in accordance with the amount that the board regards as being available for dividends.

Ordinary shareholders receive dividends after the preference shareholders have received theirs. Ordinary shareholders also usually have the right to receive any surplus assets of the company after it has been wound up.

Normally, ordinary shareholders will have the right to vote at meetings of shareholders. In terms of the Companies Act, this right may be curtailed so that one class of ordinary shareholders will not have the right to vote. However, there must always be at least one class of shareholders that has the right to vote; and if there is only one class of shareholders, then all the shareholders must have the right to vote.

7.2.3 Deferred shares

Occasionally, shares are issued to the founders of a company; these shares entitle them to dividends only if the dividend amount exceeds a certain threshold and after the ordinary shareholders have been paid. In other words, deferred shareholders are last in line to receive dividends.

7.3 Issue of shares

The board of directors has the power to issue shares without approval of the shareholders, but these shares must be authorised by the memorandum of incorporation, either before the shares are issued or within 60 business days after the issue.

The board of directors has the authority to increase or decrease the authorised number of shares, except to the extent that the company's memorandum provides otherwise.

The shareholders may also amend the authorised share capital by way of an amendment to the memorandum by special resolution.

In the following circumstances, a resolution by the board of directors to issue shares must be approved by a special resolution of the shareholders:

- where the shares are issued to a current or future director or prescribed officer of the company (A "future director" or "future prescribed officer" does not include a person who becomes a director or officer more than six months after the shares were issued.)
- where the shares are issued to a person related or interrelated to the company, a director or a prescribed officer of the company

A natural person is related to another natural person if he or she is married to, or lives together with, that person as if they were married, or if they are separated by no more than two degrees of natural or adopted consanguinity, in other words, a person's parent, child, sister or brother, or grandparents. A natural person is related to a company when he or she directly or indirectly controls the company by either having the majority of voting rights or by having the right to appoint the majority of directors of the company.

A juristic person is related to another juristic person if it directly or indirectly controls the other by either having the majority of voting rights or by having the right to appoint the majority of directors of the company, or if it is a subsidiary of the company, or if it controls the business of the company.

- where the shares are issued to a nominee of any of the persons mentioned above
- where the voting power of the shares to be issued will exceed 30% of the voting power of the shares of that class held immediately before the issue

7.4 Right of pre-emption (section 39 of the Companies Act)

Every shareholder in a private company (and a personal liability company) has the right, before any other person who is not already a shareholder of the company, to be offered and to subscribe (within a reasonable time) for a percentage of any shares issued or proposed to be issued equal to the voting power of that shareholder's general voting rights immediately before the offer was made.

However, a company's memorandum of incorporation may limit, exclude or restrict this right with respect to any or all classes of shares of that company.

The general rule, therefore, is that shareholders of private companies have a right of pre-emption to new shares issued by the company. This means that when the company issues new shares, these shares must be offered to existing shareholders first, pro rata to their current shareholdings. However, the right of pre-emption will not apply if the shares are issued in terms of options or conversion rights, as capitalisation shares or if the shares are issued for future consideration.

This provision was included in the Companies Act to guard against the dilution of ownership in private companies. Dilution of ownership can be explained as follows: Suppose that Fidelity (Pty) Ltd has two shareholders who each hold ten shares. At a meeting of shareholders, they will have equal voting power.

Suppose that Fidelity (Pty) Ltd wants to issue 20 more shares. If a third person acquires all 20 of these shares, that person will have half of the voting rights at a meeting of shareholders. The original shareholders will then have only a 25% voting power in the meeting of shareholders. If they exercised rights of pre-emption, each of them would have been entitled to half of the 20 shares and, consequently, they would retain the same voting power in the company.

ACTIVITY 7.1

The directors of Rainbow (Pty) Ltd want to issue shares to Fred. Fred is not currently a shareholder of Rainbow (Pty) Ltd, but he has agreed to become the managing director of Rainbow (Pty) Ltd in a month's time. Fred has entered into a service agreement with Rainbow (Pty) Ltd and is required to hold qualification shares in the company before he can become a director.

The company's memorandum provides that the pre-emptive right of existing shareholders to subscribe to newly issued shares will not apply to this company.

Advise the directors on whether they may take the decision to issue the shares to Fred without shareholder approval.

Feedback

Fred is a future director of the company and, therefore, shareholder approval is required by way of a special resolution.

7.5 Debentures

A debenture is the most usual type of debt instrument and is an acknowledgment by a company that the company owes the debenture holder a certain sum of money, as evidenced in the document. Debenture holders are creditors of the company by virtue of having extended loans to the company. For that reason, they do not receive dividends on their debentures, but interest.

The duties of the company towards the debenture holders can be secured or unsecured. A trustee will usually be appointed to hold security on behalf of the debenture holders. If the company defaults on its commitments to the debenture holders, the trustee will be able to enforce the security on their behalf, without the need for every debenture holder to institute action individually.

The board of directors may authorise the company to issue debentures without approval of the shareholders, unless otherwise indicated in the memorandum of incorporation.

Shares, debentures and other debt instruments are all included in the definition of "securities", but there are important distinctions between shareholders and debenture holders:

- The shareholder of a company has the right to be paid a dividend only if a dividend has been declared by the company; he or she also has the right to a share in the net assets of the company if it is wound up. However, a shareholder also has a duty to abide by the company's memorandum of incorporation.
- As a debenture is a debt instrument, the holder of a debenture has effectively loaned a sum of money to the company on certain terms.
- Accordingly, the debenture holder is entitled to repayment of the sum of money loaned to the company and is, therefore, a creditor of the company. A debenture holder also has the right to be paid interest according to the conditions of the debenture. A debenture is a document issued by a company to acknowledge that it is indebted to the debenture holder in the amount stated therein.
- A debenture or other debt instrument may be issued in which the holder of the debt instrument is given the right to attend and vote at general meetings, to appoint directors and to have special privileges regarding the allotment of securities, unless the memorandum of incorporation provides otherwise. This was not previously the case under the Companies Act 61 of 1973.

7.6 Distributions

Section 46 of the Companies Act regulates distributions. A distribution is any direct or indirect transfer by a company of money or other property of the company (except its shares) to one or more of its shareholders or beneficial holders of shares, whether as the payment of dividends, payment for the purchase by a company of its previously issued shares, the incurrence of a debt for the benefit of one or more of the shareholders of the company, or the forgiveness of a debt owed to the company by one or more of the shareholders of the company.

A distribution may be made in the following circumstances:

- The board of directors must authorise the distribution.
- It must reasonably appear that the company will be able to satisfy the solvency and liquidity test immediately after the distribution has been made.

- The board must acknowledge by way of a resolution that it has applied the solvency and liquidity test and reasonably concluded that the company will satisfy the test immediately after completion of the proposed distribution.

The solvency and liquidity test is set out in section 4 of the Companies Act:

Solvency test: considering all reasonably foreseeable financial circumstances of the company at that time, the assets of the company, fairly valued, equal or exceed the liabilities of the company as fairly valued.

Liquidity test: considering all reasonably foreseeable financial circumstances of the company at that time, it appears that the company will be able to pay its debts as they become due in the ordinary course of business for a period of 12 months after the distribution. If the distribution was in the form of giving a loan to a shareholder or forgiving a loan made to a shareholder, the period runs from 12 months after the test was considered.

The distribution must be made within 120 days after the test was applied, otherwise the resolution by the board must be taken again and the test must be applied again.

As long as these requirements are met, dividends can be paid out of the share capital of a company. However, usually dividends are paid from the profits of a company. The board of directors decides how much of the profits they want to pay out to shareholders.

They are free to decide that they are going to keep all profits for the expansion of the business of the company. Normally, in such circumstances, the shareholders are not entitled to dividends.

7.7 Company or subsidiary acquiring company's shares

The board of a company may determine that a company will acquire a number of its own shares. The board of a subsidiary company may determine that it will acquire a number of shares of its holding company. The company or subsidiary may then, in terms of section 48 of the Companies Act, make an offer to the shareholder/shareholders. This offer may subsequently be accepted or rejected.

Section 48 of the Companies Act does not require that an offer be made to all shareholders or that the offer be made according to the interest that the shareholders hold in the company.

If the shares are to be acquired from somebody who is related to the company or a prescribed officer of the company, the board's decision to acquire the shares must be approved by the shareholders by way of special resolution. If a company wishes to acquire more than 5% of the shares of a particular class, special requirements apply. A subsidiary may likewise not own more than 10% of the number of any class of shares after acquiring shares from its holding company, and the shares so acquired will not enjoy voting rights in the holding company for as long as the subsidiary remains a subsidiary. An acquisition of shares that would have the effect of leaving only convertible or redeemable shares is prohibited.

The acquisition of its own shares by a company is considered to be a distribution. Therefore, the requirements of section 46 of the Companies Act (as discussed above in 7.6) must be complied with.

If the solvency and/or liquidity criteria, as required in sections 46 and 48 of the Companies Act, are not complied with, the acquisition of shares cannot be enforced. In such a case, the company may, within 2 years after the acquisition, apply to court for an order reversing the acquisition of the shares. The court has discretion to order the return of the amount paid by the company and return of the shares.

Directors who are present at a meeting or participate in authorising the acquisition may be held personally liable for the loss or damages suffered by the company resulting from failure to vote against a decision, despite knowing that the requirements of sections 46 and 48 of the Companies Act were not complied with.

ACTIVITY 7.2

Prosperity Ltd wants to decrease its issued share capital through a repurchase of shares.

Advise the board of directors of Prosperity Ltd of the requirements before they may proceed with this transaction.

Suppose that it emerges after the transaction has been approved by the board of directors that one of the company's main debtors is insolvent and will not be able to pay its debts to the company. This means, in turn, that Prosperity Ltd will not be able to pay its debts after the repurchase of the shares. Advise Prosperity Ltd on possible steps it may take to remedy the situation.

Feedback

A company is allowed to repurchase its shares. This is considered a distribution, which means that the solvency and liquidity test must be applied and passed. A company may make distributions out of profits or share capital, as long as solvency and liquidity are maintained.

After the company has purchased its shares, there must be shares left, other than convertible or redeemable shares. Some shares must be held by shareholders other than the company's subsidiaries.

If the company agreed to repurchase shares and it emerges that the company will not be able to meet its obligations in terms of the agreement because it will not meet the requirements of section 48 (2) and (3) – which includes the requirements set out in section 46 for a distribution, and thus the solvency and liquidity test – the agreement between the shareholder and the company, in terms of which the company would repurchase the shareholder's shares, remains enforceable. The company must apply for a court order to suspend the repurchase of the shares.

The company bears the burden of proof that it cannot meet the requirements of the Companies Act. The court may make any order it deems just and equitable to ensure that the person from whom the shares are bought will be paid at the earliest possible time and that the company will also be able to fulfil its other financial obligations as they fall due and payable.

If the repurchase has been completed but it subsequently appears that the acquisition was in contravention of the requirements of sections 46 or 48, the company must, within two years after the acquisition, apply for a court order to have the repurchase reversed.

The person from whom the shares were bought will then be required to return the consideration received. The company, in turn, will have to issue to that person the same number and class of shares as those it acquired.

Directors who approved a repurchase of shares in contravention of the requirements relating to distributions are liable in the same manner.

7.8 Financial assistance for the purchase of securities

You need only know the following cases, as they are discussed herein.

In terms of section 44 of the Companies Act, a company may give financial assistance by way of a loan, guarantee, provision of security or otherwise to a person for the purpose of or in connection with the acquisition of shares and other securities in the company, provided that such assistance is not prohibited by the memorandum of incorporation and that certain requirements are met.

The decision to assist a person to acquire shares in the company rests with the board of directors, but only where the assistance is in terms of an employee share scheme or where a special resolution by the shareholders taken within the previous two years authorised such assistance to a specific person, or to persons that fall in a specific class or category. In the latter case, the person to whom the assistance will be given must fall in that class.

Section 44 further requires that the board be satisfied that the solvency and liquidity requirements will be met immediately after providing the financial assistance (see above) and that the assistance be given under terms that are fair and reasonable to the company.

The memorandum of incorporation may place further restrictions on the provision of financial assistance and the board must ensure that these requirements are also met.

The *Lipschitz v UDC Bank Ltd* 1979 (1) SA 789 (A) [138] decision dealt with the prohibition of financial assistance in terms of the 1973 Companies Act. However, the decision is still important for the application of section 44 because it gives us guidelines for when the provisions of the section will be applicable to a particular scenario.

In *Lipschitz v UDC Bank Ltd,* it was held that the transaction must be assessed in two phases:

- First, it must be ascertained whether there was financial assistance. In *Gradwell (Pty) Ltd v Rostra Printers Ltd* 1959 (4) SA 419 (A), the "impoverishment test" was formulated to assist in determining whether financial assistance was provided. In terms of the impoverishment test, you consider whether a transaction will have the effect of leaving the company poorer. If so, financial assistance was provided. In *Lipschitz,* the court held that this is not the only measure of financial assistance, but that exposing the company to risk will also qualify as financial assistance for purposes of the Act. For example, if the person obtained a loan to purchase shares in the company and the company stood surety for that loan, it will count as financial assistance. If the company buys an asset from the person to enable that person to purchase shares in the company, it will depend on the facts whether this constitutes financial assistance. Factors that have emerged from case law to assist in this regard include whether the company needs the asset in its normal business and whether the company paid a fair price for it.
- Second, it must be determined whether that assistance was for the purpose of acquiring shares in the company.

When a transaction passes these two phases, it will have to comply with section 44 to be valid. If it was not financial assistance, or if the assistance was not in connection with the purchase of shares, section 44 is not relevant to the transaction.

ACTIVITY 7.3

David wants to subscribe for shares in Free-4-All (Pty) Ltd. He does not have money available, but he offers to sell some computer equipment left over from a previously unsuccessful business to the company. He will then use this money to pay for the shares in Free-4-All (Pty) Ltd.

Advise the board of directors of Free-4-All (Pty) Ltd whether the company must comply with the requirements of section 44 of the Companies Act before they may enter into this agreement with David.

Feedback

You will have to consider the approach of the court in the *Lipschitz* decision in your answer. Remember that we are not asking you to describe the requirements of section 44 in this activity; rather, you must determine whether section 44 is applicable to this scenario. After discussing the process as formulated in *Lipschitz,* you must come to a conclusion. For instance, you may say that if Free-4-All (Pty) Ltd needs the equipment, this will not be financial assistance and the company will not need to comply with section 44.

ACTIVITY 7.4

Vusi, a shareholder and director of Securities (Pty) Ltd, agrees to sell his shares in the company to Jonathan for R20 000. To enable Jonathan to acquire the shares, Securities (Pty) Ltd agrees to lend Jonathan the sum of R20 000.

Explain whether this transaction amounts to financial assistance and, if so, what requirements have to be satisfied in order for it to be a valid transaction.

Feedback

Since this is clearly a loan for the purpose of the purchase of shares in the company, it is obviously financial assistance, as described in section 44. You will therefore have to discuss the requirements of section 44 for it to be a valid transaction.

Reflection

Clearly, capital maintenance is important to ensure that company creditors are not prejudiced by some of the transactions companies may enter into. That is why the solvency and liquidity test must be applied before a company enters into transactions that may affect its financial position.

REVIEW

In this study unit we introduced you to the topic of shares and debentures. Both shares and debentures are issued by companies to raise capital. However, they confer different rights on their holders. You should be able to identify these differences. We also explained the circumstances under which a company may make distributions.

In the next study unit we will look at the role of shareholders as an important organ of the company. You will also learn how decisions are taken at company meetings.

Study unit 8

Shareholders and company meetings

Contents

Introduction

You have learnt that a company may divide its shares into different classes and that the holders enjoy different rights according to the class of shares that they hold.

In this study unit you will learn who is responsible for taking decisions in companies. These decisions are taken at different types of meetings. In this study unit we will explain what happens at these meetings and the important role that shareholders play.

You will know that you understand the study unit if you are able to answer the following key questions:

- Why and how are meetings convened?
- What is the quorum requirement under the Companies Act?
- What are the requirements for valid notice of a meeting under section 62 of the Companies Act?
- What is representation by proxy?
- What is the difference between an ordinary and a special resolution?
- Is it possible to pass a resolution without holding a formal meeting?

- What matters must be dealt with in the annual general meeting?
- When must a meeting be postponed or adjourned?

8.1 The meaning of "shareholder"

Important terms:	**Meaning:**
Proxy	A person who is appointed to represent a shareholder at a meeting of shareholders.
Majority rule	In the affairs of a corporation, the will of those holding a majority of votes must ultimately prevail.
Ordinary resolution	A decision taken at a shareholders' meeting, with the support of more than 50% of the voting rights exercised, or as indicated in the memorandum of incorporation.
Special resolution	A decision taken with the support of more than 75% of the voting rights exercised, or as determined in the memorandum of incorporation.
Quorum	The number of persons needed to be present at the shareholders' meeting for the meeting to begin.
Unanimous assent	If all the shareholders agree to pass a resolution.

The Companies Act uses only the term "shareholder" in respect of a profit company. The term "member" of a company is reserved for non-profit companies that do not have shareholders. There is a definite difference in meaning between a member and a shareholder.

There are two definitions of a "shareholder" in the Companies Act. The definition in section 1 is more limited, since it refers to the holder of a share issued by a company who is entered as such in the company's securities register. A "shareholder" is defined in section 57(1) as a person who is entitled to exercise any voting rights in relation to a company, irrespective of the form, title or nature of the securities to which those voting rights are attached.

The second definition thus also includes a debenture holder who has voting rights. This definition applies only to Part F of Chapter 2 of the Act, which deals with governance of companies.

8.2 Notice of meetings

A notice of a meeting must

- be in writing
- indicate the date, time and place of the meeting
- indicate the purpose of the meeting
- indicate that a shareholder is entitled to appoint a proxy
- include a copy of any proposed resolution
- be given at least ten days prior to the meeting (15 days for public companies and non-profit companies with members)

If there has been a material defect in the giving of notice, the meeting may proceed only if every person who is entitled to vote in respect of any item on the agenda is present at the meeting and votes to approve the ratification of the defective notice.

A company may provide for a shareholders' meeting to be conducted by electronic communication. Where a company allows for participation in a meeting by electronic communication, a notice convening the meeting must inform the shareholders or their proxies of the option to participate electronically. Costs for participation are borne by the shareholder.

8.3 Representation by proxy

A shareholder may appoint someone (including someone who is not a shareholder) to act, speak or vote on his or her behalf at a shareholders' meeting or to provide or withhold consent in terms of section 60.

Requirements for appointment of a proxy:

- The appointment must be in writing and signed by the shareholder.
- The appointment is valid for one year.
- The appointment may be for a specific period of time.
- The appointment may be for two or more persons concurrently exercising voting rights for different shares.
- A proxy may delegate authority to act on behalf of the shareholder to another person.
- A copy of the proxy appointment form must be delivered to the company before the shareholders' meeting.
- A shareholder is not compelled to make an irrevocable proxy appointment.
- A shareholder may alter a proxy by cancelling it in writing, appointing another proxy and delivering a copy of the revocation to both the proxy and the company.

ACTIVITY 8.1

The memorandum of incorporation of Zithulele (Pty) Ltd provides that should shareholders wish to exercise the right to appoint a proxy, they may appoint only one proxy from the list provided by the company.

In this regard, advise Mr Ngcobo, who is a shareholder of the company and wishes to appoint a person who is not a shareholder as his proxy.

Feedback

A shareholder may appoint more than one proxy. Shareholders could be invited by the company on the proxy appointment form to appoint a proxy from a list provided by the company. However, a shareholder is not obliged to choose one or more persons from the list. The appointment form should contain sufficient space for the shareholder to indicate whether the proxy will vote in favour or against the resolution. Mr Ngcobo may appoint two or more proxies concurrently, who will exercise voting rights attached to different shares held by him.

8.4 Demand to convene a shareholders' meeting

A shareholders' meeting **may** be called by the board of directors or any person authorised to do so by the memorandum of incorporation. A meeting **must** be convened if required by the Companies Act or the memorandum of incorporation, or if demanded by shareholders holding at least 10% of the voting rights that may be exercised at that meeting.

8.5 Shareholders acting other than at a meeting

You need only know the cases referred to, as they are discussed herein.

In English and South African case law, the common-law rule of unanimous assent was accepted. In terms of this rule, certain decisions may be valid without a meeting being held if all the members are fully aware of the facts and all of them assented thereto, although this need not be in writing. In *Gohlke and Schneider v Westies Minerals (Pty) Ltd* 1970 (2) SA 629 (A), the court held that members may validly appoint a director to the board without any formal meeting being held because there was evidence of their unanimous consent. The court in *In re Duomatic Ltd* [1969] 1

All ER 161 (Ch) held that the unanimous approval of directors' remuneration by the two directors holding all the voting shares in a company could be regarded as a resolution of a general meeting approving the payment.

Although it is still possible to apply the common-law principle of unanimous assent, the Companies Act now provides another option. The general principle still remains that shareholders exercise their rights through resolutions at meetings. However, in terms of section 60 of the Companies Act, a resolution may be submitted to shareholders and, if adopted in writing by the required majority, will have the same effect as if it had been adopted at a meeting, without actually holding a general meeting of shareholders. This means that the unanimous assent (in terms of which each and every shareholder must agree) is not required under section 60.

As long as the required majority agrees in writing, a decision may be validly passed without convening a shareholders' meeting. However, any business of a company that must be conducted at an annual general meeting may not be conducted by using the section 60 procedure.

ACTIVITY 8.2

The shareholders of Zithulele (Pty) Ltd want to pass a resolution regarding the appointment of a new director. Advise the shareholders regarding a possible alternative to holding a formal meeting, as provided for under common law and in terms of the Companies Act to appoint the new director.

Feedback

If all the shareholders agree, it is possible to make the appointment through unanimous assent. Reference should be made to *Gohlke and Schneider v Westies Minerals*.

If there are dissenting shareholders (i.e. some shareholders who are not in agreement), it may be possible to use the procedure prescribed in section 60 of the Companies Act, as long as the required majority agrees and it is not a matter reserved for the annual general meeting in terms of the Companies Act (see list below). The shareholders of Zithulele (Pty) Ltd may then, by written polling of all shareholders entitled to vote on the election, pass the resolution. The company must deliver a statement within ten business days after adopting the resolution, describing the results of the vote, consent process or election to every shareholder entitled to vote on the resolution.

8.6 Annual general meeting

In terms of the Companies Act, only public companies have a statutory obligation to convene annual general meetings.

Section 61(8) of the Companies Act stipulates that at least the following matters must be transacted at the annual general meeting:

- election of directors to the extent required by the Companies Act or the company's memorandum of incorporation
- appointment of an auditor for the following financial year
- appointment of an audit committee
- presentation of the directors' report
- presentation of audited financial statements for the immediately preceding financial year
- presentation of an audit committee report
- any matter raised by shareholders

8.7 Convening a meeting in special circumstances

If a company cannot convene a meeting because it has no directors or all its directors are incapacitated, section 61(11) of the Companies Act applies. In terms of this section, it is possible to authorise another person in terms of the memorandum of incorporation to convene a meeting under these circumstances.

