



Department of Mercantile Law

Commercial

Law IIA

Only study guide for CLA2601

University of South Africa, Pretoria

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LEARNING UNIT 0

Purpose of this study guide and an introduction to company law

Welcome to the study of Commercial Law IIA.

Learning unit 0 firstly introduces you to your study guide and thereafter provides you with a general introduction to company law before we start with learning unit 1.

THIS STUDY GUIDE IS IMPORTANT AS IT

- contains the **general background information** that you will require to study for the examinations
- places **additional information** in tutorial letters in context
- explains some **difficult concepts**
- provides you with the **references** to the prescribed textbook, legislation and case law.

WHAT THIS MODULE IS ALL ABOUT

In this module, we teach you about the main South African business forms. 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 to decide which one will best suit the commercial needs of the specific business he or she has in mind. You will learn how to advise such a person, taking into account the relevant legislation, the common law principles and appropriate case law.

Our focus is on profit-oriented businesses. You are exposed to the law applicable to companies, partnerships, trusts and close corporations. On completion of this module, you should have 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 to solve practical problems that may arise within the context of these business forms.

You should study the general information in the learning units and read the prescribed sections in the textbook. We suggest that you first read the content of the particular learning unit in this study guide so as to provide you with an overview. Then you can read the prescribed section in the textbook for more detailed information, examples and additional case law to illustrate the principles and information explained in this study guide. The legislation is discussed and some excerpts from cases are included in this document. You are only required to know and be able to refer to the case law to the extent that it is discussed here and in the prescribed sections of the textbook.

Activities are included in the study guide. You should attempt to do the activities for the different learning units and think about similar examples and scenarios of your own to ensure that you understand the underlying principles.

On completion of this module you should have a sound knowledge of the principles of law governing the main business forms in South Africa and be able to apply them in solving problems that may arise in regard to these business forms.

Unisa's transformation themes have been incorporated in this study guide – these are: Ubuntu, social responsibility and graduateness, and humanising the law. We also refer to principles of the Constitution when pertinent to a specific topic.

We trust that you will enjoy studying this module and that you will find the knowledge you gain in the process to be of great value.

STUDENTS WHO ARE UNABLE TO ACCESS THE INTERNET REGULARLY

This printed document is part of your study package for this module. The University has decided that all material for online modules that are made available in learning units on myUnisa should also be made accessible to students in a printed form that does not require internet access. This document provides comprehensive information to replace the study guide that was used previously.

If you do not access myUnisa often, you may use this study guide as a primary source. Students who regularly access myUnisa will have the benefit of being able to exchange ideas and discuss problems with other students in the discussion forum. Taking part in discussion forums will help you to develop the necessary application skills. We recommend that you scrutinise these discussions regularly.

INTRODUCTION TO COMPANY LAW

The **Companies Act 71 of 2008 (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 continues to regulate the winding-up of insolvent companies. (The winding-up of companies is not included in the prescribed work for this module.)

Although **we only deal with the provisions of the Companies Act and not those of its predecessor, the Companies Act 61 of 1973**, some principles of our **common law** continue to apply insofar as these principles have not been repealed by the Companies Act. 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.

The common law features in many of the topics dealt with in the company law component of the course:

- (1) The common law is applicable in the discussion concerning agency and representation.
- (2) The common law duties of directors remain applicable.
- (3) The concept of piercing the corporate veil is a common law concept.
- (4) Common law alternatives to concluding pre-incorporation contracts still apply.
- (5) The common law *Turquand* rule has not been repealed.
- (6) The common law personal action and representative action can still be used by shareholders to enforce their rights. Only the derivative action that previously existed at common law has now been expressly abolished.

Also read chapter 1 of the prescribed textbook, which provides an overview of the purposes of company law reform and highlights new concepts and entities that have been adopted.

Now you are ready to start with the first learning unit in company law.

LEARNING UNIT 1

Legal personality

Table of contents

- 1.1 Introduction to legal personality
- 1.2 Legal personality of branches and divisions
- 1.3 Trusts and partnerships are not juristic persons
- 1.4 Disregarding separate juristic personality
- 1.5 Reflection
- 1.6 Conclusion
- 1.7 Self-assessment questions

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 when that legal personality is abused, in order to hold persons inside the company personally liable

1.1 INTRODUCTION TO LEGAL PERSONALITY



PRESCRIBED STUDY MATERIAL

Textbook: chapter 2, par 2.1–2.5, and chapter 16, par 16.1 and 16.13 (close corporations)

- **Case law as discussed here and in your prescribed textbook**

In this learning unit, we consider the main benefit associated with companies as a business form, that is, legal personality. Laypersons often misunderstand the concept of “juristic or legal personality”. An attorney or an advocate is not what is meant by a “legal person”! Two of the business forms that we teach you about – companies and close corporations – have the benefit of legal personality.

Although it is not a legal requirement that everyone wishing to conduct business must form or incorporate a company, most business men and women prefer to operate within a formalised business environment. However, prior to incorporating a business, a number of issues require consideration. These include, but are not limited to the following:

- the number of persons who will be involved in the business and the extent of their involvement
- the capital required to start the business
- the sources of capital
- customer and client requirements
- tax issues
- the strategic objectives of those involved

Only after careful consideration of these and other issues is it possible to decide whether a business should be run in the form of a sole proprietorship, a partnership, a company or a business trust. It is no longer possible to register new close corporations, but it is still possible to buy an existing close corporation to run a new business.

The principle of **legal personality** provides for the limitation of the liability of participants in the business. **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 is formed in terms of another Act.

The registration of a company (by getting a Registration Certificate issued) confers legal personality on 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 enjoy **limited liability**.

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 associated with such rights.

Separate legal personality ceases when a company is dissolved and deregistered after winding-up.

You have now learnt

- which factors should be considered prior to incorporating a business
- what separate legal personality means
- how and when a company acquires separate legal personality.

Now do activity 1.1 to ensure that you understand these principles and that you are able to apply them.

ACTIVITY 1.1

List and briefly discuss the main advantages of incorporating a business.

FEEDBACK

Refer to paragraph 2.1 in your textbook and ensure that you understand why certain people would decide to incorporate a company, exactly what the

consequences of incorporating a business are, and which factors should be taken into consideration prior to taking this decision.

1.2 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. 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**.

1.3 TRUSTS AND PARTNERSHIPS ARE NOT JURISTIC PERSONS

Although “juristic person” as defined in section 1 of the Companies Act includes trusts created inside or outside the Republic of South Africa, you should note that trusts are not usually acknowledged as juristic persons. It is just for purposes of application of the Companies Act that trusts are recognised as juristic persons. Trusts do enjoy one benefit that is associated with legal personality: **limited liability** for debts of the trust.

Although partnerships are viewed as being separate from their members, except in two exceptional circumstances, they do not have any of the benefits attached to legal personality.

1.4 DISREGARDING SEPARATE JURISTIC PERSONALITY

The exclusion of liability of persons inside business enterprises is not an absolute right. It is possible in certain circumstances to ignore the separation that is 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 (s 20(9) of the Companies Act for purposes of companies and s 65 of the Close Corporations Act for close corporations).

PRESCRIBED STUDY MATERIAL

Textbook: chapter 2, par 2.3, and chapter 16, par 16.13.1

- **Case law as discussed herein and in your prescribed textbook**

Before the adoption of the principle of disregarding a company’s separate existence by the Companies Act in section 20(9), this matter was only regulated by the common law and was referred to as “**lifting**” or “**piercing**”



the corporate veil. The courts used it to place limitations on the principle of separate legal personality in order to avoid abuse.

Courts have made it clear that they will not allow the use of any legal entity to justify wrongs, 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 only pierce or lift the corporate veil in exceptional circumstances where there is **no alternative remedy** available and where 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 this 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 conducted 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, in a particular instance, it has abused its separate legal personality, such status 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 (W), a test was formulated to determine when the corporate veil should be disregarded. In this judgment, it was held that only if an "unconscionable injustice" would result should the court lift the corporate veil. In *Cape Pacific* (above), this test was held to be too rigid. A more flexible approach was propagated: that is, to take the facts of each case into consideration to determine whether or not it is appropriate to pierce the corporate veil.

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 notwithstanding 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* that the test in *Botha v Van Niekerk* was 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 was 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.

You have now learnt and should be able to explain

- what the lifting of the corporate veil means
- in which circumstances the court will consider lifting the corporate veil.

Now do activity 1.2 to ensure that you understand these principles and that you are able to apply them.

ACTIVITY 1.2

Discuss the principle of lifting the corporate veil and indicate the circumstances, if any, under which this principle becomes relevant. Give your own example of circumstances where this principle may apply.

FEEDBACK

Refer to paragraph 2.3 in your textbook. Before answering the question make sure that you understand the underlying principles. Remember to discuss both the common law position and the position in terms of section 20(9) of the Companies Act and refer to relevant case law.

1.5 REFLECTION

Legal personality entails various rights and privileges. You should be able to say when a company acquires legal personality and describe the **nature and implications of legal personality**. 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 could 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 registration**. 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 the case law and which is applicable to both companies and close corporations) or the **legal personality will be disregarded** (the statutory principle that 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 abusing the separate legal personality of the company. Furthermore, separate legal personality will cease upon **deregistration** of the company.

1.6 CONCLUSION

You should now understand the concept of separate legal personality. A company acquires separate legal personality upon registration. Companies are afforded most of the rights and attributes of natural persons. It is evident that the company's separate existence has many implications in 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 abuse of the corporate form. Furthermore legal personality will cease upon **deregistration** of the company.

1.7 SELF-ASSESSMENT QUESTIONS

- What is legal personality?
- Do branches and divisions of a company have their own separate legal personality?
- Are partnerships and trusts generally regarded as juristic persons?
- What is the purpose of lifting the corporate veil?

LEARNING UNIT 2

Types of companies

Contents

- 2.1 Introduction
- 2.2 Profit companies
- 2.3 Non-profit companies
- 2.4 Transitional provisions and close corporations
- 2.5 External companies
- 2.6 Domesticated companies
- 2.7 Reflection
- 2.8 Conclusion
- 2.9 Self-assessment questions



PRESCRIBED STUDY MATERIAL

Textbook: chapter 2, par 2.6–2.9

- **Case law as discussed in this learning unit and in the prescribed textbook**

2.1 INTRODUCTION

In learning unit 1 you learnt that a company acquires legal personality and is regarded as an entity that can acquire rights and duties that are separate from those of its shareholders or members. You also learnt that the principle of separate legal personality should not be abused and the corporate veil can be lifted in certain instances. In this learning unit, we highlight the different types of companies that can be incorporated in terms of the Companies Act.

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 object other 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 offer its shares to the public and whose shares can be listed on the Johannesburg Stock Exchange
Private company	A private company that prohibits the issue of shares to the public and restricts the transfer of shares in its Memorandum of Incorporation

Important terms	Meaning
Personal liability company	A private 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 [Companies and Intellectual Property Registration Office]) with which companies must be registered
Securities	Shares, debentures or other instruments that a profit company may issue.

The Act provides for two types of companies – **profit companies** and **non-profit companies**.

2.2 PROFIT COMPANIES



PRESCRIBED STUDY MATERIAL

Textbook: chapter 2, par 2.6

Refer to figure 2.1 in the textbook for a diagram relating to the different types of companies in terms of the Companies Act, 2008. (See, also, the summary at the end of chapter 2 of the textbook.)

These cases you only need to know as discussed in this learning unit and in the prescribed textbook:

- ***Fundtrust (Pty) Ltd (In Liquidation) v Van Deventer 1997 (1) SA 710 (A)***
- ***Sonnenberg McCloughlin Inc v Spiro 2004 (1) SA 90 (C)***

A **profit company** has the object of achieving 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 can have.

There are four types of profit companies:

- (1) Public companies
- (2) State-owned companies
- (3) Personal liability companies
- (4) Private companies

Each type of company has distinguishing characteristics.

Public company ("Ltd"):

- It is any profit company that is not a state-owned enterprise, a private company or a personal liability company.
- Its shares may be offered to the public and are freely transferable.
- The company can be listed on the JSE Limited, or unlisted.
- The Memorandum of Incorporation (MOI) is the governing document of a public company.
- 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.

State-owned company ("SOC Ltd"):

- It is registered in terms of the Companies Act and is either listed as a public entity in Schedule 2 or 3 of the Public Finance Management Act of 1999, or is owned by a municipality.
- Examples of state-owned companies are: Airports Company South Africa (ACSA); Public Investment Corporation; Denel; 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.

Personal liability company ("Inc" or "Incorporated"):

- It is a profit company that meets the criteria for a private company.
- It is mainly used by professional persons (such as attorneys).
- Its Memorandum of Incorporation must state that it is a personal liability company.
- The directors are jointly and severally liable along with the company for debts and liabilities contracted during their term of office.
- 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.

Section 19(3) of the Companies Act 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 liable jointly and severally, 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 will be able to hold the directors jointly and severally liable for the company's contractual debts and liabilities. A director who has paid the debts will have a right of recourse against his or her fellow

directors for their proportionate share. Refer to *Sonnenberg McCloughlin Inc v Spiro* 2004 (1) SA 90 (C) (par 2.6.3 of your textbook) on a section 53 company under the Companies Act of 1973. This company is similar to the personal liability company under the Companies Act of 2008.

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.
- See *Smuts v Booyens; Markplaas (Edms) Bpk v Booyens* 2001 (4) SA 15 (SCA) on the requirement that a private company cannot transfer shares freely to the public (par 2.6.4 of your textbook).
- A private company’s Memorandum of Incorporation must contain a prohibition against the offering of its securities to the public and must restrict the transferability of its securities.
- It can be formed by one person.
- It must have at least one director.

2.3 NON-PROFIT COMPANIES (“NPC”)



PRESCRIBED STUDY MATERIAL

Textbook: chapter 2, par 2.6.5

- 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.
- It 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 have performed.
- A non-profit company does not have to have members. If it has 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.
- Examples of non-profit companies include companies that are registered to pursue any of the following objectives:
 - (a) Provision of social services for the youth, the elderly or the disabled.
 - (b) Child welfare, child protection or child adoption.
 - (c) Assistance of refugees.
 - (d) Prevention and education about HIV and AIDS.
 - (e) Protection of the environment and animal welfare.

(Give your own examples of the specific objects and activities for which non-profit companies may be registered.)

You have now learnt to identify

- the two types of companies – profit companies and non-profit companies
- four types of profit companies
- the distinguishing characteristics of each of these types of companies.

Now do activity 2.1 to ensure that you understand the above principles regarding profit and non-profit companies and that you are able to apply them.

ACTIVITY 2.1

Gugu wishes to incorporate a company. She comes to you for advice regarding the differences between a profit and a non-profit company.

Complete the following table, indicating the advice you would give her.

	Profit	Non-profit
(1) Types and abbreviations after name	– State-owned () – Private () – Personal liability () – Public ()	Non-profit ()
(2) Object		
(3) Required number of persons and directors	State-owned: Private: Personal liability: Public:	

- (a) Explain the main difference between private and public companies.

FEEDBACK

- (a) Refer to paragraph 2.6 in your textbook and ensure that you understand the difference between a profit and non-profit company.
- (b) Read paragraphs 2.6.1 and 2.6.4 in your textbook. Note that a private company may not offer 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.
-

2.4 TRANSITIONAL PROVISIONS AND CLOSE CORPORATIONS

PRESCRIBED STUDY MATERIAL

Textbook: chapter 2, par 2.7



Close corporations that existed at the commencement of the Companies Act of 2008 will continue to exist. However, it is no longer possible to register new close corporations since the commencement of the Companies Act of 2008. Likewise, companies will not be permitted to convert to close corporations. Many of the provisions of the Companies Act of 2008 also apply to pre-existing close corporations such as the provisions in respect of names and persons disqualified from participating in the management of the corporation.

You have now learnt to describe

- the transitional provisions and close corporations
- the implications of the Companies Act of 2008 on the future of close corporations.

Now do activity 2.2 to ensure that you understand the implications of the Companies Act of 2008 on close corporations and that you are able to apply them.

ACTIVITY 2.2

It is the year 2016. Danny wants to incorporate a close corporation. He does not want a company because it is much cheaper to form a close corporation. Advise Danny whether or not this is possible.

FEEDBACK

Refer to paragraph 2.7 in your textbook. You will notice that close corporations that existed at the commencement of the Companies Act of 2008 will continue to exist. However, it will no longer be possible to form new close corporations after the commencement of the Companies Act of 2008. Therefore, Danny will not be able to form a new close corporation. He needs to use one of the forms of business permitted in the Companies Act of 2008. Alternatively he could acquire the members' interests in an existing close corporation.

2.5 EXTERNAL COMPANIES



PRESCRIBED STUDY MATERIAL

Textbook: chapter 2, par 2.8

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. 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** (hereafter “the Commission”) within 20 days after it first begins to conduct business or non-profit activities in South Africa.

The Companies Act gives a list of activities which will **not solely** be regarded as conducting business, such as the following:

- Holding shareholders or board meetings in South Africa.
- Establishing or maintaining a bank account in South Africa.
- Establishing or maintaining offices or agencies in South Africa for the transfer, exchange, or registration of the company's securities.
- Creating or acquiring debts in South Africa, or mortgages or security interests in any property in South Africa.
- Securing or collecting any debt, or enforcing any mortgage or security interest within South Africa.
- Acquiring any interest in any property within South Africa.

2.6 DOMESTICATED COMPANIES



PRESCRIBED STUDY MATERIAL

Textbook: chapter 2, par 2.9

A domesticated company is a foreign company whose registration has been transferred to South Africa. Such a company will then exist as a company in terms of the South African Companies Act as if it had been originally incorporated and registered in terms of that Act. Domesticated companies are treated exactly the same as companies that were originally incorporated in South Africa.

You have now learnt and should be able to describe

- what an external company is and the requirements applicable to this category of company
- the activities that will **not solely** be regarded as “conducting business”
- what a domesticated company is
- the requirements that must be satisfied for a foreign company to transfer its registration
- the circumstances in which a foreign company would be prohibited from transferring its registration.

Now do activity 2.3 to ensure that you understand these principles regarding external companies and domestic companies and that you are able to apply them.

ACTIVITY 2.3

The directors of Pike River Wines Limited, a company registered in New Zealand, want to transfer the company's registration to South Africa in order to pursue its business interests effectively in the Cape winelands. They have heard that under the Companies Act 71 of 2008 a domesticated company is treated exactly the same as a company that was originally incorporated in South Africa.

Advise the directors of Pike River Wines Limited on the requirements of the Companies Act 71 of 2008 that the company must satisfy to be able to transfer its registration.

FEEDBACK

Refer to the requirements of such a transfer listed in paragraph 2.9 of your textbook.

2.7 REFLECTION

You need to familiarise yourself with the types of companies for which the Companies Act makes provision, 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 its distinguishing characteristics. A private company, for instance, may not offer 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 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.

Note that, in terms of the transitional provisions, close corporations that existed at the commencement of the Companies Act of 2008 will be allowed to continue. However, it is no longer possible to form new close corporations since the commencement of the Companies Act of 2008.

A foreign company that is carrying on business or non-profit activities in South Africa must be registered with the Commission as 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 in the Companies Act as a **domesticated company**.

2.8 CONCLUSION

In this learning unit you learnt about the types of companies for which the Companies Act makes provision, namely, profit companies and non-profit companies. You also learnt about an external company and 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 complied with in order to form a specific type of company.

2.9 SELF-ASSESSMENT QUESTIONS

Now that you have read the information contained in this learning unit you should answer the following self-assessment questions:

- The Memorandum of Incorporation of a company (type of company) prohibits it from offering any of its securities to the public and restricts the transferability of its securities.

- If a company is a company, (type of company) the directors and past directors are jointly and severally liable, together with the company, for the debts and liabilities of the company contracted that are or were contracted during their respective periods of office.
- A company (type of company) must have at least three directors, but they are not allowed to obtain any financial gain from the company other than remuneration for work they have performed.
- Sarah wishes to incorporate a company in order to raise funds for the care of indigent families across South Africa. Advise Sarah what type of company would be most appropriate, and on the requirements for this type of company.
- Explain the main difference between private companies and public companies.
- Pumpkin Patch (Pty) Ltd is a company, (type of company) in terms of the Companies Act 71 of 2008.
- Asbestos Disease Awareness Association NPC is a company, (type of company) in terms of the Companies Act 71 of 2008.

LEARNING UNIT 3

Registration of companies

Contents

- 3.1 Introduction
- 3.2 Procedure for the incorporation of companies
- 3.3 The role of the Companies and Intellectual Property Commission (CIPC)
- 3.4 Rules made by the board of directors
- 3.5 The legal status of the MOI and the rules
- 3.6 Ring-fenced companies
- 3.7 Amending the MOI
- 3.8 Alteration of the MOI
- 3.9 Translations of the MOI
- 3.10 Consolidation of the MOI
- 3.11 Authenticity of versions of the MOI
- 3.12 The MOI and shareholders' agreements
- 3.13 Reflection
- 3.14 Conclusion
- 3.15 Self-assessment questions

3.1 INTRODUCTION

You have learnt about the different types of companies that may be formed in terms of the Companies Act. They may have distinctive characteristics, but all companies have one thing in common: once they are registered, they are recognised as separate legal entities or juristic persons.

