

Department of Mercantile Law



# Company Law

Only study guide for LML4806

University of South Africa, Pretoria

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**TABLE OF CONTENTS**

	<i>page</i>
Role of the Study Guide.....	iv
Learning Unit 1 .....	5
Learning Unit 2 .....	11
Learning Unit 3 .....	20
Learning Unit 4 .....	27
Learning Unit 5 .....	32
Learning Unit 6 .....	45
Learning Unit 7 .....	51
Learning Unit 8 .....	54
Learning Unit 9 .....	65
Learning Unit 10 .....	69
Learning Unit 11 .....	71

## **Role of the Study Guide**

### **STUDENTS WHO CANNOT ACCESS THE INTERNET ON A REGULAR BASIS**

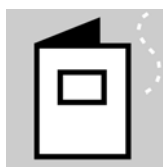
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## LEARNING UNIT 1

# Shareholders and company meetings

This learning unit deals with the provisions of the Companies Act 71 of 2008 (hereinafter referred to as “the Companies Act” or “the Act”) relating to the types and convening of meetings, voting rights, and resolutions at meetings of shareholders.



**Study the prescribed sections in Chapter 11 of your prescribed textbook.**

**Study sections 58 to 65 and section 66(1) of the Companies Act.**

## 1.1 INTRODUCTION AND DEFINITIONS

Section 11.2 of the prescribed textbook

Section 66(1) of the Companies Act

Section 66(1) of the Companies Act provides that the business of the company must be managed by, or under the direction of, its board, which has the authority to exercise all the powers and perform any of the functions of the company, except to the extent that the Act or the company’s Memorandum of Incorporation (MOI) provides otherwise. The directors therefore have a duty to manage the company, but shareholders retain control over the directors by their power to appoint and remove directors. Some important decisions taken by directors must also be approved by the shareholders.

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

- What is a record date?
- What kinds of meetings can be held by a company?
- Why and how are the meetings convened?
- What is representation by proxy?
- Which decisions require a special resolution?
- How do shareholders exercise their voting rights?

This learning unit is based on the following structure:

- record date
- calling of shareholders’ meetings
- notice of meetings
- postponement and adjournment of meetings
- representation by proxy
- quorum
- conduct of meetings
- majority rule
- some exceptions to applicable rules and formalities
- shareholders acting other than at a meeting
- annual general meeting
- convening a meeting in special circumstances
- decisions of shareholders and others

## **1.2 RECORD DATE**

Section 11.3 of the prescribed textbook  
Section 59 of the Companies Act

The board of directors may set a record date for determining the right of shareholders regarding the following:

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

## **1.3 CALLING OF SHAREHOLDERS' MEETINGS**

Section 11.7 of the prescribed textbook  
Section 61 of the Companies Act

Note that the directors or other person specified in the MOI may call a meeting at any time, but there are circumstances in which a meeting must be called.

## **1.4 NOTICE OF MEETINGS**

Section 11.8 of the prescribed textbook  
Sections 62 and 63(2) of the Companies Act

A company may provide for participation in a shareholders' meeting by electronic communication. If this is allowed, the notice convening the meeting must inform the shareholders or their proxies that electronic participation is possible. The costs of electronic participation are borne by the relevant shareholder.

Note the conditions under which a meeting may proceed if the company did not give notice or the notice was defective. Also note that a shareholder is deemed to have received or waived notice of the meeting merely by being present at the meeting.

## **1.5 POSTPONEMENT AND ADJOURNMENT OF MEETINGS**

Section 11.13 of the prescribed textbook  
Section 64(4)–(13) of the Companies Act

A meeting may be postponed for a week without a motion, vote or further notice if there is no quorum present. 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.

## **1.6 REPRESENTATION BY PROXY**

Section 11.5 of the prescribed textbook  
Section 58 of the Companies Act

A proxy is defined as a person appointed by a shareholder in order to represent such a shareholder at a meeting.

The appointment of a proxy is subject to the following conditions:

The appointment must be in writing and must be signed by the shareholder.

- It is valid for one year.
- A proxy may be appointed for a specific period of time.
- The appointment may be for two or more persons concurrently exercising voting rights for different shares.
- A proxy may delegate authority to act on behalf of the shareholder to another person.

- A copy of the proxy appointment form must be delivered to the company before the shareholders' meeting.
- A shareholder is not compelled to make an irrevocable proxy appointment. A shareholder may alter the proxy appointment by cancelling it in writing, appointing another proxy and delivering a copy of the revocation to the proxy and the company.

## 1.7 QUORUM

Section 11.12 of the prescribed textbook

Section 64 of the Companies Act

Note that, in terms of section 64(1), a quorum is required for the meeting to begin, as well as for the consideration of each specific matter. An aggregate of at least 25% of all the voting rights that are entitled to be exercised in respect of at least one matter to be decided in a meeting must be present before the meeting may start.

## 1.8 CONDUCT OF MEETINGS

Sections 11.9 and 11.10.1 of the prescribed textbook

Section 63 of the Companies Act

Note the difference in the number of votes that may be exercised, depending on whether voting takes place by a show of hands or through a poll. The prescribed textbook states that a person who abstains or fails to exercise his or her 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. The requirements for both a special and an ordinary resolution clearly state that the required percentage of votes **exercised** on the resolution must be in favour of the resolution before it can be validly adopted. Therefore, only the votes of shareholders who actually exercise their votes are taken into consideration.

## 1.9 MAJORITY RULE

When a person becomes a shareholder in a company he agrees to be bound by the decisions of the majority. 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 18, which is not prescribed for this module.

## 1.10 SOME EXCEPTIONS TO APPLICABLE RULES AND FORMALITIES

Sections 11.4.2, 11.4.3, 11.10.2 and 12.6.2 of the prescribed textbook

Section 57(2)–(6) of the Companies Act

Three possible situations are discussed under this heading. Briefly summarised, they are the following:

- (1) 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.
- (2) A profit company (other than a state-owned enterprise) with only one director:
  - The director may exercise any power or perform any function of the board at any time, except when the MOI provides otherwise.

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

The court in *Pender v Lushington* (1877) 6 ChD 70 stated that shareholders, unlike directors, do not have to exercise their voting rights for the benefit of the company and can act entirely in their own interests. A shareholder has a right to have his or her vote recorded, even if that vote made no difference to the final results.

## 1.11 SHAREHOLDERS ACTING OTHER THAN AT A MEETING

Sections 11.4.1 and 11.15 of the prescribed textbook  
Section 60 of the Companies Act

The Companies Act 61 of 1973 provided that a particular annual general meeting need not be held if all the members who were entitled to attend such a meeting consented in writing. In such a case, any resolution that would have been dealt with at that meeting would also have been deemed to be valid if it was in writing and signed by all the members entitled to vote at that meeting. Otherwise, resolutions had to be taken at properly constituted members' meetings.

However, in English and South African case law, the common law rule of unanimous assent was accepted. In terms of this rule, certain decisions may be valid without a meeting being held if all the members are fully aware of the facts and they have all assented thereto, which assent need not be in writing. In *Gohlke and Schneider v Westies Minerale (Edms) Bpk* 1970 (2) SA 685 (A), the court held that members may validly appoint a director to the board without any formal meeting having been held if there is evidence of their unanimous consent. The court in *In re Duomatic Ltd* [1969] 1 ALL ER 161 (Ch) held that the unanimous approval of directors' remuneration by the two directors holding all the voting shares in a company could be regarded as a resolution of a general meeting approving the payment.

The situation has now been changed by the Act. 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). This means that the unanimous assent of all shareholders will no longer be necessary. However, any business of a company which, in terms of the Act or the company's MOI, must be conducted at an annual general meeting may not be conducted by using this procedure.

## 1.12 ANNUAL GENERAL MEETING

Section 11.6 of the prescribed textbook  
Section 61(7)–(10) of the Companies Act

In terms of the Companies Act 61 of 1973, every company was compelled to convene an annual general meeting at the times prescribed by that Act, unless all the members who were entitled to attend the meeting agreed in writing that the meeting need not be held. In terms of the Companies Act, only public companies have a statutory obligation to convene annual general meetings.

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

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



### **1.13 CONVENING MEETINGS IN SPECIAL CIRCUMSTANCES**

Section 11.7.3 of the prescribed textbook  
Section 61(11)–(12) of the Companies Act

Two different situations are discussed 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. The second situation is regulated by section 61(12). Here 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.

### **1.14 DECISIONS OF SHAREHOLDERS AND OTHERS**

Section 11.14 of the prescribed textbook  
Section 65(7)–(11) of the Companies Act

Like the Companies Act 61 of 1973, the Act (in s 65(7) and (9)) provides for two types of resolution that may be taken at a shareholders' meeting, namely an ordinary resolution, requiring more than 50% of the votes exercised, and a special resolution, requiring at least 75% of the voting rights exercised. The important difference is that the Act 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 10% between the percentages required for an ordinary and a special resolution. A special resolution is compulsory for certain resolutions stipulated in the Act, but may also be required by the MOI.

## LEARNING UNIT 2

# Directors, board committees and the company secretary



Study the prescribed sections in Chapters 12 and section 15.9 of the prescribed textbook.

Study sections 1, 66, 67, 68, 69, 71, 72, 73, 75, 76, 78, 85, 86, 87, 88, 89 and 162 of the Companies Act.

## 2.1 INTRODUCTION

Section 12.1 of the prescribed textbook

In **Learning Unit 1**, you were introduced to one of the organs of a company, namely the general meeting of shareholders. The shareholders of a company exercise their rights and the functions entrusted to them by the Companies Act 71 of 2008 (hereinafter referred to as “the Companies Act” or “the Act”) or the Memorandum of Incorporation (MOI) by adopting resolutions at the meeting of shareholders. In **Learning Unit 2**, we will introduce the other main organ of the company, namely the board of directors (all the directors acting collectively). The functions and responsibilities of a company director arise by virtue of the nature of the company. As you know, a company is a legal entity which exists separately from its management and shareholders. Since the company cannot act on its own behalf, company acts are carried out by representatives. These representatives could act either as organs or agents (representatives in the strict sense of the word). The board of directors is one of the organs through which the company acts. We will also introduce you to one of the office-bearers of a company, namely the manager of a company.

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

- What are the legal position of a company director and the board of directors? What are the different types of directors?
- What is the difference between directors and managers?
- Who are ineligible to become directors or disqualified from becoming directors?
- How are directors appointed and removed?
- How are meetings of the board of directors conducted? How are company secretaries appointed?
- What are the duties of company secretaries?

## 2.2 MEANING OF THE WORD “DIRECTOR”, TYPES OF DIRECTOR AND BOARD COMPOSITION

Sections 12.2 of the prescribed textbook

Sections 1 (definition of a director), 66(4)(a)(i–iii), 66(4)(b) and 68 of the Companies Act

A director is a member of the board of a company and the term includes any person occupying the position of a director or alternate director, by whatever name designated. 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 or holding office in accordance with the provisions of section 66 of the Companies Act.

For the purposes of section 75 (director's personal financial interest), section 76 (standards of directors' conduct) and section 77 (liability of directors and prescribed officers), the Companies Act includes as a director all of the following:

- directors
- alternate directors
- a prescribed officers
- members of board committees

The word "director" must therefore be applied in a much broader sense than at first appears. The business and affairs of a company are managed by, or at the discretion of, the board. They have the authority to exercise all the powers and perform any of the functions of the company. This is, however, subject to the provisions of the Act or a company's MOI. The powers of the board of directors may therefore be limited by the Act or a company's MOI.

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

- an *ex officio* director
- An MOI-appointed director
- an alternate director
- an elected director
- a temporary director who is appointed in order to fill a vacancy

The Companies Act furthermore endorses a unitary board structure. This means that a company's board should consist of both executive directors and non-executive directors. As a rule, "non-executive" directors attend and vote at board meetings, but do not work full-time for the company and have no service contract, whereas "executive" directors have a service contract in terms of which they work for the company in a full-time capacity.

You should note, however, that the court in *Howard v Herrigel* 1991 (2) SA 660 (A) held that it is unhelpful or even misleading to classify company directors as "executive" or "non-executive" for **purposes of determining their duties** to the company or when any specific or affirmative action is required of them. Once a person accepts an appointment as a 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.

Two categories of de facto directors may be distinguished. In the first instance, there are persons who act as directors without having been appointed as such in the manner prescribed by the MOI. The controllers behind nominee directors are included in this category, although, internally, they are not regarded as directors. They are not, for example, entitled to directors' remuneration and, should the MOI permit an ordinary director to convene an extraordinary general meeting, a de facto director will not be able to do so. The second category of de facto directors consists of people who have been appointed to the office of director, although their qualifications or the particulars of their appointment do not comply with the requirements. These persons are legally also not directors, although some of them are treated as such. Their actions prior to the discovery of the defect in their appointment or qualifications are nonetheless valid.

## 2.3 DIRECTORS AND MANAGERS

Sections 12.5.1 and 12.5.2 of the prescribed textbook

There are many differences between being a director and being a manager. A **manager** is an **employee** of a company, whereas a **director does not have to be an employee**. Managers and directors also fulfil different functions regarding leadership, decision making, and their respective duties and responsibilities. The board of directors, for example, is responsible for the leadership and direction of a company, whereas the task of the managers is to carry out the strategy on behalf of the directors. Further, directors are responsible for organisational decision-making, whereas managers are concerned with the implementation of such decisions and policies.

A **managing director** is usually entrusted with the power to transact the whole, or a material part, of the company's affairs and to do everything necessary for that purpose.

## 2.4 NUMBER OF DIRECTORS AND CONSENT

Section 12.16.1 and 12.7.3 of the prescribed textbook  
Section 66(11) of the Companies Act

In terms of the Companies Act, the different types of companies are each required to have a certain minimum number of directors. The minimum number of directors for a public or non-profit company stipulated in section 66(2) is in addition to the minimum number of directors required to appoint an audit committee (which must consist of at least three non-executive directors).

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 a written consent accepting such position.

## 2.5 DIRECTORS: MEMORANDUM OF INCORPORATION MAY VARY CERTAIN PROVISIONS OF THE COMPANIES ACT

Sections 66(2)(a) and (b), 66(4)(a)(ii–iii), 66(10) and 66(11) of the Companies Act

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

## 2.6 INELIGIBLE AND DISQUALIFIED PERSONS

Section 12.11 of the prescribed textbook  
Sections 69 of the Companies Act

Certain people are **ineligible** to be appointed as directors of a company and certain others are **disqualified**.

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

If a person is **disqualified** from being appointed as a director, this means that, with the exception of a person who has been prohibited from being a director by a court of law, a person may still be appointed as a director of a company with the permission of the court. The other disqualifications are thus **not absolute**, because the court has a discretion, on application, to allow such disqualified persons to be appointed as directors.

## 2.7 DIRECTOR DISQUALIFICATIONS: EXEMPTIONS

Section 12.11.7 of the prescribed textbook  
Sections 69(8)(b) and 69(11) of the Companies Act

Section 69(11) gives a court a discretion to exempt certain disqualified persons.