If no provision is made in the memorandum of incorporation, any shareholder may request the Companies Tribunal to convene a meeting.

Section 61(12) of the Companies Act applies to the situation where, for other reasons than the lack of or incapacity of directors, a company fails to convene its annual general meeting or a meeting required by its memorandum of incorporation or shareholders. Under these circumstances, any shareholder may apply to court for an order to convene a meeting.

8.8 Quorum

Section 64 provides that a meeting may not begin until sufficient persons holding at least 25% of all the voting rights in respect of at least one matter to be decided on at the meeting are present. The percentage (25%) may be increased or reduced in the memorandum of incorporation. However, if a company has more than two shareholders, at least three shareholders must be present.

If a quorum is not achieved within an hour after the time for which the meeting was scheduled, the meeting must be postponed for one week. Where a quorum is not present at the postponed or adjourned meeting, those present in person or by proxy will be deemed to constitute a quorum.

8.9 Conducting of meetings

You need only know the following case, as it is discussed herein.

The requirements for both a special and an ordinary resolution clearly state that the required percentage of votes exercised on the resolution must be in favour of the resolution in order for it to be validly adopted. Only the votes of shareholders who actually exercise their votes are taken into consideration.

Majority rule:

Companies take decisions through majority vote. This rule is not contained in the Companies Act itself, but is a common-law rule.

In *Sammel and others v President Brand Gold Mining Co Ltd* 1969 (3) SA (629) (A), Trollip J summarised the position as follows (at 678):

"By becoming a (minority) shareholder in a company, a person undertakes by his contract to be bound by the decisions of the prescribed majority of shareholders, if those decisions on the affairs of the company are arrived at in accordance with the law, even where they adversely affect his own rights as a shareholder."

8.10 Exercise of voting rights

Three possible situations are discussed in section 57 of the Companies Act. Briefly summarised, they are as follows:

(1) A profit company (other than a state-owned enterprise) with only one shareholder:
- The shareholder may exercise all the voting rights.
- Rules of setting a record date, which is the date for determining the shareholders' rights with regard to the meeting (section 59), written polling (section 60), convening a

shareholders' meeting (section 61), notice of meetings (section 62) and the normal quorum requirements do not apply.

(2) A profit company (other than a state-owned enterprise) with only one director:

- The director may exercise any power or perform any function of the board at any time, except when the memorandum of incorporation provides otherwise.

(3) A company (other than a state-owned enterprise) where every shareholder is also a director:

- Shareholders may decide on any matter to be referred by the board at any time, without notice or compliance with any internal formalities, except when the memorandum provides otherwise; subject to certain specified conditions.

ACTIVITY 8.3

Every shareholder of Zithulele (Pty) Ltd is also a director of the company. Advise the directors on whether they have to convene a formal meeting of shareholders to consider matters that have to be referred to shareholders.

ACTIVITY 8.4

Where every shareholder is also a director of a company (except a state-owned company), they may decide on any matter to be referred by the board at any time, without notice or compliance with any internal formalities, except when the memorandum provides otherwise (section 57(4)). Every director must be present at the board meeting when the matter is referred to them in their capacity as shareholders.

A quorum must be present at the meeting and the resolution passed must be accepted for it to be either an ordinary or special resolution. All the shareholders of Zithulele (Pty) Ltd may decide on any matter to be referred by the board at any time, without notice or compliance with any internal formalities, except when the memorandum of incorporation provides otherwise.

8.11 Shareholder resolutions

Section 65 (7) and (9) of the Companies Act provides for two types of resolutions that may be taken by shareholders, namely an ordinary resolution, requiring more than 50% of the votes exercised, and a special resolution, requiring at least 75% of the voting rights exercised.

A company is allowed to stipulate a higher percentage for approval of an ordinary resolution (except for the removal of a director) or a different percentage (i.e. higher or lower) for special resolutions in its memorandum of incorporation, on condition that there must always be a difference of at least 10% between the highest percentage required for an ordinary resolution and the lowest percentage for any special resolution.

8.12 Decisions that require a special resolution

A special resolution is required at least

- to amend the memorandum of incorporation
- to approve the voluntary winding-up of a company
- to approve proposed fundamental transactions

A special resolution may also be required for other transactions in terms of the memorandum of incorporation.

8.13 Postponement and adjournment of meetings

If, after one hour of the appointed time of a meeting, a quorum is not present, the meeting must be postponed for one week. In exceptional circumstances, it is possible to extend the one hour period. A company's memorandum of incorporation or rules may specify other time limits. No new notice needs to be issued regarding the meeting that has been postponed for one week, unless the venue changes.

The shareholders entitled to vote may, despite achieving a quorum, at any time decide to adjourn a meeting and set a date for a subsequent meeting at any agreed-upon time, as long as it is not later than 120 business days after the date of the original adjourned meeting.

ACTIVITY 8.5

At the shareholders' meeting of Zithulele (Pty) Ltd, the chairperson, Mr Phakathi, wants to adjourn the meeting because there are not enough shareholders to form a quorum.

Advise the shareholders whether the meeting may be validly adjourned.

Feedback

A meeting may be adjourned for a week if, within an hour of the scheduled starting time, the quorum has not been formed. On the grounds of exceptional circumstances, Mr Phakathi may extend the one hour limit when the quorum has not been formed at the scheduled starting time.

A notice of adjournment will be given only if the location of the adjourned meeting is different. Shareholders of Zithulele (Pty) Ltd may agree on different periods in the memorandum of incorporation and alter the one-hour rule and the one-week adjournment.

A meeting may be adjourned for a fixed time and place or until further notice. Where a meeting is adjourned, it may not be adjourned for more than 120 business days.

REVIEW

In this study unit you learnt that shareholders are important in the decision-making process of companies. Shareholders enjoy voting rights attached to the class of shares that they hold. You also learnt about the procedure to call a meeting where a decision, either by ordinary resolution or special resolution, is to be passed. Please ensure that you know the different notice periods for the different companies, the quorum requirements and how and when a meeting may be postponed or adjourned.

Please ensure that you are able to answer the key questions at the beginning of this study unit.

In the next study unit you will be introduced to directors and board committees.

Study unit 9

Directors and board committees

Contents

Introduction

You have already been introduced to one of the organs of a company: the general meeting of shareholders. The shareholders of a company exercise their rights and functions entrusted to them in the Companies Act and the memorandum of incorporation by adopting resolutions at a meeting of shareholders. In this study unit you will be introduced to the other main organ of a company, namely the board of directors. We will also introduce you to one of the office bearers of the company, namely the director.

You will know that you understand this study unit if you are able to answer the following key questions:

- List the different types of directors recognised in the Companies Act and the King Code respectively.
- How many directors must there be in a private company?
- How many directors must there be in a public company?
- What happens if the number of directors falls below the prescribed number?
- Indicate which groups of people are ineligible to be appointed as directors of companies in terms of the Companies Act 71 of 2008.
- Which groups of persons may become directors only with the consent of the court, but are disqualified otherwise?
- How are directors appointed?
- What procedure must be followed in order to remove a director from his or her office as a director?
- List the duties of directors in terms of the common law and the Companies Act 71 of 2008 respectively.
- What needs to be proven before a director can rely on the business judgment rule?
- List at least five contraventions for which a director can incur personal liability in terms of section 77 of the Companies Act.

9.1 Meaning of the word "director"

You need only know the cases referred to, as they are discussed herein.

Important terms:	**Meaning:**
Ex officio director	A director who holds office as a director of a company as a result of his or her holding another office or title or status.
Alternate director	A person appointed to the board of directors of a company as a substitute for a particular elected director of that company.
Executive director	A director who participates in the day-to-day management functions of a company. (Usually such a director is also an employee of the company.)
Independent director	A director appointed to the board of directors from outside, who is independent and unrelated to the company and its subsidiaries.
King Code	***King Report on Corporate Governance, 2009****, or King III*; the report on corporate governance principles for South African companies.
Non-executive director	A director who does not participate in the day-to-day management of a company. (These directors are usually not recognised as employees of the company in terms of labour law principles.)
Ineligible to be a director	The term for a person who is absolutely prohibited from becoming a director of a company.

Important terms:	**Meaning:**
Disqualified from being a director	The term for a person who is prohibited from being a director, unless a court gives him or her permission.
Board of directors	The group of directors responsible for the management of the business and affairs of a company.
Codification	A systematic and comprehensive compilation of the entire body of law.
Business judgement rule	The principle that a director is not in breach of his or her statutory duties if he or she took reasonably diligent steps to inform himself or herself of the matter in question, had no personal interest, and had a rational basis for believing that his or her decision was in the best interests of the company.

A director is a member of the board of a company; this includes any person occupying the position of a director or alternate director, by whatever description. A person becomes a director only

- when he or she has given his or her written consent to serve as director
- after having been appointed or elected, or holding office in accordance with the provisions of section 66 of the Companies Act

9.2 Types of directors

Different types of directors have been recognised by both the *King Report on Corporate Governance, 2009* (King Code) and the Companies Act.

Remember that the principles in the King Code are soft-law principles. They are not enforceable, except for provisions that have been included in legislation or have been made compulsory in another way, for example by being included in the listing requirements of the JSE Ltd for companies that wish to list on the stock exchange. They are guidelines to indicate the principles that a company should adhere to for purposes of good governance.

The King Code differentiates between the following three types of directors:

- executive directors
- non-executive directors
- independent directors

However, the court in *Howard v Herrigel* 1991 (2) SA 660 (A) held that it is unhelpful or even misleading to classify company directors as "executive" or "non-executive" for purposes of determining their duties to the company or when any specific or affirmative action is required of them. Once a person accepts an appointment as director, he or she is obliged to display the utmost good faith towards the company, irrespective of whether such a person is an "executive" or a "non-executive" director. In other words, a director can be held liable for a breach of his her statutory duties whether or not he or she participates in the running of the company business on a full-time or intermittent basis.

The Companies Act recognises the following types of directors:

- an *ex officio* director
- a memorandum of incorporation-appointed director
- an alternate director
- an elected director
- a temporary director who is appointed in order to fill a vacancy

The following explanation may be helpful in deciding which type of director a person would qualify as:

- Shareholders must elect at least 50% of the directors of a profit company. These directors will be classified as elected directors.
- A person can hold the office of director because he or she holds another office. (For example, the memorandum of incorporation may provide that any person who is appointed as legal adviser of the company will also be a director of the company. In such case, a person appointed as legal adviser will automatically be a director – an *ex officio* director.)
- A person can hold the office of director because he or she was appointed by name in the memorandum of incorporation, or because he or she was appointed by someone who was given the authority in the memorandum of incorporation to appoint a director – a memorandum of incorporation-appointed director.
- A person can hold the office of director because he or she is an alternate director who replaces a director during a temporary absence and is thus authorised to attend meetings and to vote. Depending on the memorandum of incorporation, these directors may either be appointed by the board of directors or elected by the shareholders, but at least 50% of the alternate directors must be elected by the shareholders.
- A person can hold the office of director because he or she is standing in for an absent director – a temporary director. Depending on the memorandum of incorporation, the board of directors may appoint these directors.

ACTIVITY 9.1

Sam is appointed as a director in ABC Ltd, a subsidiary of FAB Ltd. Sam has a separate employment contract with the company and is engaged in the day-to-day operations of the company.

Peter was elected as a director by the shareholders. However, he does not participate in the management of ABC Ltd or any of its subsidiaries, nor does he have a separate contract of employment with ABC Ltd.

In the company's annual report, it is stated that ABC Ltd's chief executive officer will, by virtue of holding this office, be a director. Jack is appointed as the chief executive officer, but was never appointed as a director by the shareholders at any meeting.

Calvin was appointed by the directors of ABC Ltd to stand in for Sandra, an executive director of the company, while she is on maternity leave.

Distinguish between the different types of directors as recognised in the Companies Act and the King Code. Indicate which types of directors Sam, Peter, Jack and Calvin would be classified as.

Feedback

Note the difference between the three types of directors recognised in terms of the King Code and those recognised in terms of the Companies Act.

You should have indicated the following:

- Sam is an executive director.
- Peter is an elected director. (Owing to the fact that he does not participate in the daily running of the business, he is also a non-executive director.)
- Jack is an *ex officio* director because he is only a director by virtue of his other appointment in the company; he was not elected as such.
- Calvin is a temporary director and an executive director.

9.3 Directors and managers

There are differences between being a "director" and a "manager". A manager is an employee of a company, whereas a director is not necessarily an employee. Managers and directors also differ in their roles with regard to, *inter alia,* leadership, decision-making and their respective duties and responsibilities. The board of directors, for example, is responsible for the leadership and direction of a company, while the managers' tasks are to carry out the strategy on behalf of the directors. Directors are also responsible for organisational decision-making, while managers are concerned with the implementation of such decisions and policies.

9.4 Number of directors and consent

The different types of companies should each have a specified minimum number of directors in terms of the Companies Act:

Type of company	Number of directors
Private company	**1**
Personal liability company	**1**
Public company	**3**
Non-profit company	**3**

Note: Where a company does not have the prescribed number of directors, any act performed by the board of directors or the company will nevertheless remain valid.

A person becomes a director of a company when that person

- has been appointed or elected as a director in terms of the Companies Act or memorandum of incorporation; or
- holds an office, title, designation or similar status entitling that person to be an *ex officio* director of the company.

Special activity

Access this case and summarise it:

S v Vandenberg and others 1979 (1) SA 208 (D). Remember to follow the instructions at the beginning of the study guide.

A person will become a director only once he or she has delivered written consent accepting such a position.

9.5 Directors: the Companies Act and a company's memorandum of incorporation

Certain provisions of the Companies Act, including some in respect of directors, may be changed by the provisions of a company's memorandum of incorporation, while others may not.

A public company may, in terms of its memorandum of incorporation, specify a higher number than the minimum number of directors required in terms of the Companies Act. Section 66(4) of the Companies Act provides that the memorandum of incorporation of a profit company must provide that the shareholders will be entitled to elect at least 50% of any alternate directors. A company's memorandum of incorporation may provide for the payment of remuneration to its directors and the term of their office.

9.6 Ineligible and disqualified persons

You need only know the cases referred to, as they are discussed herein.

Certain people are ineligible to be appointed as a director of a company, while others are disqualified.

Note: If a person is ineligible to be appointed as a director, this means that such a person is absolutely prohibited from becoming a director; there are no exceptions.

If a person is disqualified from being appointed as a director, this means that, with the exception of a person who has been prohibited from being a director by a court of law, a person may still be appointed as a director of a company with the permission of the court.

Therefore, the other disqualifications are not absolute, as the court has discretion – on application – to allow such disqualified persons to be appointed as directors.

In *Ex Parte Barron,* the court held that it would be more lenient in a case where a private company is affected than where a public company is affected. This is due to the fact that a director of a public company could potentially deal with a vast number of people's funds. Such a director should obviously be under more scrutiny than a director of a private company.

Ineligible (may **never** be appointed)*:* A person who is ineligible to be a director is absolutely prohibited from becoming a director.
There are no exceptions to the prohibition. Ineligible persons are ● a juristic person ● an unemancipated minor/a minor under legal disability ● a person who is ineligible in terms of the provisions of the memorandum of incorporation
Disqualified: A disqualification from being a director is not absolute.
A court has discretion to permit a disqualified person to accept an appointment as a director. Disqualified persons are ● a person declared delinquent ● an unrehabilitated insolvent ● a person prohibited from being director in terms of a public regulation ● a person removed from an office of trust for misconduct/involving dishonesty ● a person convicted of fraud, dishonesty, theft or a related offence ● a person disqualified in terms of the provisions of the memorandum of incorporation

9.7 Application to declare a person delinquent or under probation

The power given to a court to declare a director either **delinquent** or **under probation** was introduced into South African company law for the first time by the Companies Act 71 of 2008 (section 162).

Depending on the grounds on which a person has been declared delinquent, he or she will be either unconditionally disqualified from being a director for the rest of his or her life, or disqualified for a period of **at least seven years**, and subject to any **conditions** that the court considers appropriate.

An order of probation, on the other hand, may not exceed a period of **five years** and may be made subject to any **conditions** the court considers appropriate, such as a designated remedial programme, performance of community service or the payment of a fine.

A director may be declared delinquent or under probation in terms of section 162 of the Companies Act.

The Commission must keep a public registry of persons who are subject to an order of the court in terms of this section.

9.7.1 Delinquency

Applicant/s:

- company
- shareholder
- director
- company secretary or prescribed officer
- registered trade union/other employee representative

The Commission or Takeover Regulation Panel or a state organ may also, under certain circumstances, apply to declare a director delinquent.

Grounds for the order:

- served as a director while disqualified
- acted as director while under probation in a manner that contravened order of probation
- grossly abused position of director
- took personal advantage of information/an opportunity
- intentionally/by gross negligence caused harm to company/subsidiary
- acted in a manner that amounts to gross negligence, wilful misconduct or breach of trust

Delinquency order:

In a declaration of delinquency, the court may order that the person

- undergo remedial education
- carry out a designated programme of community service
- pay compensation

9.7.2 Probation

Applicant/s:

- company
- shareholder
- director
- company secretary or prescribed officer
- registered trade union/other employee representative

The Commission or Takeover Regulation Panel may also bring an application under certain circumstances.

Grounds for the order:

A person may be placed under probation on the same grounds as for delinquency. In addition, he or she can be placed under probation if he or she, while serving as a director,

- was present at a meeting and failed to vote against a resolution, despite the inability of the company to satisfy the solvency and liquidity test
- acted in a manner which is materially inconsistent with the duties of a director;
- acted in a way that had a result that was oppressive or unfairly prejudicial to a shareholder or another director, or that unfairly disregarded the interests of a shareholder or another director;
- acted in a way that had a result that the business of the company, or a related person, was being or had been carried on or conducted in a manner that was oppressive or unfairly

prejudicial to a shareholder or another director, or that unfairly disregarded the interests of a shareholder or another director;
- exercised his powers in a manner that was oppressive or unfairly prejudicial to a shareholder or another director, or that unfairly disregarded the interests of a shareholder or another director;

or if:

- within any period of 10 years after the effective date, the person has been a director of more than one company, or a managing member of more than one close corporation, irrespective of whether concurrently, sequentially or at unrelated times; and during this time, two or more of those companies or close corporations each failed to fully pay all of its creditors or meet all of its obligations, except in terms of a business rescue plan.

Probation order:

In a declaration of probation, the court may order that the person

- undergo remedial education
- carry out a designated programme of community service
- pay compensation
- be supervised by a mentor/limited to serving as a director of a private company or a company of which he or she is the only shareholder

ACTIVITY 9.2

Gary is a director of Centro Pharmaceuticals (Pty) Ltd. Centro has found a new cure for pneumonia. Gary gives the formula to the senior scientist of Acerbic Pharmaceuticals (Pty) Ltd in exchange for a fee. Centro Pharmaceuticals (Pty) Ltd is very upset about this.

Explain whether Centro Pharmaceuticals (Pty) Ltd will be able to lodge an application to have Gary declared delinquent. If so, also explain what the effect of such an order will be.

Feedback

In order to answer the question, you will have to know and understand the following:

- who may make an application
- the grounds for an application
- the relevant order sought
- the effect of an order

Your answer should reflect the following:

- A company (Centro Pharmaceuticals (Pty) Ltd) can apply to a court of law for an order to have a director declared delinquent.
- Gary grossly abused his position as director and acted in a manner that amounted to a breach of trust.
- A declaration of delinquency may be made.
- This declaration may be subject to any conditions the court considers appropriate and will be for at least seven years from the date of the order.

9.7.3 Application to court to suspend or set aside a delinquency order

Note that this application may be made only in those cases where the declaration was not made unconditional and for the lifetime of the person declared delinquent. Also note that the applicant first has to apply for a suspension of the order and then, after a further two years, may apply for it to be set aside.

ACTIVITY 9.3

Steven was a director of Hamilton (Pty) Ltd, but in 2012 the court declared him delinquent because he used information obtained as a director for his personal advantage. He feels that he has now rehabilitated himself and has met all the conditions of his court order. He would like to serve as a director of Hamilton (Pty) Ltd once again. Explain whether Steven will be able to apply to a court to suspend the order of delinquency.

Feedback

Steven will be able to apply for the suspension of the order of delinquency as three years have passed since the order of delinquency was made, and the order was not based on one of the two grounds that would have resulted in an unconditional declaration subsisting for his lifetime. He will, however, have to satisfy the court that he has rehabilitated himself and that he has met all the conditions of his court order.

9.8 First directors of a company

Upon incorporation of a new company, every incorporator is deemed to be a director of such company until sufficient directors have been appointed to meet the required minimum number of directors.

If, after its incorporation, the number of directors of that company is lower than the minimum number of directors required for that company, the board of directors must call a meeting within 40 business days after the date of incorporation for the purpose of electing sufficient directors to fill all vacancies.

9.9 Vacancies on the board

You need only know the cases referred to, as they are discussed herein.

A vacancy will arise on the board of a company if, for example, a director resigns, dies or is unable to perform his or her duties as director.

In *Rosebank Television & Appliance Co (Pty) Ltd v Orbit Sales Corporation (Pty) Ltd* 1969 (1) SA 300 (T), the court confirmed that a resignation becomes effective once it has been communicated to a company, irrespective of whether it was accepted only later.

If a vacancy arises on the board, other than as a result of an *ex officio* director ceasing to hold that office, it must be filled by a new appointment or by a new election as prescribed by section 67 of the Companies Act.

9.10 Removal of directors

A director can be removed by shareholders and, in some circumstances, by the board of directors. Despite any provision contained in the company's memorandum of incorporation or any agreement of shareholders between the company and the director, removal may be effected by an ordinary resolution (section 71 of the Companies Act).

The director must receive notice of the contemplated removal and be afforded the opportunity to make representations before the resolution to remove him or her is put to the vote.

A director who has been removed from office may apply to a court to review the determination of the board. This application must be brought within 20 business days from the date of a decision taken by the board. The court has discretion whether to confirm the determination of the board.

A removal in terms of section 71 does not detract from any right that the director so removed has to claim compensation or damages resulting from the loss of his or her office.

ACTIVITY 9.4

Andile is a director of Oldco Ltd. The company's memorandum of incorporation determines that the directors are appointed for a period of two years. Six months after Andile's appointment as director, the shareholders want to remove Andile from his post as director. Advise Oldco Ltd regarding the following:

(a) Who can remove a director?
(b) What type of resolution is required to remove a director from his or her position as director?
(c) Does the stipulation contained in the memorandum of incorporation make it impossible to remove Andile before two years have elapsed? Could the inclusion of a stipulation in an employment contract prevent premature termination of his services as a director?
(d) Will Andile be able to claim damages from the company if he had not concluded a separate contract of employment with the company?

Feedback

A director can be removed by the shareholders. In certain instances, a director can be removed by the board of directors. A director is removed by means of an ordinary resolution. Removal of a director is possible, despite any agreement to the contrary and even if the memorandum of incorporation determines otherwise. A director may institute a claim for breach of any agreement that was caused by the early termination as a result of the removal.