Before a company is recognised as a legal person, there are various steps that need to be taken. There is the registration of the company as well as the registration of the company's name. Moreover, it may be necessary to conclude pre-incorporation contracts. Below, we explain the process of incorporating a company.



PRESCRIBED STUDY MATERIAL

Textbook: chapter 2 par 2.10

- **Companies Act: sections 7, 8 and 13**

Important terms	Meaning
Memorandum of Incorporation	The constitutive document of a company
Notice of Incorporation	The document filed with the Companies and Intellectual Property Commission ("the Commission"/CIPC) together with the Memorandum of Incorporation (MOI) in order 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 MOI
Unalterable provision	A provision that may not be altered in substance in the MOI
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 that enjoy the same legal status as the MOI

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 predictable regulation of companies.

To promote the competitiveness and increased effectiveness of the South African economy, one of the aims of the Companies Act is to simplify the procedure for the incorporation of companies by reducing the associated costs and formalities. 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 a company must have a complex business structure. Advise them on the

objectives of the Companies Act 2008, which allows individuals to form a company.

FEEDBACK

When advising Muofhe and Tau you should have considered the following:

- The Companies Act's objectives of simplicity and flexibility, which would allow them to form a company.
- The fact that the Act provides that anyone can register a company.
- That it is possible to incorporate a company with a simple business structure.

3.2 PROCEDURE FOR THE INCORPORATION OF COMPANIES

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



PRESCRIBED STUDY MATERIAL

Textbook: chapter 2 par 2.10.2 and 2.10.12

- **Companies Act: sections 1 and 13**

To register a company, a Notice of Incorporation and a copy of the Memorandum of Incorporation (MOI) must be lodged with the Commission of Companies and Intellectual Property (CIPC), and the prescribed registration fee must be paid. Section 1 of the Companies Act determines that to “lodge” the documents means to deliver them to the Commission (CIPC), which is responsible for registration.

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 [CIPC] of the incorporation of that company, for the purposes of having it registered” (s 1).

The Notice serves as notification to the CIPC of the incorporation of the company. Therefore, it is the way in which promoters of a company let the CIPC 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 the MOI, 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
 - list of four names to be checked by the CIPC

The **Memorandum of Incorporation (MOI)** is the document that sets out the rights, duties and responsibilities of shareholders, directors, and others within the company, and in relation to the company and other matters. Provisions in the MOI 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 MOI.

The Companies Regulations of 2011 contain standard-form (pro forma) examples of the MOI of the different types of companies. Use of the standard form (pro forma) for a MOI (CoR 15.1A-E) is optional. Companies are allowed to draft their own unique MOI as long as it includes the required information.

3.3 THE ROLE OF THE CIPC



PRESCRIBED STUDY MATERIAL

Textbook: chapter 2 par 2.10.13

- **Companies Act: sections 6(8), 13(4), 14 and 66(2)**

Once the Notice of Incorporation and a copy of the MOI have been filed with the Commission and the prescribed fee paid, the CIPC may either accept or reject the Notice of Incorporation.

The Notice of Incorporation **may be rejected** by the CIPC in the following circumstances:

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

The Notice of Incorporation **must** be rejected by the CIPC in the following circumstances:

- if the initial number of directors is below the prescribed minimum number (s 13(4)(b))
- where, as a result of a director's disqualification, the initial number of directors drops below the prescribed minimum number (s 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 CIPC 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 directors being fewer than the prescribed number, the CIPC has no choice. It must reject the Notice of Incorporation.

Where there is a deviation from the design or content of the prescribed form, the deviation will only invalidate the actions of the person 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 (s 6(8)(b)(i) and (ii)).

The registration of a company is governed by section 14 of the Companies Act.

Once the Notice of Incorporation has been filed, the CIPC

- 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 in the Notice of Incorporation, the date on the registration certificate will be either that date or (if it is later) the date on which the certificate is issued by the CIPC.

You have now learnt and can describe

- the procedure for the incorporation of companies and the important information required to be lodged with the CIPC
- the role of the CIPC.

Now do activity 3.2 to ensure that you understand what you have read and learnt above and that you are able to apply your knowledge.

ACTIVITY 3.2

Vanitha and Sandra have just moved to a new town. There they meet a mutual friend, Wilma, from their days at boarding school. The town has many orphans who are homeless. Vanitha, Sandra and Wilma decide to form a non-profit company that will provide food and shelter to the orphans. They have completed drafting the MOI for the company to be registered as Hayani NPC. They want to start operating before winter. The directors are Vanitha, Sandra and Wilma. A day before filing their documents with the CIPC, Vanitha finds out that Sandra has been prohibited from becoming a director by a court of law. 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 MOI and the Notice of Incorporation, together with the prescribed fee with the CIPC. How must the CIPC deal with this Notice of Incorporation?

FEEDBACK

Refer to paragraph 2.10.13 in your textbook as well as the relevant Sections of the Companies Act 71 of 2008. Although the Companies Act allows for flexibility, there are circumstances in which the CIPC is compelled to reject the Notice of Incorporation. You should know these circumstances and apply them to the facts at hand when answering the question.

3.4 RULES MADE BY THE BOARD OF DIRECTORS



PRESCRIBED STUDY MATERIAL

Textbook: chapter 2 par 2.10.3

- **Companies Act: section 15**

Where both the Companies Act and the MOI are silent regarding certain matters that have to do with the governance of the company, the board of directors of the company is generally allowed to

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

Such rules must not be in conflict with the MOI of the company or 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 MOI, the rule will be void, but only to the extent of its inconsistency.

Can you think of any circumstances in which directors might create a rule or rules that is/are inconsistent with the Companies Act or the MOI?

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

(a) *Publication of a copy of the rules (s 15(3)(a))*

Rules made by the board must be published in the manner stated in the MOI. If there is no manner stated, the rules must be published in the manner stated in the rules themselves.

(b) *Filing of a copy of the rules with the CIPC (s 15(3)(b))*

The rules must be filed as required by the Companies Act within ten business days after the rules have been filed, or ten business days after the date stipulated in the rules, if applicable, whichever is the latest of the two dates, the **rules become effective**. Note that the textbook incorrectly states that the rules only need to be filed with the CIPC if so required by the MOI and that rules become effective 20 days after filing. 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, there must be ratification by way of 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 only make a similar rule within 12 months if this is approved in advance by way of ordinary resolution at the shareholders' meeting.

3.5 THE LEGAL STATUS OF THE MOI AND THE RULES



PRESCRIBED STUDY MATERIAL

Textbook: chapter 2 par 2.10.4

- **Companies Act: Section 15**

The relationship created in terms of section 15 of the Companies Act seems to be of a contractual nature. The Companies Act 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 MOI and rules.

3.6 RING-FENCED COMPANIES



PRESCRIBED STUDY MATERIAL

Textbook: chapter 2 par 2.10.5

Ring-fenced companies

Section 15(2)(b) provides that the MOI 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 MOI to prohibit the amendment of any particular provision in the MOI. If the MOI of a company contains the provisions allowed by section 15(2)(b) or (c), the name of the company must be followed by the expression/suffix "(RF)". This is an abbreviation for the words "ring fenced" and is intended to warn outsiders dealing with the company that there are special conditions contained in the MOI that 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 to be found in the MOI (s 13(3)).

You have now learnt

- what information must be contained in the MOI
- the contents of the MOI must be consistent with the provisions of the Companies Act
- where special conditions are contained in the MOI of a company, the name of the company must end with suffix "RF"
- which document prevails when there is a conflict
- who is bound by the MOI and the rules.

Now do activity 3.3 to ensure that you understand these principles and are able to apply them.

ACTIVITY 3.3

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 MOI 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 CIPC 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 is already addressed by the Companies Act. You also realise that another rule is actually inconsistent with the MOI of the company. Advise the board of directors on whether the rules are valid or not. Furthermore,

advise the board of directors when the rules will become permanent and on whom they are binding.

FEEDBACK

Refer to paragraphs 2.10.3 and 2.10.4 in your textbook as well as the relevant sections of the Companies Act 71 of 2008. You should be familiar with the process prior to the rule becoming effective. This will help you to decide whether the rule will be valid and consequently whether the rule will be permanent. Once this is ascertained, you will then know who is bound by the rules.

3.7 AMENDING THE MOI



PRESCRIBED STUDY MATERIAL

Textbook: chapter 2 par 2.10.6

- **Companies Act: sections 15 and 17(1)**

Changes may be made to the MOI, unless the amendment of a provision is prohibited by the MOI itself in terms of section 15(2)(c).

Such amendments may be in the form of

- a new MOI, or
- amendments to the existing provisions of the MOI.



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

A company's MOI 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 sections 36(3) and (4) (These allow the board to amend the authorised share capital of the company, unless the MOI 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 MOI may be sent or delivered by hand to the 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 delivered to them (s 60 of the Companies Act)

- **in terms of the procedure set out in the company's MOI.**

To effect the amendment, 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 this is required in terms of a company's MOI), or a copy of the amended MOI, must accompany the notice.

An amendment may result in a profit company no longer meeting the criteria for that category of profit company. When this happens, the name and the ending expression/suffix 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 MOI 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 who could suffer prejudice if that liability is terminated.

3.8 ALTERATION OF THE MOI



PRESCRIBED STUDY MATERIAL

Textbook: chapter 2 par 2.10.7

The Companies Act allows for changes or alterations to be made to the company's rules and to the MOI to correct 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 the changes.

For an alteration to be affected

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

3.9 TRANSLATIONS OF THE MOI



PRESCRIBED STUDY MATERIAL

Textbook: Chapter 2 par 2.10.8

- **Companies Act: section 17(3) and 17(4)**

A company that has filed a MOI has the right to file a translation of it. 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 MOI, and a sworn statement by the translator confirming that

the translation is a true, accurate and complete translation of the MOI, must be filed. A filing fee is payable.



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

ACTIVITY 3.4

After Exit (Pty) Ltd was incorporated, the MOI 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 MOI should prevail and why?

FEEDBACK

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

3.10 CONSOLIDATION OF THE MOI



PRESCRIBED STUDY MATERIAL

Textbook: Chapter 2, par 2.10.9

- **Companies Act: sections 17(5) and 17(6)**

After filing the MOI, a company may still amend or alter it. At any time thereafter, the company may file a consolidated revision of its MOI indicating all the new changes. The CIPC may also require the company to consolidate its MOI by sending a form CoR 15.6 request.

The consolidated revision has to be filed together with a notice (form CoR 15.5) as well as 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 MOI. Payment of a filing fee is required.

ACTIVITY 3.5

Punch (Pty) Ltd has altered its MOI three times within the past year. The CIPC is concerned about the number of documents that have to be handled each time one has to read Punch (Pty) Ltd's MOI. How can the problem be addressed?

FEEDBACK

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

3.11 AUTHENTICITY OF VERSIONS OF THE MOI



PRESCRIBED STUDY MATERIAL

Textbook: chapter 2, par 2.10.10

- **Companies Act: section 18**

In the event of a conflict between the MOI and its translated versions, the MOI, as altered or amended, prevails. The same applies to a conflict between the MOI, as altered or amended, and its filed, consolidated version. The consolidated version will 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 MOI endorsed by the CIPC and any other document purporting to be a MOI, the latest version as endorsed by the CIPC will prevail.

ACTIVITY 3.6

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

One of the directors approaches you as he is worried that the MOI is made up 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.

FEEDBACK

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

When you advise the director, you may tell him about the possibility of consolidating the MOI.

3.12 THE MOI AND SHAREHOLDERS' AGREEMENTS



PRESCRIBED STUDY MATERIAL

Textbook: chapter 2, par 2.10.11

- **Companies Act: section 15(7)**

Shareholders may enter into agreements with each other regarding any matter concerning the company. Such agreements must be consistent with the Companies Act and the company's MOI. Where a provision of the agreement is inconsistent with the Act or with the MOI, it is void to the extent of its inconsistency.

ACTIVITY 3.7

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 MOI. He is concerned about the validity of the agreement. Advise Ryno.

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 MOI. Provisions that are inconsistent are void to the extent of the inconsistency.

3.13 REFLECTION

The Companies Act has made the process for incorporation of companies much simpler. Can you still remember the procedure for incorporation and also what terms may be included in the MOI? Keep in mind that you could be asked to give advice on which documents of the company will prevail in instances where there are alterations and amendments to, and translations of, the MOI and also the role played by the CIPC.

3.14 CONCLUSION

You have learnt about the procedure for the incorporation of companies. You should, therefore, 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 – the MOI – is required. The board of directors, which is responsible for the management of the company's business, may, however, adopt rules to regulate internal processes.

3.15 SELF-ASSESSMENT QUESTIONS

- Explain the procedure for amending a company's MOI.
- Briefly explain the steps that would need to be taken to incorporate a company.
- What documents need to be lodged to register a company, and where should they be lodged?
- Explain the restrictions placed on the choice of the company name in terms of the Companies Act 71 of 2008.
- Veronica and Precious want to incorporate a public company called Aspex Ltd.
 - Briefly state the legal requirements that they must comply with in terms of the Companies Act 71 of 2008 to register the company.
 - How would your answer have been different if Veronica and Precious were incorporating a company called Aspex (Pty) Ltd instead?
- List five matters that must be covered in a company's MOI.

LEARNING UNIT 4

Pre-incorporation contracts

Contents

- 4.1 Introduction
- 4.2 Agreement for the benefit of a third party
- 4.3 Statutory method of conclusion of a pre-incorporation contract
- 4.4 Reflection
- 4.5 Conclusion
- 4.6 Self-assessment questions



PRESCRIBED STUDY MATERIAL

Textbook: chapter 2 par 2.11

Important terms	Meaning
Common law	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 yet exist
<i>Stipulatio alteri</i>	An agreement that is concluded for the benefit of a third party

4.1 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 as 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 the common law alternatives may also be used.

In this learning unit, we start off by looking at the available alternatives at common law for concluding a contract before incorporation of a company, going on to consider the requirements for pre-incorporation contracts under the Companies Act.

4.2 AGREEMENT FOR THE BENEFIT OF A THIRD PARTY

It is impossible for an agent to act on behalf of a principal that does not exist. In other words, the general principles of agency are unavailable for use before a company is registered and acknowledged as an existing entity. Nevertheless, it may be necessary for a company to conclude a contract before it is incorporated. For example, securing a lease contract or purchasing property or offices – to ensure that the company will be able to commence business effectively after its incorporation. Although there are several ways in which it is possible to conclude a contract that will bind a yet to be incorporated company in terms of the common law, we only highlight the most commonly used one, namely the *stipulatio alteri*.

A person concludes an agreement with another party on behalf of the company to be formed. If the company is formed, it can accept the offer or decline it. The risk is that the company may not come into existence or may not accept the offer. The person who concluded the agreement will only incur liability under the agreement if it is specifically so provided.

Can you think of a situation where a third party might have concluded an agreement with a company yet-to-be formed and the company declined it or, worse still, the company was not formed? What do you think would happen to the person who concluded the agreement?

You have now learnt and can state the following:

- A common law alternative for concluding a pre-incorporation contract.
- The liability of persons after conclusion of pre-incorporation contract.

4.3 STATUTORY METHOD OF CONCLUSION OF A PRE-INCORPORATION CONTRACT (S 21)



PRESCRIBED STUDY MATERIAL

Textbook: chapter 2 par 2.11

- **Companies Act: sections 1 (definition of “pre-incorporation contract”) and 21 (requirements for pre-incorporation contracts)**

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

- 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
- the contract was concluded in writing, and
- 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.)

Note, however, that joint and several liability does not apply where the contract is replaced with another similar contract after incorporation.

The common law alternative could be used more effectively and safely to avoid possible personal liability. The common law construction has 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.

You have now learnt and can explain

- pre-incorporation contracts
- the formal requirements for a contract to be binding on 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 if a pre-incorporation contract is concluded under section 21 of the Companies Act and the company rejects the contract.

Now do activity 4.1 to ensure that you understand these principles and are able to apply them.

ACTIVITY 4.1

Busi wishes to conclude a contract for the purchase of a property on behalf of a company that she intends to incorporate next year. Advise Busi of the requirements that need to be adhered to in terms of the Companies Act 71 of 2008 for the contract to be binding on the company when it is formed. Furthermore, explain whether Busi would incur liability for performance in terms of the contract if the company is subsequently not registered.

FEEDBACK

Refer to paragraph 2.11 in your textbook. Before answering the question, make sure that you understand the underlying principles. Remember to refer to the relevant section of the Companies Act and apply it to the facts of the question.

4.4 REFLECTION

You have now been introduced to the statutory position where contracts are concluded prior to the incorporation of a company, or **pre-incorporation contracts**. Can you still remember the common law alternative available for the conclusion of a pre-incorporation contract? The possible personal liability of the promoter that is brought about by the Companies Act might be more risky than some of the common law alternatives.

4.5 CONCLUSION

You should now understand the concept of pre-incorporation contracts. Under common law, an agent could not contract with a third party on behalf of a principal that did not yet exist. However, there were alternatives that became available that allowed pre-incorporation contracts to be binding once the company was formed.

Section 21 of the Companies Act does not exclude the common law, but ensures that a company will not lose a business opportunity that presents itself prior to incorporation of the company.

4.6 SELF-ASSESSMENT QUESTIONS

- What are pre-incorporation contracts?
- Explain the process for the conclusion of an agreement to the benefit of a third party (*stipulatio alteri*).
- What are the formal requirements for a contract to be binding on a company under section 21 of the Companies Act?
- 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?

LEARNING UNIT 5

Registration of company names

Contents

- 5.1 Introduction
- 5.2 Reservation process
- 5.3 Effect of a name reservation
- 5.4 Change of name
- 5.5 Use of name and registration number
- 5.6 Reflection
- 5.7 Conclusion
- 5.8 Self-assessment questions

5.1 1 INTRODUCTION

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

Therefore, it is imperative that there are 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 have registration numbers as their names.

In this learning unit, the process for the reservation of a company's name will be considered. In addition, the criteria will be set out for determining whether a company's name would be considered objectionable.

5.2 RESERVATION PROCESS



PRESCRIBED STUDY MATERIAL

Textbook: chapter 2 par 2.12

- **Companies Act: section 11**

In order to reserve a name, form CoR 9.1 must be completed and a filing fee is payable.

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

The Companies Act restricts a company name only as far as it is 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 trademarks) from other persons passing themselves off as such owners or coat-tailing on the owners' reputation and good standing, and
- 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 cooperative; 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, and so forth, and
- 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.

Also note the following:

- 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 Companies and Intellectual Property Commission (CIPC).
- 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 the 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 made aware before registration that a similar name would accordingly 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.

Can you think of a few names of companies that have the potential to deceive members of the public and would consequently be denied registration?

5.3 EFFECT OF A NAME RESERVATION

A name reservation is valid for six months. It is possible to apply for an extension of a name reservation for an additional 60 business days by lodging 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 the reservation of a name may transfer the reserved name to another person by lodging 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.

5.4 CHANGE OF NAME



PRESCRIBED STUDY MATERIAL

- **Companies Act: section 11(3)**
- **Case law as discussed here**

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.

You have now learnt

- the criteria for the acceptance of company names
- that names may be reserved for use at a later stage
- the factors a court would consider to ascertain whether or not a name is desirable.

Now do activity 5.1 to ensure that you understand these principles and are able to apply them.

ACTIVITY 5.1

Suppose that John, who was previously a franchisee of McTucky's Ltd, wants to incorporate a company with the name MacTuckies (Pty) 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. In your answer, you should indicate the factors a court would consider to ascertain whether or not a proposed name is undesirable? Refer to relevant case law in your answer.

FEEDBACK

Refer to paragraph 2.12 in your textbook and ensure that you understand the reasons why certain names are prohibited, the restrictions placed on company names and the process of changing the name of a company where such name is already the same or similar to a company already registered in that name.

5.5 USE OF NAME AND REGISTRATION NUMBER



PRESCRIBED STUDY MATERIAL

- **Companies Act: section 32**

Section 32 requires that a company furnish 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.

5.6 REFLECTION

Although companies are not always required to reserve a name, it is preferable, as the Commission may require a company to change its name if it is too similar to another already existing company’s name or objectionable for some other reason. There are measures in place to protect a company’s goodwill and avoid deception of the public as a result of the registration of undesirable names.

5.7 CONCLUSION

You should now understand the rules that regulate company names. A name will have to be changed where such name is the same as, or similar to the name of a company already registered. There are certain criteria that have to be considered when ascertaining whether or not a name is objectionable.

5.8 SELF-ASSESSMENT QUESTIONS

- What are the criteria for the names of companies in terms of the Companies Act 71 of 2008?
- Is it possible to reserve a company name for future use?
- What factors are considered by a court to ascertain whether or not a name is objectionable?
- How should the name and registration number of a company be used?

