

**CAPITAL RULES IN THE NEW COMPANIES  
ACT NO. 71 OF 2008**

**by**

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# CHAPTER 1

## INTRODUCTION

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### 1.1 Introduction

For the company to exist and continue its existence it requires capital from investors in-order to carry out its functions.<sup>1</sup>It is submitted that the need for capital has played a vital role during the early development of company law during the industrial evolution. The capital includes both the share capital, which is received when a company issues shares to shareholders as well as the loan capital, which the company obtains from issuing debentures to creditors<sup>2</sup>. In addition, the regulation of shares into par value and no par value shares is also the most important aspect of company law. However, it should be noted that the new Act only provides for the no par values shares, following numerous criticisms against the par value shares.<sup>3</sup>

In order to protect the capital of the company, capital rules were formed to restrict the company from engaging in transactions that would adversely affect the capital of a company. For instance, in the event of insolvency of the company, members have no claim in respect of the capital contributed because their claims are considered last. Hence, the English common law principle of maintenance of capital was introduced to protect the interests of creditors.<sup>4</sup>. The idea behind the rule was that creditors depend on the company's funds for payment and are at risk of being prejudiced if the company pays out its fund by returning share capital.

### 1.2 Background

South African law adopted the capital maintenance rule from the English model (common law) as outlined above. This principle is based from the case of *Trevor v Whitworth* (1887) 12 AC 409 (HL) which created precedence for this rule because some of the conclusions on this were

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<sup>1</sup> Van der Linde K E (2007) “*Par value or no par value shares- Is that a question?*” 19 SA Merc LJ, UNISA 473-476

<sup>2</sup> Cilliers and Benade (2000) *Corporate Law* 3<sup>rd</sup> ed.: Butterworths, p 221. This describes shareholders equity as the internal source and loan capital as an external source.

<sup>3</sup> McLennan J S (2002) “*Time for abolition of the par-value shares*” 119 SALJ 39- 43.

<sup>4</sup> 1989 (3) SA 71 (T), *Exparte Lebowa Development Corporation Ltd*: In this case, it was argued that persons that invests in the company rely on the issued share capital for the payment of their claims.

that a company may not buy back its own shares, pay dividends out of capital and issue shares at a discount. This endorsed the need to protect creditors because shareholders obtain the benefit of limited liability when they invest in a company, but this come at a cost to the creditors. The philosophy in the United Kingdom was that capital is a fund available to meet creditors' claims<sup>5</sup>, hence its argued that creditors need to be compensated and that this be provided by law rather than contract. The capital maintenance rule was formalised in South African context through the Companies Act 61 of 1973<sup>6</sup> in consideration of common law. It has been argued that capital rules are no longer an appropriate means of protecting the interests of creditor. However, after the rules were incorporated into our law, it transpired that the rules were not easy to apply as a result they were argued to be "imprecise and uncertain" and contained serious flaws in respect of the ability of the company to protect itself against manipulation of share prices". The principle of maintenance of capital was not a point of departure, but the technicalities presented by the rule were enormous.<sup>7</sup>

South African law developed through the enactment of the amendment Act (Act 37 of 1999) which was intended to relax the capital maintenance principle and adopted a US approach on capital rules as contained in the Model Business Corporation Act (MBCA) in order to provide maximum flexibility to shareholders<sup>8</sup>. The capital maintenance rule, as implemented and refined in the US, requires that two tests should be satisfied - an equity solvency test (liquidity test) and a balance sheet solvency test (net assets or solvency test)<sup>9</sup>. The liquidity test requires that a company should be able to meet its cash-flow requirements and the net assets test requires that assets must exceed liabilities. In these cases, no minimum capital requirement is necessary. The 1999 Act tried to improve the rigid rules of the previous legislation and included provisions for both the protection of shareholders and options for the protection of creditors. After the enactment in 1999, a company could acquire its own shares under certain circumstances (s85) (2) (d) and could make payments to its shareholders (s90), irrespective of its profitability, but provided that it met the solvency and liquidity test and that there is authorisation of such payments through the articles of the company.

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<sup>6</sup> Companies Act No. 61 of 1973, The Act introduced a system of no par value shares

<sup>7</sup> Delpont P A "*Capital rules*", Dejure , 411

<sup>8</sup> Mode Business Corporation Act, 1990

<sup>9</sup> Government Gazette No 26493, 23 June 2004 , 36

Recently, South Africa has undergone a major process of law reform, culminating in the Companies Act No. 71 of 2008, which will come into effect in 2010. This Act makes significant changes to South African law, including the capital rules. The changes include *inter alia* provision for financial assistance for subscription of securities and acquisition of own shares subject to fulfilment of certain conditions, restrictions on distributions and issuing of authorised shares as capitalisation shares to the shareholders on a pro rata basis. The Act has also removed the par value concept which forms part of the capital maintenance concept.<sup>10</sup> These rules have shifted from an outdated approach to a more modern approach, but the efficiency and applicability of these rules remains a question. It is not clear whether South Africa wants to completely remove this outdated concept or improve its applicability.<sup>11</sup>

### 1.3 Problem Statement

It has been argued by the legal scholars, from which South Africa took a direction for the capital rules, that the main intentions of the inclusion or the development of the capital rules in many countries like in the US and UK, is to regulate the conflict that exist between creditors and shareholders in a company regarding how to allocate the capital of a company.<sup>12</sup> The reason behind this thinking is the fact that in most circumstances, shareholders control the operations of a company directly, through the general meeting and indirectly, through the board of directors. In this regard, they are in a better position to benefit themselves at the expense of the creditors by for instance making distributions to themselves and in so doing reducing the equity available to repay creditors or manipulating the investment profile of the company in a way which disadvantages creditors.