9.11 Board committees

The board of directors may, except to the extent that a memorandum of incorporation provides otherwise, appoint committees and delegate any of the authority of the board to such a committee. You should, however, note that a director will still remain liable for the proper performance of his or her duties, despite the delegation of a duty to a committee.

The Minister of Trade and Industry may, in terms of the Companies Act, prescribe that a company or a certain category of company must have a social and ethics committee.

In terms of section 94(2), every **public** or **state-owned** company must appoint an audit committee of at least three members. The King Code also proposes that board committees be established to assist the directors by giving detailed attention to important areas. Examples of such committees include an audit committee and a remuneration committee.

In terms of the King Code, a public listed company should at least have both an audit and a remuneration committee. The establishment of a nomination committee is also recommended. The respective committees make certain recommendations and assist the board of directors with regard to the specific area of expertise.

9.12 Board meetings

Board meetings may be called by directors so authorised. The necessary notice must be given to all directors before any meeting is held. A majority of the directors of the board must be present at a meeting before a vote may be called. Every director has one vote per meeting, while the chairman has a deciding vote in the event of a tie. Minutes of all decisions, as well as any resolution taken by the board at a meeting, must be kept.

9.13 Duties of directors

You need only know the cases referred to, as they are discussed herein.

9.13.1 Sources of duties

There are four sources from which the duties of directors arise: their employment contracts with the company (if any), the company's constitution (memorandum of incorporation), the Companies Act and the common law. The rights and duties created by contract are determined by referring to the specific contract. The duties imposed by the Companies Act, as well as by the common law, are discussed next.

9.13.2 Partially codified directors' duties

Apart from a few specific duties and limitations placed on directors by the Companies Act of 1973, such as the duty to disclose to the board any interest in contracts of the company, most of the duties of directors were determined by the common law. At common law, directors are subject to fiduciary duties to exercise their powers bona fide (in good faith) and for the benefit of the company, as well as to the duty to exercise their powers with care and skill.

The Companies Act of 2008 introduced a **partially codified** regime of directors' duties, which includes the common-law fiduciary duties and the duty to perform their functions with reasonable care and skill. The common law is not excluded by the statutory provisions and will continue to apply, except in so far as it is specifically amended by the Companies Act or is in conflict with its provisions.

Note that, for purposes of these codified duties, "director" includes an alternate director and a member of a committee of the board who is not a director.

Briefly summarised, the partly codified (statutory) duties of directors in the Companies Act entail the following:

- For the first time, the Companies Act places a specific duty on the board of directors to manage the company (section 66(1)).
- A director must disclose to the board any personal financial interest in matters of the company (section 75).
- A director may not use the position of director or information obtained as director to gain an advantage for himself or herself or another person, or to cause harm to the company or a subsidiary (section 76(2)(*a*)).
- A director must disclose to the board of directors any material information (section 76(2)(*b*)).
- A director must act in good faith and for a proper purpose (section 76(3)(*a*)).
- A director must act in the best interests of the company (section 76(3)(*b*)).
- A director must act with reasonable care, skill and diligence (section 76(3)(*c*)).

The provisions in the Companies Act are subject to, and not in substitution of, any of the duties of directors under the common law. The courts must still have regard to the common law, including past case law, when interpreting the provisions of the Companies Act. Therefore, the body of case law that was applied in respect of the common-law duties remains of great value and should be taken into account when studying the Companies Act. It should also be kept in mind that the provisions in the Companies Act relating to directors' duties are a **partial codification** (i. e. adopting the general principles, while allowing some room for the development of the common law) of company law. These statutory duties are elaborated on below with reference to some of the common-law standards (laid down in cases) that influenced them.

9.14 Standards of directors' conduct

9.14.1 Directors must not abuse their position or information (section 76(2)) and must act in a certain way when there is a personal financial interest (section 75)

Firstly, section 75 of the Companies Act prescribes how a director should act when his or her personal financial interests conflict with those of the company. Two different situations are regulated in this provision. If a director is the only director, but not the only shareholder of the company, he or she must disclose any personal interest in an agreement or other matter of the company to the shareholders and obtain their prior approval by an ordinary resolution before he or she enters into this agreement or deals with the matter. In all other cases, disclosure must be made to the board of directors of any personal financial interest of the director in a matter to be considered at a board meeting, and such director may not be present or take part in the discussion. A director may also make an advance general disclosure of his or her personal financial interests to the shareholders or board, as the case may be.

Secondly, in terms of section 76(2)*(a)* of the Companies Act, a director may not abuse his or her position as director, or information obtained while acting as a director, to gain an advantage for himself or herself or for another person other than the company or a wholly owned subsidiary of the company, or to knowingly cause harm to the company or a subsidiary of the company.

The third duty is the duty of a director to disclose any information that comes to his or her attention, subject to some stated exceptions.

In *Regal Hastings Ltd v Gulliver* [1942] 1 All ER 378 (HL) [1967] 2 AC 134, the court held that directors should avoid placing themselves in a position where their duty to the company conflicts with their own interests. In this case, a director who had since resigned was held liable for profits made in the course of the performance of his duties in the company. The court held that it makes no difference if the profit is made in good faith with full disclosure and whether or not the company suffered any loss as a result of the director's actions.

Also note the case of *CyberScene Ltd and others v i-Kiosk Internet and Information (Pty) Ltd* 2000 (3) SA 806 (C), in which it was confirmed that the duty applies to a **non-executive director** too. There are, however, limits to the duties that a director owes to his or her company. The court held, in *Ghersi and others v Timber Developments (Pty) Ltd and others* 2007 (4) SA 536 (SCA), that the facts of each case are important in determining whether or not a person has acted in breach of the fiduciary duty owed to his or her company.

ACTIVITY 9.5

Capricorn Construction (Pty) Ltd wishes to purchase a crane. Michael, one of the company's directors, is instructed to buy the crane on behalf of the company. However, he fails to reach an agreement with the owner of the crane on behalf of the company. He resigns as a director of Capricorn Construction (Pty) Ltd and then concludes an agreement with the owner of the crane in his personal capacity. He purchases the crane for R50 000 and then sells it to Capricorn Construction (Pty) Ltd at a fair price of R70 000. Discuss whether or not Michael's conduct would qualify as a breach of his duties towards Capricorn Construction (Pty) Ltd.

ACTIVITY 9.6

Phumudzo is a non-executive director of Rubberz (Pty) Ltd, a company that manufactures tyres. Phumudzo, in his capacity as a director, obtains information that a limited amount of rubber, which is used for the manufacture of tyres, is being sold very cheaply by a foreign company. Phumudzo resigns as a director of Rubberz (Pty) Ltd and incorporates Greatyears (Pty) Ltd. His company also manufactures tyres. Phumudzo then enters into a contract with the foreign company on behalf of Greatyears (Pty) Ltd for the purchase of the entire rubber stock.

Advise the directors of Rubberz (Pty) Ltd whether or not Phumudzo has acted in breach of his duties towards the company. Refer to relevant case law.

Feedback

A director should not abuse his or her position as director or misuse any information obtained as director. He or she must prevent a conflict arising between his or her own interests and those of the company. This means that a director may not, for personal gain, make use of any information he or she has acquired in his or her capacity as a director. You should then deal with the prescribed case law. You should also note that a director may be in breach of the duties owed by him or her to the company, despite termination of his or her office. In the *Sibex Construction (SA) (Pty) Ltd v Injectaseal* 1988 (2) SA 54 T case, the directors resigned from their office to form a close corporation that competed directly with the business of the company. The court found that the knowledge they had gained while employed by the company could not be used to the advantage of a rival before or after they had left the employ of the company.

When answering a question concerning the duties of directors, you should keep in mind that the standards of conduct, as laid down in section 76 of the Companies Act, are only a partial codification of the common-law duties. In other words, the cases decided before the enactment of the new legislation remain relevant. In the second activity (i.e. 29), you are asked specifically to refer to the cases. Let the wording of the question and the mark allocation guide you in the examination.

ACTIVITY 9.7

Mrs Slot is one of the directors of Middlestone (Pty) Ltd. The company manufactures and sells oak products. Mrs Slot prefers working for herself and intends resigning as a director of the company to start a similar business. She is unsure whether she may use the company's client list, compiled over a number of years, to inform potential clients of her new business.

Advise Mrs Slot on whether she is allowed to make use of the company's client list. Substantiate your answer.

Feedback

In your answer, you should include the following points:

A director should not abuse his or her position as director or misuse any information obtained as director. He or she must prevent a conflict from arising between his or her own interests and those of the company. This means that a director may not, for personal gain, make use of any information he or she has acquired in his or her capacity as a director. You should then deal with the prescribed case law. You should also note that a director may be in breach of the duties owed by him or her to the company, despite termination of his or her office. In the *Sibex Construction (SA) (Pty) Ltd v Injectaseal* 1988 (2) SA 54 T case, the directors resigned from their office to form a close corporation that competed directly with the business of the company. The court found that the knowledge they had gained while employed by the company could not be used to the advantage of a rival before or after they had left the employ of the company.

9.14.2 Acting in good faith and with a certain degree of care, skill and diligence

The duties to act in good faith and for a proper purpose, as well as in the best interests of the company, are equally important. Whereas the duty to act in the best interests of the company speaks for itself, the duty to act for a proper purpose perhaps needs some explanation. This is one of the fiduciary duties recognised in terms of our common law as well, and it requires that directors use their powers for the real or true purpose for which these powers were given. One example of a breach of this duty that has often occurred in practice is where boards issued shares to dilute the voting rights of other shareholders or obtain more votes for themselves in order to ensure their continued control over the company, instead of using this power for its real purpose, namely to obtain more capital for the company.

9.14.2.1 Duty of care, skill and diligence

Directors must carry out their duties in good faith and for the benefit of the company. They must also act with a certain degree of care and skill. This is necessary in order to ensure good corporate governance, which attracts global capital and international investment. Although a distinction can be drawn between the functions fulfilled by executive directors and non-executive directors, both executive and non-executive directors are bound by the duty of care and skill to the companies that they serve. They must apply their minds when they perform their functions and they should focus their abilities in a way that discharges their duties. Therefore, directors must acquaint themselves with the content of applicable laws, rules, codes and standards related to their duties in order to ensure compliance.

Before the **partial codification** of the duty of care, skill and diligence, the common law was used to define the directors' duties. English cases were used in order to set a standard for the care and skill expected from directors. In *Fisheries Development Corp of SA Ltd v Jorgenson* & *another* 1980 (4) SA 156 (W), the court held that the degree of care and skill to be expected from a director depends on the nature of the particular company's business endeavours. It was argued that this would determine what the specific function assigned to the director in question would be.

If this standard is applied, a difference exists between the position of an executive director, who is involved in the day-to-day management of the company's business, and a non-executive director, who has no special obligation and is not required to give continuous attention to the affairs of the company. The non-executive director performs duties only at periodic board meetings or other meetings where his or her attention is required. A director is not required to have any kind of special business expertise or experience of the company business. However, a person with his or her knowledge and experience could be expected to exercise care reasonably and not to be liable for mere errors of judgement. A director is also justified in trusting an official to perform his or her duties honestly and in relying on and accepting advice that is given by such an official. However, the director must not accept the advice blindly.

Care requires the director to make the necessary effort to understand the business of the company and to exercise his or her own judgement, based on his or her knowledge and experience.

The view adopted in the *Fisheries Development* case, as discussed above, shows that the courts were very lenient towards directors in the past, and it has been argued that this opened the door to mismanagement and incompetence of companies.

The cases that were decided later in South Africa indicate a slightly different approach. For example, the view of classifying directors as executive and non-executive was regarded as unhelpful and misleading in determining the director's duties towards the company or any other specific action required of them (*Howard v Herrigel & another NNO* 1991(2) SA 660 (A) at 676)).

The common-law duty of care and skill is partially codified in the Companies Act. Section 76(3) of the Companies Act requires a director of a company to act and perform his or her functions with reasonable care, skill and diligence. The degree of skill required is measured against that of a person that carries out the same functions that the particular director does in the company and who has the same general knowledge, skill and experience.

The wording of this provision clearly reflects both objective and subjective elements. This coincides with the duty contained in the common law. The court first has to determine the expectations of a director carrying out the same functions in relation to the company as those carried out by the director whose conduct is being scrutinised. The objective test works as a baseline standard before the subjective element is considered. In this regard, it will be obvious that a director who accepts the position while knowing that he or she does not possess the necessary knowledge, skill and experience will be doing that at his or her own risk.

The statutory provision allows directors to rely on other professionals and competent persons, whom they reasonably believe to be experts, to perform certain delegated duties, and also to rely on reports presented by them (section 76(5) of the Companies Act). However, despite this power to delegate functions, directors are not absolved from the duty to supervise the discharge of the delegated function, and they maintain ultimate responsibility. Being negligent can result in the disqualification of a director. Also, as part of liability for the breach of the duty of care and skill, a director can be sued under the common-law principle of delict for any loss, damage or costs incurred by the company (section 77(2) of the Companies Act).

Therefore, the statutory duty of care and skill preserves the principles that are contained in the common law. Although the legislation does not clearly state the minimum standard of care and skill required of directors, the partial codification of the duty of care and skill makes it more accessible.

> In instances where this type of breach occurs, it is usually not clear that there is a conflict between the director's interests and those of the company. As mentioned, a clear conflict of interests is indicative of a potential breach of fiduciary duties.

9.14.2.2 Objective test with subjective elements

In *Philotex (Pty) Ltd v Snyman and others; Braitex (Pty) Ltd and others v Snyman and others* 1998 (2) SA 138 (SCA), the Supreme Court of Appeal held that although the test to establish whether or not a **breach of the duty of care and skill** is an **objective** one, it contains **subjective** elements. The general knowledge, skill and experience of the particular director in question are taken into account. A director who is a chartered accountant will, therefore, need to be more skilful when it comes to the company's financial affairs than a director who is an electrician by trade.

ACTIVITY 9.8

Herman is an experienced quantity surveyor. He has extensive knowledge of the valuation of immovable property. Herman is approached to serve as a director of PropSite (Pty) Ltd, a small company that deals in property speculation. He agrees to serve as a director on the understanding that he will not be involved in the day-to-day running of the company. After two years, Herman has made a significant contribution to the company in terms of property valuation advice, but only when he was specifically asked, and on an intermittent basis. He never attended the board meetings and he has trusted the rest of the board to take all the other decisions.

Herman is informed by the managing director that a decision was taken at the previous evening's board meeting that PropSite (Pty) Ltd should invest in a new property development. The development site is in a rural area. Herman is aware of the fact that potential losses are always higher in rural areas. However, he agrees that the company should take the risk and invest in the development. PropSite (Pty) Ltd proceeds with the development. After six months, it becomes apparent that the development is a failure. The company suffers a loss of R5 million. The shareholders want to institute legal action on behalf of the company against the board for breach of their duty of care, skill and diligence.

Explain how the court would go about determining whether or not Herman is liable for breach of his duty to act with care, skill and diligence.

Feedback

You should have mentioned that the court would use an objective test to determine whether Herman had acted as a director would usually have acted in the same situation. The court will also take into consideration subjective elements, such as Herman's experience and qualification as a quantity surveyor.

9.14.3 The business judgement rule

The Companies Act introduced the so-called business judgement rule. Section 76(4) states that a director will be regarded as having acted in the best interests of the company and with the required degree of care, skill and diligence if the director

- took reasonable steps to become informed about the matter;
- had no material personal financial interest in the subject matter of the decision nor knew of anybody else having a financial interest in the matter, or else disclosed his or her interests; and
- made or supported a decision in the belief that it was in the best interests of the company.

A director is also entitled to rely on information provided by certain persons specified in the Companies Act.

In any proceedings against a director, other than for wilful misconduct or wilful breach of trust, a court may relieve the director from liability if it appears to the court that the director has acted honestly and reasonably or it would be fair to excuse the director.

A director will also escape liability where he or she had a rational basis for believing and actually believed that the decision was in the best interest of the company.

ACTIVITY 9.9

Suppose Herman in activity 31 has heard that the Companies Act 71 of 2008 has introduced the business judgement rule, which apparently affects directors' liability. Explain to Herman what the business judgement rule entails. Also advise him whether or not it could protect him in these particular circumstances.

Feedback

You should have referred to section 76(4) of the Companies Act, which contains the elements to be proven in order to rely on the business judgement rule. Herman would have to prove that he

- took reasonable steps to become informed about the matter;
- had no material personal financial interest in the subject matter of the decision nor knew of anybody else having a financial interest in the matter, or else disclosed his interests; and
- made or supported a decision in the belief that it was in the best interests of the company.

He may also avoid liability on the basis of the fact that a company director is entitled to rely on information provided by certain persons specified in the Companies Act.

ACTIVITY 9.10

Tinyiko is a non-executive director of Verytaste (Pty) Ltd. She attended a meeting where she became aware of the fact that the company defaulted on certain payments due to Distribo (Pty) Ltd, which is responsible for the distribution of the company's products. Distribo (Pty) Ltd had threatened to cancel the contract, but Verytaste (Pty) Ltd's chief financial officer assured the board that this was only due to a temporary cash flow problem. Tinyiko relied on this assurance and did not attend the next two board meetings. At a subsequent board meeting, Tinyiko learnt that Distribo (Pty) Ltd had cancelled the contract as a result of continuous non-payments by Verytaste (Pty) Ltd. As a result of the interruption in distribution, Verytaste (Pty) Ltd suffered a loss in excess of R5 million and has now been placed in liquidation.

Answer the following questions relating to the set of facts provided above:

- On what basis could the liquidator hold the directors liable for the loss that the company suffered?
- How will the court determine whether or not the directors are liable for the loss? Refer to relevant case law in your answer.
- Explain the defence that could be raised by Tinyiko, in terms of the Companies Act, to avoid liability.

Feedback

If a company fails as a result of decisions made or lack of proper decision-making by the directors, the directors may, under certain circumstances, be held liable for breach of their duty to act with reasonable care, skill and diligence. This will be the case only if the directors acted with gross negligence.

In determining whether or not a director has breached the duty of care, skill and diligence, the *Fisheries Development Corporation of SA v Jorgenson case* is of relevance. In this case it was held that

- the extent of the director's duty of care and skill depends to a considerable degree on the nature of the company's business and on any particular obligations assumed by or assigned to him or her
- the law does not require a director to have special business acumen and that directors may assume that officials will perform their duties honestly
- the fact that someone is a non-executive director does not exclude assumption of liability, as section 76 (1) of the Companies Act does not distinguish between a director and a non-executive director

The Companies Act introduces the business judgement rule as a defence for directors. It is possible to escape liability, despite having failed to act with the required degree of care, skill and diligence, if the director took reasonable steps to become informed about the matter; had no material personal financial interest in the subject matter of the decision nor knew of anybody else having a financial interest in the matter, or else disclosed his or her interests; and made or supported a decision in the belief that it was in the best interests of the company.

In the set of facts in the question, the liquidator may try to hold the directors accountable for not performing their functions with reasonable care and skill. Because the common law remains in force, despite the enactment of the Companies Act, the courts would look at decisions such as in *Fisheries Development Corporation of SA*. The Companies Act has a new defence that could be raised by directors who allegedly breached their duties. Whether or not Tinyiko would be able to rely on this defence must be determined on the facts of the specific matter.

Perhaps you could also argue that Tinyiko could escape liability because, in terms of the Companies Act, directors are allowed to rely upon information acquired from specific persons.

9.14.4 Liability of directors and prescribed officers

Directors and prescribed officers may be held liable for certain financial losses or damage sustained by the company due to their actions. A director can incur potential personal liability if he or she is guilty of a breach of fiduciary duties, a breach of his or her duty of care, skill and diligence, for acting on behalf of the company without the required authority to do so, for running the business of the company recklessly or fraudulently, for acting on behalf of the company with fraudulent intent, etc. A claim in terms of section 77 prescribes if no action is instituted within a period of three years of the act or omission by the director. A director can use the business judgement rule as a defence against liability in instances where a claim is brought in terms of section 77 of the Companies Act.

The remaining influence of the common law is clear when looking at this liability because the Companies Act states that for a breach of the first five duties in the list in section 77, a director will be held liable in accordance with the common-law principles relating to breach of a fiduciary duty, while for a breach of the duty of care, skill and diligence, liability will be on the basis of the common-law principles of delict.

A director will be jointly and severally liable with any other person who is or may be held liable for the same act. The court may, however, relieve a director from liability, other than for wilful misconduct or wilful breach of trust, provided it appears to the court that the director acted honestly and reasonably.

9.14.5 Indemnification and director's insurance

A company may not indemnify a director in respect of liability arising out of certain circumstances, such as a breach of his or her fiduciary duties. Under certain circumstances, a company may not indemnify a director at all. Indemnity insurance may also not be taken out for such circumstances.

A company is, however, entitled to take out indemnity insurance to protect a director against any liability or expenses for which the company is permitted to indemnify a director. The company may also take out insurance to insure itself against expenses that the company is permitted to advance to a director to defend litigation.

ACTIVITY 9.11

Clause 12 of the memorandum of incorporation of De Beers Construction Ltd provides that "the company undertakes to indemnify and absolve from liability all directors in all transactions concluded by them on behalf of the company, provided that the directors have not been grossly negligent when conducting such transactions".

Explain whether clause 12 of the memorandum of incorporation of De Beers Construction Ltd is a valid clause in terms of the Companies Act.

Feedback

The Companies Act makes it impossible to exempt directors from personal liability for negligence, default, breach of duty or breach of trust. The memorandum of incorporation may not conflict with any statutory rule. Thus the board of directors of De Beers Construction Ltd should be advised that the provisions purporting to exempt directors from liability in all instances except where gross negligence was present, are void.

Reflection

You have seen that the ownership of a company is vested in the general meeting of members and that the control of the company is vested in the board of directors. Do you think it is a good principle to separate ownership and control, or should the members of the company also manage it? It is here that the principle of the separate legal personality of the company comes into play again. It is the company that owns its assets and is responsible for its liabilities, not the shareholders. The shareholders hold only a right to share in those assets, should the company be wound up.

REVIEW

We have discussed the composition and functioning of another organ of the company, namely the board of directors. We have also discussed the duties of directors, as well as the persons ineligible to become directors and those disqualified from becoming directors.

The board of directors is one of a company's two main organs. A director is a member of the company's board. The board of directors is responsible for the running of a company's business. Different types of directors can be appointed in companies, but they all have the same duties. Directors have duties that are conferred by common law as well as by statute. The business judgement rule has been adopted in South African corporate law to ensure that directors are protected in instances where they take calculated risks in the running of the business. In different types of companies, different numbers of directors are required. Certain persons are ineligible to be appointed as directors, while others may be disqualified temporarily from acting as a director.

Directors can be held personally liable for contraventions; they may be removed and have to reimburse the company and others for losses suffered as a result of their conduct.

Please ensure that you are able to answer the key questions at the beginning of the study unit.

In the next study unit you will learn about the appointment, functions and removal of company auditors.