LEARNING UNIT 6

Corporate finance

Contents

- 6.1 Introduction
- 6.2 The solvency and liquidity test
- 6.3 Shares as a source of finance and the nature of shares
- 6.4 Authorised, issued and unissued shares
- 6.5 Issued shares
- 6.6 Right of pre-emption or pro-rata offer
- 6.7 Financial assistance for the subscription or purchase of securities
- 6.8 Company distributions
- 6.9 Share buybacks
- 6.10 Debt instruments
- 6.11 Reflection
- 6.12 Conclusion
- 6.13 Self-assessment questions



PRESCRIBED STUDY MATERIAL

Textbook: chapter 4

- **Case law as discussed in this study guide and in the prescribed textbook**

6.1 INTRODUCTION



PRESCRIBED STUDY MATERIAL

Textbook: chapter 4 pars 4.1, 4.2 and 4.3

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 is responsible for its own liabilities and 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 chapter, we 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 and give financial assistance to a person to buy shares in that company. You will learn when a company may buy back shares. Finally, we pay attention to the circumstances in which a company may assist a person financially to purchase shares in that company.

A company needs funds (also referred to as working capital) to conduct its business. There are two possible means by which a company can obtain the capital it needs for its business: equity financing and debt financing. Equity financing entails the issuance of shares in return for money, which then makes up the company's share capital. Debt financing takes the form of loans, either in the form of 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, and 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 company creditors. The return on their investment is interest and the principal amount of the loan must be repaid to the creditors at a specified time as agreed.

In contrast to many other countries, there is no requirement in the Companies Act of 2008 that a company must have a specified prescribed minimum capital. This means that many companies are started with only a small share capital and have to obtain their working capital through loans and debentures. Do you think this is a weakness in our law or is it perhaps a way of encouraging people to start businesses by making it easier to do so?

6.2 THE SOLVENCY AND LIQUIDITY TEST



PRESCRIBED STUDY MATERIAL

Textbook: chapter 4 par 4.4

The solvency and liquidity tests are set out in section 4 of the Companies Act:

- *Solvency test*: considering all reasonably foreseeable financial circumstances of the company at the particular 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 the 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 date on which the test is considered. However, if the test is applied for an intended distribution as described in section 1, part (a) of the definition of a distribution, the period is 12 months from the date on which the distribution is made. These would include transfers of money or other property to shareholders by the company, such as the payment of dividends, payments in lieu of capitalisation shares or payments for share buy-backs.

6.3 SHARES AS A SOURCE OF FINANCE AND THE NATURE OF SHARES



PRESCRIBED STUDY MATERIAL

Textbook: chapter 4 par 4.5

The Companies Act defines a “share” as “one of the units into which the proprietary interest in a profit company is divided” (s 1). Shares are incorporeal movable, transferable property without a nominal or par value.

A shareholder is essentially one of the contributors to 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.

Note the definition of “securities”, which includes both shares and debentures. This is because debentures are sometimes subject to the same provisions as shares, such as when debentures are offered to the public.

6.4 AUTHORISED, ISSUED AND UNISSUED SHARES



PRESCRIBED STUDY MATERIAL

Textbook: chapter 4 par 4.6

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 for 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 for the stated amount
Dividend	A distribution by a company to its shareholders usually paid out of profits
Ordinary shares	The residual category of a company’s shares that does not carry any special class rights, such as preferential rights to payments of dividends
Preference shares	A class of share that provides a preferential right, usually a preference to receive dividends when declared, for its holder

The number of shares must be authorised in the Memorandum of Incorporation (MOI). The MOI 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 only issue shares that are authorised by the MOI. However, unless the company’s MOI provides differently, 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. Therefore, it is clear that there are personal rights attached to shares. The extent of these rights depends on the class of shares held.

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

- the right to vote
- the right to information
- the right to share in the dividends if any have been declared
- the right to share in the assets that are left on 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**.

6.4.1 Preference shares

Preference shares provide their holders with a preference over other shareholders to dividends and/or return of capital on winding-up. One needs to consult the MOI 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 by the company.

In return for the preferential rights to dividends, the right of preference shareholders to vote is usually curtailed in the MOI. However, even if the MOI 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 share 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 can 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: The right to convert the preference shares to shares of another class after a certain date attaches to the preference shares.

ACTIVITY 6.1

Thato is a cumulative preference shareholder of United (Pty) Ltd. He receives notice of a meeting that informs him that a resolution is proposed to change the rights of United (Pty) Ltd's preference shareholders, so that they will not have cumulative rights to dividends. The terms of issue of his shares read that the shares do not entitle their holders to vote at meetings of shareholders of the company. Advise Thato on whether he will have the right to vote at the meeting where the resolution is proposed.

FEEDBACK

The Companies Act provides that any shareholder has the right to vote at meetings where a resolution is proposed that will effect an amendment of his rights in terms of his shares. When you answer a question like this in an examination, remember to end by clearly stating the answer to the question, in this case, that Thato will have the right to vote at the meeting.

6.4.2 Ordinary shares

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, they must all have the right to vote.

6.4.3 Deferred shares

Occasionally, shares are issued to the founders of a company that 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.

6.5 ISSUED SHARES



PRESCRIBED STUDY MATERIAL

Textbook: chapter 4 par 4.7 up to par 4.7.4; pars 4.7.7 to 4.8 and par 4.9.3

The **board of directors** has the power to issue shares without approval of the shareholders, but these shares must be authorised by the MOI, either before the shares are issued or within 60 business days after 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 MOI provides otherwise. The shareholders may also amend the authorised share capital by way of an amendment to the MOI by means of a special resolution.

Section 40 of the Companies Act provides that the board may only issue shares for adequate consideration. The board must determine what will be an adequate consideration for the shares. The consideration may be in the form of cash, or an agreement for future services, future benefits or future payment by the subscriber to the company. The Act, therefore, leaves a lot of discretion for this determination in the hands of the board. The determination may only be challenged on the grounds that it constituted a breach of the standard of conduct expected of directors (s 76).

Unless prohibited by the MOI, shares may also be issued as capitalisation shares, where shares are issued to an existing shareholder instead of paying the dividends that have been declared. The board may further then also resolve that shareholders will be given the choice to be paid in cash rather than receive capitalisation shares.

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 (see section 2 for an explanation of "related person")
- where the shares are issued to a nominee of a director or prescribed officer
- 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

ACTIVITY 6.2

Forget-Me-Not Ltd has 1 000 ordinary shares and each share carries one vote. The board of directors wants to issue a further 500 ordinary shares that would also carry one vote each. Advise the board on whether they need the approval of the shareholders to authorise this new issue.

FEEDBACK

If a further 500 shares are issued, each carrying one vote, there will be 1 500 ordinary shares, and the new shareholders will have just over 33 per cent of the vote. This exceeds the limitation imposed in section 41(3) of the Act. The issue must, therefore, be approved by a special resolution of the company's shareholders.

No special resolution is required where the issue is

- in terms of an underwriting agreement
- in the exercise of pre-emptive rights
- in proportion to existing shareholdings and on the same terms and conditions as have been offered to all shareholders
- in pursuance of an employee share scheme
- in pursuance of an offer of shares to the public.

A company may not issue shares to itself.

6.6 RIGHT OF PRE-EMPTION OR PRO RATA OFFER



PRESCRIBED STUDY MATERIAL

Textbook: chapter 4 par 4.7.5

In terms of 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 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.

A company's MOI may, however, restrict or exclude this right in respect of any or all classes of shares in the company. (In other words, this is an alterable provision of the Act.)

Therefore, the general rule 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.

The reason why this provision was included in the Companies Act is 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 the voting rights at a meeting of shareholders. The original shareholders will each now only have 25 per cent voting power at meetings of shareholders. If they had 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.

6.7 FINANCIAL ASSISTANCE FOR THE SUBSCRIPTION OR PURCHASE OF SECURITIES



PRESCRIBED STUDY MATERIAL

Textbook: chapter 4 par 4.7.6

You only need to know the following cases as discussed below:

- ***Lipschitz v UDC Bank Ltd 1979 (1) SA 789 (A)***
- ***Gradwell (Pty) Ltd v Rostra Printers Ltd 1959 (4) SA 419 (A)***

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 MOI and that certain requirements are met.

The decision to give financial assistance to 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 must be satisfied that the **solvency and liquidity requirements** will be satisfied immediately after providing the financial assistance (see above), and that the assistance is given on terms that are fair and reasonable to the company. The MOI 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* 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 on 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:

- Firstly, it must be ascertained whether there was financial assistance. In *Gradwell (Pty) Ltd v Rostra Printers Ltd*, the “impoverishment test” was formulated to help determine whether financial assistance was provided. In terms of the impoverishment test, one considers whether a transaction will have the effect of leaving the company poorer. If so, financial assistance will have been 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, this 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 there was financial assistance. Factors that have emerged from case law to assist in this regard are whether the company needs the asset in its normal business and whether the company paid a fair price for it.
- Secondly, it must be determined whether that assistance was for the purpose of acquiring shares in the company or whether it was for a different purpose.

When a transaction passes these two phases, it will have to comply with **section 44 of the Companies Act in order 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.

6.8 COMPANY DISTRIBUTIONS



PRESCRIBED STUDY MATERIAL

Textbook: chapter 4 pars 4.9 to 4.9.1

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

Just to refresh your memory, here is the solvency and liquidity test again:



The solvency and liquidity tests are set out in section 4 of the Companies Act:

Solvency test: That, in 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: That, in 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 incurrence of a debt for the benefit of a shareholder or forgiving a debt or other obligation owed to the company by a shareholder, the period runs for 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.

Provided 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 it wants to pay out to shareholders. It is free to decide that it is 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.

6.9 SHARE BUYBACKS



PRESCRIBED STUDY MATERIAL

Textbook: chapter 4 par 4.9.2

The board of a company may determine that the 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 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 must 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 from a prescribed officer of the company, the board's decision to acquire the shares must be approved by the shareholders by way of a special resolution. If a company wishes to acquire more than five per cent of the shares of a particular class, special requirements apply. A subsidiary may likewise not own more than ten per cent 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, it must comply with the requirements of section 46 of the Companies Act.

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

Should the company have agreed to buy back shares, and it later becomes clear that it will not be capable of complying with its obligations in terms of the agreement, since it will not be able to satisfy the requirements of section 48(2) and (3) – which includes the requirements of section 46 regarding a distribution (thus the solvency and liquidity tests) – the agreement between the shareholder and the company in terms of which the company would buy back the shares, remains enforceable. The company, in such a case, must make application to the court for an order suspending the acquisition of the shares. The company bears the onus of proving that it is unable to comply with the requirements of the Companies Act. The court may make any order that it deems justified and fair, which ensures that the person from whom the shares were purchased will be paid at the earliest opportunity feasible for the company, and that the company will also be able to meet its other financial obligations as they become payable.

If the repurchase was in contravention of the solvency and liquidity tests, the company must, within two years, 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 will have to issue the shares to that person in return.

Can you see that there are several risks for shareholders when the company acquires their shares? They may have to wait a long time for payment if the company will be unable to satisfy the solvency and liquidity test just after payment should the payment be made immediately. They may also find themselves in a situation where the company did not meet the requirements when the transaction was concluded and they are then ordered to return the money paid for the acquisition of their shares to the company while the company has to issue the shares to them again – even if the shares are now worth much less than when they were acquired by the company. That does not seem very fair does it?

ACTIVITY 6.3

The directors of Mega-Manufacturers Ltd took a decision 14 months ago that the company must acquire some shares from its shareholders. The board of directors considered the solvency and liquidity test and was satisfied at the time that it was met. However, it has now been found that a patent owned by the company was grossly overvalued in its financial statements and the company had in fact been insolvent at the time. Mega-Manufacturers Ltd has now applied to court to have these transactions reversed.

Asanda was one of the shareholders whose shares were acquired by the company and she wants to know what her rights are. What would you say to her?

FEEDBACK

If the application is successful, Asanda will have to return the money she received from the company as payment for her shares. The shares will then be issued to her again.

6.10 DEBT INSTRUMENTS



PRESCRIBED STUDY MATERIAL

Textbook: chapter 4 par 4.10

A debenture is an acknowledgement by a company that the company owes the debenture holder a certain sum of money, as evidenced by the document. Debenture holders are creditors of the company by virtue of having extended loans to the company.

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 MOI.

Section 43(3) expressly allows the issue of debt instruments with special privileges, like voting rights and the right to appoint directors, thus blurring one of the traditional distinctions between shares and debentures. However, this is an alterable provision and may be excluded or limited by the MOI.

Do you think it is a good idea to give a vote to debenture holders – who are creditors of the company and not investors – so they can vote on important matters like electing directors? Many companies exclude this possibility in their MOI because they don't want creditors of the company to have so much power in the running of the business.

Distinctions between shareholders and debenture holders:

- A shareholder of a company has the right to a share in the profits of that company (provided that a dividend is declared by the company), and a 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 MOI.
- 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 is a document issued by a company acknowledging that it is indebted to the debenture holder for the stated amount.

- Debenture holders may have a right to attend and vote at general meetings and to appoint directors, and have special privileges regarding the allotment of securities, unless the MOI provides otherwise (s 43(3)).

6.11 REFLECTION

The importance of capital maintenance to ensure that company creditors are not prejudiced by some of the transactions companies may enter into is clear.

Can you remember in which circumstances the solvency and liquidity criteria must be adhered to before a company is allowed to act?

The directors have very wide-ranging powers to raise capital for the company's business, and you have now seen how the Companies Act tries to balance these powers with strict requirements and rules and even personal liability of directors who do not comply with the provisions of the Act in this regard.

6.12 CONCLUSION

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 have also explained the circumstances in which a company may make distributions or acquire its own shares or provide financial assistance to others to acquire the company's shares.

6.13 SELF-ASSESSMENT QUESTIONS

- Name two instances where the solvency and liquidity test must be applied.
- Explain what is meant by the solvency and liquidity test.
- What are the two main sources of capital for a company?
- What is the difference between authorised, unissued and issued shares?
- Explain under what circumstances the issue of shares must be approved by the shareholders of the company.
- Explain the right of pre-emption that shareholders of a company have when new shares are issued by the company.
- Describe the requirements and conditions set by the Companies Act if a company wants to provide financial assistance for the acquisition of its own shares.
- List the transactions that are included in the definition of a "distribution".
- May a subsidiary acquire shares in its holding company?
- Describe the difference between a share and a debenture.

LEARNING UNIT 7

Shareholders and company meetings

Contents

- 7.1 Introduction
- 7.2 General comments regarding meetings
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- 7.7 Representation by proxy
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- 7.10 Majority rule
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- 7.12 Shareholders acting other than at a meeting
- 7.13 Annual general meeting
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- 7.17 Reflection
- 7.18 Conclusion
- 7.19 Self-assessment questions



PRESCRIBED STUDY MATERIAL

Textbook: chapter 5, par 5.1– 5.15.4

Important terms	Meaning
Shareholder	A holder of a share issued by a company and whose name is entered in the securities register
Share	One of the units into which the proprietary interest in a profit company is divided
Shareholders meeting	A meeting of holders of a company's issued securities who are entitled to exercise voting rights in relation to a particular matter
Record date	A date on which a company determines the identity of its shareholders and their shareholding for purposes of establishing who is entitled to shareholder rights
Proxy	A person who is appointed to represent a shareholder at a meeting

Important terms	Meaning
Quorum	A number of shareholders amounting to an aggregate of 25 per cent of all the voting rights entitled to be exercised in respect of a matter to be decided at a shareholders' meeting required to be present before the meeting can begin
Majority rule	Provides that when a person becomes a shareholder in a company, he or she agrees to be bound by the decision of the majority
Annual general meeting	A company's shareholder meeting held regularly (roughly yearly) in which directors' reports, financial statements and audit committee report are presented; directors are appointed; and an auditor and audit committee for the following year are appointed
Ordinary resolution	A resolution adopted with the support of more than 50 per cent of the voting rights exercised on the resolution
Special resolution	A resolution adopted with the support of at least 75 per cent of the voting rights exercised on the resolution or a different percentage as specified in a company's MOI
Voting rights	The rights of any holder of the company's securities to vote in connection with a matter

7.1 INTRODUCTION



PRESCRIBED STUDY MATERIAL

Textbook: chapter 5, par 5.1

In learning unit 6 you learnt that a profit company has two kinds of share capital, namely, authorised share capital and issued share capital. You also learnt that a company may divide its shares into different classes of shares. In this learning unit you learn that, because a company has no physical existence, it acts through its shareholders in a general meeting, its directors and its employees. Exactly who acts in respect of a particular matter is determined by a number of factors, some of which are contained in the Companies Act and a company's Memorandum of Incorporation (MOI). The Companies Act specifically provides that before certain transactions can take place they must be approved by shareholders either by way of a special resolution or ordinary resolution. The different types of meetings and voting rights of shareholders will also be explained in this learning unit.

You have now learnt and can explain

- how a company overcomes its lack of physical existence to achieve its objectives
- the circumstances under which the shareholders' duties arise and to whom they are owed.

7.2 GENERAL COMMENTS REGARDING MEETINGS



PRESCRIBED STUDY MATERIAL

Textbook: chapter 5, par 5.2

Before a shareholder's meeting can take place certain principles have to be complied with such as that it must be properly called and notice must have been given to the relevant parties.

7.3 RECORD DATE



PRESCRIBED STUDY MATERIAL

Textbook: chapter 5, par 5.3

The board of directors may set a record date for determining which shareholders are entitled to the following:

- receiving a notice of shareholders meeting
- participating in and voting at shareholders meeting, and
- deciding any matter by written consent or electronic communication.

7.4 CALLING OF SHAREHOLDERS' MEETING



PRESCRIBED STUDY MATERIAL

Textbook: chapter 5, par 5.4

The board of directors or any other person specified in a company's Memorandum of Incorporation may call a meeting at any time.

A shareholders' meeting must be called if

- the board is required to do so by the Companies Act or the MOI
- the meeting is demanded by shareholders and the demand is signed by at least 10 per cent of the voting rights entitled to vote on the proposed matter.

Certain considerations must be taken into account when a demand for a meeting is made. See the second part of chapter 5, paragraph 5.4

You have now learnt

- who may call a shareholders' meeting
- when calling a shareholders' meeting is compulsory
- what considerations must be taken into account when a demand is made.

Now do activity 7.1 to ensure that you understand these principles and that you are able to apply them.

ACTIVITY 7.1

Discuss the points that must be considered when a demand for a shareholders meeting is made.

FEEDBACK

Refer to paragraph 5.4 in your textbook and ensure that you understand these points and what they are intended to achieve.

7.5 NOTICE OF MEETINGS**PRESCRIBED STUDY MATERIAL**

Textbook: chapter 5, par 5.5

Do you know what the first thing is that you should do before you start a meeting? The starting point in convening a meeting is to send out a notice. The notice should be in writing and include, among other things, the date, time and place of the meeting, the record date (where specified by the company), a copy of the proposed resolution, a summary of financial statements to be presented at the meeting and a statement that a shareholder is entitled to appoint a proxy.

Depending on the circumstances, a material defect may or may not invalidate action taken at the meeting. An immaterial defect or inadvertent mistake in the delivery of the notice does not invalidate action taken at the meeting.

You have now learnt to identify

- the issues to be taken into account in order to give proper notice
- when a defect in the notice of a meeting may or may not render a resolution invalid.

Now do activity 7.2 to ensure that you understand the requirement of submitting a notice of a shareholders meeting and the implications of noncompliance.

ACTIVITY 7.2

The board of directors of Tower Properties (Pty) Ltd convened a meeting to be held on 18 January 2016. Mr Ngcobo, a shareholder of Tower Properties (Pty) Ltd, was given a notice dated 11 January 2016, requiring him to attend a meeting in the board room of Tower Properties (Pty) Ltd at 10:00. The agenda for the meeting was to discuss Tower Properties' business.

Advise Mr Ngcobo on whether he was given proper notice.

FEEDBACK

Refer to paragraph 5.5 in your textbook and familiarise yourself with the requirements of proper notice.

7.6 POSTPONEMENT AND ADJOURNMENT OF MEETINGS



PRESCRIBED STUDY MATERIAL

Textbook: chapter 5, par 5.6

If there is no quorum present within one hour after the appointed time, the meeting may be postponed for a week without a motion, vote or further notice. Should a quorum still not be present at the postponed meeting, the members present will be deemed to constitute a quorum.

A meeting may be adjourned for a longer period for other reasons, if a motion to that effect is supported by persons holding a majority of the voting rights held by all the persons attending the meeting and entitled to vote on at least one item remaining on the agenda or on the matter under debate. In the last-mentioned instance, the company's MOI may provide for different maximum periods than those set out in section 64(12) or may provide for unlimited periods for adjournment of meetings.

You have now learnt to specify

- when a meeting may be postponed and the conditions under which this will take place
- when a further postponement of a meeting may be allowed and the circumstances under which this will occur.

Now do activity 7.3 to ensure that you understand these principles and that you are able to apply them.

ACTIVITY 7.3

Charlie is the managing director of Flower Pot (Pty) Ltd and chairperson of the shareholders' meeting. He is considering postponing the meeting because there are not enough shareholders to form a quorum.

Advise Charlie on whether the meeting may be validly postponed.

FEEDBACK

Refer to paragraph 5.2 in your textbook and ensure that you understand the circumstances under which it is valid to postpone a shareholders meeting.