On the other hand, it should be noted that it has also been argued that creditors can also engage in behaviour which advantages themselves at the expense of the shareholders. However, this thinking has not been substantiated properly as it is a reality that most creditors will not have the control necessary to enable these measures to be implemented. With the new capital rules under the Companies Act of 2008, many restrictions have been relaxed by the inclusion of the

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<sup>10</sup> Van der Linde K E supra n1. This article deals with the regulation of company shares and gives more information to the differences between the par-value shares and the no- par value shares. It also emphasised on the need to remove the dual system as it contributed to the outdated capital regime.

<sup>11</sup> Armour J (2006) “*Legal capital: outdated concept?*” University of Oxford – faculty of law, Oxford-Man Institute of Quantitative Finance; European Corporate governance Institute

<sup>12</sup> Payne J (2008) “*Legal capital in the UK following the Companies Act 2006*”: Hart Publishing.  
<http://www.ssrn.com/link/oxford-legal-studies.html>



solvency and liquidity requirements. The question that arises in mind is whether the intention of the new Act is to remove the capital maintenance doctrine which seeks to protect creditors or to enhance its relevance in the modern company law as the solvency and liquidity tests presents some form of a restriction.

#### **1.4 Research Problem and Research Questions**

The noticeable problem provided by the new Act is the procedure by which the capital rules are regulated. Through Part C, which deals with capitalisation of shares companies are required to fulfil the solvency and liquidity requirements before performing certain transactions.

For the purposes of this research, the approach that will be employed is to analyse the capital rules as enshrined in the new Companies Act in order to point out its efficiency and its shortcoming and its applicability. In order to properly provide the analysis, a comparison with the Companies Act No. 61 of 1973 would be necessary to advocate the transition from the old Act and the gaps on the new Act.

Legal scholars have criticised the capital rules as failing to achieve what critics contend is the concepts' goal, "to protect creditors from shareholders".<sup>13</sup> The main research question that this study seeks is whether creditors need protection and to what degree do they need protection? In answering the main questions, the following are to be answered to shed more light:

Whether the capital rules are an appropriate method of protecting creditors?

Whether the new capital rules offer protection creditors and shareholders?

#### **1.5 Significance of the Research**

This research is focused on the new Companies Act as it relates to capital rules. In other words it addresses the provisions of the new companies act in relation to obligation of a company to contribute, distribute and maintain capital. In so doing the study will compare the previous Act

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<sup>13</sup> Peterson G A and Hawker N W, *Does corporate law matter? Legal capital restrictions on stock distributions*, 14 "Creditors, it is argued, focus "not on the sufficiency of assets remaining upon liquidation of the corporation..., but rather on the corporation's prospects for remaining a viable, on-going concern. Some critics suggested that legal capital may even be misleading "to the extent that [creditors] are led to believe that it provides some protection. Not only does the legal capital fail to protect creditors, it also imposes significant costs on corporations."

to the new Act with the aim to identify loopholes or gaps that were provided by the previous Act and how they have been addressed by the new Act and whether the current standing of the legislation is sufficient to address the problems. If it is not sufficient it will try to provide recommendations. This assessment is practically relevant because the content of company law has recently been reviewed and the rules relating to capital rules have always been regarded as contentious. The appropriateness of the capital rules will be investigated in order to examine also the need to align the new provision to other relevant provisions such as insolvency law, contract law provisions.

## **1.6 Research Methodology**

The approach in this study would be descriptive, analytical, comparative and prescriptive. The descriptive approach would be employed because there would be an overview and history of the evolution of capital rules in South African law. Although these rules have been loosened in the recent years (in particular 1999) they continue to bring controversy in company law. The analytical approach would be employed to evaluate the capital rules currently proposed by the new Act. A comparative approach would be used to determine in what changes have been made in the new legislation vis a vis the previous Act in order to identify strengths and weaknesses of the new Act. Lastly the prescriptive approach would be used at the end in the form of recommendations that aim at addressing the capital rules problems.

Moreover, intensive library research and desk top literature based review would be employed. This would entail gathering and analysing available literature from the library and the internet. Primary and secondary sources of information would be used.

## **1.7 Proposed Structure of the Dissertation**

*Chapter 1* is an introductory chapter that contain the background to the study, research problem and questions, research methodology, significance of research and chapter review.

*Chapter 2* will assess capital contributions and distributions.