Study unit 10

Company auditors

Contents

Introduction

Compulsory disclosure of financial information concerning the company plays an important role in protecting the interests of shareholders, investors and creditors. In order to undertake certain projects, companies usually depend on capital investments made by members of the public. For example, members of the public may purchase shares or debentures in the company or advance loans.

Investors and financiers are usually not willing to invest or lend money unless there is proper financial reporting and disclosure of how the company's funds are applied. The availability of reliable financial information regarding the company's affairs is conducive to a healthy economic climate. The whole aim of a company's financial statements is to inform the existing shareholders, as well as prospective investors in the company, of its financial standing. The financial statements reflect the general financial state of the company. They disclose whether its assets exceed its liabilities, whether it has sufficient liquid funds, and the extent of the company's working capital (liquid assets as well as credit facilities).

The annual financial statements, which must be placed before the annual general meeting, consist of the following:

- a balance sheet
- an income statement
- a statement of cash flow information
- a directors' report
- an auditor's report

The law regulating the disclosure of financial information and the auditing profession is incorporated in the Companies Act and the Auditing Profession Act 26 of 2005. The Companies

Act contains a number of sections that regulate a company's financial disclosures and maintenance of accounting records.

The Companies Act imposes certain minimum financial disclosure requirements on all companies, as well as more stringent disclosure requirements on public companies and certain private companies. Important sections of the Companies Act regarding the records of a company are as follows:

- Section 24(3) of the Companies Act sets out a number of records that must be maintained by the company, including copies of all accounting records for the current and previous seven financial years.
- In terms of section 28, a company is required to keep accurate and complete accounting records in one of the official languages, as necessary, to enable the company to satisfy its obligations under the Companies Act and any other law with respect to the preparation of financial statements (see the definition of "financial statements" in section 1). The accounting records must be kept in the prescribed manner and form and must be kept at or be accessible from the company's registered office. The type of accounting records that must be maintained by a company depends on factors such as the type of company, its purpose and the nature and extent of its activities.
- Section 29 states that the financial statements of a company must satisfy the financial reporting standards, present fairly the state of affairs and business of the company and explain the transactions and financial position of the business of the company. The financial statements must also show the company's assets, liabilities and equity, as well as its income and expenses and any other prescribed information.
- Section 30 of the Companies Act requires all public or state-owned enterprises to prepare annual financial statements within six months after the end of its financial year. The annual financial statements must include an auditor's report (section 30(3)).

In terms of section 44 of the Auditing Profession Act, it is the duty of an auditor to examine a company's financial statements and accounting records and to express an opinion as to the truth and fairness, in all material respects, of the statements and the accountant's adherence to financial reporting standards. By attesting that the financial statements fairly present the financial condition and past performance of a company, an auditor plays a vital function in reinforcing the reliability of financial information.

You will know that you understand this study unit if you are able to answer the following key questions:

- Which companies are obliged to appoint an auditor?
- Who may be appointed as an auditor?
- Which people are disqualified from becoming an auditor?
- At which meeting must an auditor be appointed?
- How often must an auditor be appointed?
- Which companies are obliged to appoint an audit committee?
- For how long may the position of auditor remain vacant in a company?
- Explain the procedure for the appointment of an auditor to fill a vacancy.
- For how many consecutive years may the same auditor compile a company's financial statements?
- What rights do company auditors enjoy?
- How is the audit committee appointed?
- What are the duties of the auditing committee?

10.1 Appointment of an auditor

Public companies, state-owned companies and certain types of private companies are required to appoint an auditor every year at the annual general meeting (see sections 34, 84, 85 and 90 of the

Companies Act). Other companies are not required to appoint an auditor in terms of the Companies Act, but they may do so voluntarily (section 34 of the Companies Act).

Section 85 of the Companies Act provides that every company that appoints an auditor must file a notice of the appointment with a commission within ten business days after the appointment. The notice must reflect the name of the auditor and the date of appointment. Section 85(4) requires that the incorporators of a company file a notice of the appointment of the company's first auditor as part of the company's notice of incorporation.

The auditor may be an individual person or a firm and is appointed by a company by way of a contract. In companies with an audit committee, the audit committee is required, in terms of section 94(7) of the Companies Act, to nominate for appointment a registered auditor who is independent of the company and to determine the auditor's fees and terms of engagement.

Only a registered auditor may be appointed as auditor of a company. In terms of section 37 of the Auditing Profession Act, only persons who have complied with the prescribed education, training and competency requirements; have made arrangements regarding their continued professional development (where they are not members of an accredited professional body); are residing within South Africa; and are "fit and proper" persons to practise the profession may be registered as auditors.

The Auditing Profession Act states further in section 37(3) that any person who has been removed from an office of trust owing to misconduct; has been convicted of theft, fraud or forgery or another act of dishonesty or corruption; or has been declared by a court to be of unsound mind and unable to manage his or her own affairs may not be registered as an auditor.

In order to ensure that the auditor has the required level of skill and is independent of the company that he or she is auditing, section 90(2) of the Companies Act disqualifies certain persons from being appointed as the auditor of a company. Such persons include a director or prescribed officer of the company; an employee or consultant of the company who was or has been engaged for more than one year in the maintenance of any of the company's financial records or the preparation of any of its financial statements; a director, officer or employee of a person appointed as company secretary; a person who, alone or with a partner or employees, habitually or regularly performs the duties of accountant or bookkeeper, or performs related secretarial work, for the company; and a person who, at any time during the five financial years immediately preceding the date of appointment, was a person contemplated above or is a person related to a person contemplated above.

10.2 Resignation and vacancies

An auditor may resign at any time during his or her period of office. The resignation is effective when the notice of resignation is filed. In terms of section 91 of the Companies Act, a new auditor must be appointed to replace an auditor who resigns within 40 business days after the filing of his or her resignation. Public and state-owned companies are required to have an audit committee. Prior to making an appointment, the board must propose to the audit committee, within 15 business days after the vacancy occurs, the name of at least one registered auditor to be considered to replace the auditor who resigned. The board of directors may appoint the person proposed if, within five business days of making the proposal, the audit committee does not give notice in writing to the board rejecting the proposed auditor.

10.3 Rotation of auditors

Section 92 of the Companies Act makes provision for the rotation of auditors. In terms of this section, the same individual may not serve as the auditor or designated auditor of a company for more than five consecutive financial years. This rotation requirement applies to individual auditors only and not to firms; it also does not apply to private companies. If a company appointed two or more joint auditors, the company is obliged to manage the rotation requirement in a way to ensure that both/all of the auditors do not stop acting as auditors within the same year.

If an auditor has served for two or more consecutive years and then ceases to be an auditor of the company, he or she will not be permitted to return before the expiry of at least another two financial years.

ACTIVITY 10.1

Suppose that Given is appointed as auditor of Moonblue Ltd to replace Daniel. Having served as auditor of Moonblue Ltd for three consecutive years, Given decides to take a six-month holiday in Europe and therefore resigns from his position as auditor. On his return from Europe, Given reapplies for the position of auditor at Moonblue Ltd. Can Given be reappointed?

Feedback

The Companies Act provides that if an individual has served as an auditor of a company for two or more consecutive financial years and then ceases to be the auditor, that individual may not be reappointed as auditor of that company until after the expiry of at least two further financial years. Given would therefore not be able to be reappointed as auditor of Moonblue Ltd after only a six-month period.

10.4 Rights and restricted functions of auditors

Section 93 of the Companies Act provides that the company auditor has a right to access, at all times, the accounting records and all books and documents of the company. The auditor may also attend any general meeting held by the company.

The auditor is entitled to apply to court for an order to enforce his or her right of access and the court may make any order that is just and reasonable to prevent frustration of the auditor's duties by the company, directors, prescribed officers or employees. The court may further make a costs order against any director or prescribed officer who the court has found to have wilfully and knowingly frustrated, or attempted to frustrate, the performance of the auditor's functions.

Section 44(6) of the Auditing Profession Act provides that a registered auditor may not conduct the audit of any financial statements of an entity, whether as an individually registered auditor or as a member of a firm, if the registered auditor has or had a conflict of interest in respect of that entity, as prescribed by the Independent Regulatory Board for Auditors (IRBA).

The IRBA is required to define in the code of professional conduct which non-audit services an auditor is prohibited from rendering to the company it is auditing.

ACTIVITY 10.2

Suppose Hamid is appointed as auditor of Moonblue Ltd after Given resigns. For the purpose of preparing the audit report, Hamid requests certain company documents from Barney, the financial director of Moonblue Ltd. Barney refuses to furnish Hamid with these documents. Advise Hamid of his legal rights, as auditor, under the Companies Act.

Feedback

Section 93 of the Companies Act provides that the company auditor has a right to access, at all times, the accounting records and all books and documents of the company. An auditor may require from the directors or officers such information and explanations as are necessary for the performance of his or her duties.

The auditor is further entitled to apply to court for an order to enforce the above rights and the court may make any order that is just and reasonable to prevent frustration of the auditor's duties by the company, directors, prescribed officers or employees. The court may further make a costs order against any director or prescribed officer whom the court has found to have wilfully and knowingly frustrated, or attempted to frustrate, the performance of the auditor's functions.

Hamid is therefore entitled to have access to the documents requested from Barney and may, if necessary, apply to court for an order that the documents be furnished to him. The court may also make a costs order against Barney in his personal capacity.

10.5 The Auditing Profession Act 26 of 2005

The Auditing Profession Act 26 of 2005 focuses solely on the regulation of the auditing profession. Section 3 of the Auditing Profession Act establishes an Independent Regulatory Board for Auditors (the IRBA) for the purpose of regulating the auditing profession. The integrity of the IRBA is safeguarded by disqualifying certain persons from membership. Section 4 of the Auditing Profession Act sets out the general functions of the IRBA. The IRBA is required to establish various committees, such as a committee for auditor ethics; a committee for auditor standards; a committee for education, training and professional development; an inspection committee; an investigating committee; and a disciplinary committee.

10.6 Audit committees

Section 94 of the Companies Act requires that at each annual general meeting, a public company, a state-owned enterprise and any other company that has voluntarily decided to have an audit committee must appoint an audit committee for every financial year.

The audit committee must have at least three members and must consist only of non-executive directors of the company who have not been involved in the day-to-day management of the company in the preceding three financial years.

The audit committee must, for the year it is appointed, perform the following functions:

- nominate and appoint a registered, independent auditor
- determine the fees to be paid to the auditor and the auditor's terms of engagement
- ensure that the appointment of the auditor complies with the Companies Act and other legislation
- determine the nature and extent of non-audit services that the auditor may provide or must not provide
- pre-approve any proposed agreement with the auditor for the provision of non-audit services
- prepare a report to be included in the annual financial statements, describing
  - how the audit committee carried out its functions;
  - stating whether the committee is satisfied that the auditor was independent of the company; and
  - commenting in any way considered appropriate
- deal with complaints
- make submissions to the board on accounting policies, financial control, records and reporting

- perform other functions as determined by the board, including development of policy to improve governance
- consider whether the auditor's independence may have been prejudiced
- consider compliance with other criteria relating to independence or conflict of interest as prescribed by the Independent Regulatory Board for Auditors

Reflection

In this study unit you learnt about auditors and audit committees. Each company must maintain accurate accounting records. These records must comply with the required financial reporting standards. Note the requirements for the appointment, resignation and rotation of auditors, as well as their rights and restricted functions. The Auditing Profession Act regulates the conduct of auditors.

Please ensure that you are able to answer the key questions at the beginning of the study unit.

In the next study unit you will learn about company secretaries.

Study unit 11

The company secretary

Contents

Introduction

Many students have a completely wrong perception of company secretaries. Company secretaries do not just type letters and make tea! Rather, as the principal administrative officers in companies, company secretaries need to be very knowledgeable of all legislation applicable to companies. They must be informed to such an extent that they are capable of advising directors on their legal duties and those of the company. In this study unit you will learn how a company secretary is appointed, what his or her duties and functions are, and how a secretary can be removed from office.

You will know that you understand this study unit when you are able to answer the following key questions:

- What type of company must appoint a company secretary?
- Who is disqualified from appointment as a company secretary?
- What are the duties of a company secretary?
- How can a company secretary be removed?

11.1 Mandatory appointment of company secretary

The company secretary is the principal administrative officer of his or her company. Every public company or state-owned enterprise must appoint a company secretary who is knowledgeable or experienced in the relevant laws. A private company, personal liability company or a non-profit company may appoint a company secretary voluntarily.

The first company secretary of a public company or state-owned enterprise may be appointed by

- the incorporators of the company; or
- within 40 business days after the incorporation of the company, by either the directors of the company or by means of an ordinary resolution of the company's shareholders (section 86(3)).

Within 60 business days after a vacancy arises in the office of company secretary, the board must fill the vacancy by appointing a person whom the directors consider to have the requisite knowledge and experience.

Every company secretary must be a permanent resident of the Republic and must remain so while serving in that capacity.

Section 87 provides that a juristic person or partnership may be appointed to hold the office of company secretary, provided that every employee of that juristic person, or partner and employee of that partnership, as the case may be, satisfies the requirements contemplated in section 84(5), and at least one employee of that juristic person, or one partner or employee of that partnership, as the case may be, satisfies the requirements contemplated in section 86.

11.2 Disqualification to serve as company secretary

A person who is disqualified, in terms of section 69(8), to serve as a director of a company may not be appointed as a company secretary either.

Briefly stated, a person is disqualified from being appointed as a company secretary if such a person

- has been prohibited from being a director or has been declared delinquent by a court order;
- is an unrehabilitated insolvent;
- is prohibited, in terms of any public regulation, from being a director of the company;
- has been removed from an office of trust on the grounds of misconduct involving dishonesty; or
- has been convicted, in the Republic or elsewhere, and imprisoned without the option of a fine, or fined more than the prescribed amount, for theft, fraud, forgery, perjury or an offence (i) involving fraud, misrepresentation or dishonesty; (ii) in connection with the promotion, formation or management of a company; or (iii) under the Companies Act or some other Acts listed in the section.

11.3 Duties of the company secretary

Section 33(3) of the Companies Act provides that every company must designate a director, employee or other person as the company's compliance officer in its annual return. In the case of a company that has a company secretary, the company secretary will automatically be the compliance officer.

Section 88 of the Companies Act provides that a company secretary is accountable to the company's board. The company secretary's duties include, but are not restricted to,

- providing the directors of the company collectively and individually with guidance as to their duties, responsibilities and powers
- making the directors aware of any law relevant to or affecting the company
- reporting to the company's board any failure on the part of the company or a director to comply with the Companies Act
- ensuring that minutes of all shareholders' meetings, board meetings and the meetings of any committees of the directors, or of the company's audit committee, are properly recorded in accordance with the Companies Act
- certifying in the company's annual financial statements whether the company has filed required returns and notices in terms of the Companies Act, and whether all such returns and notices appear to be true, correct and up to date
- ensuring that a copy of the company's annual financial statements is sent, in accordance with the Companies Act, to every person who is entitled to it
- carrying out the functions of a person designated in terms of section 33(3) (i.e. person responsible for filing the company's annual return)

11.4 Resignation or removal of company secretary

In terms of section 89 (1) of the Companies Act, a company secretary may resign from office by giving the company one month's written notice, or, with the approval of the board, less than one month's written notice.

If the company secretary is removed from office by the company's board, the secretary may require the company to include a statement in its annual financial statements relating to that financial year, setting out the secretary's contention as to the circumstances that resulted in the removal.

ACTIVITY 11.1

Mike is one of the directors of Oak Ridge Ltd. The company wants to appoint a company secretary. The position has been vacant since the incorporation of Oak Ridge Ltd. Mike wants to know whether Oak Ridge Ltd is obliged to appoint a company secretary, what the duties of the company secretary are, and by whom this company officer should be appointed. Advise Mike accordingly.

Feedback

You should advise Mike that, under section 86 of the Companies Act, a public company is obliged to appoint a company secretary. Since it is apparent that Oak Ridge Ltd is a public company, a secretary must be appointed. The duties of a company secretary, as set out in section 88, must be explained, and you should also explain that this is not a comprehensive list.

The secretary is usually the chief administrative officer of the company, but is not involved in the management of the company.

His or her specific duties will vary in scope and nature according to the size of the company, the nature of its activities and the function assigned to the secretary by the directors. The secretary should be appointed by the directors of an existing company. The first secretary (i.e. of a new company) should be appointed as provided in section 86 of the Companies Act.

11.5 Registration of company secretaries and auditors

In addition to the record of company secretaries and auditors that a company must keep, section 85 of the Companies Act requires every company that appoints a company secretary or auditor to file a notice of the appointment, or the termination of service of such an appointment, with the Commission within ten business days after the appointment or termination, as the case may be.

Section 85 (4) allows the incorporators of a company to file a notice of the appointment of the company's first company secretary as part of the company's notice of incorporation.

Reflection

We hope that you now realise what an important role company secretaries play in companies. They must ensure that they know the latest developments in the law relating to companies. They are advisors to the directors and are chief administrative officers. A public company or state-owned enterprise must appoint a company secretary.

Please ensure that you are able to answer the key questions at the beginning of the study unit.

All these legislative principles would mean very little if they are not enforced. In the following study unit we will look at the different mechanisms provided for in the Companies Act to ensure effective enforcement of its stipulations.

Study unit 12

Remedies, enforcement agencies and alternative dispute resolution (ADR)

Contents

Introduction

A very important aspect of any legislation is the enforcement thereof. This study unit focuses on the remedies available to shareholders to protect their interests and mechanisms available in the event of directors' abusing their position. The study unit will also deal with the statutory remedies aimed at the protection of the interests of shareholders. The abuse of the separate juristic personality of a company will also be discussed.

The Companies Act 71 of 2008 also introduced enforcement agencies, such as the Companies and Intellectual Property Commission (CIPC) and the Companies Tribunal. The purpose and functions of these enforcement agencies will be considered, together with an introduction to the voluntary alternative dispute resolution (ADR) mechanisms in the Act.

> You will know that you understand the study unit when you are able to answer the following key questions:
>
> - Who may bring an application to declare a director delinquent or under probation?
> - What are the consequences for directors who have been declared delinquent?
> - When may a court place a director under probation?
> - Discuss the derivative action in terms of section 165 of the Companies Act.
> - Which remedies are available to shareholders to protect their own rights?
> - Discuss the remedy for relief from oppressive or prejudicial conduct in terms of section 163 of the Companies Act.

- What is the procedure to implement a dissenting shareholder's appraisal right in terms of section 164 of the Companies Act?
- Which body is normally responsible for the enforcement of the Companies Act?
- Name four alternatives that the Companies Act envisages for addressing complaints regarding alleged contraventions of the Act.
- What are the functions of the Companies and Intellectual Property Commission?
- How may the Companies and Intellectual Property Commission respond to a complaint received?
- What are the functions of the Companies Tribunal?
- What is alternative dispute resolution?

Important terms:	**Meaning:**
Derivative action	A lawsuit brought by a company shareholder against the directors, management and/or other shareholders of the company for a failure by management. (In effect, the suing shareholder claims to be acting on behalf of the company because the directors and management are failing to exercise their authority for the benefit of the company and all of its shareholders.)
Personal action	A legal action instituted personally by the person who has been wronged himself or herself; a lawsuit initiated in order to, among other things, recover damages for some injury to a plaintiff's personal right or property.
Alternative dispute resolution (ADR)	Alternative measures to resolve disputes outside of the court. (The process involves compulsory conciliation or mediation and arbitration.)
Conciliation	The process of settling disputes by extra-judicial means through seeking an agreed settlement between the parties.
Arbitration	The determination by an impartial referee (the arbitrator) of a dispute between parties by means of a legally binding ruling.
Remedy	A legal remedy (also judicial relief) is the means by which a court of law enforces a right, imposes a penalty or makes some other court order to impose its will. (It will also be used in the context of alternative dispute resolution.)
Dissenting shareholders	Minority shareholders.
Appraisal rights	The statutory rights available to a company's minority shareholders who object to certain extraordinary corporate actions, to have a fair price for their shares determined in a judicial proceeding prior to the action and to require the corporation to repurchase their shares at that price.

12.1 Remedies against directors who have abused their position

Two remedies are available against directors who have abused their position: An application can be brought to court for an order to declare a director delinquent or under probation, in terms of section 162, and/or a derivative action can be instituted in terms of section 165 of the Companies Act.

12.1.1 Application to declare a director delinquent or under probation

Under section 162, a court may make an order declaring a person – who is acting as a director – delinquent or under probation. Such an application may be made by the company, a shareholder, a director, a company secretary, a prescribed officer, a registered trade union or other representative of the employees of the company.

A court may declare a person a delinquent director if any of the grounds set out in section 162(5)*(a)* to *(c)* are proven on a balance of probabilities. One of the grounds that can be relied upon is that the person consented to serve as a director or acted in the capacity as director or a prescribed officer of the company while ineligible or disqualified from doing so, in terms of section 69. Such an order could also have been made when such a person, while acting as a director, acted in contravention of the terms of a probation order.

Applications to place a person under probation should be based on section 162(7)*(a)*, read with (8). A probation order may be made against a serving director when such a director failed to vote against a resolution, despite the inability of the company to satisfy the solvency and liquidity test, or acted in a manner materially inconsistent with the duties of a director, or acted or supported a decision of the company to act in a manner as stipulated in section 163.

12.1.2 Derivative action in terms of section 165

Section 165 **abolishes any right at common law of a person other than a company to bring or prosecute any legal proceedings on behalf of that company**. An applicant may not take any steps to commence or continue legal proceedings to protect the legal interests of the company, unless the applicant has complied with the prerequisites of section 165.

In terms of section 165, an applicant may be a shareholder or a person who is entitled to be registered as a shareholder, a director or prescribed officer of the company or of a related company, a registered trade union or another representative of the employees of the company, or any other person the court considers necessary.

Specific steps must be taken to institute an action in terms of section 165. The procedure provides for the appointment of an independent and impartial person or committee by the company to investigate the demand and report back to the board.

Demand (notice) to company

A person must deliver a notice to a company demanding that it institute legal proceedings or take other steps to protect the company's legal interests. Only in exceptional circumstances will a court grant a person relief to continue legal proceedings in protecting the legal interests of the company without serving a demand on the company as envisaged in section 165(2).

A demand may be delivered by

- a shareholder/person entitled to be registered as a shareholder;
- a director;
- a prescribed officer;
- a registered trade union that represents employees, or another representative of the employees; or
- any person who is granted leave by the court to do so.

The company may apply to court within 15 days of receipt of a demand to have the demand set aside if it is frivolous, vexatious or without merit. If the demand is not set aside, the company must appoint an independent person or committee to investigate the demand. This person or committee must report to the board. Within 60 days (or as long a court permits), action must be instituted or a refusal notice must be served on the person who made the demand.

Personal derivative action

The person who made the demand may apply to the court for leave to continue with proceedings in the name of or on behalf of the company if

- the company failed to take steps to have the demand set aside or to appoint an independent and impartial person or committee to investigate the demand;
- the company appointed a person or committee that is not independent and impartial;
- the company accepted a report that is inadequate, irrational or unreasonable in its conclusions and recommendations;
- the company acted in a way that is inconsistent with the reasonable report of an independent, impartial investigator or committee; or
- the company has served a refusal notice.