7.7 REPRESENTATION BY PROXY



PRESCRIBED STUDY MATERIAL

Textbook: chapter 5, par 5.7

The appointment of a proxy may take place under the following circumstances:

- must be in writing and signed by the shareholder
- is valid for one year
- may be for a specific period of time
- may be for two or more persons concurrently who will exercise voting rights attached to 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 the proxy and the company
- the proxy is entitled to vote as he or she thinks fit at the meeting

You have now learnt to identify

- the circumstances under which a proxy may be appointed and the conditions subject to which he or she will function.

Now do activity 7.4 to ensure that you understand the circumstances that must prevail for the valid appointment of a proxy and the conditions under which he or she will function.

ACTIVITY 7.4

The MOI of Bandit Architects (Pty) Ltd provides that shareholders may only appoint a proxy from the list provided by the company.

Advise Santo, who is a shareholder of the company and wants to appoint someone who is not a shareholder as his proxy, whether he can do so. Give reasons for your advice.

FEEDBACK

Shareholders may be invited by the company 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. Santo may appoint two or more proxies concurrently who will exercise voting rights attached to different shares held by him.

7.8 QUORUM



PRESCRIBED STUDY MATERIAL

Textbook: chapter 5, par 5.8

A quorum is required for the meeting to commence and to consider specific matters. A quorum is constituted by persons representing an aggregate of at least 25 per cent of all the voting rights entitled to be exercised in respect of at least one matter to be decided at the meeting.

Where a company has more than two shareholders, at least three of them who can exercise at least the required percentage of voting rights must be present at a meeting to form a quorum.

You have now learnt

- how many persons and the percentage of voting rights are required to constitute a quorum.

Now do activity 7.5 to ensure that you understand the requirements of the Companies Act regarding a quorum.

ACTIVITY 7.5

The annual general meeting of Bengu Sportsware Ltd is attended by Gino who holds five per cent of the voting rights, Beni who holds five per cent and Hlengiwe who holds twenty per cent of the voting rights in the company.

Advise the chairperson of the meeting on whether the requirements of the Companies Act, 2008 have been met in relation to a quorum, which would allow the meeting to start.

FEEDBACK

Section 64 provides that a meeting may not begin until sufficient persons holding at least 25 per cent of all the voting rights are present. Furthermore, if a company has more than two shareholders, as this company clearly has, at least three shareholders must be present. Three shareholders are present and they hold 30 per cent of the voting rights, therefore a quorum is present and the meeting may commence.

7.9 PROCEDURE OF MEETINGS



PRESCRIBED STUDY MATERIAL

Textbook: chapter 5, par 5.9

Have you ever been in a situation where you had to cast a vote? How was this done? Do you know of other methods of voting? Voting in a shareholders meeting may be conducted by a show of hands or through a poll among those in attendance and entitled to vote. Where voting by show of hands, a

shareholder is entitled to only one vote, whereas where voting is by poll, a shareholder is entitled to exercise all the voting rights attached to the shares held or represented by him.

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 that they will be able to participate electronically.

The textbook states that a person who abstains or fails to exercise his voting rights on a resolution will be deemed to have voted against the resolution. This statement is not based on any provision of the Act, and must also not be taken to mean that an abstention vote will be taken into consideration when determining whether a resolution has been adopted.

You have now learnt

- the various methods a company may employ in voting and what they entail
- that there is a difference in the number of votes that may be exercised depending on the method of voting used.

Now do activity 7.6 to ensure that you understand the different methods used to vote and what they entail.

ACTIVITY 7.6

The shareholders of Step Ladder Ltd will be exercising their voting rights at a meeting through a poll. Chair holds eight per cent of the voting rights, Table holds ten per cent, Broom holds twelve per cent and Rack holds twenty per cent of the voting rights in the company. Rack decides not to vote. Advise the shareholders what the effect of this will be on the valid adoption of an ordinary resolution.

FEEDBACK

Since the shareholders of Step Ladder Ltd are voting by means of a poll, a shareholder or his proxy will exercise all the voting rights attached to the shares. The required percentage of votes that may be exercised on a resolution is present (at least 25%). Only the votes exercised on a resolution are taken into consideration. Since only 30 per cent of the voting rights will be exercised, more than half of them, that is, more than 15 per cent of the total voting rights, will have to be exercised in favour of the resolution before it can be validly adopted.

7.10 MAJORITY RULE



PRESCRIBED STUDY MATERIAL

Textbook: chapter 5, par 5.10

When a person becomes a shareholder in a company, he or she agrees to abide by the majority's decision. This rule is not contained in the Act itself,

but is a common law rule. The protection of minority shareholders against oppression by the majority as a result of majority rule is discussed in chapter 9.

You have now learnt

- what becoming a shareholder means in relation to decision making in a company.

Now do activity 7.7 to ensure that you understand what the majority rule entails.

ACTIVITY 7.7

Ingwe (Pty) Ltd has three shareholders, namely, Max, Stix and Twitch. Max holds 35 per cent of Ingwe (Pty) Ltd's shares, Stix holds 40 per cent of the shares and Twitch holds 25 per cent of the shares. In a shareholders' meeting convened to decide whether Ingwe (Pty) Ltd should merge with another company, both Max and Stix vote to pass a resolution approving the merger, However, Twitch is opposed to the resolution because he considers it to be prejudicial to his interests.

If you were to advise Twitch on the effect of the resolution taken at the shareholders' meeting, what would you say?

FEEDBACK

Since the combined shareholding of Max and Stix amounts to 75 per cent of Ingwe (Pty) Ltd's total shares, this gives the two shareholders the required majority to vote in favour of the merger with the other company. In terms of the majority rule, by virtue of becoming a shareholder, Twitch agreed to be bound by the decision of the majority. Twitch will, therefore, have to accept the decision to merge the two companies even if this decision is prejudicial to him. There are, however, other remedies provided for in the Companies Act that Twitch may invoke to avoid prejudice.

7.11 SOME EXCEPTIONS TO APPLICABLE RULES AND FORMALITIES



PRESCRIBED STUDY MATERIAL

Textbook: chapter 5, par 5.11

Three situations are covered under this heading. They are the following:

- In a profit company (other than a state-owned enterprise) with only one shareholder, the shareholder may exercise all the voting rights. The rules pertaining to setting a record date for the determination of shareholders' rights, proxies, notice of meetings and the like do not apply.
- In 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.

- In a company (other than a state-owned enterprise) where every shareholder is also a director, shareholders may decide on any matter required to be referred by the board at any time, without notice or compliance with any internal formalities except when the MOI provides otherwise; subject to certain specified conditions.

You have now learnt

- that there are circumstances under which a single shareholder can exercise all the voting rights
- that there are circumstances under which one director can exercise all the powers and perform all the functions of the board
- that there are circumstances in which shareholders can take a decision on a matter requiring referral by the board without notice or compliance with internal formalities.

Now do activity 7.8 to ensure that you understand what the majority rule entails.

ACTIVITY 7.8

All the shareholders of Phenduka (Pty) Ltd are also directors of the company. How would you advise them regarding whether they have to convene a formal meeting of shareholders to consider matters that have to be referred to shareholders.

FEEDBACK

Where every shareholder is also a director of a 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 MOI provides otherwise. 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 a special resolution. This applies to Phenduka (Pty) (Ltd).

7.12 SHAREHOLDERS ACTING OTHER THAN AT A MEETING



PRESCRIBED STUDY MATERIAL

Textbook: chapter 5, par 5.12

Is it always necessary for shareholders to call a meeting in order to take decisions? When may they dispense with this requirement? Under the Companies Act 2008 it is possible to take a decision without convening a meeting. Although the general principle still remains that shareholders exercise their rights through resolutions at meetings, 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 a general meeting of shareholders actually having been held (s 60). All shareholders entitled to

vote on the resolution must be notified about the result of the vote, consent process or election within 10 days following adoption of the resolution.

However, any business of a company that must be conducted at an annual general meeting in terms of the Act or the company's MOI, may not be conducted by means of this procedure.

You have now learnt

- it is possible for shareholders to take decisions without convening a meeting
- the circumstances under which this may happen
- the exception to application of this procedure.

Now do activity 7.9 to ensure that you understand the circumstances under which shareholders may take decisions without convening a meeting.

ACTIVITY 7.9

The shareholders of Paper Cup (Pty) Ltd wish to elect Boogie as a director to replace a director who has died. They want to know whether it is necessary to call a general meeting of shareholders for this purpose. How would you advise the shareholders on the procedure they should follow to replace a director?

FEEDBACK

The shareholders of Paper Cup (Pty) Ltd may elect Boogie as a director without having a formal meeting by conducting a written poll of all shareholders entitled to vote on his election. The company must deliver a statement within ten business days after adopting the resolution. The statement must describe the results of the vote, the consent process or the election to every shareholder entitled to vote on the resolution.

7.13 ANNUAL GENERAL MEETING



PRESCRIBED STUDY MATERIAL

Textbook: chapter 5, par 5.13

In terms of the Companies Act 2008 only public companies have a statutory obligation to convene annual general meetings. Annual general meetings must be held at least 18 months after the date of incorporation and 15 months after the date of the previous meeting.

The following matters must be discussed at the Annual General Meeting:

- appointment of an auditor for the following year
- appointment of an audit committee
- presentation of the directors' report
- presentation of audited financial statements from the previous financial year
- any matters raised by shareholders, regardless of whether or not they gave prior notice of such matters

You have now learnt

- which companies are obliged to convene annual general meetings
- when annual general meetings must take place
- what must be discussed at the annual general meeting.

Now do activity 7.10 to ensure that you understand the circumstances under which a company is required to hold annual general meetings and timing of such meetings.

ACTIVITY 7.10

Sizwe Ltd is yet to hold its first annual general meeting after its incorporation. Advise the company on whether it is obliged to hold an annual general meeting and if so when such a meeting should be held.

FEEDBACK

Public companies have a statutory obligation to convene annual general meetings in terms of the Companies Act 2008. Since Sizwe Ltd is a public company, it is required to hold these meetings. The initial meeting must be held at least 18 months after the date of the company's incorporation. Subsequent meetings must be held at least 15 month after the date of the previous meeting.

7.14 CONVENING A MEETING IN SPECIAL CIRCUMSTANCES**PRESCRIBED STUDY MATERIAL**

Textbook: chapter 5, par 5.14

When may other people besides directors convene company meetings? Under what circumstances? Two different situations are distinguished under this heading. The first one, regulated by section 61(11), is where the company cannot convene a meeting because it has no directors or all its directors are incapacitated. In these circumstances the meeting may be convened by any other person authorised by the company's MOI. Should there be no such person, any shareholder may request the Companies Tribunal to issue an administrative order convening a shareholders' meeting.

The second situation is regulated by section 61(12), which applies to cases where a company, for reasons other than those covered by section 61(11), fails to convene its annual general meeting or a meeting required by its MOI or shareholders. In this situation, a shareholder may apply for a court order requiring the company to convene a meeting on a date deemed by the court to be appropriate.

You have now learnt

- interventions can be implemented when a company cannot convene an annual general meeting
- interventions can be implemented when a company declines to convene an annual general meeting.

7.15 DECISIONS OF SHAREHOLDERS AND OTHERS



PRESCRIBED STUDY MATERIAL

Textbook: chapter 5, par 5.15

Study table 5.1 in the prescribed textbook for provisions of the Companies Act requiring a special resolution before certain actions can be taken.

Can you distinguish between the different types of resolutions that shareholders may pass at their meetings? The Companies Act 2008 (in ss 65(7) and (9)) provides for two kinds of resolution that may be taken at a shareholders' meeting, namely an ordinary resolution, requiring more than 50 per cent of the votes exercised, and a special resolution, requiring at least 75 per cent of the voting rights exercised.

An important feature of the Companies Act 2008 is that it allows a company to stipulate a higher percentage for approval of all or some ordinary resolutions in its MOI (except a resolution for the removal of a director), or a different percentage for a special resolution, on condition that there must always be a difference of at least ten per cent between the highest percentage required for an ordinary and the lowest percentage required for a special resolution.

A special resolution is compulsory for certain resolutions stipulated in the Act but may also be required by the MOI.

You have now learnt and can describe

- what a special resolution is
- what an ordinary resolution is and when it is required before acting
- the differences between the two resolutions.

Now do activity 7.11 to ensure that you understand the distinction between an ordinary resolution and a special resolution.

ACTIVITY 7.11

The board of directors of Round & Round Ltd wants to buy back the company's shares held by Hoola, the wife of one of the director of Round & Round Ltd. How would you advise the board of Round & Round Ltd regarding the type of resolution required before they can buy back Hoola's shares and what this resolution involves?

FEEDBACK

Section 48(8) of the Companies Act 2008 provides that a decisions by the board of a company to buy back shares held by a person related to a director must be approved by a special resolution. Hoola being the wife of

one of Round & Round Ltd's directors, is related to that director. A special resolution must be voted for by at least the holders of 75 per cent of the voting rights exercised on the resolution, or a different percentage as specified in the company's MOI.

7.16 VOTING RIGHTS OF SHAREHOLDERS AND OTHERS



PRESCRIBED STUDY MATERIAL

Textbook: chapter 5, par 5.15.3

The Companies Act 2008 distinguishes between voting power and voting rights. The voting power in respect of any matter is determined by a person's voting rights as a percentage of all voting rights. The voting rights of a person means, in the case of a profit company, the right of any holder of the company's securities to vote in connection with a matter. The Companies Act 2008 provides for great flexibility with regard to voting rights and a company's MOI may, to a great extent, set out the voting rights of shareholders and holders of securities. It is important to be aware of the fact that, in terms of the Companies Act, 2008, a company may issue debt instruments that grant special privileges to its holder, including the right to attend and vote at general meetings. Therefore, in determining voting rights, regard must be given to both shareholders and holders of debt instruments.

You have now learnt and can describe

- the difference between voting power and voting rights
- that voting rights may be granted to holders of other securities besides shares.

Now do activity 7.12 to ensure that you understand the distinction between voting power and voting rights.

ACTIVITY 7.12

Differentiate between a person's voting power and voting rights and then explain the way in which the Companies Act 2008 affords flexibility in voting rights.

FEEDBACK

Voting rights in the case of a profit company refer to the right of a holder of the company's securities to vote in connection with a particular matter, whereas the voting power enjoyed by a holder of a company's securities is determined by that holder's voting rights in respect of any matter as a percentage of all voting rights.

7.17 REFLECTION

You must keep in mind that a shareholders meeting must be properly convened by, among other things, giving a timely notice specifying the date, time, place and purpose of the meeting. Make sure you know the other requirements relating to the notice.

Remember that shareholders are allowed to appoint a proxy to represent them at a shareholders meeting, which may only be held if a quorum is present. During the meeting voting is either by a show of hands or through a poll, and the principle of majority rule is applicable in decision making. A shareholders meeting may also be conducted through electronic communication.

You must be able to distinguish between the two kinds of resolutions shareholders can take – an ordinary resolution and a special resolution, what is required to pass each and what they are required for. Lastly, it is important to know about voting rights and voting power and what distinguishes the two.

7.18 CONCLUSION

You learnt about different procedures and processes that a company must observe to facilitate inclusive and effective shareholders meetings. These include giving timely notice of meetings, the possibility of postponing and adjourning meetings, representation by a proxy, the requirement of a quorum, application of the majority rule and so on. This information should help you cope with and understand these concepts better.

7.19 SELF-ASSESSMENT QUESTIONS

Now that you have gone through the study unit, you should be able to answer the following self-assessment questions:

- What is a shareholder?
- What is a shareholders' meeting?
- What is a record date?
- How many proxies can a person appoint at one time?
- Can a company alter the percentage of voting rights specified in the Companies Act as constituting a quorum?
- Name the ways in which voting at a shareholders meeting may be conducted.
- In what circumstances may a single shareholder of a profit company exercise all of the voting rights of that company?
- On what conditions may a company take decisions without convening a shareholders meeting?
- What matters must be discussed at a company's annual general meeting?
- What are the requirements for passing a special resolution?
- What is the distinction between voting rights and voting power?

LEARNING UNIT 8

Directors and board committees

Contents

- 8.1 Introduction
- 8.2 Meaning of the word “director”
- 8.3 Duties of directors
- 8.4 Liability of directors and prescribed officers
- 8.5 Number of directors and consent
- 8.6 Ineligible and disqualified persons
- 8.7 Application to declare a person delinquent or under probation
- 8.8 First directors of a company
- 8.9 Vacancies on the board
- 8.10 Removal of directors
- 8.11 Board committees
- 8.12 Board meetings
- 8.13 Reflection
- 8.14 Conclusion
- 8.15 Self-assessment questions

8.1 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 (MOI) by adopting resolutions at a meeting of shareholders. We now introduce the other main organ of a company: the board of directors. We also introduce you to one of the office bearers of the company, namely, the director.

8.2 MEANING OF THE WORD “DIRECTOR”



PRESCRIBED STUDY MATERIAL

Chapter 6, par 6.1 and 6.2 in the textbook

- **Sections 1, 66(4)(a)(i) to (iii), 66(4)(b) and 68 of the Companies Act**
- **Case law as discussed here and in your prescribed textbook**

Important terms	Meaning
<i>Ex officio</i> director	A director who holds office as a director of a company as a result of him or her holding another office or title or status
Alternate director	A person appointed to the board of directors of a company in substitution for a particular elected director of that company
Executive director	A director who participates in the day-to-day management functions within 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.)

A **director** is a member of the board of a company and includes any person occupying the position of a director, or alternate director. A person becomes a director only

- when that person has given his or her written consent to serve as director
- after having been appointed or elected to hold office in accordance with the provisions of section 66 of the Companies Act.

8.2.1 Types of director

Different types of director have been recognised by both the **King Report on Corporate Governance** (“King Code”) and the Companies Act. 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 director:

- 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** in 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 “non-executive” director.

The **Companies Act** recognises the following types of director:

- an *ex officio* director
- a director appointed in terms of the MOI
- an alternate director
- an elected director
- a temporary director who is appointed 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 per cent of the directors of a profit company. These directors will be classified as elected directors.
- A director can hold the office of director because she or he holds another office. For example, the MOI may provide that any person who is appointed as legal adviser of the company will also be a director of the company. In such a case, a person appointed as legal adviser will automatically be a director – an *ex officio* director.
- A director can hold the office of director because she or he was appointed by name in the MOI, or because she or he was appointed by someone who was given the authority in the MOI to appoint a director – an MOI-appointed director.
- A director can hold the office of director because she or he is an alternate director. Depending on the MOI, these directors may either be appointed by the board or elected by the shareholders, but at least 50 per cent of the alternate directors must be elected by the shareholders.
- A director can hold the office of director because she or he is a temporary director. Depending on the MOI, the board of directors may appoint these directors.

ACTIVITY 8.1

- Sam is appointed as a director in ABC Ltd's subsidiary, FAB Ltd. Sam has a separate employment contract with FAB Ltd and is engaged in the day-to-day operations of the company.
- Linda was elected as a director by the shareholders. However, she does not participate in the management of ABC Ltd or any of its subsidiaries. She does not have a separate contract of employment with ABC Ltd.
- In the company's MOI 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, Linda, 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.
 - Linda is an elected director. Due to the fact that she does not participate in the daily running of the business she is also a non-executive director.
 - Jack is an *ex officio* director, because he is only a director due to his other appointment in the company and was not elected as such.
 - Calvin is a temporary director and an executive director.
-

8.3 DUTIES OF DIRECTORS

8.3.1 Sources of duties



PRESCRIBED STUDY MATERIAL

Chapter 6, par 6.3 in the textbook

- **Sections 66(1) and 75–78 of the Companies Act**

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

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, and to the duty to exercise their powers with care and skill.

8.3.2 Partially codified directors' duties

The Companies Act 71 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 insofar 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 (s 66(1)).

- To disclose to the board any personal financial interest in matters of the company (s 75).
- Not to use the position of director or information obtained as director to gain an advantage for himself/herself or another person, or to cause harm to the company or a subsidiary (s 76(2)(a)).
- To disclose to the board of directors any material information (s 76(2)(b)).
- To act in good faith and for a proper purpose (s 76(3)(a)).
- To act in the best interests of the company (s 76(3)(b)).
- To act with reasonable care, skill and diligence (s 76(3)(c)).

The provisions in the Companies Act are subject to, and not a replacement for, 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. You should also keep in mind that the provisions in the Companies Act relating to directors' duties are a **partial codification** (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.

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



PRESCRIBED STUDY MATERIAL

Chapter 6, par 6.3.1 in the textbook

- **Sections 75 and 76(2) of the Companies Act**
- **Case law as discussed here and in your prescribed textbook**

Can you think of ways in which directors could abuse their position, or information? 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.

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/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 the court held that directors should avoid placing themselves in a position where the company's interest in performance of 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 his 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 (K) 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 has to his or her company. The court held, in *Ghersi and Others v Tiber Developments (Pty) Ltd and Others* 2007 (4) SA 536 (HHA) 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.