## 2.8 APPLICATION TO DECLARE A PERSON DELINQUENT OR UNDER PROBATION

Section 12.12 of the prescribed textbook  
Section 162 of the Companies Act

The power given to a court to declare a director either delinquent or under probation was introduced into South African company law for the first time by the Companies Act. This is in addition to the power of the courts to prohibit a person from being a director, for which the Companies Act 61 of 1973 made provision and the Companies Act now also provides. 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, 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 that the court considers appropriate, such as a designated remedial programme. Refer to your textbook for a summary of who may apply to court, the grounds for application, the order sought, and the effect of the order.

## **2.9 Suspending and setting aside orders of delinquency**

Section 12.12.5 of the prescribed textbook

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

## **2.10 FIRST DIRECTORS OF A COMPANY**

Section 12.7.1 of the prescribed textbook

Section 67 of the Companies Act

You already know that, for different types of companies, a minimum number of directors is required for the specific type of company concerned (refer to section 12.6.1 of your textbook). On 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.

## **2.11 VACANCIES ON THE BOARD**

Section 12.13.1 of the prescribed 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. For a list of the circumstances in which a vacancy on the board may arise, refer to section 12.13.1 of your textbook.

## **2.12 FILLING OF VACANCIES**

Section 12.13.2 of the prescribed textbook

Section 70 of the Companies Act

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 Act.

## **2.13 REMOVAL OF DIRECTORS**

Section 12.14 of the prescribed textbook

Section 71 of the Companies Act

A director can be removed by shareholders and, in some circumstances, by the board of directors.

## **2.14 BOARD COMMITTEES AND THE AUDIT COMMITTEE**

Section 12.18.1–12.18.3 of the prescribed textbook

Section 72 of the Companies Act

The board of directors may, except to the extent that an MOI provides otherwise, appoint committees and may delegate any of the functions of the board to such committees. Note, however, 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 section 72(4) of the Companies Act, prescribe that a certain category of companies must have a social and ethics committee. The functions and rules of this committee will be prescribed by regulation.

Section 94(2) of the Companies Act requires that, at each annual general meeting, a public company, a state-owned company or any other company which is required by its MOI to have an audit committee must appoint an audit committee for every financial year. The audit committee must have at least three members and must consist only of non-executive directors of the company who have not been involved in the day-to-day management of the company in the preceding three financial years. (You will find a list of the functions of an audit committee in Chapter 15, section 15.8.2, of your textbook.)

## **2.15 BOARD MEETINGS**

Section 12.19–12.20 of the prescribed textbook  
Section 73 of the Companies Act

Board meetings may be called by directors who are authorised to do so. 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 taken. Every director has one vote per meeting, while the chair has a casting vote in the event of a tie. Minutes of all decisions and any resolution taken by the board at a meeting must be kept.

Note that, just as in the case of shareholders' resolutions, a board may adopt a decision without having a meeting if each director received notice of the matter and there is the required majority vote in writing in favour of the decision.

## **2.16 THE MANDATORY APPOINTMENT OF A COMPANY SECRETARY**

Sections 12.5.4 and 15.9.1–15.9.2 of the prescribed textbook  
Sections 86–89 of the Companies Act

The company secretary is the chief administrative officer of his or her company. A public company or state-owned enterprise (see s 8 of the Companies Act for the different categories of companies) is obliged to appoint a company secretary who is knowledgeable about, or experienced in, the relevant laws, while other companies are not obliged to have a company secretary but may appoint one.

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 (s 86(4)).

It is also possible for a body corporate or a partnership to be appointed to serve as company secretary. This can be done provided that every employee of that juristic person or partner or employee of that partnership is not disqualified from being appointed company secretary.. Every company secretary must be a permanent resident of the Republic and must remain a permanent resident while serving in that capacity (s 86).

A company secretary is an employee of the company and is accountable to the company's board. The exact nature of his or her duties depends on the terms of his or her employment contract, but must include the duties stated in section 88 of the Companies Act. Item (v) on the list of a company secretary's duties as stated in section 15.9.2 of the textbook is a reference to the duty of every company to file an

annual return (not to be confused with a company's annual financial statements) containing certain prescribed information (s 33). Section 33(3) provides that every company must designate a director, employee or other person as the company's compliance officer in this annual return. In the case of a company with a company secretary, the company secretary would automatically be the compliance officer.

The board of directors can adopt a resolution to remove a company secretary. A company secretary may insist that a statement setting out the company secretary's contention as to the circumstances be included in the annual financial statements relating to that financial year. A company secretary may resign from office by giving one month's notice, or less than one month's notice with the approval of the board.

## **2.17 REGISTRATION OF SECRETARIES AND AUDITORS**

Sections 15.9.3 and 15.9.4 of the prescribed textbook  
Section 85 of the Companies Act

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 service of the appointee, with the Registrar within ten business days of the appointment or termination, as the case may be. Section 85(4) allows the incorporators of a company to file a notice of the appointment of the company's first company secretary as part of the company's Notice of Incorporation.

### **Reflection**

You have seen that the ownership of a company is vested in the general meeting of members (Learning Unit 1) and that the control of the company is vested in the board of directors. Do you think it is a good principle to separate ownership and control, or should the members of the company also manage the company? 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 have a right to share in those assets should the company be wound up. You will learn more about membership and shareholders in Learning Unit 1.

## LEARNING UNIT 3

# Duties of directors



Study the prescribed sections of Chapter 14 of your prescribed textbook.  
Study sections 75 to 78 of the Companies Act.

### 3.1 INTRODUCTION

In this learning unit, we will explain the duties of directors.

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

- What is meant by the partial codification of directors' duties?
- What do fiduciary duties entail?
- What is meant by the duty of reasonable care? What is meant by a conflict of interests?
- What does acting in good faith and with a certain degree of care, skill and diligence entail?
- Under what circumstances may directors and prescribed officers be held liable for losses incurred by the company?
- What is the business judgement rule and what does it entail?
- To whom do indemnification and directors' insurance apply?

### 3.2 DUTIES OF DIRECTORS

Section 14.1 of the prescribed textbook  
Sections 75, 76, 77 and 78 of the Companies Act

Under the Companies Act of 1973, the duties of directors were found mainly in common law and in Codes of Corporate Practice such as the King Report. The common law position is that directors have a fiduciary relationship with the company. This relationship applies to all directors of companies. In *CyberScene Ltd and Others v i-Kiosk Internet and Information (Pty) Ltd* 2000 (3) SA 806 (C) the court confirmed that even non-executive directors have a fiduciary relationship with the company. It must be noted that a director's fiduciary duty is owed to the company itself and not to the other directors or to other individuals within the company.

At common law, directors are subject to a fiduciary duty to act in good faith and in the best interests of the company, as well as the duty to exercise their powers with care and skill.

The fiduciary duties of a director generally entail:

- avoiding a conflict of interest between the director's personal interests and the interests of the company;
- not exceeding the limitations of his or her power;
- maintaining an unfettered discretion and
- exercising his or her powers for the purpose for which they were conferred.

The Companies Act 71 of 2008 has introduced a partly codified regime of directors' duties, which includes duties similar to the common law fiduciary duties and the duty to perform their functions with reasonable care and skill. However, the common law is not excluded by the statutory provisions and will continue to apply, except where it is specifically amended by the Act or is in conflict with a provision of the Act.



**Note that, for purposes of the codified duties, the term “director” is extended in such a way that it includes**

- an alternate director
- a prescribed officer
- a person who is a member of a committee of a board of the company or of the audit committee of a company regardless of whether the person is also a member of the company’s board

**Note, further, that the codification of the duties of directors does not mean that the directors no longer have common law duties. The codified duties are not intended to serve as a replacement for the common law duties. When interpreting the Act, courts will continue to take into consideration the common law and court decisions made before the Act came into being.**

There are two distinct methods of codification. The first method involves complete codification. When there is complete codification, the codified rules must be rigidly adhered to. They replace the common law and leave no room for further development. The second method is partial codification. When partial codification occurs, the codified rules and the common law rules are both recognised. This flexibility leaves room for further development of the law.

**Note that the codification of directors’ duties as found in the 2008 Act amounts to a partial codification of company law.**

### 3.2.1 Standards of directors’ conduct

Section 14.3–14.4 of the prescribed textbook  
Sections 75–76 of the Companies Act

**Briefly summarised, the newly codified duties of directors as they appear in the Companies Act of 2008 are the following:**

- (1) to disclose to the board any personal financial interest in matters in which the company has a material interest (s 75)
- (2) not to use the position of director, or information obtained while acting in the capacity of a director, to gain an advantage for himself/herself or another person, or to knowingly cause harm to the company or a subsidiary (s 76(2)(a))
- (3) to disclose to the board of directors any material information that comes to the director’s attention (s 76(2)(b))
- (4) to act in good faith and for a proper purpose (s 76(3)(a))
- (5) to act in the best interests of the company (s 76(3)(b))
- (6) to act with a reasonable degree of care, skill and diligence (s 76(3)(c))

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

Sections 14.4.2 and 14.6 of the prescribed textbook  
Sections 75 and 76(2) of the Companies Act

As stated above, a director has a fiduciary relationship with the company and must avoid making use of company information for his or her own benefit. A director must also avoid causing harm to the company.

Section 75 of the Act provides for the disclosure of directors’ financial interests if they 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 in which the company has a material interest, to the shareholders and obtain

their prior approval by way of 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 this director may then not be present at the meeting 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. Such disclosure should be made by means of a written notice. The notice must explain the nature and extent of the interest.

**Note that this notice will continue to be valid until such time as it is changed or withdrawn by the director.**

Moreover, there is a possibility of a director having a personal financial interest in a matter to be discussed at a meeting of the board of directors or he or she may be aware of the fact that a related person has a personal financial interest in the matter. In such a situation, section 75 provides that the director must

- disclose the interest and its general nature **before** the matter is considered at the meeting
- disclose material information relating to the matter that he or she is **aware of if required** to do so by the other directors, and may disclose any observation or pertinent insights relating to the matter.

In terms of section 75, once a director has made the disclosures, he or she must leave the meeting and must be excluded from participating in the consideration of that particular matter. Although the director will be regarded as being present for other purposes of the meeting, when it comes to determining whether a resolution has sufficient support to be adopted, the director will not be regarded as being present.

The director is prohibited from executing any document on behalf of the company in relation to the matter unless; he or she has been specifically requested or directed to do so by the board of directors.

Section 75(6) caters for situations where a director or a person related to the director acquires a financial interest in an agreement or other matter in which the company has a material interest, after the company has approved the agreement or other matter. In such a case, the director is obliged to disclose

- the nature and extent of his or her financial interest
- the material circumstances relating to the director or related person's acquisition of that interest

The director's financial interest must be promptly disclosed to the board of directors or to the shareholders.

The validity of a decision by the board or of an agreement approved by the board is not affected by the personal interest of a director or of a person related to the director, provided that there is approval or ratification by an ordinary resolution of the shareholders.

Where a director has failed to comply with the disclosure requirements in section 75, any interested person has the right to make an application to the court for an order declaring that the transaction or agreement that has been approved by the board or by the shareholders is valid.

The following are the circumstances in which the provision dealing with the disclosure of personal financial interests does not apply:

- (1) It is not applicable to a director of a company with regard to a decision that may have an effect on
  - all the directors of the company in their capacity as directors, or
  - a class of persons, despite the fact that the director is one of the members of the class of persons, unless the only members of the class are the director or persons related to the director.

- (2) It is also not applicable to a director of a company with regard to a proposal to remove that director from office as contemplated in section 71.
- (3) It does not apply to a company or its director if one person holds all the beneficial interests of all the issued securities of the company and is the only director of that company.

Where a person is the only director of a company, but does not hold all the beneficial interests of all the issued securities of the company, such a person may not approve or enter into any agreement in which he or she or a related person has a personal financial interest, or as a director determine any other matter in which the person or a related person has a personal financial interest unless an ordinary resolution of the shareholders approves the agreement or determination, after the director has disclosed the nature and extent of that interest to the shareholders.

Section 76(2)(a) of the Act prohibits the abuse of his or her position by a director. It protects information that a director has access to while acting as a director. A director is prohibited from making use of information obtained by virtue of his or her office, for his or her own personal gain or for another person's benefit. Section 76(2) also states that a director should avoid knowingly causing harm to the company or to its subsidiary.

**Note that section 76(2)(b) states that a director must communicate to the board at the earliest practicable opportunity any information that comes to the director's attention. It further states that he or she need not do so if he or she reasonably believes that the information is immaterial to the company, is generally available to the public or is known to other directors. Where there is a legal or ethical obligation of confidentiality that prevents the director from making a disclosure, he or she is also not obliged to disclose the information.**

### 3.2.3 Fiduciary duty and duty of care, skill and diligence

Sections 14.3 and 14.5 of the prescribed textbook

Section 76(3) of the Companies Act

The discussion in the textbook confirms that a director is under a fiduciary duty and a duty to act with care, skill and diligence. This means that a director has to act in good faith and for a proper purpose, and in the best interests of the company. Whereas the duty to act in the best interests of the company speaks for itself, the duty to act for a proper purpose possibly needs some explanation. This is one of the fiduciary duties recognised in terms of our common law as well and requires that directors should use their powers for the real purpose for which these powers were conferred. One example of a breach of this duty that has often occurred 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, namely to obtain more capital for the company.

As previously stated, a director is expected to exercise his or her powers and to perform his or her functions in good faith and in the best interests of the company. This is a common law principle which has been partially codified in the Act. The Act requires a director to exercise a degree of care, skill and diligence that may reasonably be expected of a person performing the functions of a director. A director is expected to take reasonably diligent steps to ensure that he or she is informed about a particular matter.

**The test used to determine what a reasonable director would have done in the same circumstances is both an objective and a subjective test, because it takes into account issues such as the general knowledge, skill and experience of that particular director.**

### 3.2.4 The business judgment rule

Section 14.5.4 of the prescribed textbook

Section 76(4) of the Companies Act

The Companies Act introduces what is called the **business judgment rule (s 76(4))**. This provision 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 had no reasonable basis to know that any related person had a personal financial interest in the matter, or disclosed his or her interests
- made, or supported, a decision in the belief that it was in the best interests of the company

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.

**Note the list of persons and bodies in section 14.5.3.2 of the textbook and sections 76(4)(b) and 76(5) of the Companies Act on whom a director may rely for information.**

### 3.2.5 Liability of directors

Section 14.9 of the prescribed textbook

Sections 22(1), 44, 45, 47, 48 and 77 of the Companies Act

A director may be held liable for loss or damages suffered, or costs incurred, by the company in the following circumstances:

- For a breach of the first five duties in the list (see 3.2.1 above). 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.
- Where the director acted without authority, while knowing that he or she lacked the necessary authority.
- The director took part in an act or omission in the knowledge that it was intended to defraud another.
- The director signed, agreed to or provided authority for the publication of false or misleading financial statements.
- The director signed, agreed to or authorised the publication of a prospectus or a written statement containing an untrue statement or a statement to the effect that consent had been given by a person as a director of the company, when such consent had not been given and the director was aware of this.
- Where a director took part in a meeting or in the making of a decision in which formalities prescribed by the Act were not complied with.
- Where a director, despite having knowledge that shares were not authorised, failed to vote against the issuing of any unauthorised shares.
- Where the director, despite knowing that securities did not comply with the provisions of the Act, took part in the issuing of the unauthorised securities.
- Where the director took part in the granting of options to any person, while knowing that any shares for which the options could be exercised or into which securities could be converted had not been authorised.
- Where the director participated in a decision to grant financial assistance to any person for the acquisition of securities of the company in the knowledge that the provision was in contravention of section 44 of the Act or of the Memorandum of Incorporation (MOI). In terms of section 44, a

company may provide financial assistance if the solvency and liquidity of the company allows for this.