*Chapter 3* will analyse the provisions of capital rules with regard to financial assistance for acquisition of shares

*Chapter 4* will analyse the provisions of capital rules with regard to the acquisition of shares by a company or subsidiary

*Chapter 5* the main conclusions drawn from the analysis would be outlined and will consider the future and recommendations on what further changes in this area is necessary and desirable.

## **1.8 Scope and Delineation of Study**

The study shall be limited to capital distributions and capital maintenance and will not address any industry specific capital rules such as those relating to banks, brokers or insurance companies.

# CHAPTER 2

## SHARE CAPITAL AND DISTRIBUTIONS BY A COMPANY

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### 2.1 Introduction and background

In view of capital maintenance theory, South African law imposed legal restrictions on payment of dividends out of issued share capital to shareholders.<sup>14</sup> This is a common law theory, which envisaged that contributions constituted a trust fund for the payment of all debts of the company and hence dividends were only allowed to be paid out of divisible profits and not capital of the company.<sup>15</sup> This theory simply prevented the shareholders from withdrawing the assets they had contributed to the company until its creditors had been paid. It is clear that the aim of the rule was to protect creditors by trying to minimise the risk of business failure and creditor's losses in case the business was unsuccessful. Some critics argue that, the main concern for the prohibition in South Africa is not the capital maintenance concept but restricting the unlawful application of share capital.<sup>16</sup>

The situation changed in South Africa after the amendment of section 90 of the Act of 1999, because the principle of maintenance of capital was changed by the insertion of sections 85-89. In terms of this section, a company could make payments to shareholders on condition that there were reasonable grounds for believing that the company is, and after the payment is made will be, able to pay its debts as they fall due and that the consolidated assets will after the payment exceed the consolidated liabilities<sup>17</sup>.

In line with the direction followed by the Companies Act of 1973, as amended, the new Companies Act No 71 of 2008 (the new Act) also adopted the capital maintenance rule which is based on considerations of solvency and liquidity. Section 46 deals with the regulation of distributions by a company. This prohibits any form of distribution of corporate assets to

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<sup>14</sup> Cilliers and Benade supra n2 , “The rule that dividends may not be paid out of capital , which formed one of the cornerstones of the concept of capital maintenance, had as a coreollary that dividends must only be paid out of profits” 3<sup>rd</sup> , 342

<sup>15</sup> Cassim F.H.I and Cassim Rehana “ *The capital maintenance concept and share repurchases in South African law*”. Bowman Gilfian attorneys, <http://www.bowman.co.za/lawarticle/lawarticle~id~639353216.asp>

<sup>16</sup> Cilliers and Benade supra n2, 345

<sup>17</sup> Companies Amendment Act No. 37 of 1999 , S90 (2) (a) and (b)

shareholders except where the value of the distribution is less than that of the profits available for distribution.

## **2.2 Definition of distribution.**

Distribution is defined in the new Act as 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 one more holders of any of the shares of that company or of another company within the same group of companies. The definition is broad enough to cover both distribution in the form of dividends and payment in lieu of capitalisation shares. Payments pursuant to acquisition of shares by a company are also included, which is not the case with the definition of “payments to shareholders” in section 90 of the old Act. Section 90 only applies to situations where there is actual payment to shareholders and in the absence of such payment, restructuring of capital in the company are only subject to the Act and provisions of the memorandum and articles<sup>18</sup>.

## **2.3 Share capitalisation**

The key statutory provisions embodying the capital maintenance rule is Part D of the new Companies Act of 2008, which deals with capitalisation of profit companies. Section 47 (1) this Act provides that the board of that company, by resolution, may approve the issuing of any authorised shares of the company, as capitalisation shares, on a pro rata basis to the shareholders of one or more classes of shares subject to the solvency and liquidity tests being satisfied by the board<sup>19</sup>.

For the purposes of this discussion it is important to understand the meaning of capitalisation or share capitalisation. Share capitalisation refers to the capital structure of a company, in other words, the nature of a company’s wealth – including how many shares a company has and how those shares are structured. A share is a partial part of the capital of a company which becomes a person’s personal property when issued. However, the assets of the company remain the property of the company. Shares confer rights, limitations preferences, liabilities and other share terms onto the owner<sup>20</sup>. Possible rights may include the right to dividends, the right to vote and/or the right to participate in the distribution of assets upon the liquidation of

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<sup>18</sup> *Henochsberg on the Companies Act*: Lexis Nexis Butterworths, Volume 1 , 186

<sup>19</sup> Companies Act No 71 of 2008, S47 (1)

<sup>20</sup> S37

the company<sup>21</sup>. Shareholder liabilities may include the responsibility to contribute to the capital of the company. The rights and obligations of a particular class of share are described either in the MoI which is the constitution of the company.<sup>22</sup>

Share capital is divided into “authorised capital” under s36 and “issued capital” under section 38. Authorised capital is the maximum amount of shares a corporation is authorised to issue. The authorisation and classification of shares is set out the MoI and can only be changed by the special resolution of the shareholders or the board of directors<sup>23</sup>. This authorisation derives from one of the company’s constitutional documents. A partial number of the authorised capital can remain unissued to shareholders. On the other hand those shares that are actually issued to shareholders are referred to as the “issued capital”<sup>24</sup>. When a share is issued to a shareholder, a certificate is normally distributed evidencing that the listed person is a registered shareholder. The name of the shareholder is included in the company’s share register.