8.3.2.2 Standards of directors' conduct



PRESCRIBED STUDY MATERIAL

Chapter 6, par 6.3.2 in the textbook

The duties to act in good faith and for a proper purpose and 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 also one of the fiduciary duties recognised in terms of our common law, and requires that directors should use their powers for the real or true purpose for which these powers were given. One example of a breach of this duty that often occurs in practice is where boards issue shares to dilute the voting rights of other shareholders or obtain more votes for themselves to ensure their continued control over the company, instead of using this power for its real purpose: to obtain more capital for the company.

In instances where this type of breach occurs, usually it is not as 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.

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 court 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.

You have now learnt the following:

- There are four sources of directors' duties: employment contracts, the MOI, the common law and the Companies Act.
- Despite the fact that the Companies Act contains standards of conduct for directors, the legislation is not a complete codification. The common law duties are not replaced, and the case law that developed in application of the common law duties remains relevant.
- Directors stand in a fiduciary relationship to the company, whether they are executive directors or non-executive directors.
- The fiduciary relationship can extend beyond the term of an appointment as a director. In other words, even if someone resigns as a director of a company, he or she can still be guilty of a breach of the duty of good faith, if it can be proven that there was a conflict between his or her interests when he or she was the director of the company, in his or her capacity as a director.
- The test used to determine whether or not a director is in breach of the duty of care, skill and diligence is largely objective, but it also has subjective elements. Even though a director is not required to have any special business acumen, whatever knowledge, experience and skill he or she has will remain relevant when the court decides whether or not he or she should be held accountable for a breach of that duty.

Now do activities 8.2 and 8.3 to ensure that you understand these principles and that you are able to apply them.

ACTIVITY 8.2

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 Constructions (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 Constructions (Pty) Ltd.

FEEDBACK

Feedback is provided under Activity 8.3 below.

ACTIVITY 8.3

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

In both the activities above, there was a conflict between the directors' interests and the interests of the respective companies. When this is the case, it is indicative of a potential breach of **fiduciary duties**. Please refer to Chapter 6, paragraph 6.3.2.2 of your textbook and the case studies discussed in the block concerning breach of fiduciary duties by directors.

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 his or her duties to the company despite termination of his or her office.

8.3.3 The business judgement rule



PRESCRIBED STUDY MATERIAL

Chapter 6, par 6.3.3 in the textbook

- **Section 76(4) of the Companies Act**

The Companies Act introduced what is called the **business judgment 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 or knew of anybody else having a financial interest in the matter, or disclosed his/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 of liability if it appears to the court that the director 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 interests of the company.

Now do activity 8.4 to ensure that you understand these principles and that you are able to apply them.

ACTIVITY 8.4

Herman is an experienced quantity surveyor. He has extensive knowledge on 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 investment in a risky property development 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 and skill. Herman has heard that the Companies Act has introduced the business judgment rule, which apparently affects directors' liability.

Explain to Herman what the business judgment rule entails. Also advise him whether or not it could protect him in these particular circumstances.

FEEDBACK

Refer to paragraph 6.3.2.2 in the textbook. Also read the case study under paragraph 6.3.3 (*Fisheries Development Corporation of SA Ltd v Jorgensen; Fisheries Development Corporation of SA Ltd v AWJ Investments (Pty) Ltd* 1980 (4) SA 156 (W) and, in particular, the factors considered by the court when determining the extent of the duty of care and skill.

8.4 LIABILITY OF DIRECTORS AND PRESCRIBED OFFICERS



PRESCRIBED STUDY MATERIAL

Chapter 6, par 6.3.4 in the textbook

- **Section 77 of the Companies Act**

Directors may be held liable for certain losses or harm sustained by the company due to their actions. These actions may include acting without the necessary authority, fraudulently or in contravention of the provisions of the Companies Act or the company's MOI. The first item in this list refers to the liability of a director for breaching the newly codified common law duties described above. The remaining influence of the common law is clear when considering this liability, because the Companies Act states that, for a breach of the first five duties in the list, 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 of liability, other than for wilful misconduct or wilful breach of trust, provided that it appears to the court that the director acted honestly and reasonably.

You have now learnt the following:

- It is possible for directors and prescribed officers to be held personally liable for monetary losses (damages or costs) suffered by companies in specific instances.
- 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 and so on.
- In the case of a claim in terms of section 77 of the Companies Act, if no action is instituted within a period of three years of the act or omission by the director, the Act prescribes that he or she can use the business judgment rule as a defence against liability.

8.5 NUMBER OF DIRECTORS AND CONSENT



PRESCRIBED STUDY MATERIAL

Chapter 6, par 6.4 of the textbook

The different types of company 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. In addition to the above prescribed minimum number of directors the company must also have the required minimum number of directors to appoint an audit committee or a social and ethics committee if required by the Act.

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 MOI, or
- holds an office, title, designation or similar status entitling that person to be an *ex officio* director of the company.

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

You have now learnt the following:

- The board of directors is responsible for the running of the day-to-day business in a company.
- Different types of companies require the appointment of different numbers of directors.
- A director must be elected as such and formally accept his or her appointment before he or she becomes a member of the board.
- Different types of directors are recognised in terms of the Companies Act and the King III Report.
- Executive and non-executive directors have the same duties, from the moment that they accept their appointment as a director.

8.6 INELIGIBLE AND DISQUALIFIED PERSONS



PRESCRIBED STUDY MATERIAL

Chapter 6, par 6.6–6.7 in the textbook

- Sections 69(7)(a) to (c), 69(8)(a) and (b)(i) to (iv) of the Companies Act

Certain people are **ineligible** to be appointed as a director of a company, whilst certain people are **disqualified**.

Ineligible: ☹️ (May never be) A person who is ineligible to be a director is absolutely prohibited from becoming a director.

There are no exceptions to the prohibition. The following are absolutely prohibited from becoming a director:

- a juristic person
- an unemancipated minor/a person under legal disability
- a person who is ineligible in terms of the provisions of the MOI

Disqualified: A disqualification from being a director is not absolute.

A court is afforded discretion to permit a disqualified person to accept appointment as a director.

The following persons are disqualified from being a director:

- a 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/dishonesty
- a person convicted of fraud, dishonesty, theft or a related offence
- a person disqualified in terms of the provisions of the MOI

8.7 APPLICATION TO DECLARE A PERSON DELINQUENT OR UNDER PROBATION



PRESCRIBED STUDY MATERIAL

Chapter 6, par 6.8 and 6.9 in the textbook

- Section 162 of the Companies Act

Depending on the grounds on which a person has been declared to be a delinquent, he or she will subsequently 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.

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.

You have now learnt the following:

- The court can, upon application, place a director on probation or declare him or her delinquent.
- Someone who is declared delinquent is disqualified to act as a director. This disqualification can be temporary or permanent.
- A temporary, conditional declaration of delinquency usually endures for seven years or longer. Conditions can include remedial education programmes, community service or the payment of an amount of damages.
- A conditional declaration of delinquency may be reversed by means of court application if rehabilitation is evident.

Now do activity 8.5 to ensure that you understand these principles and that you are able to apply them.

ACTIVITY 8.5

Tim is a director of Kenza Ltd. A meeting is held where a decision has to be taken regarding the provision of financial assistance to one of Tim's close friends, Jerry. Tim, knowing that the transaction would render it impossible for the company to pay its debts as they become due in the ordinary course of business, allows the decision to be passed.

With reference to the facts above, explain the procedure that must be followed against Tim in terms of section 162 of the Companies Act. In your answer, you must discuss

- who can bring such an application
- the grounds upon which such an order can be brought
- the relevant order sought
- the consequences of such an order.

FEEDBACK

Refer to paragraph 6.8 in the textbook.

Your answer should reflect the following:

- A company can apply to a court of law for an order to have a director declared as delinquent.

- Tim 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.
-

8.8 FIRST DIRECTORS OF A COMPANY



PRESCRIBED STUDY MATERIAL

Chapter 6, par 6.10 in the textbook

- **Section 67 of the Companies Act**

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.

8.9 VACANCIES ON THE BOARD



PRESCRIBED STUDY MATERIAL

Chapter 6, par 6.11–6.12 in the textbook

- **Section 70 of the Companies Act**

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.

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 the Companies Act.

8.10 REMOVAL OF DIRECTORS



PRESCRIBED STUDY MATERIAL

Chapter 6, par 6.13 in the textbook

- **Section 71 of the Companies Act**

A director can be removed by shareholders and, in some circumstances, by the board of directors. Despite any provision contained in the company's MOI or any agreement between the company and the director, removal may be affected by an ordinary resolution. 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 or set aside 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.

You have now learnt the following:

- 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.
- A director may institute a claim for breach of any agreement that was caused by the early termination as a result of the removal.
- It is not possible to remove a director by means of the section 60 (round-robin) procedure as a director must be given an opportunity to state his or her case (to make representations) before the removal.

Now do activity 8.6 to ensure that you understand these principles and are able to apply them.

ACTIVITY 8.6

Andile is a director of Oldco Ltd. The company's MOI 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) What type of resolution is required to remove a director from his position as director?
- (b) Will Andile be able to claim damages from the company if he had not concluded a separate contract of employment with the company?

FEEDBACK

Refer to paragraph 6.13 in the textbook.

Only an ordinary resolution is required to remove a director. Andile will be able to claim damages from the company even if he had not concluded a separate employment contract with the company.

In terms of section 15(6) of the Companies Act, the MOI is binding between the company and each director. Section 71 of the Companies Act determines that a director may claim damages based on breach of contract for premature termination. This remedy in the Companies Act is, therefore, an additional remedy apart from any claim that the director could possibly have in terms of the Labour Relations Act 66 of 1995 if he is also an employee.

8.11 BOARD COMMITTEES



PRESCRIBED STUDY MATERIAL

Chapter 6, par 6.14–6.15 in the textbook

- **Section 72 of the Companies Act**

The board of directors may, except to the extent that the MOI provides otherwise, appoint committees and delegate any authority of the board to such committees. 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 should be established to assist the directors by giving detailed attention to important areas. Examples of such committees include an audit committee, a remuneration committee and a risk management committee.

In terms of the *King Code*, a public listed company should at least have both an audit committee 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.

8.12 BOARD MEETINGS



PRESCRIBED STUDY MATERIAL

Chapter 6, par 6.16 in the textbook

- **Section 73 of the Companies Act**

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 chairperson has a deciding vote in the event of a tie. Minutes must be kept of all decisions as well as any resolution taken by the board at a meeting.

8.13 REFLECTION

It appears that ownership of a company is vested in the general meeting of shareholders/members, and control of the company in the board of directors. Do you think it is a sound 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 that is responsible for its liabilities, not the shareholders. The shareholders only hold a right to share in those assets should the company declare a dividend or be wound up.

8.14 CONCLUSION

The board of directors is responsible for the management of the company. A director is a member of the company's board. 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 judgment rule has been adopted into South African corporate law in order 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 director. Directors can be held personally liable for contraventions, they may be removed and also have to reimburse the company and others for losses suffered as a result of their conduct.

8.15 SELF-ASSESSMENT QUESTIONS

- What are the different type of directors recognised in the Companies Act and the King Code respectively?
- How many directors do there have to be in a private company?
- How many directors do there have to be in a public company?
- Indicate which groups of people are ineligible to be appointed as directors of companies in terms of the Companies Act.
- Which groups of persons may only become directors 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.
- 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.

LEARNING UNIT 9

Capacity and representation of a company

Contents

- 9.1 Introduction
- 9.2 Capacity of a company
- 9.3 The *ultra vires* doctrine
- 9.4 Representation
- 9.5 Doctrine of constructive notice
- 9.6 The *Turquand* rule
- 9.7 The doctrine of estoppel
- 9.8 Reflection
- 9.9 Conclusion
- 9.10 Self-assessment questions



PRESCRIBED STUDY MATERIAL

Textbook: chapter 2, par 2.13

Case law as discussed here and in your prescribed textbook

- **Companies Act as discussed here and in your prescribed textbook**

Important terms	Meaning
<i>Ultra vires</i> doctrine	Any act that lies beyond the authority of a corporation to perform.
<i>Turquand</i> rule	The rule established in <i>Royal British Bank v Turquand</i> 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

9.1 INTRODUCTION

In this learning unit, we consider the legal capacity and representation of companies. The validity of the company's actions will be dealt with. This, first, entails the power or legal capacity of a company to perform a specific act, and second, the authority of the person representing a company to act on behalf of the company.

9.2 CAPACITY OF A COMPANY



PRESCRIBED STUDY MATERIAL

Textbook: chapter 2, par 2.13

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.

As soon as a company is registered, as stated in its Registration Certificate, it is a juristic person. The company exists continuously until removed from the Companies Register in accordance with the Companies Act 71 of 2008.

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 MOI provides otherwise. Although the company's Memorandum of Incorporation may limit, restrict or qualify the purposes, powers or activities of the company (i.e., 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 (s 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.**

9.3 THE *ULTRA VIRES* DOCTRINE



PRESCRIBED STUDY MATERIAL

Textbook: chapter 2, par 2.13.1

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 MOI, 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 as 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 MOI, 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 9.1

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

- Briefly explain if the contract of purchase and sale will be valid.
- What remedies are available to shareholders against the board of directors?

FEEDBACK

Although the company's MOI 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 (s 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 as yet completed the transaction, one or more shareholders, directors or prescribed officers of the company may obtain a court order restraining the company or directors (i.e. preventing them from doing so) from completing the transaction.

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 MOI, unless ratified by special resolution in terms of section 20(2). This is in addition to the remedy provided in section 165.

Note the following:

- A company has the capacity to conclude any type of contract by virtue of the fact that it is a juristic person (s 19 of the Companies Act).
 - This is a valid transaction even though the company has exceeded its capacity (s 20 of the Companies Act).
 - The effect is that the company would usually be bound by contracts – even those outside the scope of their operations – unless the third party knows of the restriction in capacity (RF companies and personal liability companies as envisaged in s 19(5) of the Companies Act).
 - Even if the third party was aware of the restriction, it is still possible for the shareholders to ratify the *ultra vires* action (s 20 of the Companies Act).
 - If the transaction is not yet completed, it is possible to apply to the court to prevent its completion.
 - If the contract is already concluded, any shareholder/s that suffered damages as a result thereof can claim damages.
-

9.4 REPRESENTATION



PRESCRIBED STUDY MATERIAL

Representation relates to a person acting on behalf of the company. Authority can be given expressly (in writing or orally) or by implication. Whether authority has been conferred is a question of fact.

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.

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, and where the company allows such a person to represent the company as if that person did have authority.

9.5 DOCTRINE OF CONSTRUCTIVE NOTICE



PRESCRIBED STUDY MATERIAL

Textbook: chapter 2, par 2.13.2–2.13.4

- **Companies Act: sections 19(4) and (5)**

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 MOI in terms of section 15(2)(b) or (c) (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 suffix "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" (RF) companies**.

Section 15(2)(b) of the Companies Act determines that a company may include restrictions and conditions in its MOI 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 in the MOI on the company and a further requirement for the amendment thereof in addition to the requirements of section 16.
- (2) A prohibition against amendment of any provision of the MOI.
- (3) The company's name must be followed by the suffix "RF" to warn the third party of the special restrictions or conditions.
- (4) The Notice of Incorporation, which 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 to have 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.

9.6 THE *TURQUAND* RULE



PRESCRIBED STUDY MATERIAL

Textbook: chapter 2, par 2.13.2

- **Companies Act: section 20(7)**
- **Prescribed cases**

These cases you only need to know as discussed here:

- ***Royal British Bank v Turquand* (1856) 6 E & B 327, 119 ER 886**

9.6.1 Common law *Turquand* rule

The *Turquand* rule was derived from *Royal British Bank v Turquand*. 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 of the fact 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 trigger the protection provided by the *Turquand* rule, there must have been an internal requirement present.

- A company's MOI 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 MOI determines that the board of directors has authority to conclude all contracts on behalf of the company. If the amount of the transaction exceeds R50 000, consent must be obtained from the shareholders at a general meeting.

The underlined part in the block above contains an internal requirement. Even though the MOI 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.

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 or 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 as when estoppel may be used. The person who represented the company had to have had **actual authority that was subject to an internal requirement** in order to rely on the *Turquand* rule.

9.6.2 “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 MOI 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 *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.

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 *Vrystaat*

Mielies v Nieuwoudt [2004] 1 All SA 396 (SCA) the court confirmed that the common law *Turquand rule* applies only if it is clear that a person has actual authority. Which means *inter alia*, that if the MOI 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.

ACTIVITY 9.2

Steelbelts Railway Carriages (Pty) Ltd's MOI 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.

Discuss whether the company will be 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 MOI 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 had failed to comply with the procedural requirement in terms of the MOI and had acted in bad faith. Based on these facts, the company is bound by the contract.

9.7 THE DOCTRINE OF ESTOPPEL



PRESCRIBED STUDY MATERIAL

Prescribed case:

You only need to know the case below as discussed here:

- *Freeman & Lockyer v Buckhurst Park Properties (Mangal) Ltd* [1964] 2 QB 480

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 acted as if he or she 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

- the company misrepresented, intentionally or negligently, that the agent concerned had the necessary authority to represent the company
- the misrepresentation was made by the company
- the third party was induced to deal with the agent because of the misrepresentation
- the third party was prejudiced by the misrepresentation.

ACTIVITY 9.3

Mike, a site manager at 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 take 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 bound by the contract.

FEEDBACK

- Mike, in the facts above, did not have actual authority. However, the company has allowed him to conclude binding contracts on behalf of the company on previous occasions.
 - Estoppel can be raised if a company denies liability based on the fact that Mike lacked actual authority, because, here, the impression was created that he was in fact so authorised. This gives rise to **ostensible authority**.
 - The result is that the company will be held to the misrepresentation that it had made previously by having allowed Mike to conclude contracts in the company's name.
 - If it had been Mike who made the misrepresentation and the company had been unaware of it, the contract would not have bound the company.
 - It would have been wrong to apply the *Turquand* rule here, as Mike, in this scenario, did not have actual authority that is made subject to an internal requirement.
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9.8 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 kind 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 person 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.

You have now learnt that companies are able to conclude any contract, whether it falls inside or outside the scope of their business. You have also learnt 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 MOI provides otherwise.

The doctrine of constructive notice has to a large extent been abolished by the Companies Act. Now only third parties dealing with “**ring-fenced**” (RF) **companies** and **companies with personal liability** are deemed to know about these special restrictions in their MOI.

Although a company may set restrictions on the scope of its actions in its MOI, 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.

9.9 CONCLUSION

You should now understand the concept of legal capacity and representation. Representation occurs when somebody acts on behalf of or in the name of a 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 MOI 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.

9.10 SELF-ASSESSMENT QUESTIONS

- Under what circumstances does a person have the authority to represent a company and to bind it to a contract?
- What is the purpose of the *Turquand* rule and how does it operate under the Companies Act 71 of 2008?

LEARNING UNIT 10

Auditors and the company secretary

Contents

- 10.1 Introduction
- 10.2 Registered office and records
- 10.3 Audit requirements under the Companies Act
- 10.4 Appointment of an auditor
- 10.5 Resignations and vacancies
- 10.6 Rotation of auditors
- 10.7 Rights and restricted functions of auditors
- 10.8 Audit committees
- 10.9 Mandatory appointment of company secretary
- 10.10 Registration of company secretaries and auditors
- 10.11 Reflection
- 10.12 Conclusion
- 10.13 Self-assessment questions



PRESCRIBED STUDY MATERIAL

Textbook: chapter 7, par 7.14, and chapter 13

10.1 INTRODUCTION

In this learning unit we examine the appointment and removal of auditors and company secretaries, the companies that are obliged to appoint an auditor and company secretary, the rights and functions of auditors and company secretaries, the rotation of auditors and the role of the audit committee.

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).

10.2 REGISTERED OFFICE AND RECORDS

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 kind 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.

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 its maintenance of accounting records. The Companies Act imposes certain minimum financial disclosure requirements on all companies, and 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 s 1 of the Companies Act).
- Section 29 states that the financial statements of a company must satisfy the financial reporting standards, must present fairly the state of affairs and business of the company, and must 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 their financial year. The annual financial statements must include an auditor's report (s 30(3)).

In terms of section 44 of the Auditing Profession Act 26 of 2005, 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.

10.3 AUDIT REQUIREMENTS UNDER THE COMPANIES ACT



PRESCRIBED STUDY MATERIAL

Textbook: chapter 13, par 13.2 and 13.3

Which companies do you think should have their annual financial statements audited?

In terms of section 30(2) of the Companies Act, public companies are required to audit their annual financial statements. The Companies Regulations of 2011 include a Public Interest Score (PIS) calculation, which determines the reporting duties of other categories of companies. If a company holds assets in a fiduciary capacity with an aggregate value of over R5 million, an audit is required. The Companies Regulations of 2011 provide for both activity and size criteria to determine whether or not companies require audited financial statements.

10.4 APPOINTMENT OF AN AUDITOR



PRESCRIBED STUDY MATERIAL

Textbook: chapter 13, par 13.4

Public companies, state-owned companies and certain types of private companies are required to appoint an auditor every year at the annual general meeting (ss 34, 84, 85 and 90 of the Companies Act). Other companies, such as private companies, personal liability companies or non-profit companies, need not comply with the extensive accounting requirements set out in chapter 3, except to the extent that the company's Memorandum of Incorporation (MOI) provides otherwise (s 34 of the Companies Act).