- Where the director is provided with financial assistance or with a loan in direct contravention of section 45 of the Act or the company's MOI.
- Where the director participated in a resolution approving a distribution despite knowing that the distribution was contrary to the provisions of section 46.
- Where there is an acquisition by the company of its shares, or the shares of its holding company, in contravention of sections 46 and 48.
- Where there is an allotment of shares in contravention of Chapter 4 of the Act.

**Note that the director is held jointly and severally liable with any other person who is, or may be, liable for the same act.**

The company must see to it that the proceedings to recover loss, damages or costs are commenced within three years of the act or omission giving rise to liability.

**Note that in any proceedings against a director, except for wilful misconduct or wilful breach of trust, the court may exercise its discretion and relieve the director wholly or partly from any liability or on any terms the court considers just. It may relieve the director from liability if it is apparent that the director has acted honestly and reasonably. A director is free to approach the court for relief.**

### 3.2.6 Indemnification and directors' insurance

Section 14.7 of the prescribed textbook

Section 78 of the Companies Act

A company may not indemnify a director in respect of liability arising out of certain circumstances such as a breach of his or her fiduciary duties. For a discussion of the circumstances in which a company may not indemnify a director, see sections 14.7.3 and 14.7.4.1 of your textbook. Indemnity insurance may also not be taken out for such circumstances.

Except to the extent that a company's MOI provides otherwise, a company is allowed to advance expenses to a director for purposes of defending litigation in any proceedings that may result from the director's service to the company.

Section 78 also allows a company to take out indemnity insurance to protect the director against any liability or expenses for which the company is permitted to indemnify a director, or to protect itself against any expenses that the company is permitted to advance to a director or for which the company is allowed to indemnify a director.

**Note that indemnification and directors' liability as provided for in section 78 apply to current and former directors of companies.**

**Note that, where a company has paid money, directly or indirectly, to or on behalf of a director of the company or of a related company in a manner which is not consistent with the above-mentioned restrictions, the company may claim restitution from the director.**



## Reflection

In this learning unit, you learnt about the duties of directors. The partial codification of the duties provides clarity with regard to certain aspects of directors' duties. The common law still plays an important role in this regard and it is expected that more developments will occur as courts deal with disputes concerning the duties of directors. Do you think that codification was really necessary?

## LEARNING UNIT 4

# Capacity and representation of a company



**Study the prescribed sections in chapter 7 of your prescribed textbook.**

**Study sections 19 and 20 of the Companies Act.**

### 4.1 INTRODUCTION

In **Learning Unit 3**, we learnt about the duties of directors. We learnt that duties of directors are codified under the Companies Act 71 of 2008. In this learning unit, we will explain the legal capacity of a company and discuss representation. We are concerned, firstly, with the power or legal capacity of a company to perform a specific act, and, secondly, with the authority of the person representing a company to act on behalf of the company.

You will learn how a company can be bound by transactions that are beyond its capacity but which have been entered into on its behalf by directors. You will also learn that, if an outsider acted in good faith while contracting with the company, the company will be bound by the transaction even though a formal internal requirement has not been complied with.

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

- What is meant by the capacity of a company?
- What is the ultra vires doctrine? What are the consequences if a company acts outside its capacity?
- In what circumstances does a person have the authority to represent a company and bind it to a contract?
- What is the purpose of the Turquand rule and how does it operate under the Companies Act of 2008?

### 4.2 LEGAL CAPACITY OF A COMPANY AND THE ULTRA VIRES DOCTRINE

Section 7.1 of the prescribed textbook  
Sections 19(1) and 20 of the Companies Act

By “capacity of a company”, it is meant the sphere of actions that a company may legally perform. The ultra vires doctrine is based on the understanding that a company exists in law only for the purpose for which it was incorporated. According to the ultra vires doctrine, when an act on behalf of the company falls outside its main and ancillary objects, the company does not exist as a legal person for the purposes of that contract and consequently such an act is not binding on the company. Such an act is described as an ultra vires act.

In *Attorney-General v Mersey Railway Co* (1907) 1 Ch 81 (HL), the court explained that whether a particular contract falls within the capacity and powers of the company is a question of fact. If the main purpose of the company is, for example, to carry on the business of a hotel, it is clear that acts necessary to achieve this purpose, such as purchasing furniture and hiring staff, are intra vires.

Under section 36 of the Companies Act of 1973, if members found out about a proposed ultra vires contract before it was concluded, they could interdict the company from entering into the contract. However, if an ultra vires contract had already been concluded, the contract would be binding on the company. An action could then be brought against directors who exceeded their powers by concluding a contract on behalf of the company which fell outside the capacity of the company on the basis that the directors had breached their fiduciary duty not to exceed their authority.

Section 19(1) of the Companies Act of 2008 now considerably broadens the capacity of a company, because it provides that a company has all the legal capacity and the powers of a natural person, except to the extent to which a juristic person is incapable of exercising any such power or the company's Memorandum of Incorporation (MOI) provides otherwise. The capacity of a company is therefore not limited by its main or ancillary objects or business (which need not even be mentioned in the MOI).

Although the company's MOI may limit, restrict or qualify the purposes, powers or activities of the company (in other words, impose restrictions on the legal capacity of the company) in terms of section 19(1)(b)(ii), any such restrictions would not render invalid any contract that conflicts with these restrictions (s 20(1)(a)). Thus, the contract remains valid and binding on the company and the other party to the contract. Section 20(6) of the 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 Act or a limitation, restriction or qualification on the powers of the company as stated in its MOI, unless ratified by a special resolution in terms of section 20(2).

However, if the company or directors have not as yet performed the planned act (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 (s 20(5)).

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 this instance that a trade union may prevent the company from acting.

### 4.3 REPRESENTATION

Sections 7.4 of the prescribed textbook  
Sections 19(4)–(5), 20(2)–(3), and 20(5)–(8) of the Companies Act

**Representation** relates to a person acting under the company's authority. If a company gives an agent authority to act on its behalf, the agent possesses actual authority and will bind the company to acts which fall within the scope of the mandate given to him or her. Authority can be given expressly (in writing or orally) or by implication. Whether authority has been conferred is a question of fact.

The shareholders, directors and prescribed officers have the same powers (in terms of s 20(5)) that they have when the company intends acting ultra vires, to restrain the company or directors from doing anything inconsistent with a limitation or restriction on the **authority of the directors** to perform an act on behalf of the company (see the discussion in 4.2 above). A bona fide third party has the same right to damages as described above. Section 20(6) also applies to this situation, meaning that every shareholder has a claim for damages against a person who fraudulently or due to gross negligence caused the company to act in contravention of this limitation or restriction on the authority of the directors, unless the action has been ratified by shareholders as described above.

A company may also be bound to a contract on the basis of ostensible authority 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.

Ostensible authority applies only when the agent did not have actual authority to bind the company. Take particular note of the fact that the misrepresentation (i.e. that the agent had the necessary authority



when in fact he or she did not) must have been made by the company as the principal. Based on such misrepresentation, the company will be estopped from denying liability if the third party can prove that

- (a) the company intentionally or negligently misrepresented the agent concerned as having the necessary authority to represent the company;
- (b) the misrepresentation was made by the company;
- (c) the third party was induced to deal with the agent because of the misrepresentation; and
- (d) the third party was prejudiced by the misrepresentation.

#### 4.4 THE DOCTRINE OF CONSTRUCTIVE NOTICE

Section 7.2 of the prescribed textbook

Sections 15(2)(b) and (c) and 19(4)–(6) of the Companies Act

The doctrine of constructive notice provides that third parties dealing with the company are deemed to be fully acquainted with the contents of the public documents of the company. Section 19(4) of the Act partly abolishes this doctrine. Thus, 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. But, section 19(5) of the 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 any restrictive or procedural requirement impeding the amendment of any specific provision of the MOI or prohibiting its amendment). This is subject to the condition that the company's name includes the letters "RF" and the Notice of Incorporation contains a prominent statement drawing attention to such a provision, as required by section 13(3).

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

#### 4.5 THE TURQUAND RULE

Sections 7.3 of the prescribed textbook

Section 20(7) of the Companies Act

The Turquand rule is derived from *Royal British Bank v Turquand* (1856) 6 El. & Bl. 327; 119 ER 886. According to the common law Turquand rule, an outsider contracting with the company in good faith is entitled to assume that all internal requirements and procedures have been complied with. The company will be bound by the contract even if the internal requirements and procedures have not been complied with. The exceptions are: if the outsider was aware of the fact that the requirements and procedures 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.

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

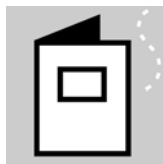
The court found that an outsider with express or constructive notice of the Articles could assume that someone was authorised to sign the notes, but not that a specific person was authorised to do so. The Turquand rule only comes into operation if an internal formality is required.

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

Section 20(7) of the Companies Act of 2008 appears to codify the Turquand rule by providing that a person dealing with a company in good faith is entitled to assume that the company has complied with all the procedural requirements in terms of this Act, its 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 its formal and procedural requirements. This section also modifies the Turquand rule by preventing a third party from invoking the rule where he or she ought reasonably to have known of non-compliance by the company. It differs from the common law Turquand rule, which requires that the third party must not have had any suspicion of non-compliance by the company. In spite of the apparent similarity between the Turquand rule and the provisions of section 20(7), the Turquand rule has not been abolished by the statutory provision, because section 20(8) specifically states that section 20(7) “must be construed concurrently with, and not in substitution for, any relevant common law principle relating to the presumed validity of the actions of a company ...”.

## LEARNING UNIT 5

# Corporate finance: shares, debentures and public offerings



**Study the prescribed sections in Chapter 9 of your prescribed textbook.  
Study sections 35, 36, 37, 39, 40, 41(3), 43 and 47 of the Companies Act.**

## 5.1 INTRODUCTION

Sections 9.1 and 9.2 of the prescribed textbook

A company obtains the funds it needs for its business by two possible means, namely equity financing and debt financing. Equity financing entails the issuance of shares in return for money, which makes up the share capital of a company. Debt financing takes the form of loans, which could either be loans by, for example, a bank or debt securities issued in a similar manner to shares. The traditional debt security is called a “debenture”.

The providers of equity financing are the shareholders of a company. They receive a return on their investment in the form of dividends. If the company is wound up, and after all the creditors of the company have been paid, the shareholders are entitled to the balance of the assets of the company. The providers of loan capital are creditors of the company. The return on their investment is interest and the principal amount of the loan must be paid back by a specific time.

Shareholders’ investment is more risky, because there is usually no guarantee that shareholders will receive a dividend in a given year.

There are different reasons why companies decide on specific types of financing, and the choice is largely based on economic factors. The debt: equity ratio of a company reflects the composition of the company’s capital structure. In other words, if a company has a debt: equity ratio of 1:2, it means that it has twice as much capital in the form of equity as in the form of debt.

If a company is doing well, it might be in the best interest of its shareholders to increase debt financing and decrease equity financing. The advantage is apparent from the effect of “gearing” or “leveraging”.

Gearing can be explained as follows:

If a company has 100 ordinary shareholders and a share capital of R100 000, and debentures of R100 000 bearing interest at 10% per annum, the company has raised capital of R200 000 and its debt: equity ratio is 1:1. The company will have to show an annual profit of at least R10 000 to pay the interest due. If the company shows a profit of less than R10 000, the shareholders will not receive any dividends. However, all the profit above R10 000 will, depending on management’s strategy, be available for dividends. If the company is performing well, it can afford to have fewer shareholders who receive a higher return on investment.

Suppose the same company shows a profit of R100 000. In the given scenario, the first R10 000 must go towards the servicing of the debt instrument. Thus, R90 000 is still available for the distribution of dividends, which means that each shareholder may receive up to R900 in dividends.

Now suppose that the company had not made use of gearing, but had chosen instead to raise all its capital in the form of equity. It raised R200 000 from the issuance of 200 shares to 200 shareholders. The full R100 000 is available for dividend distribution, but, since it has to be divided by 200, each shareholder may receive a maximum of R500 in dividends.

It is obvious that the company in this example could afford even higher gearing. Suppose the company converted 50 of its ordinary shares into preference shares, redeemable at the option of the company, and the company decide to redeem them. It then continues to raise R50 000 through the issuance of further debentures on the same terms as the first series of debentures. The company still has capital amounting to R200 000, but it now has a debt: equity ratio of 3:1.

Suppose the company shows a profit of R100 000. It pays R15 000 in interest on its debt instruments. It still has R85 000 available for the distribution of dividends. However, there are now only 50 shareholders. This means that each shareholder may receive up to R1 700 in dividends.

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

- What is the legal definition of a share?
- How can the classes of shares authorised by a company, and the rights attached to those classes of shares, be amended?
- What types of preference share are issued?
- In what circumstances will the holder of non-voting shares have the right to vote?
- When must the board obtain the approval of the shareholders before issuing shares?
- What are pre-emptive rights?
- How is adequate consideration for an issue of shares determined? And on what basis may the determination be challenged?
- What is the definition of a debenture?
- How do I determine whether a security is a share or a debenture?
- What is the difference between certificated and uncertificated securities? What is a nominee shareholder and what is a beneficial interest?
- What are public offerings?
- What are the requirements for a public offering?

### 5.1.1 Par value and no par value shares

You will notice from the prescribed textbook that it is no longer possible in terms of the Companies Act to issue par value shares. However, in terms of Schedule 5, paragraph 6(3), par value shares will continue to have the par value assigned to them. The Minister may make further regulations to assist in the conversion of these shares into no par value shares, but the rights attached to the shares must be preserved as far as possible. Any reduction of the rights due to conversion to no par value shares must be compensated for.

## 5.2 DEFINITION OF SECURITY AND SHARE

Section 9.2 of the prescribed textbook  
Section 35 of the Companies Act

An important distinction is drawn between shares and securities. Under the Companies Act 71 of 2008, a share is defined as “one of the units into which the proprietary interest in a profit company is divided”. The Act gives a much broader definition of securities, which includes ordinary and preference shares, and debentures.

To better understand the definition of a share, we should start by asking: What is a shareholder? 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.

The Memorandum of Incorporation (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, a company's board may increase or decrease the authorised share capital. It may further classify or reclassify any shares that have been authorised but not issued.

The board decides when to issue shares and how many shares should be issued. In other words, not all the authorised shares need to be issued.