Most importantly, a company may have different classes of shares which confer different rights upon their owners<sup>25</sup>. Each class contains different rights with respect to voting, receiving dividends and receiving capital in the event of liquidation.

## 2.4 Minimum capital requirements

The capital rules compel shareholders to bear some form of risk associated with the company. One way in which it ensures some amount of risk bearing on the part of shareholders is minimum capital. However, it should be noted that minimum capital is not meant to prescribe adequate capitalisation.<sup>26</sup> Potential creditors can look at the amount of subscribed capital to determine whether shareholders have assumed sufficient amount of risk upon incorporation or in a consequent capital increase. The capital maintenance regime provided in the new Act is changed from one based on a minimum amount of share capital to one based on solvency and liquidity. However, the new Act does not prescribe any minimum amount of issued share capital. Therefore, the new Act has somehow removed the capital maintenance rule with regard to minimum capital. The question that arises is how much assets a shareholder must contribute

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<sup>21</sup> S37(3)(b)(i) and (ii)

<sup>22</sup> S37 (3)(a)

<sup>23</sup> S36(2)(a) and (b)

<sup>24</sup> S38

<sup>25</sup> S36(1)(a) and (b) (i) and (ii)

<sup>26</sup> Van der Linde K E (2007) “*Aspects of the regulation of share capital and distributions to shareholders*”, LLD thesis, UNISA, <http://uir.unisa.ac.za/bitstream/105001/2543/1/thesis.pdf>.

in a company and in attempting to answer the question capital maintenance raises questions concerning the type and valuation of assets contributed which is currently not included in the new Act.

The capital rules governing the raising of capital might be understood as a response to an adverse selection of problems in corporate credit markets as mentioned above. The rules make it easier for creditors or investors to find out how much capital has been subscribed to the company. An investor can be sure that the value stated in the company's accounts has actually been contributed by the shareholder. It has also been argued that the extent of the benefit this will generate depends on how useful the information is to investors.

Many legal scholars have investigated the information taken into account by sophisticated creditors and equity investors in making lending decisions. None have found that share capital is considered to be of particular significance. These findings are readily explicable. Share capital is an indication of value contributed to a company by its shareholders at some time in the past. Yet since that value has been put into the company, it may well have been dissipated. Since the information seems to be of little use to investors, these rules are likely to be inefficient. It is clear that, many of these criticisms share a common view or understanding with regard to capital maintenance in that it is unnecessary as it fails to protect creditors against the corporate risks.<sup>27</sup> However, the premise that Capital maintenance exists to protect creditors is what may be at fault.

## 2.5 Conditions for distributions by a company

The new Act restricts distributions by a company unless certain conditions are satisfied<sup>28</sup>. Firstly, it must be pursuant to an existing legal obligation of the company or court order<sup>29</sup> and secondly, the distributions must be authorised by the board of directors<sup>30</sup>. Lastly and more importantly is the fact that, any distribution done is subject to the company complying to both the liquidity and the solvency test as set out in section 4 of the Act “immediately after giving effect to” the board's approval<sup>31</sup>. This means that, a board contemplating a distribution must

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<sup>27</sup> Amour J (1999) “*Share Capital and creditor protection: Efficient rules for a modern Company Law?* ESRC Centre of Business Research. <http://www.cbr.cam.ac.uk/pdf/WP148.pdf>

<sup>28</sup> S46

<sup>29</sup> S46(1)(a)(i)

<sup>30</sup> S46(1)(a)(ii)

<sup>31</sup> S46(1)(b)

first consider solvency and liquidity of the company. The board must actually consider what approvals are required to effect a distribution. The new Act explicitly provides that a distribution requires board authorisation. Although sections 85 and 90 of the Companies Act do not explicitly refer to board approval, this does go without saying. After the board has taken a resolution the distribution must be fully carried out within 120 business days. If not completed the board is obliged to reconsider the solvency and liquidity tests adopt a further resolution pursuant to the original resolution. As mentioned above, the distribution must be pursuant to an existing legal obligation of the company, or a court order or the board of the company, by resolution, has authorised the distribution.

Section 85 of the Companies Act required the authority of a special resolution for share buy-backs whereas, acquisitions under the new Act only need the approval of only an ordinary resolution if made from all shareholders of the class concerned.

It should be noted that in common law the only basis upon which a company could make a payment to its shareholders was by way of a dividend, declared by a company out of its profits. Section 46 provides for distributions to be made to without restricting or qualifying the cause for such distributions if they are authorised by the MoI, subject to the restrictions contained in this section.

Most importantly, the Act provides that when the board of a company has adopted a resolution it must be fully carried out within 120 business days otherwise the process would be started afresh.<sup>32</sup> In this particular instance the board is obliged to reconsider the solvency ad liquidity tests and must not proceed with the distribution unless it has adopted a further resolution.