Section 85 of the Companies Act requires that every company that appoints an auditor must file a notice of the appointment with the Registrar 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 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 a person who has complied with the prescribed education, training and competency requirements, who has made arrangements regarding his or her continued professional development where that individual is not a member of an accredited professional body, who is a "fit and proper person" to act as an auditor, and who is resident within South Africa, may be registered as an auditor.

The Auditing Profession Act states, further, in section 37(3), that any person who has been removed from an office of trust as a result of misconduct, who has been convicted of theft, fraud or forgery or other act of dishonesty or corruption, or who 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.

How do we ensure that the auditor has the requisite level of skill and independence? To ensure a required level of skill and that the auditor is independent of the company that it is auditing, section 90(2) of the Companies Act disqualifies certain persons from being appointed as the auditor of a company. Such persons include the following: 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; a person who, at any time during the five financial years immediately preceding the date of appointment, was a person mentioned above or is a person related to a person mentioned above.

10.5 RESIGNATION AND VACANCIES



PRESCRIBED STUDY MATERIAL

Textbook: chapter 13, par 13.5

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. A new auditor must be appointed to replace an auditor who resigns within 40 business days after the filing of his or her resignation.

10.6 ROTATION OF AUDITORS



PRESCRIBED STUDY MATERIAL

Textbook: chapter 13, par 13.6

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, and also does not apply to private companies. If a company has appointed two or more joint auditors, the company is obliged to manage the rotation requirement in a way so as to ensure that 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.

You have now learnt and can describe

- what types of companies are required to appoint an auditor
- the manner in which an auditor is appointed
- who is disqualified from being an auditor of a company
- the requirements regarding the rotation of auditors.

Now do activity 10.1 to ensure that you understand these principles and are able to apply them.

ACTIVITY 10.1

Suppose that Given is appointed to Moonblue Ltd as an auditor in place of Daniel. Having served as an auditor of Moonblue Ltd for three consecutive years, Given decides to take a six month holiday through Europe and resigns from his position. On his return from Europe, Given re-applies for the position as the auditor of Moonblue Ltd. Do you think Given should/ may be reappointed? Provide reasons for you answer.

FEEDBACK

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

10.7 RIGHTS AND RESTRICTED FUNCTIONS OF AUDITORS



PRESCRIBED STUDY MATERIAL

Textbook: chapter 13 (only the first paragraph of 13.7)

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 attend any general meeting held by the company.

The auditor is entitled to apply to court for an order to enforce his 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. Further, the court may 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.

You have now learnt

- what rights of access an auditor has to the accounting records and books and documents of a company
- the manner in which an auditor may defend such right of access.

Now do activity 10.2 to ensure that you understand these principles and are able to apply them.

ACTIVITY 10.2

Suppose Hamid is appointed as the 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 the documents. Advise Hamid of his legal rights as an auditor under the Companies Act.

FEEDBACK

Section 93 of the Companies Act provides that the company auditor has the right of access, at all times, to 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 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 apply to court if necessary for an order that the documents be furnished to him. The court may make a costs order against Barney in his personal capacity.

10.8 AUDIT COMMITTEES**PRESCRIBED STUDY MATERIAL**

Textbook: chapter 13, par 13.9

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 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.

You have now learnt and can describe

- what an audit committee is
- the role an audit committee plays in a company.

Now do activity 10.3 to ensure that you understand these principles and are able to apply them.

ACTIVITY 10.3

- Which companies are required under the Companies Act to appoint an audit committee and how many members must an audit committee have?
- What are the functions of an audit committee?

FEEDBACK

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 consist of only 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. In the year for which it is appointed, the audit committee must perform the functions listed in paragraph 13.9 of your textbook.

10.9 MANDATORY APPOINTMENT OF COMPANY SECRETARY



PRESCRIBED STUDY MATERIAL

Textbook: chapter 13, par 13.10

The company secretary is the principal administrative officer of his or her company. Which companies do you think should be obliged to appoint a company secretary? Every public company or state-owned enterprise must appoint a company secretary who is knowledgeable about, or experienced in, the relevant laws. A private company, personal liability company or a non-profit company may voluntarily appoint a company secretary.

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 an ordinary resolution of the company's shareholders (s 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.

Must a company secretary be an individual or may a company secretary be a juristic person, like a company? 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 listed 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.

You have now learnt

- which companies must appoint a company secretary
- what disqualifies a person from being appointed a company secretary
- what the duties of a company secretary entail
- how a company secretary may resign from office.

Now do activity 10.4 to ensure that you understand these principles and are able to apply them.

ACTIVITY 10.4

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.

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 company secretary must be appointed. The duties of a company secretary as set out in section 88 of the Companies Act 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 company 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.

10.10 REGISTRATION OF COMPANY SECRETARIES AND AUDITORS



PRESCRIBED STUDY MATERIAL

Textbook: chapter 13, par 13.11

How does the Registrar know which companies have appointed an auditor and a company secretary and who these persons are? In addition to the record of company secretaries and auditors that a company must keep, section 85 of the Companies Act also requires every company that appoints a company secretary or auditor to file a notice of the appointment, or the termination of such an appointment, with the Registrar 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.

10.11 REFLECTION

Certain companies are obliged to appoint auditors. The Companies Act requires auditors to be independent. Note the requirements for the appointment, resignation and rotation of auditors, as well as their rights and restricted functions. Public companies and state-owned companies are also required to appoint an audit committee to oversee the appointment of an auditor, the performance of the functions of the appointed auditor, and the terms of his or her engagement. The Auditing Profession Act regulates auditors' conduct.

Company secretaries have to ensure that they know the latest developments in the law relating to companies. They are advisors to the directors and the chief administrative officer. A public company or state-owned enterprise must appoint a company secretary. Both company secretaries and auditors must be registered.

10.12 CONCLUSION

You should now understand the important role and function of an auditor and company secretary in a company. It is mandatory for certain types of companies to appoint an auditor and a company secretary. This learning unit has covered how auditors and company secretaries can be appointed or discharged from office, and how they should resign. Certain persons are disqualified from being appointed as an auditor or a company secretary. The duties of an auditor and company secretary have also been explained. You have learnt that a company that appoints an auditor or a company secretary must file a notice of such appointment with the Registrar.

10.13 SELF-ASSESSMENT QUESTIONS

- How is an auditor appointed?
- Which companies are obliged to appoint an auditor?
- What happens if the auditor resigns or a vacancy arises in the office of auditor?
- How often must an auditor be appointed?
- What is the purpose of the audit committee?
- What type of company must appoint a company secretary?
- Who is disqualified from appointment as a company secretary?
- What are the functions and duties of a company secretary?
- How can a company secretary be removed?

LEARNING UNIT 11

Close corporations

Contents

- 11.1 Introduction
- 11.2 Contribution by members and nature of members' interests
- 11.3 Acquisition and disposal of members' interest
- 11.4 Duties members owe to the close corporation
- 11.5 Cessation of membership by order of court
- 11.6 Acquisition of members' interest by the corporation and financial assistance
- 11.7 Internal relations and association agreements
- 11.8 Power of members to contract on behalf of close corporations
- 11.9 Payments by corporation to members
- 11.10 Prohibition of loans to and security on behalf of members
- 11.11 Accounting officer, records and financial statements
- 11.12 Personal liability for a corporation's debts
- 11.13 Reflection
- 11.14 Conclusion
- 11.15 Self-assessment questions

11.1 INTRODUCTION



PRESCRIBED STUDY MATERIAL

Textbook: chapter 16, par 16.1–16.2

The **Close Corporations Act 69 of 1984** ("Close Corporations Act") introduced a new and cheaper option for the incorporation of small enterprises. This form of business is a combination of some of the partnership attributes and some of the corporate attributes.

A close corporation, like a company, is a legal person. Clearly, with all the benefits attached to incorporation, in addition to the fact that running the business is unstilted by onerous regulation, entrepreneurs and owners of micro- and small businesses were presented with a most viable option appropriate to their business.

Existing close corporations continue to exist alongside companies, but no further registrations of close corporations or conversions of companies to close corporations are permitted by the Companies Act.

Despite the fact that close corporations remain mainly regulated by the Close Corporations Act 69 of 1984 ("Close Corporations Act"), various provisions contained in the Companies Act have been made applicable to this type of enterprise in terms of Schedule 3 of the Act. These provisions include provisions to regulate name reservations, liquidations, business rescue, dissolution and deregistration, and orders to place persons on probation or to declare them delinquent.

In learning unit 1, you learnt that companies acquire legal personality upon incorporation. Likewise, in case of close corporations, separate legal personality was acquired upon registration of the **founding statement**. Sometimes, the court may be called upon to lift or “pierce the corporate veil” or disregard the separate legal personality of the close corporation. Revise learning units 1 and the abuse of juristic personality to familiarise yourself with the circumstances in which incorporation of a company or close corporation can be disregarded. Note that, when dealing with close corporations, reference should be made to section 65 of the Close Corporations Act and not section 20(9) of the Companies Act.

Close corporations, like companies, also enjoy **perpetual succession**, which means that the entity exists separate from its members and changes in membership will not influence its future existence.

Close corporations were intended mainly for small businesses; hence the number of members is limited to ten.

It is not permitted 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, an insolvent, or a 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 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 the maximum of ten members still applies.

Should the membership of a close corporation change, an amended founding statement must be lodged for registration. This is intended to inform outside parties involved with the corporation of the changes in membership of the corporation.

11.2 CONTRIBUTIONS BY MEMBERS AND NATURE OF MEMBERS' INTERESTS



PRESCRIBED STUDY MATERIAL

Textbook: chapter 16, par 16.3

Under the Companies Act, it is **no longer possible to register new close corporations**. However, it may still be necessary to acquire information regarding a close corporation, or to amend the founding statement by lodging a **form CK2** with the Companies and Intellectual Property Commission.

The founding statement indicates the following particulars of the business:

- the full name of the business/translations of the business name/any abbreviation of the business name
- the principal business
- the number of members

- the date of the end of the financial book year
- the aggregate member's contribution
- the postal address
- the address of the registered office
- the name and postal address of the accounting officer
- the particulars of the founding members (names, copies of identity documents, residential addresses)
- the member's interest 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.

Characteristics of a members interest

- Members' interest is expressed as a percentage (out of a total of 100%) in the founding statement.
- Member's interest may not be held jointly.
- The aggregate members' interests must at all times be 100 per cent.
- A member's interest in a close corporation is similar to a share in a company.
- Member's interest is an incorporeal, moveable thing.
- Member's interest is a personal right to share in the close corporation's profits after its creditors have been paid.

Member's interest can be acquired by

- acquiring member's interest from existing members
- making a contribution to the close corporation

11.3 ACQUISITION AND DISPOSAL OF MEMBER'S INTEREST



PRESCRIBED STUDY MATERIAL

Textbook: chapter 16, par 16.4

As a close corporation is intended for small businesses with few members in a close relationship to each other, changes in membership can affect the operations of the business very negatively. For this reason, the disposition of member's interest is controlled by the members to a large extent.

Requirements for disposal of member's interest:

- it must be made in accordance with association agreement, or
- the consent of all members is required.

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.

11.3.1 Death of a member



PRESCRIBED STUDY MATERIAL

Textbook: chapter 16, par 16.4

- **Close Corporations Act: section 35**

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, only occur with the consent of the other members.

Should the members not permit such transfer, the executor of the estate may do one of the following:

- sell the member's interest to the close corporation
- sell the member's interest to other members
- 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 then be paid over to the heir/legatee.

11.3.2 Insolvency of a member



PRESCRIBED STUDY MATERIAL

Textbook: chapter 16, par 16.4

- **Close Corporations Act: section 34(1)**

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
- sell the member's interest to the other members
- 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.

11.3.3 Attachment and sale in execution



PRESCRIBED STUDY MATERIAL

- **Close Corporations Act: section 34A**

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. The right of pre-emption entitles other members of the corporation to exercise the right to buy the member's interest, before an offer could be opened to members of the public.

11.4 DUTIES MEMBERS OWE TO THE CLOSE CORPORATION



PRESCRIBED STUDY MATERIAL

Textbook: chapter 16, par 16.5

- **Close Corporations Act: sections 42, 43, 50 and 51**

Members owe two duties to the close corporation:

- a fiduciary duty (duty of good faith) in terms of section 42 of the Close Corporations Act 69 of 1984
- a duty of care and skill

11.4.1 Fiduciary duty



PRESCRIBED STUDY MATERIAL

Textbook: chapter 16, par 16.5.1–16.5.2

- **Close Corporations Act: section 42**

A member's fiduciary duties **to the close corporation** are similar to the fiduciary duties that a director owes to a company. Fiduciary duties are intended to ensure that members (and directors of companies) adhere to the rules and regulations that govern the respective entities. Failure to act in line with one's duties, results in serious consequences for the member or director concerned. Thus, as a member or director of a company, it is important to familiarise oneself with one's respective duties. The following comprise a member's fiduciary duties:

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.

ACTIVITY 11.1

Neo, Thabo, 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. Thabo 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 with the state of affairs. Advise Chris and Duncan on what to do to provide a remedy to the close corporation.

FEEDBACK

A member who breaches any of the fiduciary duties as stipulated in terms of the Act is personally liable to the corporation for any loss suffered by the corporation or for any economic benefit derived by the member. A member who breaches a fiduciary duty must also repay any benefit obtained as a result of breaching that duty. Conduct will not constitute a breach of fiduciary relationship if the conduct has the written approval of all the members and if they were aware of all the material facts.

11.4.1.1 *Contracts concluded between member and close corporation*



PRESCRIBED STUDY MATERIAL

Textbook: chapter 16, par 16.5.1

- **Close Corporations Act: section 42(3)**

As indicated above, a member of a close corporation is in a fiduciary relationship to the close corporation and to the other members of the close corporation. Should a member have a material interest in a contract of the close corporation, this must be disclosed to the 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 will be voidable at the option of the close corporation. This essentially means that the close corporation can have the contract set aside or cancelled. Application can, however, be made to the court to declare the contract as binding on the parties despite the failure to disclose.

In the event that the fiduciary duties are breached, a member may be held personally liable for any loss suffered by the corporation or for debts incurred as a result of such a transaction (s 42(3)). The member would, in such event, have to repay any profit made by him or her unless all the members approve this conduct in writing.

11.4.1.2 *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 the other members of the close corporation and acquiring prior or subsequent written approval from all the other members.

11.4.2 *Duty of care and skill*



PRESCRIBED STUDY MATERIAL

Textbook: chapter 16, par 16.5.2

- **Close Corporations Act: section 43(1)**

A member will be liable for a 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 the case of a breach, another member may institute action against the close corporation or its members in his or her personal capacity.

ACTIVITY 11.2

Johan is a member of Baker CC. He is also a geologist with 15 years' experience in mineral exploration. He is instructed by Baker CC to do an exploration of minerals on a property owned by Baker CC. Johan negligently reports that there are no minerals on the property. The property is sold and subsequently it is discovered that there is gold on the property. Baker CC would have sold the property at a substantially higher price had it known that there were gold deposits present.

Johan will be in breach of which fiduciary duty?

FEEDBACK

Johan will be in breach of a duty of care and skill. In essence, this duty simply implies that a member in his execution of duties must act with a certain degree of care and skill. In determining whether or not a member has acted with the required degree of care and skill, a member must pass both an objective and subjective test. An objective test is applied to determine what a reasonable director would have done in the same situation. In addition, a subjective test is also applied, taking into account the general knowledge, skill and experience of the particular director. A person with Johan's experience and professional qualification should therefore have acted differently in these circumstances.

11.4.3 Remedies in the case of breach



PRESCRIBED STUDY MATERIAL

Textbook: chapter 16, par 16.5.3

- **Close Corporations Act: section 50**

Section 50 of the Close Corporations Act provides for an action to be instituted by a member against fellow members on behalf of the close corporation for liability to the company 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. The term "derivative action" means that the power of a member to bring about legal action on behalf of a corporation is derived from the close corporation, hence, the use of the term "derivative".

The duties of members of a close corporation are similar to those of directors of a company. Members must act in good faith and must carry out their functions with a reasonable degree of care and skill. If a member breaches his or her duty, any other member can take legal steps on behalf of the close corporation against such member. The reason why the person instituting the action will be liable for legal costs, should the action be unsuccessful and should the court find that the action was instituted without *prima facie* grounds, is to prevent the misuse of this action.

ACTIVITY 11.3

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 obtained from such a transaction. Which action would you advise Stella to institute against the said member?

FEEDBACK

The duties of members of a close corporation are similar to those 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. Section 50 of the Close Corporations Act would, therefore, be the remedy to use in these circumstances, as the other member has clearly breached her fiduciary duty. Section 50 is a statutory derivative action, as the corporation will be the plaintiff. The rule 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.

11.5 CESSATION OF MEMBERSHIP BY ORDER OF COURT



PRESCRIBED STUDY MATERIAL

Textbook: chapter 16, par 16.6

- **Close Corporations Act: sections 36 and 49**

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**, a member(s) 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/her part in carrying on 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/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.

The remedy in section 49 of the Close Corporations Act is available to a member whose rights are unfairly and prejudicially affected by the close corporation's conduct or by 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 as to the order it may make to provide relief for the victim of oppressive conduct. In this case, the court ordered the sale of the corporation's sole asset in order to place the close corporation in a financial position to buy back an aggrieved member's interest.

In *De Franca v Exhaust Pro CC* 1997 (3) SA 878 (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 to establish a fair price for it.

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 which was unfairly prejudicial to such member. The court will only intervene if it is just and equitable to do so. The court may then direct that the aggrieved act or omission be stopped, may order that the corporation amend its founding statement or association agreement, or, in certain cases upon application, make an order to wind-up the corporation.

11.6 ACQUISITION OF MEMBER'S INTEREST BY THE CORPORATION AND FINANCIAL ASSISTANCE



PRESCRIBED STUDY MATERIAL

Textbook: chapter 16, par 16.7

- **Close Corporations Act: sections 37–40**

It is possible for a close corporation to acquire a member's interest from one of its members.

Requirements for acquisition of member's interest by a close corporation:

- the corporation must have at least one other member
- the aggregate members' interest must remain 100 per cent

- written consent from all members is required prior to payment
- the corporation must be **solvent after payment for the acquisition and 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.

11.7 INTERNAL RELATIONS AND ASSOCIATION AGREEMENTS



PRESCRIBED STUDY MATERIAL

Textbook: chapter 16, par 16.8

- **Close Corporations Act: section 44**

Important terms	Meaning
Association agreement	A non-compulsory agreement to arrange internal affairs within the close corporation
Internal relationships	The relationships between members inter se (amongst each other) and the relationship between the close corporation and its members

Although it is advisable for members to conclude such an agreement, it is not compulsory. The internal relations between members may be regulated by an association agreement. In an association agreement, members get an opportunity to structure the affairs of the corporation, whichever way it suits them. The members of the corporation may also change provisions to suit their specific needs. However, any change that is effected or any provision of the agreement that is inserted should be consistent with the provisions of the Close Corporations Act.

Association agreements 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 Registrar and is not a public document. However, should such an agreement be concluded, it must be held at the registered offices of the business. Close corporations have only one compulsory constitutive document: the founding statement. Although association agreements are optional, it is preferable for members to conclude such an agreement in order to regulate internal relationships in the management of the business.

An association agreement must be in writing and must be 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 on how decisions will be taken, and the agreement may establish 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. A clause stating that certain members will not be permitted to call a meeting, or allowing disqualified members to participate in the management, or specifying how the member's interest of an insolvent member will be disposed of, will be void (invalid). In a nutshell, any clause, variation or stipulation that forms part of the association agreement, must be consistent with the provisions of the Close Corporations Act.

ACTIVITY 11.4

- (1) What is an association agreement?
- (2) Who may participate in the management of a close corporation?

FEEDBACK

An association agreement is an agreement entered into by members of the corporation in order to regulate their internal relations. It must be concluded in writing and must be signed by or on behalf of each member. This document is not regarded as a public document and only members of the corporation may inspect it.

In the association agreement, members agree on how the corporation will be managed and how decisions will be taken. They also establish the proportion of payments to members.

11.8 POWER OF MEMBERS TO CONTRACT ON BEHALF OF CLOSE CORPORATIONS



PRESCRIBED STUDY MATERIAL

Textbook: chapter 16, par 16.9

- **Close Corporations Act: section 54**

In terms of section 54 of the Close Corporations Act, 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.

11.9 PAYMENTS BY CORPORATION TO MEMBERS



PRESCRIBED STUDY MATERIAL

Textbook: chapter 16, par 16.10

- **Close Corporations Act: section 51**

In terms of section 51, 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 for such a payment.

Note that section 51 applies only to instances where payments are made to members in their capacity **as members** and not if the payment is made to a member in his/her capacity as creditor.

Before any type of distribution can be made to members in their capacity as members, the requirements set out in section 51 must be adhered to. 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, such creditor may apply for the winding-up of the corporation.