### 5.3 CLASSES OF SHARES

Section 9.3 of the prescribed textbook

Section 36 of the Companies Act

Shares are divided into classes according to the specific rights that a share confers on its holder. The rights that differ from one class to the next usually fall into the following categories:

- the right to vote
- the right to information
- the right to receive a dividend that has 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 rights attached to a specific class of share are determined by the MOI and the terms of issue of the shares. The MOI must set out the classes of shares that the company is authorised to issue as well as the number of shares of each class it may issue (s 36). It must further set out the preferences, rights, limitations and other terms associated with that class of shares. However, a company could designate a class of shares in the MOI without setting out the preferences, rights or limitations that those shares will confer, and leave it open for the board of directors to decide on these terms at a later stage (s 36(1)(d)). The MOI also sets out a stated number of unclassified shares that are subject to classification by the board (s 36(1)(c)).

The board has the power to increase or decrease the authorised shares of the company and to reclassify shares that have not yet been issued. The company must then file a Notice of Amendment to the MOI to set out these changes effected by the board. In terms of the Companies Act of 1973, alterations of share capital could only occur after a special resolution to such effect by the general meeting. This remains an option under the Companies Act of 2008 (s 36(2)(a)), but will probably rarely occur.

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

#### 5.3.1 Preference shares

Section 9.3.1 of the prescribed textbook

Section 37 of the Companies Act

In return for the preferential rights to dividends, the right of preference shareholders to vote is usually curtailed in the MOI (s 37(5)(a)). 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 (s 37(3)(a)).

In terms of section 194 of the Companies Act of 1973, preference shareholders always had the right to vote when their preference dividend or a redemption payment on the preference shares remained in arrears and unpaid. This provision is not repeated in the new Act. Further, in terms of the old Act, preference shareholders could always vote on resolutions which directly affected the rights or interests attached to their shares, and resolutions for the winding-up of the company or for a reduction of share

capital were expressly listed as circumstances that would affect the rights of preference shareholders and on which they would have the right to vote. The new Act does not mention the proposed winding-up of a company as a specific resolution on which a preference shareholder would have the right to vote.

*Utopia Vakansie-Oorde Bpk v Du Plessis* still provides valuable guidance in this regard. The court held that the concept “interests” was much broader than the concept “rights”. The court further held that “affect” implies that the rights or interests of the preference shareholders must potentially be prejudiced by the proposed resolution. It is submitted that the proposed winding-up of a company will directly affect the interests of preference shareholders and that this would still be a resolution on which the preference shareholders would have the right to vote in terms of the new Act.

There must always be at least one class of shareholders of the company that may vote at a meeting of shareholders and at least one class of shareholders entitled to the net assets of the company upon its liquidation (s 37(4)). In other words, a company is not allowed to issue only preference shares that do not grant their holders the right to vote.

The different types of preference shares are discussed in your textbook. One further limitation which can be imposed on shares, and which is especially used as a condition of preference shares, is the possibility of redeeming the shares at a future date or on the occurrence of a specific event (s 37(5)(b)). When a share is redeemed, it is considered a distribution in terms of section 46 of the Act which must comply with the provisions of that section (see Learning Unit 6).

### **5.3.2 Ordinary shares and general provision of shares**

Section 9.3.3 of the prescribed textbook

Ordinary shareholders normally have the right to vote at meetings of shareholders. This right may be curtailed in terms of the Companies Act 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.

As is the case with preference shareholders, if a resolution is proposed to amend the preferences, rights, limitations and other terms associated with their shares, the Companies Act provides that such shareholders have an irrevocable right to vote on such proposals (s 37(3)(a)).

### **5.3.3 Deferred shares**

Section 9.3.4 of the prescribed textbook

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

### **5.3.4 Capitalisation shares**

Section 9.7 of the prescribed textbook

Section 47 of the Companies Act

Capitalisation shares are issued when the board of a company decides to reward current shareholders by allocating additional shares to them, rather than paying a cash dividend. The capitalisation shares can be issued to specific classes of shareholders. The terms of the offer of capitalisation shares could also give the shareholders the option to receive a predetermined cash amount instead of capitalisation shares. In such a case, the pay-out is considered a distribution in terms of the Act and must conform to the requirements of section 46 (see Learning Unit 6).

## 5.4 ISSUE OF SHARES

Section 9.5 of the prescribed textbook

Section 41(3) of the Companies Act

The Companies Act regards the decision to issue shares as a management decision. Unless the MOI imposes specific limitations, the board of directors has the authority to take the decision to issue shares without approval of the shareholders. The board of directors also has the authority to increase the authorised shares of the company.

Please take note of the circumstances discussed in the textbook in which an issue of shares must be approved by a special resolution of the shareholders. Also note that, where the voting power of a class of shares that is to be issued is equal to or exceeds 30% of the total voting power of all the shares of that class held by shareholders immediately before the transaction or series of transactions, a special resolution by all the shareholders is required (s 41(3)).

### 5.4.1 Pre-emptive Rights

Section 9.10 of the prescribed textbook

Section 39 of the Companies Act

As a general rule, shareholders of private companies now 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.

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 Fidelity (Pty) Ltd has 2 shareholders, each holding 10 shares. At a meeting of shareholders, they will have equal voting power. Suppose Fidelity (Pty) Ltd wants to issue 20 more shares. If a third person acquires all 20 of these shares, that person will have half of the voting rights at a meeting of shareholders. The original shareholders will now only have 25% voting power in the meeting of shareholders. If they exercise their right of pre-emption, each of them will be entitled to half of the 20 shares, and, consequently, they would retain the same voting power in the company as before.

**Note the circumstances referred to in the textbook where the pre-emptive rights of shareholders are excluded.**

### 5.4.2 Adequate consideration

Sections 9.6 of the prescribed textbook

Section 40 of the Companies Act

Section 40 of the Companies Act provides that the board may only issue shares for adequate consideration. The board must determine what an adequate consideration for the shares would be. 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) and is in breach of their fiduciary duties or in delict (s 77). (See Learning Unit 3.)

However, the effect that a successful challenge of the determination of the consideration by the board will have on the subscriber remains uncertain. The consequences will depend on whether the determination remains valid or whether it is invalidated by the challenge. If it remains valid, the subscriber will be unaffected, because shares are regarded as fully paid once the consideration that has been determined is received (s 40(4)). If it is invalidated, the subscriber might be liable for the difference between the consideration already tendered and the adequate determination as indicated after the challenge. For the time being, the effects of such a challenge remain unresolved.

Negotiable instruments and future services, future benefits and future payment are all allowed as consideration for newly issued shares, but shares may only be transferred to the subscriber to the extent that the instruments have become negotiable by the company, or to the extent that the subscriber has fulfilled his or her future obligations. Meanwhile, these shares are issued and kept in trust. The voting rights attached to such shares held in trust may not be exercised. Any distributions (see Learning Unit 6) in respect of shares held in trust but already paid may be credited against the remaining value of the consideration still contained in an instrument that is not yet negotiable by the company or for future services, benefits or payment. The shares held in trust may not be transferred to a third party without the company's express consent. The shares may be transferred to the subscriber on a quarterly basis to the extent that the instruments have become negotiable by the company or the future services, benefits or payments have been provided. If the negotiable instrument is dishonoured, or the subscribing party has failed to fulfil his or her obligations in terms of the agreement between him or her and the company, the shares must be returned to the company and cancelled.

## **5.5 DEBENTURES/DEBT INSTRUMENT**

Section 9.8 of the prescribed textbook  
Section 43 of the Companies Act

Whereas the Companies Act of 1973 mentioned "debentures" as a form of issued company debt, the new Act refers to "debt instruments". It should be noted that the definition of "debenture" has never been finally settled in South African law or in English law. For now it is safe to assume that the terms "debt instrument" and "debenture" can be used interchangeably.

The holder of a debenture is a creditor of the company. The duties of the company towards debenture holders can be secured or unsecured. A trustee will usually be appointed to hold security on behalf of the debenture holders. The trustee must be unrelated to the company or its officers and must be a person who, in the board's opinion, has the requisite knowledge and experience to carry out the duties of a trustee. 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 can decide to issue debentures without the approval of the shareholders, unless otherwise indicated in the MOI. The directors may also issue debentures which carry the right to vote unless the company's MOI provides otherwise.

The classification of securities as either equity or debt is especially important when the proceeds of these investments have to be taxed. Dividends received are usually not taxable, but interest received is treated as income.

On the other hand, the treatment of these issues in the accounts of the company is also important. If the issue was in the form of debt, the interest payable will be an expense for the company that can be deducted from its taxable income, thereby decreasing the amount of tax payable.

Each security must be considered on its own. When considering whether a security is debt or equity, consider all the relevant factors which indicate the one or the other, and come to a conclusion.

## **5.6 SECURITIES REGISTRATION AND TRANSFER**

Section 9.11 of the prescribed textbook  
Sections 49–56 of the Companies Act

### **5.6.1 Introduction and definitions**

As mentioned previously, under the Companies Act of 2008, a company is required to maintain a securities register which must reflect some prescribed information. Shares and debentures are now regulated together by the same provisions on the registration and transfer of securities under the Companies Act of 2008. In terms of section 1 of the new Companies Act, "securities" means any shares,



debentures or other instruments, irrespective of their form or title, issued or authorised to be issued by a profit company.

## 5.6.2 Certificated and uncertificated securities

The Companies Act of 2008 makes a distinction between certificated and uncertificated securities. Certificated securities are those that are evidenced by a certificate, while uncertificated securities are not evidenced by a certificate or some written instrument. The latter are held and transferred electronically and only they can be traded on the JSE Ltd, with the exception of the instance where they are held in certificated form in collective custody by the participant or the JSE Ltd (s 49(6)). The bona fide transferee of uncertificated securities is protected in the case of fraud, illegality or insolvency of which he or she had no knowledge (s 53(4)–(5)).

## 5.6.3 Nature and content of a certificate

Section 9.11.3.2 of the prescribed textbook

A certificate only serves as proof of ownership and is not a negotiable instrument with some inherent value. Therefore, delivery of the certificate is not a requirement for the purpose of transferring rights of ownership from one person to the next. A new certificate showing the details of the new owner can be issued once ownership has passed.

The securities certificate must reflect the name of the issuing company, the name of the person to whom the securities were issued or transferred, the number and class of share or security, and any restriction on the transfer of securities evidenced by the certificate.

Each certificate has to be signed by two persons authorised by the board, but the signature can be affixed by autographic, mechanical or electronic means (s 51(2)). The certificate is prima facie proof that the named securities holder owns the securities (s 51(1)(c)).

## 5.7 SECURITIES REGISTER

Section 9.11.3.1 of the prescribed textbook

The information contained in a company's register of issued securities must include the total number of uncertificated securities, the names and addresses of the holders to whom certificated securities were issued and the number of securities issued to each, the number of shares held in trust, and either the number of certificated debt instruments issued or the names and addresses of the registered holders and beneficial holders of certificated debt instruments (s 50(1)–(2)). The securities register is sufficient proof of the facts recorded in it, in the absence of evidence to the contrary (s 50(3)). The records of the Central Securities Depository (CSD) participant or CSD in respect of uncertificated securities are deemed to form part of the company's securities register (s 50(3)).

Shares are transferable in any manner provided for or recognised in the Act or other legislation (s 35). Any transfer of certificated securities must be reflected in the company's securities register (s 51(5)). The entry may be made only if the transfer is evidenced by a proper instrument of transfer delivered to the company or if transfer took place by operation of law (s 51(6)). The company has to record the name and address of the transferee, the description of the securities or interest transferred, the date of transfer, and the value of any outstanding consideration in respect of shares (s 50(5)).

## 5.8 CENTRAL SECURITIES DEPOSITORY AND PARTICIPANTS

Section 9.11.5.1 of the prescribed textbook

Sections 52 to 55 regulate the registration and transfer of uncertificated securities and prevail over any conflicting provisions of the Act, any other law, the common law, the company's MOI and any other agreement (s 49(4)).

## 5.9 SECURITIES HELD BY NOMINEES

Section 9.11.4 of the prescribed textbook

Sometimes, securities appear in the securities register in the name of someone other than the owner – a nominee. Unlike the Companies Act of 1973, the Companies Act of 2008 expressly permits the use of nominees (s 56 (1)). A nominee is appointed by the beneficial owner to serve as the registered holder of the securities, but holds them in name only. The nominee's position is akin to that of an agent with limited authority and he or she must comply with the instructions of the beneficial owner in exercising the voting rights relating to the securities. The nominee may also not dispose of the securities, except with the owner's permission. The beneficial interest in securities is usually held by the owner and entitles the holder to participate in any distribution, to exercise rights relating to the securities, and to dispose of such securities.

Note the wording of section 56(1) ("Except to the extent that ..."), which seems to provide for the possibility that a company's MOI may limit or even prohibit the registration of shares in the name of a nominee for the beneficial interest of another person.

A nominee in a public company is required to provide the company with information on the identity of the beneficial owner as well as the number and class of the securities held every month. This is aimed at reducing the likelihood of problems such as insider trading and not knowing when there has been a change of control in the company.

## 5.10 TRANSFER OF SHARES

Section 9.11.3.5 and 9.11.5 of the prescribed textbook

In the technical sense, the term 'transfer' denotes a series of steps comprising an agreement to transfer, the execution of a deed of transfer, and the registration of transfer. The Companies Act of 2008 requires a private company to restrict the transferability of its securities.

Registered transfer must be distinguished from the transfer of ownership in so far as certificated securities are concerned. Transfer of ownership is regulated under the common law and occurs through cession. Consent of the parties concerned is sufficient to validate the cession. Even though delivery of the share certificate is not a requirement for the transfer of ownership, it can be decisive in proving that a cession occurred.

Once the transfer of ownership has taken place, registration of transfer by the company follows. The purchaser is made to sign a transfer form, which is then submitted by the purchaser to the company along with the certificate evidencing the securities. A company will generally not register transfer unless such transfer is evidenced by a proper instrument. Registration of transfer entails entering into the company's security register the name and address of the transferee, the description of the securities concerned and the date of transfer.

Transfer of ownership of uncertificated securities is regulated under the Companies Act of 2008. Only a participant or a CSD (Strate Ltd: see section 9.11.5.1 of the textbook) is permitted to effect a transfer of uncertificated securities in an uncertificated securities register. This may only happen after receipt of an authenticated instruction or a court order. Transfer of ownership in uncertificated securities entails the debiting and crediting of the relevant accounts in the uncertificated securities registers. The transfer of ownership will be valid despite any fraud, illegality or insolvency relating to the securities or transfer, except if the transferee was involved or aware of these occurrences.

Certain unlawful conduct will render the perpetrators liable to anyone who suffers direct loss or damage as a result. The person issuing the instruction to transfer uncertificated securities is deemed to guarantee the legality and correctness of such instruction and must indemnify the company, participant and CSD against certain claims and losses.