## **2.6 Solvency and liquidity test**

The solvency and liquidity test in the 2008 Act is similar to the one that a company has to consider with in terms of various sections of the 1973 Act, such as section 85 regarding circumstances when a company may buy back its own shares or make distributions to shareholders. The Companies Act of 2008 applies the solvency and liquidity test in a number of instances such as when a company declares a dividend, buys back its own shares, provides financial assistance for the purpose of or in connection with the acquisition of its own shares or undergoes an amalgamation or a merger. However, this chapter only focuses on the regulations

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<sup>32</sup> S46(2) and (3)



of distributions to shareholders. The new Act incorporated the American approach of Solvency and liquidity which is contained in the Model Business Corporation Act. The MBCA provides that: ‘No distribution may be made if after giving it effect:

(1) the corporation would not be able to pay its debts as they become due in the usual course of business; or (2) the corporation’s total assets would be less than the sum of its total liabilities plus unless the articles of incorporation permit otherwise. It is submitted that the US approach is relies on bankruptcy law much more than on corporation law to limit distributions.<sup>33</sup>

J. W. Hendriese submits that the “Solvency and liquidity are the two sides of the same coin of financial and economic sustainability”.<sup>34</sup> In order to pass the solvency test, the company’s aggregate assets, fairly valued must equal to or exceed the aggregate liabilities (including contingent liabilities) of the company fairly valued in terms of section 4 (1) (a) of the 2008 Act. In order to pass the liquidity test, the company must be able to pay its debts as they become due in the ordinary course of business for a period of 12 months after the date of which the test is considered (or in the case of distribution 12 months after the distribution) in terms of section 4 (1) (a) of the 2008 Act. However, it should be noted that the Act does not define insolvent circumstances.

A majority of the directors are typically required to confirm that the tests are met and to sign a solvency certificate as to their opinion. In other words, the company may not make distributions if it is unable to pay debts as they become due. Civil liability is usually provided to give the right of recoupment by the company of the unauthorised distribution from directors or shareholders. In addition, criminal liability is imposed on a director who signs a certificate knowing that it is false or misleading in a material particular.

A company will satisfy the solvency and liquidity tests at a particular time if, “considering all reasonably foreseeable financial circumstances” at that time:

- the company’s total assets equal or exceed its total liabilities; and
- “it appears that” the company will be able to pay its debts as they became due in the course of business for twelve months following the distribution.

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<sup>33</sup> Engert A (2006) “*Life without legal Capital: lessons from American law*”, 2. <http://www.engert.info/journals>

<sup>34</sup> Hendriese J W (2009) “*The impact of the new companies act and the relevant legislation on boards and directors-responsibilities and risk*” : Paper for CIS Corporate Governance Conference ,unpublished 6 <http://www.icsa.co.za/documents/speakerpress/hendriese>

However, the new Act has included a twelve month test. This is intended to resolve the uncertainty which the Companies Act has created as to the length of time after the distribution over which a company's liquidity must be considered. Further, it is the company's solvency immediately after the distribution that matters. The United Kingdom also applies this twelve month test to private companies to return capital to shareholders by means of a share repurchase, contingent on the directors' ability to declare that the company will remain solvent for twelve months<sup>35</sup>.

Section 46(5) of the new Companies Act, provides that if after the solvency and liquidity it appears to the company that the section prohibits its immediate compliance with a court order, the company may apply to the court varying the original order. The court may then make an order that is just and equitable, having regard to the financial circumstances of the company and should ensure that the person to whom the company is required to make a payment in terms of the original order is paid at the earliest date compatible with the company satisfying its financial obligations as they fall due<sup>36</sup>.

The Companies regulations provide that whenever the aggregate assets of a company and the aggregate liabilities of a company within a group of companies are required to be evaluated in terms of section 4 (1) (a) the evaluation must consider whether the assets of the relevant company equal or exceeds its liabilities and, the assets of each subsidiary of the relevant company equal or exceeds that subsidiary's liabilities.

## **2.7 Protection of creditors**

As discussed previously that the rules of company law that relate to share capital are commonly rationalised as being an attempt to protect corporate creditors. The relevant provisions are generally thought to be unduly complex, and to lack coherence. Some have argued that their very existence is unjustified.

The capital maintenance principle was clearly viewed by the nineteenth century judges who developed it as a means of protecting corporate creditors against the 'extra' risks associated with limited shareholder liability. This envisages protecting creditors from the risk that shareholders would subsequently withdraw their capital investment. Naturally, this would

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<sup>35</sup> UK Companies Act 1985(c.6) ss 171-177

<sup>36</sup> S46(5)(a) and (b) (i)-(ii)

increase the company's gearing and consequently the risk of default. On the other hand the risk that the capital would be lost in ordinary business activities was one which the creditor had to bear, as is made clear by Lord Watson's classic exposition:

'Paid-up capital may be diminished or lost in the course of the company's trading; that is a result which no legislation can prevent; but persons who deal with, and give credit to a limited company ... are entitled to assume that no part of the capital which has been paid into the coffers of the company has subsequently been paid out, except in the legitimate course of its business.'