11.10 PROHIBITION OF LOANS TO AND SECURITY ON BEHALF OF MEMBERS



PRESCRIBED STUDY MATERIAL

Textbook: chapter 16, par 16.11

- **Close Corporations Act: section 52**

The Close Corporations Act contains a prohibition against the provision of loans and security to members. Only if all the other members consent 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.

11.11 ACCOUNTING OFFICER, RECORDS AND FINANCIAL STATEMENTS

Close corporations are not exempted from financial reporting. An annual financial statement must be drawn up. A close corporation need not, in terms of the Close Corporations Act, appoint an auditor. However, an accounting officer must be appointed who must account in conformity with generally accepted accounting practice. He or she also plays a very important reporting function. If an accounting officer becomes aware of irregularities in the accounting policies or practices within the corporation, this must be disclosed to the members. The Registrar must also be informed should the accounting officer be removed, if the corporation is not carrying on business, or if its liabilities exceed the assets at the end of the financial year.

Accounting records must be kept and approved by members holding at least 51 per cent of the member's interest in the close corporation annually. The accounting records need not be submitted to the Registrar. A report must be drawn up by the appointed accounting officer.

NB! The Companies Act requires some close corporations to audit their financial statements in the same circumstances as a private company.

11.12 PERSONAL LIABILITY FOR A CORPORATION'S DEBT



PRESCRIBED STUDY MATERIAL

Textbook: chapter 16, par 16.13

- **Close Corporations Act: section 23, 52, 64 and 65**

A close corporation is a separate legal person. Despite this fact, the court at times may “pierce the corporate veil” in order to hold the guilty parties liable. In some instances, the members and/or other guilty parties (such as the accounting officer) incur personal liability (ss 23; 26; 42; 43; 52 and 65), and, in other circumstances, they are held jointly liable (s 63) for the losses incurred as a result of their actions.

If a member (or members) of a close corporation trades in the name of the close corporation without using the identifying abbreviation (“CC”) or its equivalent in another language (e.g. “BK” in Afrikaans), such a member would incur personal liability in terms of section 63 of the Close Corporations Act for any losses incurred as a result of the transaction by a third party who was unaware of the fact that it was dealing with a close corporation owing to the omission.

The aim of section 64 of the Close Corporations Act is to protect creditors. A person who knowingly conducts or is 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. The test used to determine whether trading was reckless is whether a reasonable businessperson in the position of the CC's member would continue trading in the belief that creditors would receive payments as they become due.

11.13 REFLECTION

A close corporation is a simple, deregulated and flexible limited liability entity, which is suitable for small businesses. It has its own legal personality and enjoys perpetual succession. It has members who are responsible for running the business of the close corporation. Membership of a close corporation is limited to 10. Membership is obtained through the acquisition of a member's interest, which is expressed as a percentage. This entitles a member to own and to participate in the business of the corporation. New members acquire membership interests either from an existing member, or by making a contribution in the form of money or other assets to the corporation. Members owe a fiduciary duty and a duty of care and skill to the close corporation. Membership can be terminated through an order of court or if members have been found guilty of unfairly prejudicial conduct.

In terms of the Companies Act 71 of 2008, no new close corporations may be incorporated under the Close Corporations Act. Existing close corporations will continue indefinitely or may be converted into companies.

Internal relations between members may be regulated by an association agreement. Every member of the corporation qualifies as an agent of the corporation. Payments by a corporation to any member of the corporation by reason of his or her membership may be made only if the corporation passes the solvency and liquidity test. A close corporation is prohibited from making loans to members, any other corporation or a company without the express consent of all its members. A member of a close corporation can be held personally liable for the debts of the close corporation in a variety of circumstances, especially if the corporation's juristic personality was abused.

11.14 CONCLUSION

In this study unit, you have been taken through the concept of close corporations as it applies in South Africa. You have learnt that even though a close corporation is a small business enterprise, it does have a separate legal personality separate from its members. However, such separate existence can be disregarded to impose liability on those who may have committed wrongful acts. You have also learnt about the membership limitation applicable in close corporations, and the contributions that each member has to make for the successful running of the business of the corporation. In addition, circumstances giving rise to termination of membership were discussed. You have familiarised yourself with the fact that each member has a right to represent the company in various matters, including contracts. However, an association agreement can be drawn up to regulate the affairs of the corporation, and to stipulate who among the members is best suited to represent the corporation.

11.15 SELF-ASSESSMENT QUESTIONS

- Compare the membership limitation of a close corporation with that of various types of companies.
- It is the year 2020 and Mpho, Neo and Nyiko (Pty) Ltd would like to incorporate a small business enterprise. Consider whether incorporation of a close corporation will be possible and provide a reason for your answer.

LEARNING UNIT 12

Remedies, enforcement and alternative dispute resolution

Contents

- 12.1 Introduction
- 12.2 Derivative action in terms of section 165
- 12.3 Remedies available to shareholders to protect their own rights
- 12.4 Enforcement of rights and compliance with the Act
- 12.5 Reflection
- 12.6 Conclusion
- 12.7 Self- assessment questions



PRESCRIBED STUDY MATERIAL

Textbook: chapter 14, par 14.1–14.5

- **Case law as discussed in this learning unit and your prescribed textbook**

12.1 INTRODUCTION

A very important aspect of any legislation is its enforcement. This learning unit focuses on the remedies available to shareholders to protect their interests, and mechanisms available in the event of directors abusing their position. The learning unit also deals with the statutory remedies aimed to protect the interests of shareholders. Further, the abuse of the separate juristic personality of a company is also 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 are considered together with the introduction of the voluntary alternative dispute resolution mechanisms in the Act.

Important terms	Meaning
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

Important terms	Meaning
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 (Here, it is also used in the context of alternative dispute resolution.)

12.2 DERIVATIVE ACTION IN TERMS OF SECTION 165



PRESCRIBED STUDY MATERIAL

Textbook: chapter 14, par 14.2.2

- **Case law as discussed in this learning unit and your prescribed textbook**

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.

An applicant in terms of section 165 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.

You have now learnt and can describe

- who may institute proceedings in terms of section 165
- the importance of serving a demand on a company in terms of section 165
- the procedure that should be followed by a company after receiving a demand in terms of section 165
- the circumstances under which a court may grant relief to an applicant to institute legal proceedings on behalf of the company in terms of section 165.

12.3 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 against unfairly prejudicial conduct, while section 164 makes provision for the appraisal rights of dissenting shareholders.

12.3.1 Relief from oppressive or unfairly prejudicial conduct in terms of section 163



PRESCRIBED STUDY MATERIAL

Textbook: chapter 14, par 14.3.1

- **Case law as discussed in this learning unit and your prescribed textbook**

In terms of section 163 of the Companies Act, a shareholder or a director may bring an application for relief against 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. Reliance can also be placed on this section if the business of the company, or 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 susceptible 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, or
- an order for the trial of any issue as determined by the court.

You have now learnt and should be able to list

- who may rely upon an application in terms of section 163
- the grounds upon which an applicant may rely in terms of section 163
- the relief a court may grant to an applicant in terms of an application based on section 163.

ACTIVITY 12.1

Consul Ltd passed a special resolution that would effectively change control in the company. Sarah is a minority shareholder who has voted against the decision as it would prejudice her rights as a shareholder of Consul Ltd.

Draft a written opinion to Sarah on 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

Refer back to paragraphs 14.3.1 and 14.3.2 in your textbook and make sure you understand the difference between relief from oppressive or unfairly prejudicial conduct in terms of section 163 and the appraisal rights of a dissenting shareholder in terms of section 164.

12.3.2 Dissenting shareholders' appraisal rights in terms of section 164



PRESCRIBED STUDY MATERIAL

Textbook: chapter 14, par 14.3.2

- **Case law as discussed in this learning unit and your prescribed textbook**

An appraisal right is the right of a shareholder to require the company to buy his/her shares at 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.

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

- where the company proposes to adopt 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 all or the greater part of the assets or undertaking of the company
- in circumstances where the company is considering merging or amalgamating with another company
- where a company is considering entering into a scheme of arrangement with the shareholders or a class of shareholders

You have now learnt and should be able to explain

- what the appraisal rights of a shareholder are
- the circumstances under which the appraisal rights of a shareholder are triggered
- the procedure which should be followed should a shareholder wish to exercise his or her appraisal rights.

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



PRESCRIBED STUDY MATERIAL

Textbook: chapter 14, par 14.3.3

- **Case law as discussed in this learning unit and your prescribed textbook**

Section 161 provides a remedy to holders of securities that are independent of any other common law or statutory remedies available to security holders. The holder of issued securities may apply to court for a declaratory order regarding his/her rights. In terms of section 161(1)(b), 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.

You have now learnt and can explain

- who may rely on the provision of section 161
- the relief a court may grant in terms of section 161.

12.4 ENFORCEMENT OF RIGHTS AND COMPLIANCE WITH THE ACT



PRESCRIBED STUDY MATERIAL

Textbook: chapter 14, pars 14.1 to 14.5.1 up to the end of the chapter

- **Case law as discussed in this learning unit and your prescribed textbook**

Unlike its predecessor, which extensively provided for criminal sanctions, the Companies Act 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 Companies 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 (s 213), or to sign or agree to a false or misleading financial statement or prospectus, or to be reckless in the conduct of the company's business (s 214).

The body that is normally responsible for the enforcement of the Companies Act is the Companies and Intellectual Property Commission (CIPC). Among other things, the Commission must monitor proper compliance with the Companies Act, investigate complaints concerning contraventions of the Act, promote the use of alternative dispute resolution (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 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. The use of ADR is voluntary, and all parties must agree to the use of the process.

You have now learnt and should be able to explain

- the purpose, objectives and functions of the Companies and Intellectual Property Commission
- the legal effect of a compliance notice
- how the Commission investigates complaints
- the functions and powers of the Companies Tribunal
- how alternative dispute resolution is conducted in terms of the Act.

ACTIVITY 12.2

Billy alleges that Timex (Pty) Ltd has contravened certain provisions of the Companies Act 71 of 2008. Billy's complaint can basically be addressed in 4 different ways. List Billy's options and, further, make a list of the advantages and disadvantages of each of the available options.

FEEDBACK

Return to paragraph 14.5 in your textbook. The different ways in which a complaint can be addressed 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.

12.5 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 upon by the parties, and that the less formal process may exclude the necessity for legal representation.

12.6 CONCLUSION

By now you should understand 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 application of section 163 and 165. Further, the Act makes provision for the protection of holders of securities in section 161. Another important remedy, which is a new innovation in the Act, 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.

12.7 SELF-ASSESSMENT QUESTIONS

- What type of relief may a court grant in terms of section 161?
- Who may rely on relief in terms of section 161?
- Name five (5) orders a court can make in terms of section 163.
- Name the grounds upon which an applicant may rely for relief in terms of section 163.
- Who may bring an application in terms of section 163?
- Describe the procedure a shareholder must follow to exercise his or her appraisal rights in terms of section 164.
- Describe the procedure that must be followed by an aggrieved shareholder in terms of section 165.

LEARNING UNIT 13

Partnerships

Contents

- 13.1 Introduction
- 13.2 Definition of a partnership
- 13.3 Types of partnerships
- 13.4 The *essentialia* of a partnership
- 13.5 The *essentialia* as an aid
- 13.6 Legal nature of a partnership
- 13.7 Relationships in partnerships
- 13.8 Representation in partnerships
- 13.9 Personal liability of a partner
- 13.10 Dissolution of a partnership
- 13.11 Reflection
- 13.12 Conclusion
- 13.13 Self-assessment questions

13.1 INTRODUCTION

Partnerships are one of the oldest, simplest business forms used in South Africa. Partnerships are very easy and cheap to form and provide a lot of 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. Therefore, it is 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 and there is no Partnerships Act in South Africa.

IMPORTANT SECTIONS OF LEGISLATION: You need to know these sections and rules as discussed here and in your prescribed textbook.

INSOLVENCY ACT 24 OF 1936:

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

Rule 14 of the Uniform Rules of the High Court and Rule 54 of the Magistrates' Courts Act 32 of 1944
Partners may sue and be sued in the name of the partnership.



PRESCRIBED STUDY MATERIAL

Textbook: chapter 17, par 17.1–17.10

- Case law as discussed here and in your prescribed textbook

Important terms	Meaning
Joint liability	The situation when two or more persons are both/all 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 <i>essentialia</i>) between partners, which sets out the terms and conditions of the relationship between the partners
Universal partnership	A partnership where the partners agree to put in common all their property, <i>universorum bonorum</i> , not only what they have presently but also future assets and obligations
Particular partnership	A partnership formed for a single transaction or enterprise
Anonymous partnership	Also known as a “silent partnership” (A partner/s may enjoy limited liability so long as he/she/they remain anonymous in their capacity as partner/s and do not participate in the operation of the partnership.)
Partnership <i>en commandite</i>	An extraordinary partnership in terms of which a partner (or partners) enjoys limited liability to co-partners for the losses of the partnership up to an agreed amount, on condition that he or she receives a fixed share of the profits

A partnership may be described as a contractual relationship between two or more 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. The continued existence of a partnership is dependent on the involvement of the partners. It is also largely dependent on the legal capacity of the partners. As a result of the risks associated with the continued existence of partnerships, as well as other risks associated with this enterprise form, a relationship of utmost good faith is required among 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 a separate entity for certain limited purposes.

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 them 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. Therefore, personal possessions of the partners are not protected against any claim.

Once a partnership has been dissolved, the partners are jointly and severally liable for partnership 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 by, for example, 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, the partners will, during the existence of the partnership, 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 the management of the partnership and concludes a contract within the scope of the partnership will, however, be in breach of his/her fiduciary duty to his/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 personal circumstances of its partners or their incompatibility in running the business.

13.2 DEFINITION OF A PARTNERSHIP



PRESCRIBED STUDY MATERIAL

Textbook: chapter 17, par 17.1, 17.2

- **Case law as discussed here and in your prescribed textbook**

In *Pezutto v Dreyer and Others* 1992 (3) SA 379 (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. Do you know of any such partnership?

13.3 TYPES OF PARTNERSHIPS



PRESCRIBED STUDY MATERIAL

Textbook: chapter 17, par 17.3

- **Case law as discussed here and in your prescribed textbook**

Apart from ordinary partnerships, which form the subject of the discussion in this learning unit, there are also universal, particular and extraordinary partnerships.

13.3.1 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 kinds of universal partnerships can be distinguished: 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, which 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. In *Bester v Van Niekerk* 1960 (2) SA 779 (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. This is known as a **particular partnership**.

13.3.2 Ordinary and extraordinary partnerships

Extraordinary partnerships differ from other kinds of partnerships in that the liability of certain partners to third parties may be limited. Three types of extraordinary partnerships can be distinguished: 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. He or she, however, 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 only liable to the other parties 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, were 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. The repeal of this legislation does not affect any action undertaken under the repealed Act, nor does it affect rights acquired or liabilities incurred under this Act.

13.3.3 Differences between partnerships and companies

What do you think are some of the most pertinent differences between a partnership and a company? Take time to consider this question before reading further.

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. 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 where their main object is not to make a profit, that is, 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 the membership of a partnership 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 joint co-owners of the partnership assets.
- All profits made belong to the company and shareholders only become entitled to profits after the company has declared a dividend, whilst 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, like private companies, only one shareholder is required.
- In a partnership, there are partners, while, in a company, there are shareholders (in profit companies) or members (in non-profit companies).

13.3.4 Advantages and disadvantages associated with partnerships

Partnerships offer the following **advantages**:

- ease of formation
- diversification of skills and means
- better opportunity to build capital
- minimal legal formalities and regulation

Partnerships have the following **disadvantages**:

- the personal liability of partners
- the relative difficulty in disposing of an interest in the partnership

- the potential for conflict between partners
- lack of continuity (but this can be overcome by agreement)

13.4 THE *ESSENTIALIA* OF A PARTNERSHIP



PRESCRIBED STUDY MATERIAL

Textbook: chapter 17, par 17.4

- **Case law as discussed here and in your prescribed textbook**

There can never be a partnership that is formed by less than two persons. It is impossible to conclude a partnership agreement unilaterally. 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 goes to the core of the business and, if the relationship is destroyed, the enterprise cannot continue to exist. We now consider how valid partnerships are formed and what factors the courts consider in order to ascertain whether or not a valid partnership has been brought into existence.

The *essentialia* are those elements that must form part of an agreement 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 are now discussed under separate headings below.

13.4.1 Contribution by partners



PRESCRIBED STUDY MATERIAL

Textbook: chapter 17, par 17.4.1

Each partner must contribute something or give a binding undertaking to make some kind of contribution to the partnership that has commercial value, like 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 with 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.

13.4.2 The business should be carried on for the joint benefit of the partners



PRESCRIBED STUDY MATERIAL

Textbook: chapter 17 par 17.4.2

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 only share in the profit 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.

13.4.3 The business should be carried on with the object of making a profit



PRESCRIBED STUDY MATERIAL

Textbook: chapter 17, par 17.4.3

- **Case law as discussed here and in your prescribed textbook**

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.

13.4.4 The contract should be a legitimate contract



PRESCRIBED STUDY MATERIAL

Textbook: chapter 17, par 17.4.4

- **Case law as discussed here and in your prescribed textbook**

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*.

13.4.5 Other legal formalities

A partnership is nothing more than a specific kind 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.

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.

13.5 THE *ESSENTIALIA* AS AN AID

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 *Pezutto v Dreyer* 1992 (3) SA 379 (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.

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.

You have now learnt and can describe

- the definition of a partnership
- the different kinds of partnerships
- differences between partnerships and companies
- advantages and disadvantages associated with partnerships
- the *essentialia* of a partnership
- the *essentialia* as aid to determine whether a partnership exists

Now do activity 13.1 to ensure that you understand these principles and are able to apply them.

ACTIVITY 13.1

Pule, Riaan and Cindy want to form a partnership. They want to buy and sell secondhand 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 vehicles will be divided equally between Pule and Cindy while Riaan will be paid a stipulated 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.

13.6 LEGAL NATURE OF A PARTNERSHIP



PRESCRIBED STUDY MATERIAL

Textbook: chapter 17, par 17.5

- **Case law as discussed here and in your prescribed textbook**

A company enjoys legal personality. This is one of the main advantages associated with this form of business. Partnerships differ from companies in the sense that they do not have to be registered with the Registrar, but they do not acquire their own separate legal personality either. The effect 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 are discussed below.

A partnership does not exist independently from 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 only when the time arose at the end of an accounting period would a partner become entitled to claim a separate determinable share of the partnership profits. 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 only exceptions to this rule are found in the way a partnership is dealt with in the case of insolvency and litigation.

13.6.1 Insolvency



PRESCRIBED STUDY MATERIAL

Textbook: chapter 17, par 17.5.1

- **Case law as discussed here and in your prescribed textbook**

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 members.

However, 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.

Nevertheless, 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.

13.6.2 Litigation



PRESCRIBED STUDY MATERIAL

Textbook: chapter 17, par 17.5.2

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 cannot generally 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 to be 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 against the separate property of the partners.

The fact that a partnership generally does not enjoy separate legal personality means many negative things: partnerships do not grant partners limited liability, the business enjoys no perpetual succession, and the business may be terminated if, for any reason, the membership should change. It is possible, in the course of a partnership, to sue a partnership in either the Supreme Court or the Magistrates' Court in the partnership's name, and this will have the same effect as suing each partner jointly. After dissolution of the partnership, partners may be held **jointly and severally liable** for all the debts of the partnership.

If a partner becomes insolvent or the partnership is insolvent, the business will have to dissolve. "Partnership" debts and personal debts of partners are deemed separate from each other as far as this is possible.

You have now learnt and can describe

- the legal nature of a partnership.

Now do activity 13.2 to ensure that you understand these principles and are able to apply them.

ACTIVITY 13.2

Rina, Elize and Lepaku have formed a partnership. Rina then 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 is explained later.

13.7 RELATIONSHIPS IN PARTNERSHIPS

Certain rights and obligations arise naturally from partnership agreements (*naturalia*). The partners may, however, agree to change these automatic consequences by including specific stipulations to the contrary (or *incidentalia*) in the partnership agreement. The *naturalia* of a partnership are highlighted below. We also look at the internal relationship between partners, and the relationship that partners have with outsiders or third parties.

13.7.1 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 must 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 partnership, but, if the value of the contributions cannot be ascertained, the partners 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 be 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. They are co-owners of each partnership asset.

13.7.2 The relationship between partners

**PRESCRIBED STUDY MATERIAL****Textbook: chapter 17, par 17.6**

- **Case law discussed here and in your prescribed textbook**

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 the 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 the interests 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 the following:

- 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 to the partnership include the following:

- 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 had 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 each other 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 caused 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
- a duty to guard against a conflict of interest, and
- 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: 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, to obtain the return of a partnership asset, and so on.
- 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.

You have now learnt and can describe

- the regulation of the relationships in a partnership.

Now do activity 13.3 to ensure that you understand these principles and that you are able to apply them.

ACTIVITY 13.3

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. They find out about Piet's extra job and now want your advice on whether this is acceptable practice from a partner.