## 5.11 PUBLIC OFFERINGS OF COMPANY SECURITIES

Study the prescribed sections in Chapter 16 the prescribed textbook  
Sections 95–96, 98–101, and 104–108 of the Companies Act

### 5.11.1 Introduction to public offerings

Study sections 16.1–16.6 of the prescribed textbook

The reason why the Companies Act of 2008 (like the Companies Act of 1973) regulates public offerings is that, when company securities are offered to the public, the offer must be accompanied by enough information to enable a prospective investor to make an informed decision on whether this will be a good investment or not. The prescribed information must be contained in a prospectus or, in those instances allowed by the Act, in a written statement which is not as complicated (or as expensive) to produce as a prospectus.

The provisions regarding public offerings will not apply to a private company (and therefore also not to a personal liability company), because a private company is not allowed to offer its securities to the public.

To understand the topic of public offerings, it is important that you know the various definitions as discussed in section 16.2 of your prescribed textbook. You must, among other things, be able to distinguish between an offer for subscription where the company is inviting people to subscribe for securities which it is issuing and the company will receive the issue price, and offers for the sale of issued shares (or secondary offerings) where an existing shareholder is offering his or her shares for sale to the public and the shareholder will thus be receiving the money that the purchasers pay for the shares.

A very important aspect is discussed in sections 16.5 and section 96 of the Act, namely the circumstances in which an offer will be regarded as an offer to the public, and the circumstances in which it will not. This is important because, if an offer is not regarded as an offer to the public, it does not have to comply with the fairly onerous and strict requirements of the Act for offers to the public.

### 5.11.2 The prospectus

Study section 16.7 of the prescribed textbook

The prospectus is the document that must accompany all initial public offerings and all primary offerings for unlisted securities (primary offerings for listed securities must comply with the requirements of the relevant exchange). All secondary offerings must be accompanied by either a prospectus or a written statement (s 101). (The contents of a written statement are discussed below.)

Note that a prospectus must first be registered with the Commission before it may be issued, and may not be issued more than three months after the date of its registration.

### 5.11.3 Liability for untrue statements in a prospectus

Study section 16.9 of the prescribed textbook

The wide-ranging liability in terms of section 104 for untrue statements in a prospectus is intended to ensure that the public can rely on the information contained in the prospectus before acquiring securities in a company. In terms of section 104, all the following persons are personally liable to a person who acquired securities and suffered any loss or damage as a result of any untrue statement in the prospectus:

- a person who becomes a director between the issuing of the prospectus and the first meeting of shareholders where directors are elected;
- a person who consented to be named in the prospectus as a director or as having agreed to become a director immediately or after a stipulated period;
- a promoter of the company; or
- a person who authorised the issue of the prospectus or made the offer to the public.

In addition, a director may also be held liable to the company for any loss, damages or costs it suffered if the director knew that the prospectus contained an untrue, false or misleading statement (s 77(3) (d)(ii)).

#### **5.11.4 Regulation of secondary offerings**

Study section 16.8 of the prescribed textbook

You will notice that, also in the case of secondary offerings, listed securities are excluded. Strangely, there is no provision for personal liability for untrue statements in a written statement, although it is a criminal offence.

## LEARNING UNIT 6

# Capital maintenance



Study the prescribed sections in Chapter 10 of your prescribed textbook.

Study sections 44, 46, 47 and 48 of the Companies Act.

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

- Which transactions will be considered to be “distributions” in terms of the Companies Act 71 of 2008?
- What are the requirements before a company may repurchase its shares?
- What is a dividend?
- What are the requirements before a company may give financial assistance to a person so that such person may buy shares in the company?

## 6.1 CAPITAL MAINTENANCE

Section 10.2.1 of the prescribed textbook  
Section 48 of the Companies Act

Originally, companies were required to maintain their share capital. In other words, they were not allowed to return to shareholders some of the funds originally paid in return for their shares, nor were companies allowed to issue shares at a discount, causing the company to gain less share capital in return for the shares than the nominal value of the shares reflected. However, the rule on capital maintenance was gradually relaxed through amendments to the Companies Act of 1973.

## 6.2 SHARE REPURCHASES

Sections 10.3.1–10.3.6 and 10.4 of the prescribed textbook  
Sections 46 and 48 of the Companies Act

Section 48(2)(a) allows a company to acquire its own shares if the decision to do so satisfies the requirements of section 46, which is the section that regulates distributions (discussed in 6.4 below). Note that, although the textbook refers to the “repurchase” of its shares by the company, the Act uses the word “acquire”, which has a broader meaning. Since this is considered to be a distribution, the acquisition of its shares by a company must meet all the requirements of a distribution, including the requirements that it must be authorised by the board and must satisfy the solvency and liquidity tests.

Section 48(2)(b) allows any subsidiary of a company to acquire shares in that company, subject to the conditions that: (i) no more than 10% of all the issued shares of any class of shares of the company may be held by, or for the benefit of, all the subsidiaries of that company taken together; and (ii) no voting rights attached to those shares may be exercised while the shares are held by a subsidiary of the company. (Please ignore the term “treasury shares” used in the textbook; this term is not used in the Act and is not known in South African company law.)

All acquisitions of its shares by a company or its subsidiary are subject to the following:

After the company or subsidiary has acquired the shares, there must be shares left other than convertible or redeemable shares (s 48(3)(b)). There must also be shares in issue that are held by shareholders other than the company's subsidiaries (s 48(3)(a)). Remember that shares acquired by the company itself must be cancelled and will thus revert to being authorised but unissued shares (s 35(5)(a)).

An agreement for the acquisition of shares is enforceable, provided that the requirements of section 48(2) and (3) as described above have been met, including the requirement that the solvency and liquidity test can be satisfied and the necessary unconvertible and unredeemable shares remain in issue to a shareholder other than the company's subsidiaries (s 48(4)). However, should a company be unable to fulfil its obligations in terms of a repurchase agreement because of the operation of section 48(2) or (3), section 48(5) provides the following remedy:

The company must apply for a court order in terms of this subsection (probably an order to suspend the acquisition of the shares). The company bears the burden of proof that fulfilment of its obligations will breach the requirements of section 48(2) or (3).

The court may make an order that is just and equitable in view of the financial circumstances of the company, ensuring that the person to whom the company is required to make a payment in terms of the agreement is paid at the earliest possible date, keeping in mind when the company will be able to satisfy its other financial obligations as they fall due and payable (s 48(5)(c)).

The Act does not provide for any other order, and if this is the only order the court could make, it will not suffice to address the company's inability to comply with the non-financial requirements such as the types of shares that must remain in issue.

In terms of the Companies Act of 2008, if the company acquired shares without meeting the solvency or liquidity test or any of the other requirements of section 48, the agreement between shareholders and the company in terms of which the company would repurchase their shares apparently remains enforceable. In terms of section 48(6) the company must apply to court not more than two years after the acquisition, to have the acquisition reversed.

The court may then order

- the person from whom the shares were bought to return the consideration received, and
- the company to issue to that person an equivalent number of shares of the same class as those acquired.

A director who was present at the meeting when an acquisition of shares in terms of section 48 was approved, or participated in the making of this decision, and who failed to vote against it despite knowing that the acquisition was contrary to section 46 (requirements for distributions) or section 48, will be liable for any loss, damages or costs sustained by the company as a direct or indirect consequence of this approval (s 48(7)).

## 6.3 SOLVENCY AND LIQUIDITY

Section 10.2.4 of the prescribed textbook

Section 4 of the Companies Act

The provisions dealing with the solvency and liquidity test are among the most important in the Companies Act of 2008. To satisfy the test, a company must, considering all its reasonably foreseeable financial circumstances, meet the following conditions:

The assets of the company, fairly valued, must equal or exceed its liabilities; and it must appear that the company will be able to pay its debts as they become due in the ordinary course of business for 12 months following the date on which the test is undertaken, or, in the case of a distribution, 12 months following that distribution.

## 6.4 DISTRIBUTIONS

Sections 10.2.2, 10.2.3 and 10.2.4 of the prescribed textbook

Section 1 (definition of “distribution”) and section 46 of the Companies Act

In the Companies Act of 1973, the concept “distributions” was rather narrowly defined. Payments made to shareholders in their capacity as shareholders were included in the concept, but a repurchase of shares by a company and redemption of shares were expressly excluded. In the Companies Act of 2008, the last-mentioned actions are now also classified as distributions.

Section 46 of the Companies Act regulates distributions. In terms of section 1, the following actions are regarded as distributions:

- (a) a direct or indirect transfer by a company of money or other property of the company, other than its own shares, to or for the benefit of its own shareholders or those of another company within the same group of companies,
  - (i) in the form of a dividend;
  - (ii) a payment in lieu of a capitalisation share;
  - (iii) consideration for the acquisition of its own shares or those of another company in the group;
  - (iv) any other transfer of money or property in respect of any of the shares of that company or of another company within the same group of companies;
- (b) incurrence of a debt or other obligation by a company for the benefit of one or more holders of any of the shares of that company or of another company within the same group of companies;
- (c) forgiveness or waiver by a company of a debt or other obligation owed to the company by one or more holders of any of the shares of that company or of another company within the same group of companies.

A distribution may be made in the following circumstances:

The board of directors must authorise the distribution, unless it is made in terms of an existing legal obligation of the company or a court order. It must reasonably appear that the company will satisfy the solvency and liquidity test immediately after completing the distribution.

The board of the company must acknowledge, by means of a resolution, that it has applied the solvency and liquidity test and reasonably concluded that the company will satisfy this test immediately after completing the proposed distribution.

**The solvency and liquidity tests are set out in section 4 of the Act.**

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

**Liquidity test: Considering all reasonably foreseeable financial circumstances of the company at that time, it appears that the company will be able to pay its debts as they become due in the ordinary course of business for a period of 12 months after the distribution.**

If the distribution was in the form of granting a loan to a shareholder or cancelling a shareholder’s obligation to repay a loan, the period runs from 12 months after the test was considered.

The distribution must be effected within 120 days after the solvency and liquidity test was applied, otherwise another resolution by the board to authorise the distribution is required and the test must be applied again.

## 6.5 FINANCIAL ASSISTANCE FOR THE PURCHASE OF SHARES

Section 10.5 of the prescribed textbook  
Section 44 of the Companies Act

In terms of the Companies Act of 1973, a company was prohibited from providing financial assistance to a person to enable the person to acquire shares or other securities in the company, except for some very specific exceptions.

In terms of section 44 of the Companies Act of 2008, a company may assist a person in acquiring shares and other securities in the company, provided that such assistance is not prohibited by the Memorandum of Incorporation (MOI) and that certain requirements are met.

The decision to assist a person to acquire shares in the company rests with the board of directors, but must be taken in accordance with the conditions stipulated in section 44 and discussed in the textbook. These include the stipulation that the assistance must be in terms of an employee share scheme or that a special resolution by the shareholders must have authorised such assistance to a specific person or persons who fall into a specific class or category. In the latter case, the person to whom the assistance will be given must fall into that class and the resolution must have been taken within the two years preceding the board's decision to assist.

Section 44 further requires that the board must be satisfied that the solvency and liquidity requirements have been met (see s 4 of the Companies Act of 2008) and that the assistance is given under 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.

Some of the cases dealing with the prohibition under the old Act are still relevant to section 44. Their relevance is based on the fact that they provide some guidelines concerning the circumstances in which the provisions of section 44 will be applicable.

The leading case in this regard is *Lipschitz v UDC Bank Ltd* 1979 (3) SA 781, where it was held that a 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* 1959 (4) SA 419 (A), the "impoverishment test" was formulated to assist in determining whether financial assistance was provided. In terms of the impoverishment test, one considers whether a transaction will have the effect of leaving the company poorer. If so, financial assistance was provided. In *Lipschitz*, the court held that the "impoverishment test" was not the only measure of financial assistance, but that providing security or otherwise exposing the company to risk would also qualify as financial assistance for the 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 would count as financial assistance. If the company buys an asset from the person in order to enable that person to purchase shares in the company, the facts will determine whether there was financial assistance. Case law indicates that it is necessary to consider whether the company needs the asset in its normal business and whether the company paid a fair price for it. The court in *Jacobson v Liquidator of M Bulkin & Co Ltd* 1976 (3) SA 781 also ruled that the decision whether financial assistance has been provided should not be based on the likelihood of a loan becoming irrecoverable or of a security being enforced owing to the default of the principal debtor.

Secondly, it must be determined whether that assistance was for the purpose of acquiring shares in the company. Suppose Company A is a major creditor of Company B. Company A acquires most of the shares in Company B. After the acquisition, Company A causes Company B to grant security over its movable assets to secure the loans. This would be financial assistance in terms of the first test, but it is not assistance in connection with the purchase of shares. The assistance is to secure a loan. In *Fidelity Bank Ltd v Three Women (Pty) Ltd* [1996] 4 All SA 368, the fact that a particular transaction which facilitated the purchase of shares did not serve any legitimate commercial interest of the company led the court to conclude that the purpose of the transaction was indeed to give assistance for the purchase of shares.



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

## LEARNING UNIT 7

# Groups of companies



Study Chapter 8 of your prescribed textbook.

Study sections 1, 2, 3, 4, 48(2), 76, 95, 101, 112 and 115 of the Companies Act.

### 7.1 INTRODUCTION AND DEFINITIONS

Section 8.1 of the prescribed textbook

There are many reasons why it may be desirable for one company to control another, including the elimination of competition between companies, the pooling of technical expertise, and even the control of a particular industry without falling foul of the Competition Act 89 of 1998. Where various aspects of a business are undertaken by different companies in the group, control of one company by another can help to decentralise management.

The regulation by the Companies Act of company groupings is necessary for two important reasons. Firstly, there should be proper accounting, as there is a danger – particularly where the holding company is a private company – that some financial information could be concealed from shareholders or creditors of the holding company. Secondly, the Act attempts to prevent abuse which could arise as a result of the control by the holding company over the subsidiary. Abuse is most likely to occur where the subsidiary makes a loan to, or provides security in favour of, the holding company or its directors.

In this learning unit, we will explain what groups of companies are, how control, holding companies and subsidiary companies are defined, how general voting rights are determined, and what the legal consequences for groups of companies are. We will also refer to groups and annual financial statements.

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

- How is a group of companies defined in the Companies Act of 1973?
- How is a group of companies defined in the Companies Act 71 of 2008?
- How is control defined?
- How is a holding company defined?
- How is a subsidiary company defined?
- How are general voting rights determined?
- What are the main legal consequences which flow from the existence of a group of companies?

The essential idea of a group is the existence of control through one company of one or more subsidiary companies. In Schedule 4 to the Companies Act of 1973, a group of companies is defined as a holding company, not itself being a wholly owned subsidiary, together with all the companies being its subsidiaries. The Companies Act 71 of 2008 contains a new definition of a group of companies.

### 7.2 DEFINITION OF GROUP OF COMPANIES

Section 8.2 of the prescribed textbook

Sections 1 and 2 of the Companies Act

A group of companies is defined as two or more companies that are related or interrelated. One company is related to another company if

- one company directly or indirectly controls another company (or its business), or
- one company is a subsidiary of another company.