The court will grant relief to an applicant if the court is further satisfied that the applicant in the application is acting in good faith, that the proposed or continuation of the legal proceedings involves a serious question of material consequences to the company, and that it is in the best interest of the company to grant relief to the applicant to commence or continue legal proceedings on behalf of the company. To determine whether it would be in the best interest of the company to grant such an order, the court should take into consideration the rebuttable presumption that is contained in section 165(7).

12.1.3 Remedies available to shareholders to protect their own rights

The Companies Act makes specific provision for the protection of the rights and interests of shareholders in sections 161, 163 and 164. Section 161 is a remedy specifically aimed at the protection of the rights of holders of securities. Section 163 provides relief from prejudicial conduct, while section 164 makes provision for the appraisal right of the dissenting shareholders.

12.1.4 Relief from oppressive or prejudicial conduct in terms of section 163

In terms of section 163 of the Companies Act, a shareholder or a director may bring an application for the court to provide relief from oppressive or unfairly prejudicial conduct by the company.

Section 163(1) is directed against any act or omission of the company, or a person related to the company, that is oppressive or unfairly prejudicial to, or that unfairly disregards the interests of, the applicant. This section can also be relied on if the business of the company, or of a person related to the company, is conducted in such a manner that it is oppressive or unfairly prejudicial to, or unfairly disregards the interests of the applicant. The exercise of powers of a director or prescribed officer of the company or a person related to the company is also subject to section 163.

The court enjoys a wide discretion to provide relief. The order may include

- restraining the conduct complained of
- appointing a liquidator if the company appears to be insolvent
- placing the company under supervision and commencing business rescue proceedings
- regulating the company affairs by amending the memorandum of incorporation or amending a shareholders' agreement
- directing an issue or exchange of shares
- appointing directors in place of, or in addition to, all directors in office, or declaring any person delinquent or under probation
- directing the company or any other person to repay the consideration that the securities holder paid for shares with or without conditions
- varying or setting aside a transaction/contract
- requiring the company to produce financial statements for the court or an interested person
- ordering payment of compensation to an aggrieved person

- directing rectification of the registers or records of the company
- an order for the trial of any issue as determined by the court

12.1.5 Dissenting shareholders' appraisal right in terms of section 164

An appraisal right is the right of a shareholder to require the company to buy his or her shares at a fair value if the company takes any of the listed triggering actions. A specific procedure must be followed by the shareholder once the company has taken a triggering action. Section 164 provides a remedy for dissenting shareholders who are aggrieved by the variation of class rights. This remedy becomes available only when a resolution that is detrimental to the shareholders is taken; therefore, it cannot be used before the adverse decision has been taken.

The appraisal remedy is triggered and becomes available in the following instances:

- where the company has adopted a special resolution to amend its memorandum of incorporation by altering the preferences, rights or other terms of any class of its shares in a manner that is materially adverse to the rights or interests of the holders of that class of shares
- where a company is considering adopting a resolution concerning the disposal of the greater part of the assets of the company
- in circumstances where the company is considering merging or amalgamating with another corporate entity
- where a company is considering entering into a scheme of arrangement

Procedure:

Dissenting shareholders may, **before** the meeting at which one or more of the triggering actions take place, lodge a **written objection** to the proposed resolution of the company.

Within ten business days after adoption of the resolution, the company must send a notice that the resolution has been adopted to each security holder who filed an objection and has not withdrawn the objection, or who voted in favour of the resolution. The shareholder may then **demand payment of a fair value** for the shares held by him or her.

The demand must be sent **within 20 business days** after receiving notice from the company that the resolution has been adopted, or, if no notice is received**, within 20 business days** after the said resolution has been adopted. The company must then, **within five business days**, make a **written offer** to pay an amount considered by the company's directors to be a fair value, accompanied by a statement showing how the value was determined.

The offers made by the company to dissenting shareholders must all be on the same terms. The **offer must be accepted within 30 business days** after it is made. The company must pay the agreed amount **within ten business days** after the shareholder has accepted the offer and tendered the share certificates or transferred the shares to the company or the company's transfer agent. If the company fails to make an offer, or the offer is considered to be inadequate, the shareholder may apply to court to determine a fair value and for an order requiring the company to pay the shareholder that fair value. If compliance with a court order would result in a company's being unable to pay its debts as they fall due and payable over the next 12 months, the company may apply to court for an order varying its obligations.

ACTIVITY 12.1

Consul Ltd passed a special resolution that would effectively change the control in the company. Sarah is a minority shareholder who has voted against the decision, as this would prejudice her rights as a shareholder of Consul Ltd. Advise Sarah whether the remedy contained in section 163 for relief from oppressive or unfairly prejudicial conduct – or the remedy afforded by section 164, which contains the dissenting shareholder's appraisal rights – would be available to her.

Feedback

It should be noted that in some circumstances, the remedy in terms of sections 163 and 164 may overlap. In the facts given in the activity above, both sections 163 and 164 may apply. It is important to note the differences in procedure that a shareholder has to follow when exercising his or her rights, depending on whether he or she relies upon section 163 or section 164.

12.1.6 Application to protect the rights of securities holders in terms of section 161

Section 161 provides a remedy to holders of securities that is independent of any other common-law or statutory remedy available to securities holders. The holder of issued securities may apply to court for a declaratory order regarding his or her rights. Alternatively, the holder of the securities can apply for an appropriate order to protect his or her rights or to rectify any harm done to him or her by the company as a result of an act or omission in contravention of the Act, the memorandum of incorporation, the rules, or applicable debt instrument, or harm done by any of the company's directors, but only to the extent that they may be held liable under section 77.

12.1.7 Liability for abuse of separate juristic personality of company

The third category of remedies pertains to liability for the abuse of the separate juristic personality of a company. You are advised to study this study unit in conjunction with the part in study unit 1 that deals with the abuse of the separate juristic personality of a company or the lifting of the corporate veil.

Effectively, this remedy entails the lifting of the corporate veil and the consequent imposition of personal liability if the separate juristic personality of a company has been abused. The court may declare that the company is to be deemed not a juristic person in certain respects.

12.1.8 Enforcement of rights and compliance with the Act

Unlike its predecessor, which provided extensively for criminal sanctions, the Companies Act 71 of 2008 generally uses a system of administrative enforcement. There are very few remaining offences – only those arising out of a refusal to respond to a summons, to give evidence, perjury, and the situation where, in order to improve corporate accountability, the Company Act states that it will be an offence, punishable by a fine or up to ten years' imprisonment, for a director to commit a breach of confidence (section 213), or sign or agree to a false or misleading financial statement or prospectus, or to be reckless in the conduct of the company's business (section 214).

The body that is normally responsible for the enforcement of the Companies Act is the Companies and Intellectual Property Commission. Among other things, the Commission must monitor proper compliance with the Companies Act, investigate complaints concerning contraventions of the Act, promote the use of ADR by companies for resolving internal disputes, keep a companies register and advise the Minister on changes to the law.

The Commission plays a central role in the enforcement of the Companies Act. Any person may file a complaint with the Commission. The Commission may also initiate complaints on its own motion, or at the request of another regulatory authority. The Commission may respond to complaints in different ways.

The Companies Act also establishes a new entity, the Companies Tribunal. Its two main functions are to serve as a forum for voluntary alternative dispute resolution (ADR) in any matter arising under the Companies Act and to carry out reviews of administrative decisions made by the Commission.

As an alternative to applying to court or filing a complaint with the Commission, an applicant or complainant may refer a matter to the Companies Tribunal or to an accredited entity for resolution by mediation, conciliation or arbitration. There are certain differences between these three methods of ADR. Use of ADR is voluntary, and all parties must agree to the use of the process.

ACTIVITY 12.2

Billy alleges that Timex (Pty) Ltd has contravened certain provisions of the Companies Act 71 of 2008. Billy's complaint can be dealt with in various ways in terms of the Companies Act. List Billy's options.

Feedback

The different ways in which a complaint can be handled must not be confused with the alternatives to court proceedings, namely mediation or conciliation and arbitration. Alternative dispute resolution is just one of the ways in which a complaint can be addressed. In summary, Billy can approach the court, the Companies Tribunal, file a complaint with the CIPC or initiate the alternative dispute resolution process.

Reflection

Various remedies are available to companies and shareholders. You should be able to advise a client concerning the grounds for instituting the various actions and regarding the onus of proof.

There are alternative forums (not only courts) available for the referral of complaints. Would you be able to advise an aggrieved shareholder of the procedure to follow in the case of conduct on the part of the company that is prejudicial to his or her rights? Remember that alternative dispute resolution has to be agreed to by the parties, and that the less formal process may exclude the necessity for legal representation.

In this study unit we discussed the various remedies available to companies and shareholders. You should be able to advise a client regarding the grounds for instituting the various actions and what the onus of proof is in each case.

REVIEW

By now you will have gained an understanding of the statutory remedies available to shareholders. These statutory remedies include the personal remedy in the form of section 163 and the derivative action in terms of section 165. It is important to be able to distinguish between the application of section 163 and section 165. Furthermore, the Act makes provision for the protection of holders of securities in section 161. Another important remedy, which is an innovation in the Companies Act 71 of 2008, is the appraisal remedy in section 164. You should also be able to describe in which circumstances a court will disregard the legal personality of a company.

Please ensure that you are able to answer the key questions at the beginning of the study unit.

PART 2

Partnerships

Contents

PLEASE NOTE THAT YOU ARE NOT EXPECTED TO ACCESS THESE SECTIONS FROM THE ACTUAL ACTS. YOU SIMPLY HAVE TO UNDERSTAND THEM AS THEY ARE DISCUSSED HEREIN.

INSOLVENCY ACT 24 OF 1936:

Section 13(1) – During sequestration, a partnership's estate should be dealt with separately from partners' personal estates.

COMPANIES ACT 71 OF 2008:

Section 8(3) – No association formed for the purpose of acquisition of gain by the association or its members will be a legal person, unless it is registered as a company.

INCOME TAX ACT 58 of 1962:

Section 24H – Each partner is deemed to be a participant in the partnership business.

HIGH COURT AND MAGISTRATES' COURT RULES:

Rule 14 of the Uniform Rules of the High Court

Rule 54 of the Magistrates' Courts Act 32 of 1944

Partners may sue and be sued in the name of the partnership.

ALL THE CASES IN THIS STUDY UNIT SHOULD BE STUDIED AS DISCUSSED HEREIN.

IN ADDITION TO THE SELF-ASSESSMENT QUESTIONS AT THE BEGINNING OF EACH STUDY UNIT, YOU MUST DO ALL THE ACTIVITIES IN EACH STUDY UNIT.

INTRODUCTION

Partnerships are one of the oldest, most simplistic business forms used in South Africa. Partnerships are very easy and cheap to form and provide great flexibility. A partnership is formed by the conclusion of a partnership agreement. The basis of a partnership is for the partners to work together to make a profit. Partnerships do not enjoy separate legal (juristic) personality. It is therefore important for partners to maintain good relations and the utmost good faith to ensure continuance of their business.

Partnerships are mainly regulated by common-law principles; there is no such thing as a Partnerships Act in South Africa.

Study unit 13

Definition and types of partnerships

Contents

Introduction

A partnership may be described as a contractual relationship between two or more – but usually not more than 20 – persons (called partners), who operate a lawful business with the object of making a profit. Partners may be natural or juristic persons. The essential characteristics of a partnership are that each partner has to contribute something to the partnership, the partnership must be carried on for the joint benefit of the partners, and each partner should have the expectation of sharing in the profit.

Owing to the fragility regarding the continued existence of partnerships and the risks associated with this particular business form, a relationship of utmost good faith is required between partners.

A partnership does not have legal personality. The partners in their personal capacity, rather than the partnership as such, jointly enter into all transactions or contracts. The assets contributed to or accumulated by the partnership belong to all the partners jointly as co-owners. The partners are also jointly liable for all the partnership debts.

Although a partnership is not a juristic person, the law nevertheless regards a partnership as an entity for certain limited purposes.

The continued existence of a partnership depends on the continued involvement of the partners. It is also largely dependent on the legal capacity of the partners.

During the existence of the partnership, the partners are jointly liable for all claims against the partnership, regardless of who was responsible for bringing about the claim. A creditor must either sue all the partners jointly or sue in the name of the partnership. If the partnership assets are insufficient to meet the claim of the creditor, the partners are liable for the debt out of their personal estates. The personal possessions of the partners are therefore not protected against any claim.

Once a partnership has been dissolved, the partners are jointly and severally liable for the partnership's debts. This means that a creditor can recover the full debt from one partner only, leaving it to the partner who settled the claim to claim the necessary proportionate contributions from his or her co-partners.

The partners have joint control and authority over the business. However, the partners can adjust the control and authority aspect in their partnership agreement, for example by excluding one or more partners from representing or participating in the management of the partnership. This would, however, not necessarily exclude liability in terms of transactions concluded by such an excluded partner. The principle of mutual mandate provides for liability of the partners for contracts concluded by any partner in the name of the partnership, if such transaction falls within the scope of the partnership business. Therefore, during the existence of the partnership, the partners will be held jointly liable in terms of any transaction concluded by a partner if such contract is not outside the scope of the business. A partner who is excluded from participating in management and concludes a contract within the scope of the partnership will, however, be in breach of his or her fiduciary duty to his or her co-partners.

The joint management of the partnership can lead to problems if the partners have different opinions or work ethics. A partnership may even be terminated as a result of the personal circumstances of its partners or their incompatibility in running the business.

Partnerships are mainly regulated by common-law principles; there is no partnership legislation in South Africa.

You will know that you understand this study unit if you are able to answer the following key questions:

- What is the definition of "a partnership"?
- What is the difference between a universal and a particular partnership?
- Distinguish between a partnership *en commandite* and an anonymous (silent) partnership.
- What are the differences between a partnership and a company?

Important terms:	**Meaning:**
Co-owners	An individual or group that shares ownership in an asset with another individual or group. Partners are co-owners of partnership assets.
Joint liability	When two or more persons are both responsible for a debt, claim or judgment.
Joint and several liability	A designation of liability by which members of a group are either individually or mutually responsible to a party in whose favour a judgment has been awarded.
Partnership agreement	A specific nominate contract (with certain *essentialia*) between partners, which sets out the terms and conditions of the relationship between the partners.
Universal partnerships	The partners agree to place all their property, *universorum bonorum*, at the disposal of the partnership/to combine all their property in the partnership, not only what they have at present, but also their future assets and obligations.
Particular partnerships	A partnership formed for a single transaction or enterprise.

Important terms:	**Meaning:**
Anonymous partnership	Also known as a silent partnership. One or more partners may enjoy limited liability as long as they remain anonymous in their capacity as (a) partner(s) and do not participate in the operation of the partnership.
Partnership *en commandite*	An extraordinary partnership in terms of which a partner or partners enjoy limited liability to their co-partners for the losses of the partnership up to an agreed amount, on condition that they receive a fixed share of the profits.

13.1 Definition of a partnership

You need only know the cases referred to, as they are discussed herein.

In *Pezzutto v Dreyer and others* 1992 (3) SA 397 (A), a partnership was defined as a legal relationship created by way of a contract between two or more persons, in terms of which each of the partners agrees to make some contribution to the partnership business, which is carried on for the joint benefit of the parties with the object of making a profit.

13.2 Types of partnership

You need only know the cases referred to, as they are discussed herein.

Apart from ordinary partnerships, which form the subject of the discussion in this study unit, there are also universal, particular and extraordinary partnerships.

13.2.1 Universal and particular partnerships

Universal partnerships differ from other types of partnerships in their ambit – they are not restricted to a particular transaction or a specific business.

Two types of universal partnerships can be distinguished, namely the *societas universorum bonorum* and the *societas universorum quae ex quastu veniunt.*

The *societas universorum bonorum* is a partnership of all property that will generally take place within the context of marriage.

The *societas universorum quae ex quastu veniunt* is a partnership of all profit that occurs within the context of commercial undertakings.

A partnership can be established in respect of a specific project, for example the construction of a block of flats. This is known as a particular partnership.

In *Bester v Van Niekerk* 1960 (2) SA 799 (A), it was held that if persons who are not partners in other business share the profits and loss of one particular transaction, they become partners as to that transaction, but not as to anything else.

13.2.2 Ordinary and extraordinary partnerships

Extraordinary partnerships differ from other types of partnerships in that the liability of certain partners to third parties may be limited.

Three types of extraordinary partnerships can be distinguished, namely the anonymous partnership (also called the silent partnership), the partnership *en commandite* and special partnerships, which were registered under the now repealed Special Partnerships Limited Liabilities Act of the Cape Province and Natal.

In an anonymous or silent partnership, the business is conducted by one of the partners in his or her name. While an anonymous or silent partner remains undisclosed to the public, he or she is not liable to third parties for the debts of the partnership. However, he or she remains liable to his or her partner/s for his or her proportional share of the partnership losses. In other words, he or she shares the full risk of the enterprise.

In a partnership *en commandite,* the business of the partnership is also carried on in the name of one or more of the partners, but every partner whose name is not disclosed is liable to the other parties only to the extent of the fixed amount of the agreed capital contribution made by him or her. Therefore, if the partnership incurs losses, the liability of the partner *en commandite* will not exceed the fixed amount.

Special partnerships, which were registered under the now repealed Special Partnerships Limited Liabilities Act of the Cape Province and Natal, referred to partnerships where the limited liability of a special partner would be lost if his or her name was employed in the name of the firm or if he or she personally entered into a transaction on behalf of the partnership.

13.3 Differences between partnerships and companies

Some of the most pertinent differences between a partnership and a company are the following:

- A company has a separate legal personality, while a partnership does not.
- A company comes into existence through incorporation in terms of the Companies Act, whereas a partnership is formed by agreement, and no formalities are required.
- The main object of a partnership is to make a profit. Companies can be incorporated even when their main object is not to make a profit, for example non-profit companies.
- A change in the membership of a company does not have any effect on the company's existence, while any change in membership leads to the dissolution of a partnership.
- The company is the owner of company assets and the members do not have any property rights therein, whereas the partners in a partnership are co-owners of the partnership assets.
- All profits made belong to the company and shareholders become entitled to the same only after the company has declared a dividend, while partners are entitled to share in the net profit available for division.
- Partners, unless otherwise agreed, have the authority to bind the partnership to transactions that fall within the partnership business (mutual mandate applies), whereas a shareholder cannot – in his or her capacity as shareholder – act on behalf of and bind the company to transactions that fall within the company business.
- There must be at least two partners in a partnership, while in some companies – such as private companies – only one shareholder is required.
- A partnership consists of partners, while a company consists of shareholders (in profit companies) or members (in non-profit companies).

13.4 Advantages and disadvantages of partnerships

Partnerships offer the following advantages:

- ease of formation
- diversification of skills and abilities of partners
- increased opportunity for accumulation of capital
- minimal legal formalities and regulation

The partnership has the following disadvantages:

- personal liability of partners
- relative difficulty in disposing of an interest in the partnership
- potential for conflict between partners
- lack of continuity (can be overcome by agreement)

REVIEW

You have now learnt what a partnership is and about the distinctive characteristics of the various types of partnerships that can be entered into.

As you have already learnt about companies, it is important to be able to distinguish between these two forms of business enterprises. It is also imperative to understand the advantages and disadvantages associated with partnerships.

Please ensure that you are able to answer the key questions at the beginning of the study unit.

In the next study unit we will discuss the essential characteristics and formation of partnerships in more detail.

Study unit 14

The *essentialia* of a partnership

Contents

Introduction

A partnership cannot be formed by less than two persons. It is also impossible to conclude a partnership agreement unilaterally.

The Companies Act has removed the limitation of no more than 20 members for a partnership, but the nature of partnerships implies a small number of participants. The contracting parties to a partnership agreement are known as the partners. From the moment that a partnership agreement is concluded, a very special relationship is created between the partners. The relationship is fundamental to the business and if the relationship is destroyed, the enterprise cannot continue to exist.

In this study unit we will consider how valid partnerships can be formed and what factors the courts consider to ascertain whether or not a valid partnership has been formed.

You will know that you understand this study unit if you are able to answer the following key questions:

- What requirements must be adhered to in order to conclude a valid partnership agreement?
- What are the *essentialia* of a partnership agreement?
- How will a court determine whether or not a valid partnership agreement has been concluded?

Important terms:	**Meaning:**
Essentialia	The essential elements that distinguish a nominate contract, such as a partnership agreement.
Contribution	The economic input (something with an economic value, as agreed upon in the partnership agreement) that must be provided by each partner to qualify for partnership.

Important terms:	Meaning:
	The contribution may be in the form of money, assets, labour, skills or knowledge. Two requirements apply, namely it must have an economic value and it must be exposed to the risk of the business.

You need only know the cases referred to, as they are discussed herein.

The *essentialia* are those elements that must form part of an agreement in order for such agreement to constitute a partnership agreement. These *essentialia* of a partnership agreement were set out in *Joubert v Tarry and Co* 1915 TPD 277. The elements will now be discussed under separate headings.

14.1 Contribution by partners

Each partner must contribute something, or give a binding undertaking to make some kind of contribution to the partnership that has commercial value, such as money, property, skill, knowledge, expertise, contacts or experience.

A partner's contribution must be exposed to the risks of the partnership business. If a partner makes a contribution on condition that it will be returned to him or her even if the enterprise fails, that contribution will not meet this requirement of the *essentialia*.

However, take note that partners can agree that a partner will retain full ownership of the goods that he or she contributes to the partnership, in which case only the use of the goods is made available to the partnership. As the use still has an economic value, the contribution would remain valid, despite his or her retention of ownership.

14.2 The business should be carried on for the joint benefit of the parties

It is one of the *essentialia* of a partnership that each partner must be entitled to share in the net profit of the partnership, but partners need not receive equal shares in the profit.

An agreement that a partner will share in the profit only if the net profit exceeds a stipulated profit margin is also valid. Although such a partner will not share in the profit if the profit margin is not exceeded, he or she at least has a right to share in it when the business of the partnership improves. One partner cannot be entitled to all the benefits while another has to bear all the losses. However, it is possible to exclude a partner from sharing in a net loss.

14.3 The business should be carried on with the object of making a profit

According to the court in *Ally v Dinath* 1984 (2) SA 451 (T), the profit motive does not refer to purely pecuniary profit, but also to the achievement of another material gain, such as a joint exercise for the purpose of saving costs.

However, sports clubs and welfare or charitable institutions cannot be considered to be partnerships.

14.4 The contract should be a legitimate contract

A partnership is established by means of a valid agreement and the contracting parties must have the intention of establishing a partnership.

In *Harrington v Fester and others* 1980 (4) SA 424 (C), there was no written partnership agreement and the applicant claimed the existence of a partnership, but certain correspondence indicated that the applicant had treated the respondent as an employee, which is totally inconsistent with the existence of a partnership.

If the intention is not to establish a partnership, no partnership will come into existence, despite the presence of the *essentialia*.

14.5 Other legal formalities

A partnership is nothing more than a specific type of contract. A valid contract must be lawful, parties must have contractual capacity, they must reach an agreement (consensus) and the agreed performance must be possible.