It has been submitted by the legal scholars that, the idea that creditors require some form of protection against the abuse of limited liability is almost ubiquitous, and is used to explain a wide range of corporate and insolvency law doctrines<sup>37</sup>. Applied to this particular question, it would assert that the law should protect creditors only insofar as the social benefits of such protection exceed the social costs.

However it is not clear whether the new Companies Act protects the creditors as there are many steps to be followed before a distribution can be made. We could safely say it is a measure to maintain the capital of the company.

## 2.8 Liability of Directors for breach

The new Companies Act makes emphasise on personal liability of directors for losses suffered by the company, shareholders and others arising from statutory breaches. The new Act holds directors liable if distributions are made contrary to the provisions of the Act<sup>38</sup> and, in so doing, the directors also breach the provisions of the Act dealing with directors' fiduciary and other duties. The Act provides that a director of a company is liable to the extent set out in section 77(3) (e) (vi) if the director was present at the meeting when the board approved a distribution or participated in the making of such a decision in terms of section 74; and failed to vote against the distribution, despite knowing that the distribution was contrary to this section.

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<sup>37</sup> Amour J (1999) "*Share Capital and creditor protection: Efficient rules for a modern Company law?*" : <http://www.cbr.com.ac.uk/pdf/WPI48.pdf>. The article refers to creditor protection as a norm which is "inadequate to delineate the extent to which such rules are required. Such a norm could be used to rationalise any rule that tends to protect creditors—regardless of the consequences for other groups, or the economy more generally.

<sup>38</sup> S46 (6) (a) and (b)

The directors could be liable for the amount by which the distribution exceeds the amount that could have been distributed without such a contravention. Section 90 of the old Act is silent in this regard, the section does not provide for any liability on the part of company directors or any remedy for the creditors, but they are left with general common law fiduciary duties to which directors are subject and the provisions of section 424 of the Companies Act relating to reckless and fraudulent trading.

Even though the new Act provides for distributions to shareholders, it however restricts companies from making distributions to its shareholders at any point at which the company's net assets do not exceed the stated value of its capital accounts meaning the solvency and liquidity approach.

## **2.9 Conclusion**

Generally, the provisions of part D are similar to those currently contained in section 85 which deals with share buy-backs and section 90 which deals with payments to shareholders of the Companies Act of 1973. Both these legislations kept the capital regime by ensuring that the solvency and liquidity tests are applied before any distributions are made. The other important factor is that the distribution must be pursuant to a legal obligation of the company or a court order. It seems that the new Act is more concerned with the wrongful application of the share capital than the protection of creditors. It also gives absolute liability to the directors for contraventions with S46. In this Act shareholder liability is not included.

# CHAPTER 3

## FINANCIAL ASSISTANCE FOR SUBSCRIPTION OF SECURITIES

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### 3.1 Introduction and background

The new Companies Act 71 of 2008 is removing the restrictions on financial assistance for subscription of shares by providing a gateway procedure that a company could follow in order to allow the granting of financial assistance. The famous rules of common law as indicated in chapter 1, restricted companies from buying back their own shares and issuing shares at a discount, hence the restriction on giving of financial assistance was incorporated. Even though their intention was to protect creditors, these restrictions on companies giving financial assistance have created numerous problems in company law as a result their efficacy is questionable. It has been argued these restrictions are not only unnecessary, but also unquestionably harmful as they are likely to obstruct legitimate, economically worthwhile transactions<sup>39</sup>.

The reason for the prohibition of financial assistance has been that a company may not as a general rule buy its own shares because this involves a return of capital to members. However, the revised rules have been changed and the principle reform is that the prohibition no longer applies to companies. A specific situation is where an individual or company seeks to acquire a controlling interest in the shares of a company i.e. takeover. It is financial assistance if the bidder intends, gaining control of the company, to use the assets of the company to pay for or secure payment of the price of the shares.

The new Act is providing a movement towards a more liberal regulatory framework in order to promote the development of the South African economy by creating flexibility and simplicity in the formation and maintenance of companies. For the purposes of this research, the capital

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<sup>39</sup> Ferran E (2005) “*Financial assistance in the UK*”. 2, European Business Organization Law Review 6: 93-99 9 TMCSSER PRESS © 2005 ...A. <http://www.law.cam.ac.uk/faculty-resources/1002168.pdf>.

rules dealing with financial assistance will be analysed with a view of establishing their efficiency in protecting both creditors and shareholders of a company.

The prohibition was stamped in our law by the Companies Act No 61 of 1973 from English Companies Act to prevent companies from trading in their own shares as a result, reducing its capital unlawfully as discussed in chapter 1. After a lot of deliberations in this regard, the Companies Act was amended in 1999 to allow returns of capital in certain limited circumstances to shareholders in terms of section 38 subject to the fulfilment of certain conditions.<sup>40</sup> It seems like the drive behind the introduction of this section was to ensure that the acquisition of shares is done from the own resources of the interested party and to prevent a potential risk of the company's fund as well as the unlawful reduction of share capital in certain cases. This also raised a lot of controversy as the section still contained the restrictions as will be discussed in detail in this chapter.