### 7.3 DEFINITION OF CONTROL

Section 8.2 and 8.4.1.4 of the prescribed textbook  
Section 2 of the Companies Act

Company A controls company B (or its business) if

- company B is a subsidiary of company A, or
- company A, on its own or together with any related or interrelated person, is
  - directly or indirectly able to exercise (or control the exercise of) the voting rights in company B (whether pursuant to a shareholders' agreement or otherwise), or
  - able to appoint or elect (or control the appointment or election of) directors of company B, who control the majority of votes at the company's board meetings.
- Company A has the ability to materially influence the policy of company B.

### 7.4 DEFINITION OF HOLDING COMPANY

Section 8.2 of the prescribed textbook  
Sections 2 and 3 of the Companies Act

A holding company (in relation to a subsidiary) is the company that controls the subsidiary.

### 7.5 DEFINITION OF SUBSIDIARY COMPANY

Section 8.2 of the prescribed textbook  
Section 3 of the Companies Act

Section 3 of the Companies Act 71 of 2008 changes the definition of a subsidiary company, but, in general terms, it retains the broad architecture of the definition in the Companies Act of 1973, in that it is based on the majority of voting rights or the right to appoint directors holding the majority of votes on the board.

### 7.6 DETERMINATION OF GENERAL VOTING RIGHTS

Section 8.2 of the prescribed textbook  
Section 3 of the Companies Act

Section 3(2) of the Companies Act 71 of 2008 provides for specific rules that will apply for the purpose of determining whether a person controls all (or the majority of) the general voting rights in a company.

### 7.7 LEGAL CONSEQUENCES FOR GROUPS OF COMPANIES

Sections 8.1, 8.3, 10.4.1 10.5.8, 10.6.3 and 14.4.2.1 of the prescribed textbook  
Sections 45, 48(2), 76, 95, 101, 112 and 115 of the Companies Act

Several important consequences flow from the existence of a group, even though the law does not recognise a separate legal personality for the group.

The main consequences can be grouped under the following headings:

- Acquisition of shares – a subsidiary company may acquire shares in its holding company provided it does not acquire more than 10% in aggregate of the number of issued shares of any class of

shares of the holding company. No voting rights attached to those shares may be exercised while the shares are held by the subsidiary (see section 48(2) of the Companies Act and section 10.4.1 of your prescribed textbook).

- Directors' conduct – a director of a company must not use his position as a director, or any information obtained while acting in the capacity of a director, to gain an advantage for himself 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 (see section 76(2)(a) of the Companies Act and section 14.4.2.1 of your prescribed textbook).
- Public offerings – employee share schemes (in terms of which a company offers shares to its employees) are defined in section 95 of the Companies Act in such a way that an employee of a company is treated also as an employee of a subsidiary company, for the purposes of the scheme. Likewise, a secondary offering of shares is defined in section 95 of the Companies Act as meaning an offer for sale to the public of any securities of a company or of its subsidiary made by or on behalf of a person other than that company or its subsidiary. Thus a secondary offer of shares is treated as though the shares of one company in a group are those of any member of the group of companies.
- Disposal of all or the greater part of assets or undertaking – where a disposal of all or the greater part of the assets or undertaking of company constitutes a transaction between a wholly owned subsidiary and its holding company, there is an exemption from having to comply with the approval and other requirements of section 112 and 115 of the Companies Act. An exemption is also granted where a section 112 disposal constitutes a transaction between or among (i) two or more wholly-owned subsidiaries of the same holding company; or (ii) a wholly owned subsidiary of a holding company on the one hand and its holding company and one or more wholly owned subsidiaries of that holding company on the other hand (see section 112(1) of the Companies Act).
- Financial assistance – the restrictions on companies providing financial assistance for the purchase of shares and loans to directors also apply in relation to other companies in the group (see sections 44 and 45 of the Companies Act and sections 10.5.8 and 10.6.3 of your textbook)

## **7.8 GROUPS AND ANNUAL FINANCIAL STATEMENTS**

The Companies Act 71 of 2008 does not specifically require a group of companies to prepare consolidated annual financial statements. However, under the current International Financial Reporting Standards, listed companies are required to prepare group financial statements (consolidated financial statements). Companies whose shares are not listed are currently not required to do so.

## LEARNING UNIT 8

# Takeovers, offers and fundamental transactions



**Study the prescribed sections in Chapter 17 of your prescribed textbook. Study sections 112 to 127 of the Companies Act.**

## 8.1 INTRODUCTION

Section 17.1 of the prescribed textbook

Chapter 5 of the Companies Act of 2008 is entitled “Fundamental Transactions, Takeovers and Offers” and it contains the new provisions relating to the regulation of such transactions. Part C of Chapter 8, entitled “Regulatory Agencies and the Administration of the Act”, contains the provisions dealing with the Takeover Regulation Panel.

Chapter 5 of the Companies Act of 2008 is divided into three parts:

- Part A, which deals with the rules affecting fundamental transactions as they apply to all companies
- Part B, which deals with the authority of the Takeover Regulation Panel and the Takeover Regulations
- Part C, which deals with the regulation of affected transactions and offers

Parts B and C are applicable only to “regulated companies” (see s 118).

Transactions that significantly affect the ownership of a company’s assets or that signal a change in its shareholding attract additional regulation. These transactions are termed “**fundamental transactions**” or “**affected transactions**”. Some transactions are not permitted at all.

It is important for you to understand the difference between “affected transactions” and “fundamental transactions”. A transaction is referred to as an “affected transaction” if a regulated company is involved, in which case the Takeover Regulation Panel has jurisdiction over the transaction. A “fundamental transaction” may involve regulated or unregulated companies and is a term given to all transactions dealt with in Part A of Chapter 5 of the Companies Act of 2008. A “fundamental transaction” will accordingly be an “affected transaction” if a **regulated company** is involved.

Included in “fundamental transactions” are: disposals of all or the greater part of the assets or undertaking of a company (s 112); amalgamations or mergers (s 113); and schemes of arrangement (s 114).

The definition of an “affected transaction” is to be found in section 117(1)(c). It includes a disposal of all or a greater part of the assets or undertaking of a regulated company (s 112), a merger or amalgamation involving at least one regulated company (s 113), and a scheme of arrangement between a regulated company and its shareholders (s 114) (see s 117(1)(c)(i), (ii) and (iii)). **(See below for a discussion of affected transactions, fundamental transactions and regulated companies.)**

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

- What is a fundamental transaction?
- What is an affected transaction?
- How does the Companies Act of 2008 define a regulated company?
- What is a mandatory offer and in what circumstances must it be made?
- What is a compulsory acquisition or squeeze out and in what circumstances would it apply?
- What requirements must be complied with before a company may sell or dispose of all or the greater part of its assets or undertaking?
- What is meant by the term “scheme of arrangement”?
- What is an amalgamation or merger?

## 8.2 REGULATED COMPANIES

Section 17.5.3 of the prescribed textbook

It is important to note that the definition of an affected transaction refers to **regulated companies**. These are defined (by s 117(1)(i)) as a company to which Part B, Part C and the Takeover Regulations apply, as determined in accordance with section 118(1). The company must be a public company (s 118(1)(a)), a state-owned enterprise unless exempted in terms of section 9 (s 118(1)(b)) or a private company, but only if the percentage of issued securities of that company that have been transferred (other than by transfer between related person) within a 24-month period before the affected transaction or offer exceeds the percentage prescribed by the Minister (s 118(1)(c)(i)). As far as this prescribed percentage is concerned, the Minister, after consultation with the Takeover Regulation Panel, may prescribe a minimum percentage of not less than 10% of the issued securities, which would bring the company within the application of Parts B and C of Chapter 5 and the Takeover Regulations (s 118(2)).

The definition of a regulated company includes a private company, the Memorandum of Incorporation (MOI) of which expressly provides that the company and its securities are subject to Parts B and C (of Chapter 5) and the Takeover Regulations, irrespective of whether the company falls within the criteria set out in section 118(1)(c)(i)).

### A. FUNDAMENTAL TRANSACTIONS

## 8.3 DISPOSAL OF ALL OR THE GREATER PART OF THE ASSETS OR UNDERTAKING

Section 17.3 of the prescribed textbook

Section 112 of the Companies Act

The disposal or sale of all or the greater part of the assets of a company constitutes a fundamental transaction and, if a regulated company is involved, it also constitutes an affected transaction. Section 112 of the Companies Act of 2008 regulates the disposal or sale of all or the greater part of the assets of a company. The Companies Act has introduced a definition for “all or the greater part of the assets or undertaking” as being in the case of a company’s assets, more than 50% of its gross assets fairly valued, irrespective of its liabilities, or in the case of the company’s undertaking, more than 50% of the value of its entire undertaking, fairly valued. In terms of this section, a company may only dispose of or sell all or the greater part of its assets or undertaking if the following requirements are met:

- (a) the specific proposed disposal is approved by a special resolution of the shareholders (either approved in advance or subsequently ratified)
- (b) the notice of the shareholders’ meeting to consider the resolution is accompanied by a written summary of the terms of the transaction
- (c) the assets or undertaking to be disposed of are given a fair market value

The above requirements do not apply to the disposal or sale of all or the greater part of the assets of a company where the transaction is:

- (a) as a result of a business rescue plan (**see Learning Unit 9**),
- (b) between a holding company and its wholly owned subsidiary,
- (c) between two or more wholly owned subsidiaries of the same holding company, and
- (d) between a wholly owned subsidiary on the one hand, and its holding company and one or more wholly owned subsidiaries of that holding company on the other hand.

## 8.4 AMALGAMATIONS OR MERGERS

Section 17.2.1–17.2.4 of the prescribed textbook  
Section 113 of the Companies Act

Section 1 of the Companies Act of 2008 provides that an amalgamation or merger refers to a transaction, or series of transactions, involving two or more companies, resulting in the survival of one or more of the amalgamating or merging companies or the formation of one or more new companies, which together hold all of the assets and liabilities previously held by the several merging or amalgamating companies. Therefore, an amalgamation or merger occurs when

- (1) two or more companies combine their assets and liabilities,
- (2) these assets and liabilities are then held by one or more of the surviving companies OR by one or more newly formed companies, and
- (3) all the other amalgamating or merging companies then cease to exist upon completion of the amalgamation or merger.

Such a transaction (amalgamation or merger) is a fundamental transaction and is also an affected transaction if it involves one or more regulated companies.

Amalgamations or mergers are governed by section 113 of the Companies Act of 2008. Section 113(1) provides that two or more profit companies, including holding and subsidiary companies, may amalgamate or merge if, upon completion of the transaction, each amalgamated or merged company will satisfy the solvency (the company's assets, fairly valued, are equal to or exceed its liabilities) AND liquidity (the company is able to pay its debts as they fall due in the ordinary course of business) test. It is the duty of the board of each amalgamating or merging company to consider whether, upon completion of the transaction, each proposed amalgamated or merged company will satisfy the solvency and liquidity test. The transaction must also be approved by a special resolution of the shareholders.

Section 113(5) provides that the notice of the shareholders' meeting must include a copy or summary of the amalgamation or merger agreement and details of the proposed special resolution and appraisal rights. (**See section 17.2.4 of the prescribed textbook on appraisal rights.**)

In terms of section 113(2), companies which intend to amalgamate or merge must enter into a written agreement setting out the terms of the amalgamation or merger. There are certain particulars which must be included in the agreement.

## 8.5 SCHEME OF ARRANGEMENT

Section 17.4 of the prescribed textbook  
Section 114 of the Companies Act

A scheme of arrangement is a fundamental transaction and, if it involves a regulated company, it is also an affected transaction. Schemes of arrangement are governed by section 114 of the Companies Act of 2008. Basically a scheme of arrangement is any arrangement or agreement between the company and any class of its security holders (which would include shareholders), including a reorganisation of the

share capital of the company. In terms of section 114, a company may, on the initiative of the board and subject to approval by special resolution, implement any scheme of arrangement between the company and the holders of any class of its securities.

In terms of section 114(1)(a)–(f), the arrangement or agreement may involve

- (a) a consolidation of securities of different classes
- (b) a division of securities into different classes
- (c) an expropriation of securities from the holders thereof
- (d) an exchange of its securities for other securities
- (e) a reacquisition by the company of its securities in terms of section 48 (**see Learning Unit 6**)
- (f) a combination of the above

Section 114 expressly provides that a company may not propose a scheme of arrangement if it is in liquidation or in the course of business rescue proceedings (**see Learning Unit 9**).

Owing to the complex nature of schemes of arrangement, section 114 of the Companies Act of 2008 requires that an independent expert be retained by the company proposing the arrangement in order to compile a report concerning the proposed scheme of arrangement. The report must be furnished to the board and to the security holders involved in the proposed scheme.

The Companies Act requires that the expert be impartial and independent of the company. To this end, the expert must not have any relationship with the company or holders of securities, must not have had any such relationship in the previous two years, nor be related to any person who has or has had such a relationship (s 114).

Schemes of arrangement have been used to make a company a wholly owned subsidiary of another company. The following is an example of a scheme of arrangement:

A subsidiary company proposes an arrangement with the holders of shares that are not already held by the holding company. The shareholders in the scheme agree to give up their shares in exchange for shares in the holding company. The company thus becomes a wholly owned subsidiary.

## 8.6 COURT INTERVENTION IN THE IMPLEMENTATION OF FUNDAMENTAL TRANSACTIONS

Section 17.2.3 of the prescribed textbook

Section 115 of the Companies Act

The court may intervene in the implementation of any fundamental transaction (whether it is a proposed scheme of arrangement, a proposed disposal or sale of all or the greater part of the assets of a company, or a proposed amalgamation or merger). Section 115 provides that, notwithstanding any special resolution, a company may not proceed with the implementation of any proposed fundamental transaction (which would include an affected transaction if a regulated company is involved in the proposed transaction) in the following circumstances:

- (a) Where the special resolution approving the proposed transaction was opposed by at least 15% of the voting rights that were exercised on that resolution. In this situation, any person who voted against the resolution may require that the company obtain court approval, in which case the proposed transaction may not proceed without the sanction of the court;  
OR
- (b) Where the court finds that the resolution is manifestly unfair to any class of security holders or that the vote was materially tainted by conflict of interest, inadequate disclosure, or failure to comply with the Companies Act of 2008, the MOI or any other applicable company rules, or finds any other significant procedural irregularity and as a result orders that the resolution be set aside.

Section 115 further permits a security holder who voted against the proposed fundamental transaction to seek an appraisal remedy in terms of which the security holder can have his or her securities



independently valued and repurchased by the company at a fair price. The aggrieved security holder may only seek an appraisal remedy if he or she

- (a) notified the company in advance of his or her intention to oppose the special resolution, AND
- (b) was present at the meeting and voted against the special resolution.