A partnership must comply with the law and cannot conduct business that is prohibited by law or public policy. The Companies Act changed the restriction on the number of partners in a partnership. Previously no more than 20 persons could conclude a partnership agreement. No such restriction exists under the current Companies Act. There is no limit on the number of partners in any partnership. At least two partners are required for a partnership to come into existence. There are no formal requirements for the actual partnership agreement and, therefore, the agreement may be concluded in writing or orally or be implied by conduct, unless the partners agree on certain formalities.

The ***essentialia*** as an aid

You need only know the cases referred to, as they are discussed herein.

The *essentialia* play an important role in determining whether or not a partnership is formed.

If all the *essentialia* are present and the parties to the contract had the intention to conclude a partnership agreement, a valid partnership is formed.

In *Pezzutto v Dreyer* 1992 (3) SA 397 (A), it was held that the fact that partners considered themselves to be partners is important, but not conclusive in deciding whether or not a partnership was brought into existence. In the absence of even a single essential element of a partnership agreement, no partnership would come into existence.

Furthermore, the presence of all the *essentialia* of a partnership agreement does not necessarily mean that a partnership was formed. In *Purdon v Muller* 1961 (2) SA 211 (A), it was decided that the court will give effect to the intention of the partners, despite the presence of the *essentialia* of a partnership agreement, where the parties intended to conclude another type of contract, for instance a lease contract and not a partnership agreement.

ACTIVITY 14.1

Pule, Riaan and Cindy want to form a partnership. They want to buy and sell second-hand motor vehicles. It is agreed that Pule will contribute R100 000 for the purchase of the first two vehicles, Riaan will service and clean the vehicles and Cindy will be the salesperson. It is further agreed that the net profit derived from the sale of the vehicles will be divided equally between Pule and Cindy, while Riaan will be paid a fixed salary every month. Explain whether a valid partnership will come into existence.

Feedback

You should ask yourself whether all the essential elements are present. Here, the agreement is not for the benefit of all the partners, as Riaan is excluded. It is therefore not a valid partnership agreement.

REVIEW

You have now been introduced to the main characteristics of a partnership. You should be able to advise a client which essential elements must be included in a partnership agreement.

Please ensure that you are able to answer the key questions at the beginning of the study unit.

In the next study unit we will highlight the two exceptions to the rule that partnerships are not considered to be separate from their members.

Study unit 15

Legal nature of a partnership

Contents

Introduction

In part 1, study unit 1, you learnt that a company enjoys legal personality. This is one of the main advantages of this form of business.

Partnerships differ from companies in the sense that they do not have to be registered with the Companies and Intellectual Property Commission under any law, but they also do not acquire their own separate legal personality. The effect of this is that partnerships do not enjoy all the rights and benefits attached to legal personality. There are only two instances in which a partnership will be deemed separate from its members. These two exceptions will be discussed in this study unit.

You will know that you understand this study unit if you are able to answer the following key questions:

- How are partnerships formed?
- Do partnerships generally enjoy separate legal (juristic) personality?
- What are some of the negative effects resulting from the fact that partnerships do not enjoy separate legal personality?
- What are the two exceptions to the rule that partnerships are not considered as being distinct from their members?

You need only know the cases referred to, as they are discussed herein.

A partnership does not exist independently of the partners. Section 8 (3) of the Companies Act determines that no association formed for the purpose of acquisition of gain by the association or its members will be a legal person, unless it is registered. Partnership agreements are not registered with the Companies and Intellectual Property Commission under any law. The rights and obligations of the partnership are those of the partners and the assets belong to the partners. When one of the partners dies or retires, the partnership dissolves.

In *Sacks v Commissioner for Inland Revenue* 1946 AD 31, the court held that unless a partnership agreement provided otherwise, receipts of income of a partnership were so received by the partners in common, and a partner would be entitled to a determinable share of the partnership's profit from the income only when the time arose at the end of an accounting period. However, this position has been altered by section 24H of the Income Tax Act 58 of 1962, which ensures that each partner is regarded as carrying on the business of the partnership.

The general rule is that a partnership does not exist independently of the partners. The ways in which a partnership is dealt with in the case of insolvency and litigation are exceptions to this rule.

15.1 Insolvency

You need only know the cases referred to, as they are discussed herein.

Section 13 (1) of the Insolvency Act provides that sequestration of a partnership estate is to be treated as distinct from the estates of the individual partners.

If the estate of an insolvent partnership is sequestrated, the partnership estate (which comprises the contributions of partners and further assets acquired by the partnership) and the estates of the partners must be sequestrated simultaneously.

The debts of the partnership are first paid from the partnership estate before the private estates of the partners will be looked at to pay the partnership debt. In *Michalow NO v Premier Milling Co Ltd* 1960 (2) SA 59 (W), the court held that the Insolvency Act departed from the common law by retaining the partnership estate as a separate estate from the estates of the partners.

15.2 Litigation

The rights and obligations of the partnership are the rights and duties of partners jointly. Therefore, an individual partner cannot be sued for a partnership debt during the subsistence of the partnership, and an individual partner can generally not enforce a partnership claim.

In principle, all the partners must sue and be sued jointly in their own names during the subsistence of the partnership. However, in terms of Rule 14 of the Uniform Rules of the High Court, a partnership may be sued and may sue in its business name. A similar provision is found in Rule 54 of the Magistrates' Courts Act. When judgment is levied against a partnership, the partnership assets must first be exhausted before execution can be levied on the separate property of the partners.

ACTIVITY 15.1

Rina, Elize and Lepaku formed a partnership. Rina later becomes insolvent and her estate is sequestrated. Explain the effects of Rina's insolvency on the partnership.

Feedback

You should have explained that the partnership estate and the partners' personal estates will be sequestrated, but that Rina's creditors will first be paid from her personal estate before the partnership estate will be looked at.

A further consequence is that the partnership will dissolve, since the insolvency of one of the partners is a ground for the dissolution of a partnership. The dissolution of a partnership will be explained in a later study unit.

REVIEW

By now you should realise that the fact that a partnership generally does not enjoy separate legal personality has many negative consequences: partnerships do not grant partners limited liability, the business enjoys no perpetual succession and it may be terminated if, for any reason, the membership should change. It is possible to sue a partnership in either the High Court or a magistrates' court in the partnership's name, and this will have the same effect as suing all the partners jointly.

If an individual partner or the partnership itself becomes insolvent, the business will have to be dissolved. Partnership debts and personal debts of partners are deemed separate from one another, as far as possible.

Please ensure that you are able to answer the key questions at the beginning of the study unit.

In the next study unit we will consider the various relationships in partnerships.

Study unit 16

Relationships in partnerships

Contents

Introduction

Certain rights and obligations arise naturally from partnership agreements. The partners may, however, agree to change these automatic consequences by including specific stipulations to the contrary (or *incidentalia*) in the partnership agreement. In this study unit, the *naturalia* of a partnership will be highlighted, whereafter we will consider the internal relationship between partners and the relationship partners have with outsiders or third parties.

You will know that you understand this study unit if you are able to answer the following key questions:

- List the *naturalia* of a partnership agreement.
- Explain the nature of the fiduciary duty that a partner owes to his or her partners.
- What rights do partners enjoy?
- Explain the nature of the two main legal remedies available to partners in a partnership.
- What does mutual mandate entail?
- When will partners in a partnership be bound by transactions concluded by another partner who did not have authority at the time of concluding the contract?
- What are the requirements for relying on estoppel to hold partners in a partnership liable for contractual performance?

Important terms:	**Meaning:**
Essentialia	Terms of a contract that identify the contract as a specific type of contract.
Naturalia	Terms in a specific contract that are implied by law.
Incidentalia	Other terms of the contract that parties have to agree to. These terms may vary the *naturalia* of an agreement.
Actio pro socio	A general action by means of which any partner could compel his or her co-partners to perform their obligations. The grounds on which this action may be brought are non-specific.

Important terms:	Meaning:
Actio communi dividundo	A right enjoyed by a partner, as co-owner of partnership assets, to apply to a court for a fair division if partners cannot agree on the method of dividing a particular jointly owned asset.
Fiduciary duty	Also known as the duty of good faith. A duty imposed by law on persons in a fiduciary position to act in the best interest of the person to whom they owe the duty.
Joint liability	When two or more persons are both responsible for a debt, claim or judgment. In the course of a partnership, all the partners are jointly liable for partnership debts.
Joint and several liability	Designation of liability by means of which partners are either individually or mutually responsible to a party in whose favour a judgment has been awarded. Partners become jointly and severally liable for partnership debts upon dissolution of a partnership.
Ratification	Acceptance of an approved action that was not authorised prior to performance thereof; it often has a retrospective effect of validating the action.
Ostensible authority	Authority as it appears to the outside world. The authority of an agent based on estoppel, which may exist even though he or she did not have actual authority.

16.1 Natural consequences of a partnership agreement (*naturalia*)

There are certain natural consequences (or *naturalia*) that ensue from a partnership agreement. In contrast with the *essentialia* of a partnership, as discussed earlier, partners are free to alter the *naturalia* of a partnership. If these consequences are not altered by the partners, the *naturalia* are the legal rules that will apply to the partnership.

The most important *naturalia* are the following:

- It is one of the *essentialia* of a partnership that each partner be entitled to share in the net profits of the partnership, but partners need not receive equal shares in the profits. In the absence of an agreement on how profits are to be shared, profits are shared between the partners in proportion to the value of their respective contributions to the firm, but if the value of the contributions cannot be ascertained, the partners must share the profits equally.
- The losses of the partnership are shared in the same proportion that the profit would have been divided. Although it is permissible for partners to exclude one or more partners from sharing in the losses, should the partnership make no profit and sustain a net loss, there must remain at least one ordinary partner who will carry the losses of the partnership.
- Each partner has the power to represent the partnership in transactions that fall within the usual scope of the business of the partnership.
- A partner is not entitled to compensation for his or her contribution to the partnership. Partners are, however, entitled to come to a different arrangement.
- The assets of the partnership belong to the partners jointly.

16.2 The relationship between partners

You need only know the cases referred to, as they are discussed herein.

A close, mutual, fiduciary relationship exists between partners. In *Purdon v Muller* 1961 (2) SA 211 (A), the court held that under our common law, a partnership is considered to be a contract of utmost good faith.

The requirements of the fiduciary relationship are not strictly defined, but the following three broad categories of duties may be distinguished:

- A partner must comply with his or her duties in terms of the partnership agreement.
- A partner must further the interests of the partnership unselfishly and avoid a conflict between his or her personal interests and those of the partnership.
- A partner must disclose to his or her co-partners all information that affects the partnership.

The rights of partners between themselves include

- a right to share in the profits of the partnership
- a right to participate in the management of the business
- the right to compensation
- the right to inspect the partnership books
- the right to distribution of assets on dissolution

The duties of partners to the partnership include

- the duty to make a contribution to the partnership
- a duty to share in the losses
- a duty of care and skill
- a duty of full disclosure or a duty to account

As indicated above, one of a partner's duties to the partnership is a duty of care and skill. To ascertain the reasonableness of an act by a partner, regard is given to the degree of care that the partner displays in the management of his or her own affairs. No basic level of expertise or any qualifications are required.

Partners choose one another and have only themselves to blame if they take into the partnership an incompetent partner, without restricting his or her management powers. However, if a partner undertakes to contribute any particular skill or expertise to the partnership, he or she will be liable for loss caused by any failure to display such skill or expertise.

For example, if a partner undertakes to render professional services to the partnership, he or she will be liable for any losses to the partnership if his or her services fail to comply with applicable professional standards.

Separate duties that flow from the principle of utmost good faith include

- a duty to accept and fulfil the obligations of the partnership agreement (*Purdon v Muller* 1961 (2) SA 211 (A))
- a fiduciary duty to fellow partners and a duty not to compete with the partnership (*Mattson v Yiannakis* 1976 (4) SA 154 (W))
- a duty to guard against a conflict of interest (*De Jager v Olifants Tin 'B' Syndicate* 1912 AD 505; in this case, the court held that no partner may gain a benefit that was in the scope of the partnership and that the partner had to acquire for the benefit of the partnership)
- a duty to disclose to all co-partners all information in his or her possession that affects the partnership

Remedies available to partners:

There are two specific actions with which a partner can enforce his or her rights as a partner against any of his or her co-partners, namely the *actio pro socio* and the *actio communi dividundo:*

- The *actio pro socio* is a general multipurpose partnership action with which partners can enforce their mutual rights. It can be used, for example, to enforce compliance with the partnership agreement, to request an interdict against a partner or to obtain the return of a partnership asset.
- The *actio communi dividundo* is an action with which co-owners effect physical division of tangible things that they hold in joint ownership. After dissolution of the partnership, a partner can bring this action to obtain physical division of jointly owned partnership assets.

ACTIVITY 16.1

Piet, Dorothy and Moseki practise in partnership as accountants. During his spare time, Piet does accounting work for AFC Enterprises Ltd, without Dorothy and Moseki's knowledge. The latter two find out about Piet's extra job and now want your advice on whether this is acceptable practice for a partner.

Feedback

Partners may not allow their personal interests to conflict with those of the partnership in any transaction falling within the scope of the partnership business. Accordingly, no partner may acquire and retain for himself or herself any benefit or advantage that is within the scope of the partnership business and that the partner is, therefore, obliged to acquire for the partnership, rather than personally. All such benefits must be shared with and accounted for in respect of his or her partners.

Where a partner purports to obtain a benefit for himself or herself in conflict with this duty, such benefit is legally regarded as having been acquired for the partnership and the partner is obliged to transfer the benefit to the partnership. You should have referred to the *De Jager* case in this regard.

The only way in which a partner may lawfully retain a benefit is by fully disclosing the relevant facts in connection with the acquisition of the benefit to his or her co-partners and by obtaining their approval.

16.3 The relationship between partners and third parties

You need only know the cases referred to, as they are discussed herein.

Each partner is liable jointly and severally for partnership debts. However, during the existence of the partnership, creditors of the partnership cannot sue partners individually for the partnership's debts.

When a partner contracts with a third party on behalf of the partnership, he or she binds all his or her partners, provided that he or she acts within the scope of his or her authority. His or her authority to bind the other partners may be based on actual or ostensible authority. Furthermore, actual authority may be express or implied.

Each partner has implied authority to perform all acts that are necessary for or incidental to the proper conduct of the business of the partnership. This is sometimes referred to as the principle of mutual mandate.

If a bona fide third party wishes to hold the partnership liable in terms of a contract concluded by a partner, it is sufficient for him or her to prove that the contract fell within the scope of the business of the partnership. If it can be shown that a transaction fell outside the scope of the partnership business, then the contracting partner has exceeded his or her implied authority. Remember that if a partner has been granted express authority to contract on behalf of the partnership, the partnership will be bound, even if the transaction falls outside the scope of the partnership business.

A partner's implied authority to bind his or her partners may be limited or excluded by agreement between the partners. However, a third party who is bona fide and unaware of a limitation on a partner's authority will be able to hold the partnership to a contract concluded within the scope of the partnership business (*Goodrickes v Hall and Another* 1978 (4) SA 208 (N)).

ACTIVITY 16.2

Riander, Daleen and Sipho are partners in a construction business. Riander's authority to contract on behalf of the partnership is excluded by express agreement between the partners.

Riander buys material that can be used in the construction of buildings from Johan. Johan is unaware of the agreement that excludes Riander's authority to contract on behalf of the partnership. Will the partnership be bound by this contract? Explain.

Feedback

Partners have implied authority to represent the partnership. The scope of this implied authority is, however, limited in a sense, since only transactions that would benefit the partnership business (i.e. promote its main or ancillary objectives) are covered by this mutual mandate. For transactions that do not relate to the partnership business, actual authority (either express or in writing) is required.

The doctrine of constructive notice does not apply to partnerships. Third parties dealing with the partners are therefore not deemed to know the content of the partnership agreement.

In this scenario, the contract would be binding on the partnership, since the material purchased can be used for construction of buildings, which is the main business of the partnership. Therefore, it falls within the scope of Riander's implied authority or mutual mandate to conclude such a contract.

REVIEW

In this study unit you learnt what rights and obligations usually emanate from partnership agreements. Remember that partners are free to change these *naturalia* to suit their specific needs. We also looked at the relationship between partners, that is, the duties to act with utmost good faith and to perform duties diligently and with reasonable care and skill.

In partnerships, all partners are representatives of the partnership for any transaction that falls within the scope of the partnership business. Each partner has implied authority to conclude a contract in the name of the partnership, as long as it benefits the partnership.

This implied authority is known as mutual mandate. As soon as a transaction falls outside the scope of the partnership business, the situation is different. Then the contract will not be binding on the other partners (i.e. only the contracting party will remain liable for performance), unless the contracting party was expressly authorised to conclude the contract in the partnership's name or if it is subsequently ratified by the other partners.

In the course of the partnership, the relationship between partners and outsiders (third parties) is different from their relationship after termination of the partnership. While a partnership exists, partners are jointly liable for all debts incurred. After termination of a partnership, partners become jointly and severally liable to outsiders.

Please ensure that you are able to answer the key questions at the beginning of the study unit.

In the next study unit we will highlight the ways in which a partnership may be terminated (dissolved).

Study unit 17

Dissolution of partnerships

Introduction

You have learnt that partnerships do not enjoy separate legal personality and that they are largely dependent on the partners. Partners are joint owners of the partnership assets and are jointly liable for the debts of the partnership. They all have the power to conclude binding contracts that fall within the scope of the partnership business. It makes sense that partners must have a very close relationship to make this kind of business work for everyone. In this study unit we will highlight the different reasons for terminating partnerships.

> You will know that you understand this study unit if you are able to answer the following key questions:
>
> - List the ways in which a partnership can be terminated.
> - When will a partnership dissolve automatically?
> - When will a court order dissolve a partnership?
> - What are the consequences of termination of a partnership?
> - Who must a third party sue for payment of a partnership's debt while a partnership is still in existence?
> - Who may a third party sue for payment of a partnership's debt if the partnership has been dissolved?

You need only know the cases referred to, as they are discussed herein.

The different ways in which a partnership may be dissolved or terminated include

- effluxion of term
- end of undertaking (completion of partnership business)
- mutual agreement
- change in membership (which can occur because of the death or retirement of a partner or the admission of a new partner)
- death of a partner
- insolvency and sequestration of partnership estate or the estate of any partner
- bona fide notice of dissolution by any partner
- where partners become alien enemies on or after the outbreak of war
- an order of court

Regarding an order of court for the dissolution of a partnership, the following should be noted: an order may be given upon application by one or more of the partners for good cause. What constitutes good cause is a factual question, which will need to be determined in each individual case. The courts have indicated some reasons that would be considered good cause.

A court will also grant an order in the case of a breach of the fiduciary relationship between the partners. It should be noted that the situations under which a court will grant an order are not situations or grounds for automatic dissolution of a partnership, as would be the case, for instance, with the effluxion of time, completion of partnership business, change in membership and the other grounds for dissolution mentioned above.

If the court is approached for an order for the dissolution of a partnership, it has discretion to make the order and the partnership will dissolve only upon the granting of such order.

As indicated above, a partnership dissolves when the partnership estate or the estate of any of the partners is sequestrated or, should the partner be a company or a close corporation, when its estate is liquidated. The sequestration of the partnership estate leads to the simultaneous but separate sequestration of the personal estates of the partners, with the exclusion of the estates of extraordinary partners and estates that cannot be sequestrated under the Insolvency Act, for instance because it is a company or a close corporation. A partner can also avoid sequestration of his or her estate by furnishing an undertaking that he or she will pay the partnership debts and by giving security for such payment.

In principle, private creditors cannot claim against the partnership estate and partnership creditors cannot claim against the different estates of the partners. If a residue remains in one of the private estates after all the creditors of that partner have been paid, the balance will be available to the trustee of the partnership estate in so far as it may be required to pay partnership debts. Should a surplus remain in the partnership estate, it will be divided and each partner's proportional share will be made available to the trustee of his or her personal estate.

Consequences of termination of a partnership include the following:

- A proper rendering of an account must be completed before amounts owed to the individual partners can be claimed.
- Upon termination, any creditor of the partnership can sue the partners as individuals, jointly and severally, for partnership debt *(Lee and another v Maraisdrif (Pty) Ltd* 1976 (2) SA 536 (A)). The creditors of the partnership can therefore hold any of the partners liable for the total amount of their claims after dissolution of the partnership, but a partner who pays the total amount of a claim can recover from his or her former partners that portion of the payment that exceeded his or her proportional share.
- After termination, no partner has implied authority to bind the partnership.
- After termination, each partner may demand an account from his or her partners.

Reflection

Partnerships are probably the easiest form of enterprise to establish in South Africa. All that is required in order to form a partnership is the conclusion of a valid partnership agreement. There are, however, many risks associated with this type of enterprise.

REVIEW

The partnership is one of the oldest organised business forms. In South Africa, there is no legislation regulating partnerships. This type of enterprise is therefore mainly regulated by the common law. Partnerships are formed by means of a contract. The partnership does not enjoy any separate legal personality. The existence of a partnership is dependent upon its partners.

You should now know how partnerships are formed. In addition, you should be able to explain the relationships between partners and third parties and between the partners themselves, both during the existence of the partnership and after its dissolution.

Please ensure that you are able to answer the key questions at the beginning of the study unit.

In part 3 we will introduce you to another business form aimed specifically at small businesses, namely close corporations. Unlike partnerships, close corporations enjoy the benefits of separate legal personality, as do companies.

You have now reached the end of the part dealing with partnerships. We hope that you have found it interesting and that you feel that you have learnt something about this South African business form.

PART 3

Close corporations

Contents

IMPORTANT SECTIONS OF LEGISLATION FOR THIS PART:

PLEASE NOTE THAT YOU ARE NOT EXPECTED TO ACCESS THESE SECTIONS FROM THE CLOSE CORPORATIONS ACT. YOU SIMPLY HAVE TO UNDERSTAND THEM, AS THEY ARE DISCUSSED HEREIN.

CLOSE CORPORATIONS ACT 69 OF 1984:

Section 34(1)	– **Mandatory procedure for disposal of an insolvent member's interest**
Section 36	– **Disposal of a member's interest and cessation by order of court**
Sections 38 & 39	– **Acquisition of a member's interest by the close corporation**
Section 40	– **Financial assistance by corporation in respect of the acquisition of a member's interest**
Sections 42 & 50	– **The fiduciary duties of members towards the close corporation**
Section 43	– **Personal liability of member for negligence (not acting with reasonable skill and care)**
Section 44	– **Association agreements**
Section 49	– **Statutory personal action**
Section 50	– **Statutory derivative action**
Section 51	– **Payments to members**
Section 52	– **Prohibition for the making of certain loans or provision of security**
Section 54	– **Representation in close corporations**
Section 56	– **Personal liability for not keeping proper accounting records**
Section 58(2)	– **Accounting requirements in close corporations**
Section 62	– **Duties of accounting officers**
Section 62A	– **Application of accountability provisions of Companies Act**
Section 63	– **Joint liability for failure** ● to use "CC" after corporation's name (section 22) ● to contribute the agreed contribution (section 24)

- to qualify as a member
- to comply with the rules relating to giving of financial assistance in terms of section 40
- vacancy of an accounting officer in excess of 6 months or managing the close corporation when disqualified to do so

Section 64 – **Liability for reckless and fraudulent trading**

Section 65 – **Gross abuse of the legal personality of a close corporation**

ALL THE CASES IN THIS PART SHOULD BE STUDIED AS DISCUSSED HEREIN.