### **3.2 Definition of financial assistance**

There is no broad definition of financial assistance outlined in the new Companies Act. However, section 44 (2) of the Act, provides that “financial assistance” includes assistance by way of a loan, guarantee, the provision of security or otherwise, to any person for the purpose of, or in connection with, the subscription of any option, or any securities, issued or to be issued by the company or a related or inter-related company, or for the purchase of any securities of the company or a related or inter-related company. However, this excludes lending money in the ordinary course of business by a company whose business is lending of money.

The definition provided by the new Act is not comprehensive and this is going to create inconsistencies in the interpretation of the definition of financial assistance as it was previously the case before the new Act. This has been the situation even in the previous legislations whereby the courts used certain tests, to determine if financial assistance had been given by a company. One such test include the impoverishment test, which was used in *Gradwell (Pty) Ltd*

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<sup>40</sup> Companies Act of 1999, supra n15. A company is according to this section is prohibited from giving financial assistance “*whether directly or indirectly, and whether by means of a loan, guarantee, for the purpose of or in connection with a purchase or subscription made or to be made by any person of or for any shares of the company, or where the company is a subsidiary company, of its holding company.*” According to Henochsberg on the Companies Act supra “It relates to ‘any’ financial assistance, whether given ‘directly or indirectly’, and it relates to such assistance not only when it is given for the purposes of the purchase of or subscription for any shares in the company, but also when it is given ‘in connection with’ such purchase or subscription.”

v *Rostra Printers Ltd*<sup>41</sup> This involved asking if a company had become poorer as a result of what was done for the purpose of, or in connection with, the purchase of or subscription for the company's shares<sup>42</sup>. In addition to the above, this test has also been critiqued by courts in *Lipschitz v UDC Bank Ltd*<sup>43</sup>, whereby the AD stated that the primary "concern is not only at preventing actual loss of company funds but also at the exposure of company funds to possible risk".

### **3.3 Procedure by a company to give financial assistance**

The new Act has given away the restrictions on giving of financial assistance by the introduction of section 44 which allows giving of "financial assistance" by a company or subsidiary subject to certain requirements that must be satisfied. This section replaces section 38 of the Companies Act of 1973, which prohibited the giving by a company of financial assistance for the purchase of shares in itself or in its holding company. However this section was amended in 2007 to allow the giving of such assistance provided that the company was authorised to do so by way of a special resolution of its members and that after the giving of such assistance, the company was both solvent and liquid (the so-called "solvency and liquidity test"). Section 44 applies to "securities" as stipulated Securities Services Act of 2004, which includes "shares, bonds, debentures, and this is different to section 38 which only applied to shares.

#### **3.3.1 Authorisation by the Memorandum of Incorporation (MoI)**

According to the new Act in terms of section 36, the MoI must permit the giving of financial assistance, which sets out terms with regard to the classes and number of shares that a company is authorised to issue including the preferences, rights and limitations. The conditions or restrictions with respect to the granting of financial assistance stipulated in the MoI must be satisfied before any decision is made.<sup>44</sup>

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<sup>41</sup> 1959 (4) SA 419 (A)

<sup>42</sup> Pretorius J T et al(2007) "*Hahlo's South African Company Law Through Cases*" Juta Legal and Academic publishers, 130

<sup>43</sup> 1979 (1) SA 789 (A)

<sup>44</sup> S44 (4), this section requires a board to ensure that all conditions in the MoI are complied with.

### 3.3.2 Conditions of giving financial assistance

In order for a company to provide financial assistance to any other person for the purpose of acquiring or subscribing to any shares in the company or its holding company, all of the following procedure must be followed:

- i. The Board of directors must, by means of a vote of a majority of all the directors holding office at the time of the resolution, and after taking into account the financial position of the company and conditions of the MoI, their fiduciary obligation towards the company, pass a resolution to authorise the granting of financial assistance by the company for a specific transaction;
- ii. The Directors' resolution must be affirmed by an special resolution adopted by the shareholders of the company within in two years of such assistance<sup>45</sup> ;
- iii. The conditions must have been complied with, prior to the contemplated grant of financial assistance by the company; and
- iv. The financial assistance must be pursuant to an employee share scheme in terms of s97

The board approval has relaxed the requirements of s38 (2A) of the old Act of obtaining shareholder approval on a transaction-by-transaction basis. This has brought some form of flexibility of the procedure for giving of financial assistance.

The new provisions have, however, also attracted a reasonable degree of criticism. Those who advocate the prohibition's total abolition criticise that the mere introduction of a formal procedure to derogate from the general restriction in certain cases, and only in respect of private companies, does not go far enough. The question is whether section 44 completely removes the prohibition as intended by the legislature.