## B. AFFECTED TRANSACTIONS

### 8.7 AFFECTED TRANSACTIONS AND THE ROLE OF THE TAKEOVER REGULATION PANEL

Section 17.5.1–17.5.3 of the prescribed textbook

As the Takeover Regulation Panel is required to regulate affected transactions, it is important to know how an **affected transaction** is defined in the Companies Act of 2008. In terms of section 117(1)(c)(i), (ii) and (iii), an affected transaction includes a disposal of all or a greater part of the assets or undertaking of a regulated company (s 112), a merger or amalgamation involving at least one regulated company (s 113) and a scheme of arrangement between a regulated company and its shareholders (s 114). (Note that all these types of fundamental transaction are subject to the approval requirements stipulated in s 115. However, if any of these transactions occurs in the context of an approved business rescue plan in terms of Chapter 6, the provisions in the Companies Act of 2008 regulating affected transactions, as well as the Takeover Regulations, do not apply (s 118(3)).

The definition of an affected transaction includes the acquisition of (or the announcement of the intention to acquire) a beneficial interest in voting securities of a regulated company to the extent contemplated in section 122 (see s 117(1)(c)(iv)). What is covered here is the situation where a person acquires enough securities of a class with the result that he or she holds a beneficial interest in the securities amounting to 5%, 10%, 15% or any further multiple of 5% of the issued securities of that class. (A disposal of securities that results in a person no longer holding a beneficial interest in securities amounting to a particular multiple of 5% of the issued securities of that class is also covered by the definition.) Holding a “beneficial interest” in securities means that a person has a right or is entitled to receive or participate in dividends in respect of the company’s securities, or to exercise (or cause to be exercised) any or all of the rights attaching to the securities (e.g. the right to vote) or to dispose of (or direct the disposal of) the securities (s 1). Section 122 makes it clear that it covers persons acting alone or in concert and the section explains how to determine the number of issued securities of a class in order to work out the percentages.

The definition of an affected transaction also covers an announced intention to acquire a beneficial interest in the remaining voting securities of a regulated company that are not already held by a person or persons acting in concert (see s 117(1)(c)(v)).

### 8.8 TAKEOVER REGULATION PANEL

Section 17.5.4 and 17.5.5 of the prescribed textbook

Section 121 of the Companies Act

The Takeover Regulation Panel has replaced the Securities Regulation Panel as the body that regulates affected transactions. The Companies Act of 2008 establishes the Takeover Regulation Panel as an organ of state within the public administration, but outside the public service (s 196(1)). The Takeover Regulation Panel comprises the Commissioner of the Companies and the Intellectual Properties Commission, the Commissioner of the Competition Commission, three persons designated by each exchange named by the Minister, and a number of persons appointed by the Minister who have knowledge and experience of the regulation of securities and takeovers (s 197(1)). Without regard to the commercial advantages or disadvantages of the transaction, the Takeover Regulation Panel is required to regulate affected transactions and offers to the extent provided for in Chapter 5 and the Takeover Regulations, investigate complaints relating to affected transactions and offers, and consult with the Minister in respect of changes to the Takeover Regulations (see s 201 for the functions of the panel, and

see also s 119). Section 119 requires the Takeover Regulation Panel to regulate affected transactions in order to promote integrity and fairness in the marketplace, to ensure the provision of adequate information and time to allow informed decisions to be made by companies and holders of securities, and to prevent actions that may frustrate or defeat takeover offers.

In terms of the Companies Act of 2008, it now falls to the Minister to prescribe the rules to be known as the Takeover Regulations in consultation with the Takeover Regulation Panel (s 120 read with s 201(1)(d)). These Takeover Regulations are intended to give effect to the purposes of Parts B and C of Chapter 5 of the Companies Act of 2008 and must include regulations that provide for compliance with, and enforcement of, the provisions of Parts B and C, the administration, operation and procedures of the Takeover Regulation Panel, and any other matters relating to the powers and functions of the Takeover Regulation Panel (s 120).

Section 121 obliges any person proposing an affected transaction to comply with the reporting or approval requirements set out in the Takeover Regulations (unless exempted). Such person may not give effect to the transaction unless he or she has received a clearance notice or been granted an exemption. In carrying out its mandate to regulate affected transactions, the Takeover Regulation Panel may require the filing of various documents for approval and issue clearance notices if the transaction satisfies the applicable requirements of the Companies Act of 2008 (s 119(4)(a) and (b)). The Takeover Regulation Panel may also initiate or receive complaints and conduct investigations and thereafter issue compliance notices in accordance with Chapter 7 (the chapter dealing with remedies and enforcements) or the Takeover Regulations (s 119(4)(c)). This is specifically stated as one of the functions of the Takeover Regulation Panel (s 201(1)(b)). A person may file a complaint himself or herself in relation to an affected transaction (s 168(1)(a)) or a complaint may be initiated directly by the Takeover Regulation Panel or at the request of another regulatory authority or the Minister (s 168(2)–(3)). The Takeover Regulation Panel may investigate the complaint under section 169 and act in terms of section 170. Objections to the compliance notice may be made to the Takeover Special Committee (a committee of the panel established in terms of section 202(1)) or to a court so that the notice can be reviewed (s 172(1)). After considering representations, the Takeover Special Committee or the court may confirm, modify or cancel all or part of the notice and then the applicant would have to comply with it (s 172(2)–(3)). A decision by the Takeover Special Committee is binding, subject to any right of review by, or appeal to, a court (s 172(4)).

## **8.9 COMMON TYPES OF AFFECTED TRANSACTIONS**

Two common types of affected transactions are

- (1) mandatory offers
- (2) compulsory acquisitions (or “squeeze out”)

### **8.9.1 Mandatory offers**

Section 123 of the Companies Act

Mandatory offers as defined in section 123 also fall within the definition of an affected transaction (see s 117(1)(c)(vi)). A mandatory offer refers to a transaction where one or more persons who are related or interrelated or are acting in concert attain a prescribed percentage of all voting securities in the company. The prescribed percentage is laid down by the Minister on the advice of the panel, but it must not be more than 35% of the voting securities of a company (s 123(5)). Upon obtaining such prescribed percentage, such person or persons are required to make an offer for all outstanding securities in the company. The first situation in which a mandatory offer to acquire remaining securities must be made is where a regulated company reacquires any of its voting securities in terms of section 48. (Section 48 regulates the circumstances in which a company may acquire its own shares.)

The second situation in which a mandatory offer must be made is where a person (alone or in concert) acquires a beneficial interest in any voting securities issued by a regulated company. However, before the obligation to make a mandatory offer arises, the situation must be such that, before the acquisition, the

person (or persons acting together) exercised less than the prescribed percentage of voting rights attaching to the securities and as a result of the acquisition (together with the other securities already held) they would be able to exercise at least the prescribed percentage of the voting rights attached to the securities (s 123(2)).

If the reacquisition or acquisition results in the threshold of 35% referred to above being reached, the person or persons in whom 35% or more of the voting rights beneficially rests must give notice to the holders of the remaining securities within one day after the date of the acquisition (s 123(3)). The notice must include a statement that they are in a position to exercise at least 35% of all the voting rights attached to securities of that regulated company, and the notice must offer to acquire any remaining such securities on terms determined in accordance with the Companies Act and the Takeover Regulations. Thereafter, within one month after giving the notice, the issuers of the notice must deliver a written offer in compliance with the Takeover Regulations to the holders of the remaining securities of that company, to acquire those securities on the terms contemplated (s 123(4)).

The case of *Sefalana Employee Benefits Organisation v Haslam* 2000 (2) SA 415 (SCA) is relevant to mandatory offers. Although it involved the mandatory-offer rule prior to the Companies Act of 2008, the case is still important in relation to the meaning of the phrase “acquisition of securities” and mandatory offers generally. This case is not dealt with in your casebook but it forms part of the prescribed material and is considered below.

The facts of the case are briefly as follows: The defendant agreed to buy a controlling shareholding of more than 30% of the shares in the offeree company. (Note that, at the time, the specified percentage was 30%. It has now been increased to 35%.) It was common cause that the transaction amounted to an affected transaction. The defendant buyer subsequently repudiated the agreement. The seller of the shares accepted the repudiation and cancelled the contract before any offers had been made to minority shareholders. The court had to decide whether the agreement to buy the shares gave rise to an obligation to make mandatory offers to the minority shareholders. Cameron J in the court a quo considered that two factors were important in resolving the issue. These were the definitions of the words “acquisition” and “securities” in the Securities Regulation Code on Takeovers and Mergers (“the Code”) and the Companies Act, as well as the underlying purpose and rationale of the Code. The court a quo concluded that the agreement resulted in the buyer acquiring an interest in respect of sufficient securities, and, even though the agreement was subsequently cancelled, the defendant buyer had an obligation to make mandatory offers to the minority shareholders. You should study the judgment of Cameron J in order to improve your general understanding of mandatory offers.

The decision of the court a quo was reversed on appeal. Marais JA, who delivered the unanimous judgment of the Supreme Court of Appeal (SCA), held that, on the facts, the defendant buyer had not incurred an obligation to make an offer to the minority shareholders. A brief summary of the decision of the SCA which is taken from an article by Luiz “Mandatory Offers” (2000) 12 SA Merc LJ 382 at 388–389, follows.

The main basis on which the court decided that there was no obligation to make mandatory offers to the minority shareholders was that there had in fact been no change in control and there was no prospect of the defendant buyer acquiring control. Marais JA explained that, as the minority shareholders were no longer in danger of having to remain in a company in which control had changed without their approval, the mischief which the Act and the Code had been set up to regulate was “entirely absent”.

The court expressed the view that the Act and the Code should not be read in isolation and that the only circumstances in which Parliament wished to ensure that shareholders are treated equally was when there is a change of control. Marais JA stated that, even if one assumed that the simple conclusion of the agreement amounted to an acquisition of shares giving the defendant purchaser control of the company, when the agreement was cancelled before any offer was made to minority shareholders, “the rationale for the making of a mandatory offer ... no longer existed and it would have been pointless to require an offer to be made to them. No discernible legislative purpose would have been served by it.” Later in the judgment, the judge stated that, even if there had been the required acquisition, the fact that it was

cancelled before offers were made to minority shareholders “without the situs of control having been disturbed in any way” meant that no obligation to make offers arose.

Instead of concentrating on the definitions of “acquisition” and “securities” as Cameron J had done, the SCA asked what mischief the Act and the Code, in particular the mandatory-offer provisions, were attempting to regulate. Luiz (at 390) explains that, “when the court found that the mischief was no longer present in that no change of control would occur, it concluded that there was no basis for applying the provisions imposing an obligation to make mandatory offers”. What do you think of this approach?

Luiz (at 393) asserts that, although the SCA was correct when it stated that the main thrust of the Code and the applicable legislation is to regulate affected transactions, Marais JA “was not correct when he asserted that the definition of ‘affected transaction’ makes a ‘change of control a sine qua non of an affected transaction’”.

## 8.9.2 Compulsory acquisitions and squeeze out

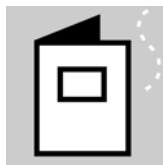
Section 124 of the Companies Act

A compulsory acquisition as contemplated in section 124 is also defined as an affected transaction (see s 117(1)(c)(vii)). An offeror who has had his or her offer for the acquisition of a class of securities of a regulated company accepted by more than 90% of the class (other than securities already held by him or her, related parties, concert parties, nominees and subsidiaries before the offer) may notify the outstanding holders of securities that the offer has been accepted to that extent, and that he or she wishes to acquire the remaining securities. After giving notice he or she is then entitled to acquire the securities on the same terms as the original offer (s 124(1)(a) and (b)). This affected transaction is also known as a squeeze out because the remaining holders of securities (less than 10%) are “squeezed out” of the company. Within 30 days after receiving the notice a holder of the remaining securities may apply to court for an order that the offeror is not entitled to acquire the applicant’s securities, or imposing different conditions of acquisition.

This means that the offeror can effectively force the minority to part with their securities and he or she will become the holder of all the securities in the company. Provision is also made for giving the outstanding minority the right to insist that their shares are acquired in certain circumstances (s 124(4)). In this context, the 90% majority takes into account securities already held by the offeror, nominees, subsidiaries and related parties. This allows the minority to avoid being left as a small minority shareholder in a company whose control has effectively changed.

## LEARNING UNIT 9

# Business rescue proceedings



**Study the prescribed sections in Chapter 20 of your prescribed textbook.  
Study sections 128 to 154 of the Companies Act.**

## 9.1 INTRODUCTION

Sections 20.1–20.2 of the prescribed textbook  
Section 128 of the Companies Act

In the 2004 policy paper, South African Company Law for the 21<sup>st</sup> Century: Guidelines for Corporate Law Reform, which sets out the objectives and scope of its review of corporate law in South Africa, the Department of Trade and Industry specifically included insolvency and the rescue of companies as one of the six areas of company law that would constitute the primary focus of the review process. It went on to state (in paragraph 4.6.2) that “judicial management is rarely used and even more rarely leads to a successful conclusion”. The intention was therefore to create a new system of corporate rescue that would be appropriate to the needs of the present-day South African economy. Chapter 11 of the United States Bankruptcy Code was to be considered when drafting the new corporate rescue provisions.

The business rescue proceedings contained in Chapter 6 of the Companies Act of 2008 are the result of this undertaking by the Department of Trade and Industry.

Carefully note the definitions contained in section 128, particularly those of “affected person”, “business rescue”, “financially distressed” and “independent creditor”.

## 9.2 RESOLUTION BY BOARD OF DIRECTORS TO BEGIN BUSINESS RESCUE

Section 20.3.1 of the prescribed textbook  
Sections 129–130 of the Companies Act

One of the objections to judicial management has been that it may be commenced only by an order of court, which makes the procedure expensive and complicated. It can therefore be regarded as one of the major improvements of the new rescue proceedings that business rescue proceedings may be commenced by a resolution taken by the board. No approval by shareholders is required and the general meeting is also not authorised to take such a resolution.

Note the provision in section 129(7), which is discussed in section 20.3.1 of the prescribed book, that, if a company board has reasonable grounds to believe that the company is financially distressed but decides not to adopt a resolution to commence business rescue proceedings, a notice must be delivered to every affected person (as defined) explaining why the members of the board believe the company to be financially distressed and why they have not adopted a business rescue resolution. What effect do you think this notice will have on the business of the company and its creditors?

To protect affected persons against abuse of the procedure by company boards, section 130 provides that the court may, on application, set aside the resolution or appoint another business rescue practitioner (see section 20.3.1.2 of the prescribed textbook). In terms of the definition in section 128(1)(a), any shareholder or creditor of the company, a registered trade union representing employees of the company, and any individual employee who is not so represented, qualify as affected persons and may thus bring such an application.

### 9.3 COURT ORDER TO COMMENCE BUSINESS RESCUE PROCEEDINGS

Section 20.3.2 of the prescribed textbook  
Sections 31(3) and 131–132 of the Companies Act

The possibility of commencing business rescue proceedings by an order of court is also included in the Act. Any affected person may apply for such an order, but the company or directors may not apply.

Note the two alternative grounds on which an applicant may rely, instead of proving financial distress (section 20.3.2 of the prescribed textbook). Also note the provisions of section 31(3) in terms of which a trade union may demand access to a company's financial statements for purposes of applying for an order commencing business rescue proceedings.