IN ADDITION TO THE SELF-ASSESSMENT QUESTIONS AT THE BEGINNING OF EACH study unit, YOU MUST DO ALL THE ACTIVITIES IN EACH study unit.

INTRODUCTION

The Close Corporations Act 69 of 1984 ("Close Corporations Act") introduced a new and cheaper option for incorporation of small enterprises. This form of business is a combination of some of the partnership attributes and some of the corporate attributes. It provides a simple, inexpensive and flexible form of incorporation for an enterprise consisting of a single entrepreneur or a small number of participants. The aim was to deregulate the system of incorporation of enterprises and to create an enabling business environment for the South African small business sector.

A close corporation, like a company, acquired legal personality upon incorporation. A legal person is regarded as an entity that can acquire rights and duties separate from its members. Close corporations also enjoy perpetual succession, which means that, unlike partnerships, they would remain in existence even if the members should change.

Clearly, with all the benefits associated with incorporation, in addition to the fact that running the business is unhampered by onerous regulation, entrepreneurs and owners of micro- and small businesses were presented with a most viable option appropriate to their business.

It is important to note that in terms of the Companies Act 71 of 2008, no new close corporations may be registered and companies may no longer be converted to close corporations. Nevertheless, existing close corporations may continue to exist alongside companies.

Study unit 18

The nature of a close corporation

Introduction

In study unit 1 you learnt that companies acquire legal personality upon incorporation. Likewise, in the case of close corporations, separate legal personality is acquired upon registration of the founding statement. Sometimes the court may be called upon to lift or pierce the corporate veil, that is, to disregard the separate legal personality of the close corporation. Revise part 1 of study unit 1 (on legal personality and abuse of juristic personality). Note that when dealing with close corporations, reference should be made to section 65 of the Close Corporations Act 69 of 1984 and not section 20(9) of the Companies Act.

Like companies, close corporations enjoy perpetual succession, which means that the entity exists separately from its members and changes in membership will not influence its future existence.

Important terms:	**Meaning:**
Legal personality	To be acknowledged in law as a person or bearer of its own rights, with liability for its own debts; also known as juristic personality.
Founding statement	(Form CK 1) Sole constitutive or registration document for close corporations.
Perpetual succession	Indicating independence from the members of the close corporation. The close corporation will continue to exist even if the members should change.

ACTIVITY 18.1

Access and read the following case: (See the information at the beginning of the study guide on how to access and analyse cases. This will teach you to use the available technology to find legal sources.)

Le'Bergo Fashions CC v Lee and others 1988 (2) SA 608 (C)

Now summarise the decision in your own words.

Feedback

Close corporations, like companies, enjoy separate legal personality from the date of registration of their constitutive document, which is called the founding statement. If the juristic personality is abused for dishonest or fraudulent purposes, or misused to avoid legal duties, the courts will pierce the corporate veil to ensure that justice and fairness prevails, under section 65 of the Close Corporations Act.

The number and nature of members

As close corporations were intended mainly for small businesses, the number of members is limited to ten. In addition, it is not permissible for more than one person to hold a member's interest jointly. In principle, only natural persons are permitted to be members of a close corporation.

Therefore juristic persons are excluded from membership and, apart from a few very specific exceptions, a company or another close corporation may not be a member of a close corporation.

A minor, insolvent or person under legal disability may become or remain a member of a close corporation with the necessary assistance from a guardian, trustee or the court. A natural or juristic person acting in the capacity of a trustee of a testamentary or *inter vivos* trust may become a member of a close corporation, subject to conditions set out in the Close Corporations Act. However, the restriction in membership to a maximum of ten members still applies.

Should the membership in a close corporation change, an amended founding statement must be lodged for registration.

ACTIVITY 18.2

Draw a table indicating which of the following people (1) may become a member of a close corporation and (2) which may not: (Also state the requirements that must be met for a person to become a member.)

- a minor
- a close corporation
- an unrehabilitated insolvent
- a beneficiary of a trust
- a woman married in community of property
- a company
- the trustee of a testamentary trust in terms of which the sole beneficiary is a close corporation
- a person under legal disability

Feedback

Most natural persons may become members of a close corporation. Even though certain natural persons may not have the legal capacity to participate in the management of a close corporation, minors, insolvent persons and other persons with legal disabilities may – with the necessary assistance – become members of a close corporation.

No juristic person (i.e. another close corporation or a company) may become a member. However, trustees – in their capacity as trustees of testamentary trusts or trusts *inter vivos,* or as administrators of persons under legal disability – may become members of a close corporation. There are restrictions on this provision, however, since no juristic person can become a beneficiary of such a trust. Furthermore, based on the principle that close corporations are meant for small businesses, if the number of trust beneficiaries added to the number of members of a corporation exceeds the stipulated number of members required to form a close corporation (i.e. ten), the membership of the trustee will cease.

Should a person who is disqualified from membership become a member, such person bears the risk of being held personally liable for all the debts of the close corporation.

In the next study unit we will examine the formation of a close corporation and the members' interests.

Study unit 19

The formation of a close corporation and members' interests

Contents

Introduction

In this study unit you will learn about the formation of a close corporation and the characteristics and disposal of a member's interest.

Important terms:	**Meaning:**
Founding statement:	(Form CK 1) The only constitutive document required for registration of a close corporation.
Amended founding statement	(Form CK 2) The document that must be lodged, should particulars of members or the business change after registration of the founding statement.
Member's contribution	A contribution must be made by each member. This can consist of money, a thing or services contributing to the business of the close corporation.

19.1 The formation of a close corporation

Under the Companies Act 71 of 2008, it is no longer possible to register new close corporations. However, it may be necessary to acquire information regarding an existing close corporation or to amend the founding statement by lodging a form CK 2 with the Companies and Intellectual Property Commission.

The founding statement indicates the following particulars of the business:

1. the full name/translations/any abbreviation of the business name
2. the principal business
3. the number of members

4. date of the end of the financial year
5. the aggregate of members' contributions
6. postal address
7. address of the registered office
8. the name and postal address of the accounting officer
9. particulars of the founding members (names, copies of identity documents, residential addresses)
10. member's interest in respect of each member, expressed as a percentage

Should any of the particulars in the founding statement change after the close corporation's registration, an amended founding statement (CK 2) must be lodged.

ACTIVITY 19.1

Janine, Sebo and Johannes started a business together. They run a mobile car-cleaning service. They come to you for advice regarding the following:

- What are the differences between partnerships and close corporations?
- Janine has applied for a position in Australia. She will know within five months whether or not her application was successful. Would the close corporation be able to continue to operate with only Sebo and Johannes, should Janine leave?
- Janine and Sebo are concerned that Johannes has many unpaid creditors and that his estate may be sequestrated in the near future. What would be the effect of Johannes's insolvency on the close corporation?
- What would happen if a member's interest in a close corporation is terminated by death?

Feedback

A close corporation is distinct from partnerships in various ways. Close corporations are registered by between one and ten natural persons, whereas partnerships are formed by an agreement between two or more persons (up to an unlimited number, under the Companies Act). Upon registration, a close corporation acquires separate legal personality. Unlike in partnerships where no legal personality exists, the existence of a close corporation will not be terminated by changes in membership, personal circumstances or even death of its members. A close corporation also holds its assets separately from its members and, therefore, it is not severely affected should the estate of a member be sequestrated.

Because a member's interest is part of a member's estate, it can be sold or bequeathed in a will. If a member dies, the remaining members must consent to the transfer of the member's interest to the legatee, otherwise the member's interest must be sold subject to a right of pre-emption in favour of the corporation and other members.

19.2 Characteristics of a member's interest

- A member's interest is expressed as a percentage (out of a total of 100%) in the founding statement.
- A member's interest may not be jointly held.
- The aggregate (total) of members' interests must always be 100%.
- A member's interest in a close corporation is similar to a share in a company.
- A member's interest is an incorporeal, movable thing.
- A member's interest is a personal right to share in the close corporation's profits after payment to its creditors.

A member's interest can be acquired by

- acquiring it from an existing member
- making a contribution to the close corporation

19.3 Disposal of a member's interest

As a close corporation is intended for small businesses with few members in a close relationship with one another, changes in membership can affect the operations of the business very negatively. For this reason, the disposal of a member's interest is controlled by the members to a large extent.

Requirements for disposal of a member's interest:

- It must be made in accordance with the association agreement; or
- consent of all the members must be obtained.

As a member's interest is part of his or her estate and has an economic value, it is important to establish the manner in which it will be dealt with, should the member die, become insolvent or if judgment is taken against a member by his or her creditors.

19.3.1 Death of a member

A member may bequeath his or her member's interest to his or her heir/legatee in a will. Transfer of the member's interest to the heir/legatee may, however, occur only with the consent of the other members.

Should the members not permit such transfer, the executor of the estate may

- sell the member's interest to the close corporation; or
- sell the member's interest to the other members; or
- sell the member's interest to a third party, subject to the other members' pre-emptive right to purchase the member's interest.

The money value will thereafter be paid over to the heir/legatee.

19.3.2 Insolvency of member

Section 34(1) of the Close Corporations Act prescribes a mandatory procedure for disposal of an insolvent member's interest. The purpose is to balance the rights of the other members with the rights of creditors of the insolvent member's estate.

If the estate of a member is sequestrated, the trustee of the insolvent estate may realise the member's interest and

- sell the member's interest to the close corporation; or
- sell the member's interest to the other members; or
- sell the member's interest to a third party, subject to the other members' pre-emptive right to purchase the member's interest.

The money value will thereafter be paid over to the creditors.

19.3.3 Attachment and sale in execution

Section 34A of the Close Corporations Act applies in instances where a member's interest is attached after judgment is taken against a member.

The member's interest may then be sold to the close corporation, other members or an outsider, subject to the right of pre-emption in favour of the close corporation and other members.

Please ensure that you are able to answer the key questions at the beginning of the study unit.

In the next study unit we will examine the duties that members owe to the close corporation.

Study unit 20

Duties that members owe to the close corporation

Contents

Introduction

In this study unit you will learn about the duties that members owe to a close corporation and the remedies in case of a breach of these duties. These duties serve the purpose of protecting the interests of a close corporation and those of other members.

20.1 Fiduciary duty

A member's fiduciary duties towards the close corporation are similar to the fiduciary duties that a director owes to a company.

The Close Corporations Act provides that a member should

- act honestly and in good faith and, in particular,
  - exercise powers to manage or represent the corporation in the interest of the corporation
  - not act without or exceed such powers
- avoid a conflict of interest between his or her own interests and those of the close corporation and, in particular,
  - not derive any personal financial gain to which he or she is not entitled by virtue of being a member of the close corporation
  - disclose any material interest in a transaction to the other members of a close corporation as soon as possible
  - not compete with the close corporation's business activities in any way

20.1.1 Contracts concluded between a member and the close corporation

As indicated above, a member of a close corporation is in a fiduciary relationship with the close corporation and its members.

Should a member have a material interest in a contract of the close corporation, it must be disclosed to other members and all material facts regarding the interest must be divulged as soon as possible.

Should a member fail to disclose his or her interest, the contract would be voidable at the option of the close corporation. Application can, however, be made to court to declare the contract binding upon the parties, despite failure to make such disclosure.

In the event that the fiduciary duties are breached, a member may be held personally liable for any loss suffered by the corporation or debts incurred as a result of such a transaction. The member would, in such an event, have to repay any profit made by him or her, unless all the members approve this conduct in writing.

20.1.2 Personal liability for debts

A member may incur personal liability for the debts of the close corporation, should a contract be concluded in conflict with his or her fiduciary duty to the close corporation.

Personal liability can, however, be avoided by disclosing all material facts regarding the member's interest in a transaction to other members of the close corporation and by acquiring prior or subsequent written approval from all members.

20.2 Duty of care and skill

A member will be liable for breach of the duty of care and skill only if the close corporation suffers a loss as a result of the breach of this duty. Also, in this instance, no liability will be incurred if all the members give their prior or subsequent approval in writing.

The member's conduct is measured against the conduct that could reasonably have been expected from a person with the same skill and knowledge as the member (to establish negligence).

In case of a breach, another member may institute action against the close corporation or its members in his or her personal capacity.

ACTIVITY 20.1

1 Anna, Bertus, Chris and Duncan are members of a close corporation. In terms of the founding statement, the principal business is the buying and selling of immovable property. Bertus buys a farm from Xander in competition with the close corporation and sells the farm at a profit. (Xander was not prepared to do business with the close corporation.) Chris and Duncan are unhappy about this state of affairs. Advise Chris and Duncan accordingly.

2 What is the nature of the fiduciary duties of members of a close corporation?

Answering an application-type question:

Remember always to refer to the important decisions and the sections of the Close Corporations Act 69 of 1984 when answering a question. Be mindful of the structure of your answer and follow the steps identified below:

1. Identify the problem that the question deals with.
2. Refer to relevant sections of the Close Corporations Act 69 of 1984.

3. Refer to case law, where applicable, and remember that the decision is the important part. You don't need to write down the full reference; just the name – or at least part of the name – of the case is sufficient.
4. Apply the law (2 and 3 above) to the facts.
5. Come to a conclusion. Reread the question to ensure that your conclusion provides a final answer to it.

Feedback

From the set of facts, you are able to see that there is a conflict of interest. In this instance, section 42(3)*(b)* of the Close Corporations Act is relevant. Remember to apply the law in order to answer what is asked. You should have discussed the effect that the breach of the fiduciary duty will have on the contract. In this instance, the contract would be voidable at the option of the close corporation. However, if the member (Bertus) had disclosed his interest and made all material facts known to the other members, the contract could be valid. The member has also acquired a financial gain in competition with the close corporation. You can now conclude that this may be a breach of the member's fiduciary duty. In this set of facts, no such disclosure took place. The close corporation can therefore reclaim the benefit that the member acquired.

20.3 Remedies in case of breach

20.3.1 Statutory derivative action

Section 50 of the Close Corporations Act 69 of 1984 provides for an action to be instituted by a member against fellow members on behalf of the close corporation for liability to the close corporation on the specified grounds, including a breach of a fiduciary duty or the duty of care and skill. Therefore, this is a statutory derivative action.

ACTIVITY 20.2

(1) When can an action be instituted in terms of section 50?
(2) Stella, one of the members of a close corporation, comes to you for advice. She alleges that another member purchased goods in her personal capacity and then sold them to the close corporation at a profit. Stella feels that the close corporation is entitled to repayment of the profit the member made. Which action would you advise Stella to institute against the member?

Feedback

The duties of members of a close corporation are similar to the duties of directors of companies. Members must act in good faith and perform their functions with a reasonable degree of care and skill. If a member breaches his or her duty, any other member may institute proceedings against such member on behalf of the close corporation. The fact that the person instituting the action will be liable for the legal costs if the claim is unsuccessful and found to have been without prima facie grounds is aimed at preventing abuse of this remedy.

20.3.2 Cessation of membership by order of court

There are two remedies for members against other members:

- Section 36: Order of court terminating membership
- Section 49: Assistance from court regarding unfairly prejudicial conduct

In terms of section 36 of the Close Corporations Act, one or more members may apply for the termination of another member's membership by order of court. In order to do so, the member(s) will have to prove

- that the member is unable to perform his or her part in carrying out the business
- that the member's conduct is likely to have a prejudicial effect on the carrying on of the business of the close corporation
- that the member's conduct has made it reasonably impossible for the other member(s) to associate with him or her in the carrying on of the business of the close corporation
- that, in the circumstances, it is just and equitable that such a person should cease to be a member of the close corporation

Relevant information relating to how the members' interests in the close corporation should be adjusted once the person's membership of the close corporation ceases should be presented. The court may then order cessation of a member's membership and make any order it deems necessary regarding the disposal of the member's interest.

Section 49 is available to a member whose rights are unfairly and prejudicially affected or who is aware of other members so affected by the close corporation's conduct or the conduct of one or more of the other members. The court may make any order that it deems fit to remedy the situation.

In *Gatenby v Gatenby* 1996 (3) SA 118 (E), it was held that the court enjoys a wide discretion in the order it may make to provide relief to the victim of oppressive conduct. In this case, the court ordered the sale of the corporation's sole asset to place the close corporation in a financial position to buy back an aggrieved member's interest.

In *De Franca v Exhaust Pro CC* [1996] 4 All SA 503 (SE), the court held that it enjoyed discretion to order the purchase of any member's interest by other members or by the corporation if the court finds it just and equitable to do so. The court, however, requires proof of the value of the member's interest in order to establish a fair price for the member's interest.

ACTIVITY 20.3

Note what the courts held in *Gatenby v Gatenby* 1996 (3) SA 118 (E) and *De Franca v Exhaust Pro CC* [1996] 4 All SA 503 (SE), as well as in section 49 of the Close Corporations Act, and then answer the following questions:

(a) When can a member institute an action in accordance with section 49?
(b) What order may a court make if a member successfully relies upon section 49?
(c) When can the statutory derivative action be implemented on behalf of the close corporation?

Feedback

Section 49 is a remedy available to a member where there was a particular act or omission in the conduct or affairs of the business by the corporation or other member(s) that was unfairly prejudicial to such member(s). The court will intervene only if it is just and equitable to do so. The court may then direct that the aggrieved act or omission be stopped, that the corporation amend its founding statement or association agreement, or – in certain cases – upon application, make an order to wind up the corporation.

20.4 Acquisition of member’s interest by the corporation

Important terms:	**Meaning:**
Solvency	The corporation’s assets, fairly valued, must exceed its liabilities.
Liquidity	The corporation must be able – and remain able – to pay its debts as they become due in the normal course of business.

It is possible for a close corporation to acquire a member’s interest from one of its members.

Requirements for acquisition of a member’s interest by a close corporation:

- The close corporation must have at least one other member.
- The aggregate of members' interests must remain 100%.
- Written consent must be obtained from all members prior to payment.
- The corporation must be solvent after payment for the acquisition and must be liquid both before and after payment.

It is also possible for a close corporation to give financial assistance to a person to enable the person to acquire a member’s interest in the close corporation. In order to do so, section 40 of the Close Corporations Act requires

- prior written consent from every member
- that the close corporation be solvent after assistance has been given and liquid both before and after assistance has been given

  In the next study unit we will look at internal relationships and association agreements.

Study unit 21

Internal relationships and association agreements

Contents

Introduction

In this study unit unit you will learn about the relationships between the members themselves and the relationship between the close corporation and its members and the arrangement of internal affairs within the close corporation.

Important terms:	**Meaning:**
Association agreements	A non-compulsory agreement to arrange internal affairs within the close corporation.
Internal relationships	The relationships between members inter se (between themselves) and the relationship between the close corporation and its members.

21.1 Association agreements

Although it is advisable for members to conclude such an agreement, it is not compulsory. The internal relationships between members may be regulated by an association agreement. The members of the corporation may change provisions to suit their specific needs in an association agreement, on condition that the agreement complies with the Act.

They may arrange

- the rights of the members to carry on business and manage the close corporation
- what the requirements are for making a decision and voting
- the procedure and proportions for payments to members

An association agreement is not lodged with the Commission (CIPC) and is not a public document. However, should such an agreement be concluded, it must be held at the registered offices of the business.

ACTIVITY 21.1

(1) (a) What is an association agreement?
    (b) Who may participate in the management of a close corporation?

(2) Draw up a table in which you indicate which matters may be altered by an association agreement and which may not.

Feedback

Close corporations have only one compulsory constitutive document, namely the founding statement. Although association agreements are optional, it is preferable for members to conclude such an agreement to regulate internal relationships in the management of the business.

An association agreement must be in writing and signed by or on behalf of each member. This document is not viewed as a public document and only members may inspect it.

In the association agreement, the members may agree on how the corporation will be managed and how decisions will be taken, as well as the proportion of payments to members.

No stipulation in contravention of the Close Corporations Act that is included in the association agreement will be valid. The Close Corporations Act clearly sets out certain issues that may not be varied by any agreement between the members. Therefore, any clause stating that certain members will not be permitted to call a meeting, that disqualified members may participate in the management or specifying how the member's interest of an insolvent member will be disposed of will be void.

21.2 Power of members to contract on behalf of the close corporation

Section 54 of the Close Corporations Act states that every member has the authority to conclude contracts on behalf of the close corporation in relation to a person who is not a member (an outsider or third party).

The doctrine of constructive notice does not apply to close corporations. This means that even if the association agreement (which is, in any event, not a public document) states otherwise, every member can conclude contracts on behalf of the corporation. It does not matter whether or not the transaction falls within the scope of the main business of the corporation.

A close corporation will therefore be bound by most agreements concluded on its behalf by its members. Close corporations will, however, not be held liable if the outsider or third party knew or reasonably should have known that the member who concluded the contract on behalf of the close corporation lacked authority.

In the case of *J&K Timbers (Pty) Ltd v GL & S Furniture Enterprises CC* 2005 (3) SA 223 (N), the court held that a member is an agent of the close corporation, even though express and implied authority is lacking, and the close corporation is bound by the act of the agent.

ACTIVITY 21.2

(1) Note what section 54 of the Close Corporations Act provides and what the court held in the case of *J&K Timbers (Pty) Ltd v GL & S Furniture Enterprises* CC 2005 (3) SA 223 (N).
(2) Answer the following questions:
    (a) Who may represent a close corporation?
    (b) Under which circumstances would a close corporation not be bound by a contract concluded on its behalf by a member?

Feedback

Section 54 of the Close Corporations Act states that every member has the authority to conclude contracts on behalf of the close corporation in relation to a person who is not a member (an outsider or third party).

The doctrine of constructive notice does not apply to close corporations. This means that even if the association agreement (which is, in any event, not a public document) states otherwise, every member can conclude contracts on behalf of the corporation. It does not matter whether or not the transaction falls within the scope of the main business of the corporation.

A close corporation will therefore be bound by most agreements concluded on its behalf by its members. Corporations will, however, not be held liable if the outsider or third party knew or reasonably should have known that the member who concluded the contract on behalf of the close corporation lacked authority.

21.3 Payments by corporation to its members

In terms of section 51 of the Close Corporations Act, no payment may be made to members in their capacity as such if the solvency and liquidity criteria are not complied with and the other members have not all provided their written consent to such a payment.

Note that section 51 applies only in instances where payments are made to members in their capacity as members, and not if the payment is made to a member in his or her capacity as a creditor.

ACTIVITY 21.3

Quatro CC concluded a loan agreement with Stella, one of its members, for the amount of R15 000. The amount is now due and payable.

Johannes, another member of Quatro CC, informs you that the close corporation cannot pay its debts in the normal course of business at the present time. Consider whether the close corporation may refuse to pay the R15 000 to Stella.

What are the requirements that must be complied with before a close corporation can make a payment to one of its members?