FEEDBACK

Partners should 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 should acquire and retain for himself or herself any benefit or advantage that is within the scope of the partnership business and which it is, therefore, the partner's duty to acquire for the partnership rather than personally. All such benefits must be shared with and accounted for to his or her partners.

Where a partner purports to obtain a benefit for him 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.

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/her co-partners, and by obtaining their approval.

His action is not in accordance with the principle of partnership law because he is aiming at enriching himself at the expense of his fellow partners.

13.8 REPRESENTATION IN PARTNERSHIPS



PRESCRIBED STUDY MATERIAL

Textbook: chapter 17, par 17.7 and 17.8

- **Case law as discussed here and in your prescribed textbook**

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 partnership 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 his or her 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 are 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 can 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 (*Goodricke’s v Hall and Another* 1978 (4) SA 208 (N)).

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/tacit 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.

The relationship between partners and outsiders (third parties) during the course of the partnership 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.

You have now learnt and can describe

- representation in a partnership.

Now do activity 13.4 to ensure that you understand these principles and are able to apply them.

ACTIVITY 13.4

Riander, Daleen and Siphon 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 to 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. Therefore, third parties dealing with the partners are 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. The reason is that it falls within the scope of Riander's implied authority or mutual mandate to conclude such a contract.

13.9 PERSONAL LIABILITY OF A PARTNER



PRESCRIBED STUDY MATERIAL

Textbook: chapter 17, par 17.9

Study the textbook on the personal liability of a partner.

13.10 DISSOLUTION OF A PARTNERSHIP



PRESCRIBED STUDY MATERIAL

Textbook: chapter 17, par 17.10

Partnerships do not enjoy separate legal personality and are to a great extent dependent on the partners. Partners are **joint owners** of the partnership's assets and **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.

The different ways in which a partnership may be dissolved or terminated include

- effluxion of the term of the partnership
- the end of the undertaking (completion of the partnership business)
- mutual agreement
- a change in membership (which can occur because of the death or retirement of a partner or the admission of a new partner)
- the death of a partner
- insolvency and sequestration of the partnership estate or the estate of any partner
- a bona fide notice of dissolution by any partner
- the situation where partners are nationals of countries that become enemies upon 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 granted upon application by one or more of the partners for **good cause**. What constitutes good cause is a factual question that will need to be determined in each individual case. The courts have indicated some reasons that would constitute 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, for instance, 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; the partnership will only dissolve 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 insofar 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. Therefore, creditors of the partnership can hold any of the partners liable for the total amount of their claims after dissolution of the partnership. A partner who pays the total amount of a claim has a right of regression. He or she can recover from his or her former co-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 co-partners.

13.11 REFLECTION

Partnerships are probably the simplest to form of all enterprise forms in South Africa. All that is required is the conclusion of a valid partnership agreement. However, there are risks attaching to this type of enterprise. Can you think of risks that will give rise to financial losses for partners?

The partnership is one of the oldest organised business forms. In South Africa, there is no Partnership Act. Therefore, this type of enterprise is **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.

13.12 CONCLUSION

You should now know how partnerships are formed. In addition, you should be able to explain the relationships between partners towards third parties and among themselves during the existence of the partnership as well as after its dissolution.

You have now reached the end of the learning unit 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.

13.13 SELF-ASSESSMENT QUESTIONS

- What is the definition of a partnership?
- What are the different types of partnerships?
- What are the *essentialia* of a partnership?

- What is the role of *essentialia* in the formation of a partnership?
- Explain the legal nature of a partnership.
- Describe the relationships in a partnership.
- Advise on the representation of a partnership.
- Advise on how a partnership is dissolved.

LEARNING UNIT 14

Trusts

Contents

- 14.1 Introduction
- 14.2 Business trusts
- 14.3 Parties to a trust
- 14.4 The trust deed, deed of trust or trust instrument
- 14.5 Types of trusts
- 14.6 Legal nature of trusts
- 14.7 Consequences of a valid trust
- 14.8 How to form a valid trust
- 14.9 Authorisation of trustees
- 14.10 Duties of trustees
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- 14.12 Rights of beneficiaries
- 14.13 Advantages and disadvantages of business trusts
- 14.14 Reflection
- 14.15 Conclusion
- 14.16 Self-assessment questions



PRESCRIBED STUDY MATERIAL

Textbook: chapter 18

- **Case law as discussed in this learning unit and in your prescribed textbook**

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 57 of 1988.
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 (Certain documents representing a reduction to writing of an agreement to establish a trust also qualify as a trust instrument (s 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) who establishes a trust

Important terms	Meaning
Trust beneficiary/ beneficiaries	Person/s stipulated in the trust instrument or trust deed who is/are earmarked to reap the benefits of the trust (The beneficiary may be a legal (juristic person).)
Business trust	A trust that carries on business
<i>Bewind</i> trust	A trust in which the beneficiary owns the trust assets, but the trustee only manages them
<i>Nomine officio</i>	Latin term loosely translated as “in his or her capacity as” (Trust assets vest in trustees only in their official capacity and not in their personal capacity.)

14.1 INTRODUCTION



PRESCRIBED STUDY MATERIAL

Textbook: chapter 18 par 18.1 to 18.3

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 does not involve the complexities and expenses associated with the other two.

A close corporation and company differ from a trust because they are formed by completing and lodging certain statutory forms with the Companies and Intellectual Property Commission (CIPC), and come into existence after registration. A trust is created by a contract or a will or a legal document, commonly referred to as a “trust deed”. A trust is separate from its founder. It never dies or is terminated unless it is terminated by agreement or it is sequestrated if it is unable to pay its debts. These qualities make trusts the only entities that will afford total asset protection and estate duty savings along with a myriad other benefits.

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 is 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 (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 for the benefit of a specified beneficiary.

We briefly set out the legislative principles applicable to trusts as a business form. The focus is on business trusts.

You have now learnt and can explain

- the purpose of establishing a trust
- the difference between a business trust and a company or close corporation.

Now do activity 14.1 to ensure that you understand these principles and are able to apply them.

ACTIVITY 14.1

Explain the advantages of a business trust over a company or close corporation.

FEEDBACK

A business trust can be structured in such a way that it resembles a company or close corporation, with the enjoyment of limited liability, but without being burdened with the complexities and expenses associated with either a company or close corporation: Refer to paragraphs 18.1 to 18.3 in your textbook.

IMPORTANT SECTIONS OF LEGISLATION AND THE COMMON LAW

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

Trusts are mainly regulated by the **Trust Property Control Act 57 of 1988** (“**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:

Prescribed case law

This case you only need to know as discussed in this learning unit:

- *Braun v Blann and Botha NNO* 1984 (2) SA 850 (A)

The **common law** forms the basis of trusts as a business form. As mentioned in *Braun v Blann and Botha NNO*, owing to the fact that many principles related to this business form were derived directly from English law, which is foreign to Roman-Dutch law, there still remain uncertainties regarding the regulation of trusts. This is why it is of utmost importance to ensure that the **trust deed** regulates the proper administration of the trust.

14.2 BUSINESS TRUSTS



PRESCRIBED STUDY MATERIAL

Textbook: chapter 18 par 18.4

Prescribed case law

This case you only need to know as discussed in this learning unit:

- ***Land and Agricultural Bank of South Africa v Parker and Others* 2005 (2) SA 77 (SCA)**

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 the trust instrument in order to be administered for the benefit of beneficiaries. Trusts were designed to protect the defenceless and to safeguard the interests of those who are absent or dead (*Land and Agricultural Bank of South Africa v Parker and Others*).

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 the trust and for carrying out his/her duties to achieve an outcome envisaged in the trust instrument in favour of the trust beneficiaries. A trust, however, 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. A trust instrument is required, which 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 copy 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 shall continue to have jurisdiction notwithstanding any change in the situation of the greater or greatest portion of the trust property.

You have now learnt and can describe

- the purpose of establishing a trust
- the concept of trusts.

Now do activity 14.2 to ensure that you understand these principles and are able to apply them.

ACTIVITY 14.2

What was the primary reason behind the concept of trusts?

FEEDBACK

Refer to paragraph 18.4 in your textbook and ensure that you understand the purpose of a trust, exactly what the consequences are of using a trust for business purposes, and what factors should be taken into consideration prior to taking this decision. Trusts were designed from the very beginning to protect the defenceless (the beneficiaries) and to safeguard the interests of those who are absent or dead (the founder). See *Landbank and Agricultural Bank of South Africa v Parker and Others* in paragraph 18.4 of your textbook.

14.3 PARTIES TO A TRUST



PRESCRIBED STUDY MATERIAL

Textbook: chapter 18 par 18.5

14.3.1 The founder

The founder establishes the trust in the form in which he or she chooses to do so. The founder decides who will be the beneficiaries, what assets will be placed in the trust, and nominates a trustee/s to administer the trust. There is no rule against juristic persons like companies and close corporations being the founders of trusts. The founder can also be a trustee in terms of the trust.

14.3.2 The trustee

The trustee is the person (whether natural or juristic) that administers the trust after his or her appointment. He or she takes control of the trust assets in his or her official capacity and does not acquire any rights to these assets in a personal capacity. There can be more than one trustee. If a trustee is not nominated in the trust deed, or if the person who was nominated declines to take up the position, the court can appoint a trustee.

14.3.3 The trust beneficiary

A trust cannot be formed without a beneficiary. A founder may also identify a class or group of beneficiaries and not a specific person. If a discrepancy exists regarding the identification of a beneficiary, the court can declare a trust valid or void. A founder cannot create a trust that infringes on the human dignity of a certain group or discriminates unfairly.

You have now learnt

- the roles of the main parties in a trust.

Now do activity 14.3 to ensure that you understand these principles and are able to apply them.

ACTIVITY 14.3

Explain the role of each of the main parties to a trust.

FEEDBACK

The founder (also called the donor or settlor) creates the trust; the trustee manages and controls trust property; and the beneficiary is the party on whose behalf the trust is created and managed. Refer to paragraph 18.5 of your textbook.

14.4 THE TRUST DEED, DEED OF TRUST OR TRUST INSTRUMENT**PRESCRIBED STUDY MATERIAL**

Textbook: chapter 18 par 18.6

A trust is created by a document called a trust deed. A trust deed comes either in the form of a contract (for an *inter vivos* trust) or a will of a testator (for a testamentary trust). It constitutes a trust's constitutive charter.

You have now learnt

- how a trust is created.

Now do activity 14.4 to ensure that you understand these principles and are able to apply them.

ACTIVITY 14.4

Distinguish between an *inter vivos* trust and a testamentary trust.

FEEDBACK

An *inter vivos* trust is created during the lifetime of the founder, whereas a testamentary trust is created upon the founder's death. Refer to paragraph 18.6 of your textbook.

14.5 TYPES OF TRUSTS**PRESCRIBED STUDY MATERIAL**

Textbook: chapter 18 par 18.7

The definition as set out in the Trust Property Control Act envisages two kinds of trusts, **ordinary trusts** and **bebind 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 vest in the child, but, until the child attains majority, the trustee controls the trust assets. Do you know of a case like this?

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/her Will.
- *Trusts inter vivos* 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 general public are invited to become income beneficiaries by contributing money or assets to the trust and then issued with certificates as proof of their share.
- *Private trading trusts* are created by private individuals wishing to channel funds towards a business and 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.

You have now learnt

- the different classifications of trusts in South Africa.

Now do activity 14.5 to ensure that you understand these principles and are able to apply them.

ACTIVITY 14.5

List and distinguish between the different kinds of trusts.

FEEDBACK

Refer to paragraph 18.7 of your textbook and make sure you are able to differentiate between the various kinds of trusts.

14.6 LEGAL NATURE OF TRUSTS



PRESCRIBED STUDY MATERIAL

Textbook: chapter 18 par 18.8

A trust is created either by a **contract** (*inter vivos* trust) or through a **will** of a testator (testamentary trust). It must be reduced to writing and its existence evidenced by a document.

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. The trustees cannot, for example, use the trust's assets for their own unilateral benefit the same way they would do if the assets were their own.
- Insolvency of either 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/her private estate.
- The trust deed may provide for the 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.

You have now learnt and can describe

- the legal nature and attributes of trusts.

Now do activity 14.6 to ensure that you understand these attributes and that you are able to apply them.

ACTIVITY 14.6

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. The children approach you as lawyer to advise them on whether a valid trust had come into being after Simphiwe's death. How would you advise them?

FEEDBACK

A trust has to be reduced to writing in the form of a contract or a will. Simphiwe's failure to reduce the arrangement with Sizwe and Taelo to writing means that a valid trust will not come into being when he dies. Refer to paragraph 18.8 of the textbook.

14.7 CONSEQUENCES OF A VALID TRUST



PRESCRIBED STUDY MATERIAL

Textbook: chapter 18 par 18.9

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, as 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 can be ceded or otherwise disposed of.

You have now learnt

- the consequences of a valid trust.

Now do activity 14.7 to ensure that you understand these principles and are able to apply them.

ACTIVITY 14.7

Thuso has been a beneficiary of a business trust for the past five years and he 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 rights in a trust, including discretionary rights. Thuso can, therefore, sell his interest in the trust to Bonolo.

14.8 HOW TO FORM A VALID TRUST



PRESCRIBED STUDY MATERIAL

Textbook: chapter 18 par 18.10

Prescribed case law

This case you only need to know as discussed here:

- *Estate Price v Barker and Price (1905) 22 SC 321 (C)*

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*, 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 that the children were not beneficiaries, as the words in the will only expressed a desire, and not an obligation. The surviving spouse in terms of the will was enabled to use the income to maintain the children, but not obliged. 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 needs to exist and at least one trustee must be appointed either in terms of the trust deed or, alternatively, by the Master. A trust deed must be concluded in writing. If the trust is formed in 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, along with the testator, must sign the testament in which the trust is created, and such witnesses may not be a beneficiary of the will.

You have now learnt

- how a valid trust is formed

Now do activity 14.8 to ensure that you understand these principles and are able to apply them.

ACTIVITY 14.8

Taki intends to create a trust and he is adamant that there is neither a need to have a trust deed or deed of trust nor reduce the intended trust to writing. Advise Taki on the legality of his intended action.

FEEDBACK

The trust should be reduced to writing in a trust deed or deed of trust, otherwise one of the essential elements for the creation of a valid trust will be lacking.

14.9 AUTHORISATION OF TRUSTEES



PRESCRIBED STUDY MATERIAL

Textbook: chapter 18 par 18.11

- **Trust Property Control Act: section 6(1)**

Prescribed case law

These cases you only need to know as discussed in this learning unit:

- *Kropman v Nysschen* 1999 (2) SA 567 (T)
- *Simplex (Pty) Ltd v Van der Merwe and Others* NNO 1996 (1) SA 111 (W)

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, 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, as “there can be no ratification of an agreement which a statutory prohibition has rendered *ab initio* void”.

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.

You have now learnt

- how a trustee is authorised to act on behalf of a trust.

Now do activities 14.9 and 14.10 to ensure that you understand these principles and are able to apply them.

ACTIVITY 14.9

Sam entered into a lease agreement on behalf of Verona trust a 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 after authorisation by the Master can a trustee act as such, which means that Sam's actions for the trust before his formal authorisation are not legally binding. Refer to paragraph 18.11 in your textbook.

ACTIVITY 14.10

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, advise whether Tsepo has acted lawfully or unlawfully. Give reasons for your answer.

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, Tsepo's conduct is lawful.

14.10 DUTIES OF TRUSTEES



PRESCRIBED STUDY MATERIAL

Textbook: chapter 18 par 18.12

- **Trust Property Control Act: sections 9, 11, 16 and 17**

PRESCRIBED CASE LAW

These cases you only need to know as discussed in this learning unit:

- ***Sackville West v Nourse and Another* 1925 AD 516**
- ***Doyle v Board of Executors* 1999 (2) SA 805 (C)**

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/her duties is void. Therefore, it is NOT possible to exempt a trustee from personal liability for failure to comply with his or her duties.

Owing to the fiduciary nature of the trustees' responsibilities, onerous duties are imposed on them.

These duties include the following:

- a duty of care, skill and diligence
- a duty to open a separate trust account at a banking institution
- a duty to indicate in his or her bookkeeping the property held as trustee
- a duty to register trust property as such
- a duty to make trust and trust investment accounts identifiable as such
- a duty to keep all documents as proof of investments for five years
- a duty to protect and conserve trust property and collect debts in favour of the trust diligently
- a duty to observe good faith in dealing with trust property
- a duty 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/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 kind of business concerned. In *Sackville West v Nourse and Another*, it was held that part of this duty entails not exposing trust assets to undue risk. An unsecured loan or a loan in respect of which the repayment is below the ordinary market rate would not be considered a sound investment.

In *Doyle v Board of Executors*, 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 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.

You have now learnt and can describe

- the duties of a trustee
- whether or not trustees can be exempted from complying with their duties.

Now do activity 14.11 to ensure that you understand these principles and are able to apply them.

ACTIVITY 14.11 _____

Samuel is asked to act as a trustee of the Jordan Family Trust. He asks you for advice regarding the duties that such an appointment would entail. Advise Samuel.

FEEDBACK

Refer to paragraph 18.12 of your textbook to familiarise yourself with the various duties imposed on a trustee.

14.11 **POWERS OF TRUSTEES**



PRESCRIBED STUDY MATERIAL

Textbook: chapter 18 par 18.13

Every trust is formed for a specific purpose. A trustee enjoys the powers inferred inherently in the kind 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 can incur personal liability.

You have now learnt and can describe

- the powers of trustees

Now do activity 14.12 to ensure that you understand these principles and are able to apply them.

ACTIVITY 14.12 _____

Sebo is asked to act as a trustee of the Davhana Family Trust. She asks you for advice regarding the source of her powers as a trustee. Advise Sebo.

FEEDBACK

Refer to paragraph 18.13 of your textbook for a discussion on the powers of trustees.

14.12 RIGHTS OF BENEFICIARIES



PRESCRIBED STUDY MATERIAL

Textbook: chapter 18 pars 18.9 and 18.14

Every trust must have an identifiable beneficiary.

You have now learnt and can describe

- the rights of beneficiaries

Now do activity 14.13 to ensure that you understand these principles and are able to apply them.

ACTIVITY 14.13

Shepherd asks you for advice regarding the validity of trust deed or deed of trust that does not identify any beneficiary instead it only states that it is formed to benefit “*all people that love me*”. Advise Shepherd.

FEEDBACK

Refer to paragraph 18.14 of your textbook for a discussion on the importance of ensuring that beneficiaries are identifiable.

14.13 ADVANTAGES AND DISADVANTAGES OF BUSINESS TRUSTS



PRESCRIBED STUDY MATERIAL

Textbook: chapter 18 in general

The **advantages** of a business trust are

- ease of formation
- limited liability
- extreme flexibility
- continuity.

Although it is not mentioned in the textbook, it can also be viewed as an advantage of a business trust that the trustees are restricted to acting within the specific bounds as laid down in the trust deed.

The **disadvantages** of a business trust are

- limited access to capital (which is usually obtained by means of loans for which security is provided)
- the potential for conflict between parties

Trusts enjoy many benefits – what do you think some of these benefits are?

The **benefits** of a business trust are as follows:

- The formation of a trust is cheap.
- There is no complex legislative structure.
- Trusts enjoy limited liability.

There are different parties to trusts: 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 recognition of trusts as juristic persons in the Companies Act is not a general recognition, but only applies in respect of the provisions of the specific legislation in so far as it impacts on business trusts.** 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: 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, a trust can enjoy perpetual existence if all the conditions in the trust deed and relevant legislation are adhered to. 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, as they have a 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 must set out the powers of the trustees. There is very little regulation of trusts when compared with the regulation of other enterprise forms. The lack of certainty in the 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 a company or close corporation. Its disadvantage is the danger of being deemed a partnership owing to the two entities often sharing similar elements. A business trust can be structured in such a way that it resembles a company or close corporation, including the enjoyment of limited liability, but without being burdened with the complexities and expenses associated with either a company or close corporation.

14.14 REFLECTION

You should reflect on how and for what purpose a trust is created and whether it is created for a general or specific purpose. You should further reflect on the effect that a **trust instrument** has on trustees' functions in relation to the trust assets and also on the role that the Master of the High Court plays in directing trustees with regard to the performance of their duties.

14.15 CONCLUSION

You should now understand the concept of trusts, in particular the essential elements relating to trusts in general as background to a specific type of trust, namely, a business trust. Trusts enjoy many benefits – the formation is cheap, there is no complex legislative structure and trusts enjoy limited liability. You have learnt the different parties to trusts, namely, the founder, trustee and the beneficiary. You should also know how trusts are formed, how they function and what the powers and duties of trustees entail.

A business trust does not acquire separate legal personality upon formation. You have to understand the advantages and disadvantages of trusts as a form of conducting business. It is evident that the use of a trust as a form of conducting business has many implications.

14.16 SELF-ASSESSMENT QUESTIONS

- What is meant by a trust and how is it created?
- What is the nature of a business trust?
- Who are the parties to a trust?
- What are the different kinds of trusts?
- What are the essential elements of a trust?
- How does one ascertain the powers of a trustee and rights of a beneficiary?
- What are the duties and obligations of a trustee?
- What are the advantages and disadvantages of business trusts?