### 9.4 LEGAL CONSEQUENCES OF BUSINESS RESCUE PROCEEDINGS

Section 20.5 of the prescribed textbook  
Sections 133–137 and 144–149 of the Companies Act

Two very contentious provisions are mentioned in this part. Firstly, section 135 provides that any claims for remuneration or other payments that become due to employees during business rescue proceedings will enjoy preference above all other creditors' claims, even those of secured creditors who provided post-commencement financing to the company. Only the business rescue practitioner's claims for remuneration and expenses, and other claims for costs of the business rescue proceedings, rank higher than these claims of employees (see section 20.5.2 of the prescribed textbook). It remains to be seen whether a company will be able to obtain any financing during business rescue proceedings under these conditions.

The second and even more contentious provision is the one discussed in section 20.5.4 of the prescribed textbook. This deals with section 136(2), which gives a business rescue practitioner the power to suspend, for the duration of the business rescue proceedings, any obligation of the company in a contract (except an employment contract or a contract to which ss 35A or 35B of the Insolvency Act apply) to which the company is a party, for example by suspending the clause that requires payment by the company in a contract of sale, but demanding delivery of the goods, or suspending the clause requiring the provision of security by the company for a loan, but insisting on the loan being made. The business rescue practitioner may also apply to court for an order to entirely, partially or conditionally cancel any agreement to which the company is a party, on any terms that are just and reasonable in the circumstances.

### 9.5 THE BUSINESS RESCUE PRACTITIONER

Section 20.6 of the prescribed textbook  
Section 138 of the Companies Act

The provisions requiring the appointment of a business rescue practitioner who is either a member of a regulated legal, accounting or business management profession, or licensed by the Commission, to manage and supervise the company during business rescue proceedings are also a major improvement over judicial management, where no qualifications were required for appointment as a judicial manager. The exact qualifications that will be required will be determined by the regulations made under the Companies Act of 2008.

### 9.6 THE RIGHTS OF CREDITORS DURING BUSINESS RESCUE PROCEEDINGS

Section 20.8.3 of the prescribed textbook  
Sections 145 and 147 of the Companies Act

Note that, unlike the situation in insolvency law, secured creditors also have voting rights for the secured part of their claims and not just for the unsecured part.

## 9.7 THE BUSINESS RESCUE PLAN

Section 20.7 and 20.9 of the prescribed textbook  
Sections 150–153 of the Companies Act

The fact that judicial management does not provide for the drafting and execution of a rescue plan has also been cited as one of the reasons for its failure to become an effective rescue procedure. The Act now prescribes highly detailed requirements for a business rescue plan and its approval by (mainly) the creditors.

## 9.8 TERMINATION OF BUSINESS RESCUE PROCEEDINGS

Section 20.4 of the prescribed textbook  
Section 132 of the Companies Act

Note that the practitioner is not compelled to apply for more time if the rescue proceedings have not ended within three months, but if he or she does not, then he or she must deliver a written progress report to the court or Commission every month. Do you think a period of three months is sufficient for the completion of the whole process?



## LEARNING UNIT 10

# Compromises



**Study the prescribed sections in Chapter 20 of your prescribed textbook.**

**Study section 155 of the Companies Act.**

### 10.1 INTRODUCTION

Section 20.10.1 of the prescribed textbook

The compromise procedure in terms of section 311 of the Companies Act of 1973 was often used to rescue a company or business.

The procedure entailed an application to court by the company, a creditor, member, the provisional or final liquidator if the company was being wound up, or the provisional or final judicial manager if the company was under judicial management, for an order directing that a meeting of the creditors (or class of creditors) of the company be called to consider a proposed compromise (s 311(1)). If the prescribed majority agreed to the compromise, the applicant had to approach the court again to sanction the compromise. Thereafter, the compromise would be binding on all creditors or on that class of creditors and also on the company (and the liquidator or judicial manager) (s 311(2)).

Chapter 6 of the Companies Act of 2008 contains the new business rescue proceedings as well as a new procedure for a compromise between a company and its creditors (s 155). You will know that you understand this learning unit if you are able to answer the following **key questions**:

- Who may propose a compromise?
- How is a proposal for a compromise structured?
- What information must be provided in a compromise proposal?
- What are the requirements for the adoption and approval of a compromise?
- What are the effects of a sanctioned compromise?

In section 155, the Companies Act of 2008 provides for a new procedure for effecting compromises. In terms of the new Act, a company may effect a compromise with its creditors irrespective of whether it is in financial distress (as defined in s 128(1)(f)), unless it is engaged in other business rescue proceedings in terms of Chapter 6 of the Act.

In terms of section 155(2), the board of a company or its liquidator (if the company is being wound up) may propose an arrangement or a compromise of its financial obligations to all its creditors or to all the members of any class of its creditors. Note that, unlike a compromise in terms of section 311 of the Companies Act of 1973, this compromise procedure is limited to creditors and does not provide for a compromise with shareholders (see Learning Unit 8 for the provisions regarding an arrangement between the company and its shareholders, which is one of the fundamental transactions).

A proposal for a compromise must be made by delivering a copy of the proposal and notice of a meeting to consider the proposal to the Commission and to every creditor of the company or every member of the relevant class of creditors whose name and address is known to, or can reasonably be obtained by, the company (s 155(2)).



## 10.2 PRESCRIBED CONTENTS OF A PROPOSAL

Section 20.10.2 of the prescribed textbook

Note the similarities between the prescribed contents of a compromise proposal and a business rescue plan.

## 10.3 ADOPTION AND SANCTIONING OF THE PROPOSAL

Section 20.10.3 of the prescribed textbook

Note that the proposal must first be adopted by the required majority of creditors, and then an application must be made to court for an order sanctioning the compromise.

Unlike the section 311 compromise, the new compromise procedure requires only one application to court, namely an application to approve the compromise once the proposal has been adopted by the required majority of creditors. It will therefore no longer be necessary to ask the court's permission to arrange a meeting where the proposed compromise will be discussed and voted on.

## 10.4 EFFECTS OF APPROVAL

Section 20.10.3 of the prescribed textbook

If the compromise is approved by the court, a copy of the order must be filed with the Commission by the company within five business days (s 155(8)(a)). A copy of the order must also be attached to each copy of the company's Memorandum of Incorporation (MOI) that is kept at the company's registered office or elsewhere as contemplated in section 25 (s 155(8)(b)). Most importantly, the order of court sanctioning a compromise is final and binding on all the company's creditors or all members of the relevant class of creditors, as the case may be, from the date on which the copy of the order is filed (s 155(8)(c)). However, a compromise sanctioned in terms of section 155 does not affect the liability of any person who is a surety of the company (s 155(9)).

A liquidator may also enter into a compromise with creditors in terms of the new section 155 discussed above. Section 311(4) of the Companies Act of 1973 specifically referred to the possibility that a compromise could provide for the discharge of the winding-up order. Section 155 does not contain a similar provision but it is clear from other provisions that this is envisaged, especially since there would not be any other reason for a company that is being wound up to enter into a compromise with its creditors.

## LEARNING UNIT 11

# Insider trading



Note that your textbook deals with the Securities Services Act 36 of 2004 on insider trading. This Act has been repealed and replaced by the Financial Markets Act 19 of 2012. You must therefore study all the information contained in this learning unit and in sections 77–79, 82, 84–85 and 109 of the Financial Markets Act 19 of 2012.

### 11.1 INTRODUCTION

The Financial Markets Act (FMA) has repealed the Securities Services Act 36 of 2004 (“SSA”). The FMA came into force on 3 June 2013. Market abuse is dealt with in Chapter X of the FMA. The offence of insider trading is dealt with in section 78 of the FMA, while prohibited trading practices are dealt with in section 80 of the FMA, and the prohibition of false, misleading or deceptive statements, promises and forecasts is dealt with in section 81 of the FMA.

### 11.2 RELEVANT DEFINITIONS

Relevant sections: Sections 77 and 79 of the FMA

The definitions of “insider” and “inside information” are very important because if you look at the definitions of the various insider trading offences, you will see that if the information is not inside information, or there is no insider involved as required by the definition of an offence, no insider trading offence has been committed.

### 11.3 OFFENCES AND DEFENCES

Relevant sections: Sections 77 and 78 of the FMA

It is not sufficient to prove that the alleged offender was in possession of inside information, but it must also be proved that he or she **knew** that it was inside information. However, it is not necessary to prove that the insider acted on the basis of the inside information or because he or she had the inside information. It is sufficient to prove that the insider had inside information and knew it when committing the offence.

The correct and complete definitions of the insider trading offences as listed in the textbook are thus as follows:

1. An insider who **knows** that he or she has inside information and who **deals** directly or indirectly or through an agent (for example a stockbroker) for his or her **own account** in the securities listed on a regulated market to which the inside information relates, commits an offence (s 78(1)).
2. An insider who **knows** that he or she has inside information and who **deals** directly or indirectly or through an agent (for example a stockbroker) for **any other person** in the securities listed on a regulated market to which the inside information relates, commits an offence (s 78(2)).
3. The FMA has introduced a new offence of dealing for an insider, contained in section 78(3). It provides that any person who deals for an insider directly or indirectly or through an agent in the securities listed on a regulated market to which the inside information possessed by the insider relates or which are likely to be affected by it, who knew that such person is an insider, commits an

offence. In this case, the person dealing is not an insider because he or she does not have inside information, but knows that the person on whose behalf he or she is dealing, is an insider.

4. An insider who **knows** that he/she has inside information commits an offence if he or she **discloses** that information to another person (s 78(4)(a)). Even if the other person does not commit any insider trading offence after the disclosure, it is still an offence to disclose it.
5. It is also an offence for an insider who **knows** that he or she has inside information to **encourage** or cause another person to deal or to **discourage** or stop another person from dealing in the securities listed on a regulated market to which the inside information relates or which are likely to be affected by it (s 78(5)). This covers the situation where no actual inside information is disclosed but the insider merely encourages or discourages the other person to act in a certain way. The Act does not provide for any defences to this prohibition.

### Defences to some insider trading offences

Note that the Financial Markets Act provides for valid defences against some of the insider trading offences.

## 11.4 SANCTIONS AVAILABLE

Relevant sections: Sections 82, 84 and 109 of the FMA

Section 82 of the Financial Markets Act deals with liability resulting from insider trading.

Any person who contravenes section 78(1), (2) or (3), is liable to pay an **administrative sanction** not exceeding

- # the equivalent of the profit that the person, or such other person or the insider (as the case may be) made, or would have made if he or she had sold the securities at any stage; or the loss avoided through such dealing; and
- # an amount of up to R1 million, to be adjusted by the Registrar annually to reflect the Consumer Price Index,
- # plus three times the amount of the profit or loss referred to above;
- # interest; and
- # costs including the investigation costs.

The phrase “or would have made a profit if he or she had sold the securities at any stage” has been included to deal with the situation where the insider buys securities when he has inside information and then keeps the securities and does not actually realise the profit.

Any person who contravenes section 78(4) or (5) is liable to pay an administrative sanction not exceeding

- # the equivalent of the profit that the other person made or would have made if he or she had sold the securities, or the loss avoided if the recipient of the information or such other person dealt in the relevant securities; and
- # an amount of up to R1 million, to be adjusted by the Registrar annually to reflect the Consumer Price Index,
- # plus three times the amount of the profit or loss referred to above;
- # interest; costs including the investigation costs; and
- # any commission or consideration received for the disclosure, encouragement or discouragement.

If the other person referred to in section 78(2), (3), (4) and (5) is liable as an insider in terms of section 78(1), the insider referred to is jointly and severally liable with that other person to pay the equivalent of the amounts set out above.

## 11.5 Special enforcement provisions

The FMA does not include an equivalent of section 77 of the SSA, which allowed the FSB to bring a civil action in court against a person who had contravened the insider trading provisions. Refer to section 82 of the FMA, which deals with liability resulting from insider trading and which only makes provision for the imposition and payment of an administrative sanction.

Special enforcement procedures for inter alia market abuse, are found in the Financial Institutions (Protection of Funds) Act 28 of 2001 as amended by the Financial Services Laws General Amendment Act 22 of 2008 which came into effect on 1 November 2008.

The Registrar of Securities Services (who is the executive officer of the FSB) has the authority to **investigate complaints** against persons providing securities services.

The Registrar may then hand over the matter to the National Prosecuting Authority for criminal prosecution or refer it to the Enforcement Committee to be dealt with in terms of the Act.

An Enforcement Committee is a committee established by the FSB in terms of section 10(3) of the Financial Services Board Act 97 of 1990. Members of the committee must be persons with appropriate experience and knowledge of the relevant field and must include advocates and attorneys.

The Enforcement Committee has the responsibility of enforcing compliance with laws regulating the provision of financial services. Matters referred to the Enforcement Committee will be assigned to a panel consisting of at least three members of the Enforcement Committee who will then deal with the matter (s 10A(2)(a)(ii) of the Financial Services Board Act). A majority decision by the panel will be considered to be a decision of the Enforcement Committee (s 6D(4) of the Financial Institutions (Protection of Funds) Act).

If the Enforcement Committee decides that a person has contravened section 78 of the Financial Markets Act (i.e. the insider trading prohibitions) that person could be ordered to pay an administrative sanction as set out above. The FSB must deposit this money into a special trust account and is entitled to reimbursement from this account of all expenses incurred in bringing these proceedings, but the balance of the funds must be distributed to persons who dealt in the same securities at the same time but did not have the inside information. They will receive the difference between the actual price at which they dealt and the price at which they would have dealt (as determined by the Enforcement Committee) if the inside information had been published at the time of dealing.

A determination by the enforcement committee has the force of an order made by the High Court and may be enforced (s 6E(2)).

A person who is aggrieved by the decision of the Enforcement Committee to impose an administrative penalty has the right to appeal to the High Court

## **11.6 THE FINANCIAL SERVICES BOARD AND THE DIRECTORATE OF MARKET ABUSE**

Relevant sections: Sections 84 and 85 of the FMA

The powers and duties of the Financial Services Board (FSB) are regulated by section 84 of the Financial Markets Act. In terms of this Act the FSB is responsible for the supervision of compliance with the chapter on market abuse in the Financial Markets Act which includes the insider trading regulations and the provisions dealing with prohibited trading practices.

The FSB has the power to investigate matters relating to insider trading and to administer proof of claims and distribution of awards. Further, the FSB may summon persons to furnish information, lodge documents or to appear for interrogation by them. Failure to appear, give evidence or produce any document is an offence. The FSB may enter and search premises and examine, seize and make extracts of documents. This must be done with a warrant although in certain circumstances no warrant is required.

Two new powers have been included in the FMA. Section 84(1)(b) provides that the FSB may, at the request of a supervisory authority, investigate or assist that supervisory authority in an investigation into possible offences similar to those referred to in section 84(2)(a), regulated in terms of the laws of a country other than South Africa that the supervisory authority administers. Section 84(2)(e) provides that the FSB may, by notice on the official website or by means of any other appropriate public media, make known the status and outcome of its investigations and the details of an investigation if disclosure is in the public interest.