Feedback

Before any type of distribution can be made to members in their capacity as members, the requirements set out in section 51 must be complied with. If a payment must be made to a member in his or her capacity as a creditor, these principles will not be applicable. Should a creditor claim payment when it is due and payable, the close corporation will be liable. Should the close corporation be unable to pay the creditor, such creditor may apply for the winding-up of the corporation.

21.4 Prohibition of loans to and security on behalf of members

The Close Corporations Act contains a prohibition on loans and the furnishing of security to members. Such a loan or security may be provided only if all the other members have agreed thereto in writing. In *Hanekom v Builders Market Klerksdorp (Pty) Ltd & others* 2007 (3) SA 95 (SCA), the court confirmed that the provision of a loan or security may be valid only if all the members have agreed thereto in writing.

If the requirements under section 52 are not met, any loan or security provided becomes null and void and members who permitted the transaction will be held accountable.

ACTIVITY 21.4

(1) Johannes, a member of Quatro CC, wishes to purchase a new car. However, he is experiencing cash flow problems and will be able to pay the purchase price only within a period of about two months. The seller is willing to accept the payment arrangement if the close corporation stands surety for the purchase price. Advise Johannes whether or not it is possible to execute such a transaction.

(2) *Read Hanekom v Builders Market Klerksdorp (Pty) Ltd & others* 2007 (3) SA 95 (SCA) and summarise it in your own words.

Hint: Remember that the decision is the most important part of the case!

Feedback

The Close Corporations Act contains a prohibition against the provision of loans and security to members. Only if all the other members consent thereto in writing may such loan or security be extended. Should the requirements of section 52 not be adhered to, any loan or security provided will be invalid and members who permitted the transaction will incur liability.

21.5 Accounting officer, records and financial statements

Close corporations are not exempted from financial reporting. An annual financial statement must be drawn up. The annual financial statement must be approved by or on behalf of members holding at least 51% of the members' interest in the close corporation. A report must be drawn up by the appointed accounting officer.

In terms of section 58(2A), section 30(2)*(b)* and (3) to (6) of the Companies Act, read with the changes required by the context, apply to a corporation that is required by the regulations made in terms of section 30(7) of the Companies Act to have its annual financial statements audited. A close corporation will thus be compelled to have its financial statements audited in the same circumstances as a private company.

ACTIVITY 21.5

Answer the following questions:

(a) What are the duties of the close corporation in respect of financial reporting?

(b) Discuss the duties of the accounting officer of a close corporation.

Feedback

A close corporation need not appoint an auditor. However, an accounting officer must be appointed. Accounting records must be kept and approved by members annually. The accounting records need not be submitted to the Commission.

The accounting officer must account for the financial state of the corporation in accordance with generally accepted accounting practice. He or she also performs a very important reporting function. If an accounting officer becomes aware of irregularities in the accounting policies or practices of the corporation, this must be disclosed to the members. The Commission must also be informed if the accounting officer is removed, the corporation is not carrying on business or its liabilities exceed its assets at the end of the financial year.

21.6 Circumstances when members and others may be liable for a corporation's debts

In terms of section 23 of the Close Corporations Act, members will be personally liable for the debts of the corporation if they fail to use the name and the registration number of a corporation on the trading documents.

In terms of section 64 of the Close Corporations Act, members will be held personally liable if they act recklessly and fraudulently when representing the close corporation.

In terms of section 65 of the Close Corporations Act, the court may ignore the existence of a corporation in circumstances where there is an abuse of a corporation as a juristic person. In the case of *Airport Cold Storage (Pty) Ltd v Ebrahim and others* 2008 (2) SA 303 (C), the court held that in the circumstances where the corporation is treated as some kind of a personal scheme of the owners, the court may apply section 65 of the Close Corporations Act to deem the corporation not to be a separate legal person for the benefit of the third parties.

ACTIVITY 21.6

Quatro CC is experiencing financial difficulties as a result of mismanagement. FNT Bank loans Quatro CC an amount of R100 000, despite being aware of the problems the close corporation is experiencing. The amount subsequently becomes due and payable by Quatro CC, but it is unable to pay. Advise FNT Bank whether or not they can hold the members of the CC personally liable for payment of the debt.

Hint: In answering this question, you should consider the following:

- the separate legal personality of the close corporation
- instances in which the separate legal personality may be disregarded

Feedback

A close corporation is a separate legal person. Nevertheless, the court may at times pierce the corporate veil to hold the guilty parties liable. In some instances, the members and/or other guilty parties (such as the accounting officer) will incur personal liability (sections 23, 26, 42, 43, 52 and 65); and in other circumstances, they will be held jointly liable (section 63) for the losses incurred as a result of their actions.

A person who knowingly conducts – or is a party to conducting – the business of the close corporation in a reckless or fraudulent manner will be held liable for all debts of the corporation.

21.7 Advantages and disadvantages of close corporations

The advantages of a close corporation are the following:

- the relative ease of formation
- the limited liability of the members
- increased potential for capital acquisition
- continuity of existence

On the other hand, a close corporation has the following disadvantages:

- Under the Companies Act 71 of 2008, no new close corporations may be formed and registered.
- Close corporations are subject to certain legislative principles contained in the Companies Act of 2008, in addition to those contained in the Close Corporations Act.
- Membership is limited to ten people.
- Juristic persons may not be members.

REVIEW

Close corporations originated as a result of a proposal to introduce a new form of enterprise specifically aimed at small businesses. Since its inception, this form of enterprise has become increasingly popular. Close corporations have been a very attractive option as they offer the advantages associated with separate legal personality, the legislative framework is less complex than in the case of companies, and the management structure is also simpler.

You have now been exposed to certain fundamental aspects regarding the establishment and procedures of this business form.

In the next study unit, you will be introduced to another form of business, namely the business trust. The characteristics of this type of business will be preceded by an explanation of the principles applicable to trusts in general.

PART 4

Trusts

Contents

NOTE THAT YOU NEED TO STUDY THESE IMPORTANT SECTIONS OF LEGISLATION FOR THIS PART, AS THEY ARE DISCUSSED HEREIN.

TRUST PROPERTY CONTROL ACT 57 of 1988:
Section 6(1) – Authorisation of trustee by the Master of the High Court
Sections 9, 11, 16 & 17 – Duties of trustees

ALL THE CASES IN THIS PART SHOULD BE STUDIED AS DISCUSSED HEREIN.

IN ADDITION TO THE SELF-ASSESSMENT QUESTIONS AT THE BEGINNING OF EACH STUDY UNIT, YOU MUST DO ALL THE ACTIVITIES IN EACH STUDY UNIT.

INTRODUCTION

A trust is an adaptable concept with various uses, including carrying on a business. Although originally an English legal concept, it has found favour in South African law because of its practical value. As a business form, the main advantage of a trust over a company and close corporation is that it enjoys the benefits without the complexities and expenses associated with the other two forms.

Close corporations and companies differ from trusts because they are formed by completing and lodging certain statutory forms with the Companies and Intellectual Property Commission, and after registration thereof, they come into existence. A trust is created by a contract or will or a legal document, commonly referred to as a trust deed. A trust is separate from its founder and it is terminated only by agreement or if it is sequestrated because it is unable to pay its debts. These qualities make trusts the only entities that will afford total asset protection and savings on estate duty, along with a myriad of other benefits.

Study unit 22

Definition and nature of a trust

Contents

Introduction

A trust is a legal relationship that is created by virtue of a trust deed or instrument. This trust deed must be drafted by a person who has the intention of establishing a trust. Such a person is known as the founder, donor or settler.

Once the trust deed has been created by the founder, assets specified in the trust deed are put under the control of a person who is tasked with the administration of the trust. This person is known as the trustee. A trust may be created during a founder's life (namely an *inter vivos* trust) or after his or her death (a testamentary trust). The purpose of creating a trust is not to benefit the trustee, but rather to allow him or her to take control of the trust assets and instruct the trustee to manage these assets to the benefit of a specified beneficiary.

In this study unit we will briefly set out the legislative principles applicable to trusts as a business form. The focus will be on business trusts.

You will know that you understand this study unit if you are able to answer the following key questions:

- How would you define a trust?
- Who are the parties to a trust?
- What is a trust deed or trust instrument?
- What is an *inter vivos* trust?

Important terms:	**Meaning:**
Trustee	Any person (juristic or natural) who acts as trustee by virtue of an authorisation under section 6 of the Trust Property Control Act.
Trust instrument	Also known as a trust deed. A written agreement or a testamentary writing or a court order according to which a trust was created.

Important terms:	**Meaning:**
	Certain documents representing a reduction to writing of an agreement to establish a trust also qualify as a trust instrument (section 2).
Trust property	Movable or immovable property, including contingent interests in property, which – in accordance with the provisions of a trust instrument – are to be administered or disposed of by a trustee.
Founder of a trust	Also known as the donor or settler. The person (juristic or natural person) that establishes a trust.
Trust beneficiary/ beneficiaries	One or more persons stipulated in the trust instrument or trust deed that are earmarked to reap the benefits of the trust. The beneficiary may be a legal (juristic) person.
Bewind trust	A trust in which the beneficiary owns the trust assets, but the trustee only manages them.
Nomine officio	A Latin term loosely translated as "in his or her official capacity"; used in the sense that trust assets vest in trustees only in their official capacity, and not in their personal capacity.

22.1 Definition of a "trust"

A trust is an arrangement through which ownership of a person's property is, by virtue of a trust instrument, made over or bequeathed to a trustee under a trust instrument, to be administered to the benefit of the beneficiaries. Trusts were designed to protect the weak and to safeguard the interests of those who are absent or dead (*Land and Agricultural Bank of South Africa v Parker and others* 2005 (2) SA 77 (SCA)).

The **founder** creates the trust; the **trustee** manages and controls the trust property; and the **beneficiary** is the party on whose behalf the trust is created and managed. All of the parties to a trust may be legal (juristic) persons. In other words, any one of the parties to a trust may be a company or a close corporation.

The trustee is responsible for administering and performing his or her duties to achieve an outcome envisaged in the trust instrument in favour of the trust beneficiaries. However, a trust is not automatically brought into existence when an executor, tutor or curator administers another person's estate under the Administration of Estates Act 66 of 1965.

For a trust to be established, a trust instrument must be lodged with the Master of the High Court. If trust property is disposed of in terms of a will, jurisdiction lies with the Master of the High Court in whose office the testamentary writing or a copy thereof is registered and accepted, or with the Master in whose area of appointment – in terms of the Administration of Estates Act – the greater or greatest portion of the trust property is situated, provided that a Master who has exercised jurisdiction will continue to have jurisdiction, notwithstanding any change in the situation of the greater or greatest portion of the trust property.

22.2 Legal nature of trusts

A trust is either created by a **contract** (*inter vivos* trust) or through a **will** of a testator (testamentary trust). It must be reduced to writing, therefore a document is proof of its existence.

Some of the legal attributes of a trust include the following:

- Not being a legal person, a trust has no separate existence and cannot contract in its own name. Note that for purposes of the limited application of the Companies Act to trusts, a trust is considered a legal person. In other words, generally speaking, trusts do not enjoy legal personality, but when the Companies Act applies to this business form, there is an exception to the rule.
- Although the trustee is legally the owner of the trust assets, a distinction is drawn between the trust's assets and the private assets of the trustee.
- Insolvency of any of the two estates does not entitle its creditors to attach the assets of the other estate, and official acts of the trustee will not bind his or her private estate.
- The trust deed may provide for continued existence of a trust, despite changes in the trustees.
- Both natural and juristic (legal) persons may be parties to a trust, whether as founders, trustees or beneficiaries.
- Parties to a trust enjoy protection against liability for the debts of the trust. The parties do not stand to lose more than what is held in the trust.

22.3 The trust deed, deed of trust or trust instrument

A trust is created by a document called a trust deed. A trust deed takes the form of either a contract (for an *inter vivos* trust) or a will of a testator (for a testamentary trust). The trust deed is a trust's constitutive charter.

22.4 Regulation of trusts

Trusts are mainly regulated by the Trust Property Control Act 57 of 1988 (the "Trust Property Control Act") and the trust deed. The Trust Property Control Act consists of only 27 sections, dealing mainly with the administration of trusts. The common law forms the basis of trusts as a business form.

22.5 Types of trusts

The definition of a "trust", as set out in the Trust Property Control Act, envisages two types of trusts, namely ordinary trusts and *bewind* trusts. An ordinary trust is a trust in terms of which the ownership and control of the trust property vests in the trustee. In a *bewind* trust, on the other hand, the beneficiaries have ownership of the trust assets, but they are under the control of the trustee.

An example of a *bewind* trust is where someone bequeaths assets to a minor child. Upon the death of the testator (who is the founder of the trust), ownership of the trust assets vests in the child, but the trustee controls the trust assets until the child reaches the age of majority.

There are also different classifications of trusts in South Africa that fall within these two main types of trusts:

- **Testamentary trusts** are formed upon the death of the founder, as part of his or her will.
- ***Inter vivos* trusts** are formed while the founder is still alive, often as part of an estate plan to avoid payment of estate duty and other taxes.
- **Business (or trading) trusts** provide the trustees with wide powers to carry on business, while granting the beneficiaries the right to sell their interests in the trust. These trusts can be either public or private.
- **Public trading trusts** are trusts where members of the public are invited to become income beneficiaries by contributing money or assets to the trust and then being issued with certificates as proof of their share.

- **Private trading trusts** are created by private individuals wishing to channel funds towards a business and they are used to drive the business.
- **Realisation trusts** are formed specifically for developing and selling fixed property.
- **Statutory trusts** are created by a particular statute to achieve a specific objective.
- **Court order trusts** are set up in terms of an order of court.
- **Offshore (or international) trusts** are established outside South Africa and fall outside the jurisdiction of the Master of the High Court.

ACTIVITY 22.1

During his lifetime, Simphiwe appointed Sizwe and Taelo as trustees of a trust he wished to set up for his young children, upon his death. However, the arrangement was not reduced to writing. Would a valid trust come into being after Simphiwe's death?

Feedback

A trust has to be reduced to writing, either in the form of a contract or a will. The failure by Simphiwe to reduce the arrangement with Sizwe and Taelo to writing means that a valid trust would not come into being when he dies.

Please ensure that you can answer the questions at the beginning of the study unit.

In the next study unit we will look at the requirements for forming a valid trust.

Study unit 23

Forming a valid trust

Contents

Introduction

We have now seen what a trust is, who the parties to a trust are and what different types of trusts exist. In this study unit, we will look at how a trust is formed. You must remember that trusts are not registered with the Companies and Intellectual Property Commission. Trusts are created by virtue of a trust deed or instrument.

You will know that you understand this study unit if you are able to answer the following key questions:

- List the requirements that must be adhered to in order to create a valid trust.
- When may a trustee start fulfilling his or her duties in terms of the trust deed?
- What are the duties of a trustee?
- May a trustee expose trust assets to risk?

23.1 Forming a valid trust

Trusts are not registered with the Companies and Intellectual Property Commission. Trusts are created by virtue of a trust deed or instrument.To form a trust, the intention to create a trust must exist. This intention or instruction to the trustee to manage the trust assets for the beneficiaries must be expressed as an obligation in a written trust deed.

In *Estate Price v Baker and Price* (1905) 22 SC 321 (C), a will provided for a usufruct in favour of the surviving spouse "in order that she may be better enabled to maintain our children until they become of age or they marry".

The court held that no trust had been created and the children were not beneficiaries, since the words in the will only expressed a desire and not an obligation. In terms of the will, the surviving spouse was enabled – but not obliged – to use the income to maintain the children. This is insufficient for the formation of a trust.

The trust must be established for a lawful purpose and the trust property must be clearly defined. Beneficiaries of the trust must be clearly identified. At least one beneficiary must be nominated and at least one trustee must be appointed, either in terms of the trust deed or by the Master of the High Court. A trust deed must be concluded in writing. If the trust is formed as part of a will, the required formalities for a valid will must also be adhered to. In other words, two witnesses above the age of 16 years must sign the testament in which the trust is created, along with the testator, and such witnesses may not be beneficiaries of the will.

Consequences of forming a valid trust:

Upon the formation of a trust, trustees incur certain obligations/duties and acquire some powers. These are found in the Trust Property Control Act, the common law and the trust deed. The beneficiaries also acquire some rights and protection, which are set out in the trust deed and the Act. The scope of the beneficiaries' rights is set out in the trust deed. Unless otherwise prohibited by the trust deed, these rights may be ceded or otherwise disposed of.

23.2 Authorisation of trustees

Only after a written authorisation by the Master can a trustee act as such.

In *Simplex (Pty) Ltd v Van der Merwe and others NNO* 1996 (1) SA 111 (W), the court held that section 6 of the Trust Property Control Act was intended to provide proof to outsiders of the fact that someone is authorised to act as a trustee, and not only for the beneficiaries.

The court held that if a person is not authorised by the Master, any act performed before such authority is received by him or her will have no legal consequence. The court continued to consider whether it would be possible to ratify a contract retrospectively and held that it was not possible, as "there can be no ratification of an agreement which a statutory prohibition has rendered *ab initio* void". In terms of section 6 (1) of the Trust Property Control Act, only after authorisation by the Master can a trustee act as such. In *Kropman v Nysschen*, the court confirmed that any act performed by a trustee in the absence of authorisation from the Master is null and void.

ACTIVITY 23.1

Sam entered into a lease agreement on behalf of Verona Trust one day before he was formally authorised to act as its trustee. Advise Sam on whether his subsequent authorisation will render the contract valid.

Feedback

In terms of section 6(1) of the Trust Property Control Act, only only after authorisation by the Master can a trustee act as such, which means that Sam's actions on behalf of the trust before his formal authorisation are not legally binding.

23.3 Duties of trustees

Every trust is formed for a specific purpose. A trustee enjoys the powers inferred inherently in the type of business carried out in the trust. The powers of a trustee are stipulated in the trust deed. No other powers not provided for in the trust deed may be inferred. Therefore, a trustee is limited in his or her capacity by what is stipulated in the trust deed. If he or she acts outside of the authority provided, he or she may incur personal liability.

Section 9(2) of the Trust Property Control Act states that any provision in the trust deed that has the effect of exempting a trustee from one of his or her duties is void. It is, therefore, also impossible to exempt a trustee from personal liability for failure to comply with his or her duties.

Owing to the fiduciary nature of the trustee's responsibilities, onerous duties are imposed on the trustee.

These duties include the following:

- a duty of care, skill and diligence
- to open a separate trust account at a banking institution
- to indicate, in his or her bookkeeping, the property held as trustee
- to register trust property as such
- to make trust and trust investment accounts identifiable as such
- to keep all documents as proof of investments for five years
- to protect and conserve trust property and collect debts in favour of the trust diligently
- to observe good faith in dealing with trust property
- to give effect to the terms of the trust deed

Although a trustee is usually not allowed to expose trust assets to risks (this would constitute a breach of his or her fiduciary duties), a trustee in a business trust is empowered to carry on a business or to trade. This implies authority to expose the trust to risks inherent in the type of business concerned.

In *Sackville West v Nourse and another* 1925 AD 516, it was held that part of this duty entails not exposing trust assets to undue risk. An unsecured loan or a loan of which the repayment is under the ordinary market rate will not be considered a sound investment.

In *Doyle v Board of Executors* 1999 (2) SA 805 (C), it was held that a trustee has to show the utmost good faith in his or her dealings on behalf of or with the beneficiaries of the trust. This includes the duty to account sufficiently to the beneficiaries.

Unless specifically prohibited by the trust deed, a beneficiary can freely cede any of his or her rights in a trust, including discretionary rights.

ACTIVITY 23.2

Tsepo is a trustee of a business trust involved in furniture retail. Although the relevant trust deed makes no provision for it, Tsepo buys a bakkie to transport the furniture. Given the requirement that a trustee must preserve trust assets, indicate whether Tsepo has acted unlawfully.

Feedback

By appointing Tsepo as a trustee of the trust, he was empowered to carry out activities that are inherent in the type of business carried on by the trust. Even though the trust deed made no provision for buying a bakkie, the nature of the business carried on by the particular trust is such that transporting furniture is necessary. In the circumstances, therefore, Tsepo's conduct is lawful.

ACTIVITY 23.3

Thuso has been a beneficiary of a business trust for the past five years and now wishes to dispose of his interest in the trust by selling it to Bonolo. The trust deed is silent on Thuso's rights in this regard. Advise Thuso on the legality of his intended action.

Feedback

Unless specifically prohibited by the trust deed, a beneficiary can freely cede any of his or her rights in a trust, including discretionary rights. Thuso can, therefore, sell his interest in the trust to Bonolo.

REVIEW

The advantages of a business trust are

- ease of formation
- limited liability
- extreme flexibility
- absence of legal regulation
- continuity

The disadvantages of a business trust are

- limited access to capital – usually obtained by means of loans, for which security is provided
- potential for conflict between parties
- may be confused with a partnership due to similarities in management structure

By now you should realise that trusts enjoy many benefits – their formation is cheap, there is no complex legislative structure and they enjoy limited liability. There are different parties to trusts, namely the founder, trustee and the beneficiary. All or any of the parties may be juristic persons.

A trust generally does not enjoy separate juristic personality. The trustee owns the trust assets in an official representative capacity. The trustee of a business trust is held liable for the trust's debts in his or her capacity as trustee. However, the only assets that the trustee stands to lose are the assets held in his or her capacity as a trustee and not the assets in his or her own personal estate. The effect is that liability is limited to what is held in trust.

A trustee is regarded as having two separate estates, namely a personal estate out of which his or her personal debts are paid, and the trust estate, which is liable for trust debts only. A trust can be created for any period of time. Therefore, it enjoys perpetual existence. The existence of a trust does not depend on the identity of the trustee or its beneficiaries.

Trusts are managed by trustees. The founder exercises control over the trustees and has the right to amend the trust deed. In a business trust, the management structure is similar to that of a partnership and the Master of the High Court oversees the trustee's functions.

It is easy and cheap to establish a trust. All that is required is a trust deed, usually in the form of a contract or a will. The trust deed must identify the trust property, trustees and beneficiaries, and set out the powers of the trustees. There is very little regulation of trusts compared with regulation of other enterprise forms. The lack of regulation of trusts can be a disadvantage. A trust deed must be properly formulated and trustees must be carefully selected.

The main advantage of a business trust is that the beneficiaries enjoy limited liability, without the complexities and expenses of forming a company or close corporation. A disadvantage is the danger of being deemed a partnership, since the two entities often share characteristics.

Conclusion

In this module you have learnt about companies, partnerships, close corporations and business trusts. You should now be able to refer to important sections in the various pieces of legislation applicable to the different forms of South African businesses. You should also be able to discuss the application of these sections by referring to the interpretation given of them by our courts in case law. As part of this module, you have also been exposed to legal material and learnt how to access, read and summarise cases.

You should now be able to advise clients on the main characteristics of these different forms of enterprise, indicating the advantages and disadvantages of each business form. You should also be able to explain some of the most pertinent regulatory measures within the respective enterprises.

We hope that you are now in a position to apply what you have learnt in practice!

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