The new Act also provides for giving of financial assistance to be issued by a company or a related or inter-related company for purchase of securities of the related or interrelated company in terms of section 44 (2). The relationship between a holding and a subsidiary company is designed to regulate abuse of control and to ensure that there is disclosure of the group financial information. Therefore, a company was not allowed to give financial assistance to itself. There are accordingly two fundamental requisites, the transaction in a company has to be acceptable in terms of the MoI as this document form the constitution of the Company and

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<sup>45</sup> S44(3) (c)



the members must pass a resolution authorising the assistance. The approval may either be general or specific.

Notwithstanding the above challenge, by allowing companies to assist in financing the purchase of their own shares by third parties will make transactions less complex and expansive. It should also be noted that the intention of the prohibition to perform certain creditor and shareholder functions, prevent manipulation of the price at which securities trade in the market and curb abusive practices in takeovers.

### **3.3.3 The Solvency and liquidity approach**

In terms of section 44, a company may give financial assistance for the purchase or subscription of its securities if certain requirements are met. These requirements entails that a company must satisfy certain solvency tests before financial assistance is allowed. In particular, the board of the company must be satisfied that immediately after the transaction the company will remain solvent, and for the duration of the transaction, the company will be liquid (known respectively as the solvency and liquidity tests).

The liquidity test prohibits a company from making any payment to acquire shares that it has issued if there are reasonable grounds for believing that the company is, or would after the payment be unable to pay its debts as they become due in the course of business. The solvency test prohibits a company from making any payment to acquire shares that it has issued if there are reasonable grounds for believing that the consolidated assets of the company fairly valued would after the payment, be less than the consolidated liabilities of the company. Additionally to the solvency requirements, shareholders of the company must sanction by a special resolution, the terms upon which the assistance is given in a general meeting. The language in this section with regard to a board being satisfied has already raised a lot of debate as to the actual meaning of the word. This wording will bring a lot of ambiguity in the interpretation of the section.

Since a contravention of section 44 is an offence, directors must be advised to carefully consider their company's position before signing a board resolution on their satisfaction. This may also require the investors to cautiously consider whether they are convinced that the board is satisfied before accepting security from the company, because if it transpires that the board was not satisfied then that security will be invalidated.

Although it is necessary to require directors to be certain of the company's solvency and liquidity 'subsequent to providing the assistance', where the transaction takes place over an extended period of time, directors might not be unable to forecast the company's liquidity over the entire period and might therefore never be satisfied of the company's liquidity for 'the duration of the transaction'. If indeed, 'duration of the transaction' is interpreted to mean that, where a company provides financial assistance to a third party in the form of a loan, the transaction continues, for the purpose of the law, until the loan has been fully repaid, the benefits of section 38 may only be limited to transactions that will be speedily concluded and these transactions are likely to be small, minimal impact transactions.

This uncertainty about the interpretation of the wording of the new exception will distress the practical usefulness of the exception. Boards of companies seeking to use the exception to provide financial assistance will have to consider whether they can be satisfied about the liquidity and solvency of the company.

### **3.3.4 Exceptions to the giving of financial assistance**

The exceptions to the prohibition allows for financial assistance only in the following circumstances: where the lending of money is in the ordinary course of a company whose business is money lending; where the assistance is in accordance with the purchase of shares by an employee share scheme; where loans were made to employees, other than directors, to enable them to purchase shares in the company they are employed by; and where assistance was given to allow a company to repurchase its own shares. An interesting observation stems from the fact that whereas the exceptions pertaining to employee share schemes are expressly qualified by the requirement, such transaction must not reduce the company's net assets below the value of its issued share capital and its nondistributable reserves.

## **3.4 Other financial assistance to directors**

Section 45 of the new Act provides for loans and other financial assistance to directors. This includes lending money, guaranteeing a loan or other obligation, and securing any debt or obligation.<sup>46</sup> This section replaces the section 226 of the old Act which prohibited loans to the directors of a company, its holding company and co-subsidiaries, as well as to companies

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<sup>46</sup> S44(1)(a)

controlled by such directors. The new section provides that the board of directors of the company may authorise the provision by the company of direct or indirect financial assistance:

- to a director or prescribed officer of the company or of a related or inter-related company, or
- to a related or inter-related company or corporation, or
- to a member of a related or inter-related corporation, or
- to a person related to any such company, corporation, director, prescribed officer or member,

This is subject to the further provisions that the financial assistance be authorised by the board pursuant to a special resolution of shareholders within the previous two years, which adopted the financial assistance. The board must also be satisfied that the company would satisfy the solvency and liquidity tests and any conditions set out in the MoI with regard to financial assistance. After adopting a resolution to authorise such financial assistance, the board is obliged to provide written notice thereof to all shareholders and, crucially, to any trade union representing its employees. If the resolution contemplates financial assistance in excess of one tenth of one percent in aggregate (with other financial assistance provided during that financial year) of the company's net worth at that time, then the notice shall be given within 10 business days after its adoption by the board.

### **3.5 Protection of creditors**

The objective of Section 44 of the new Act is still to preserve a company's capital in the interest of creditors and shareholders. This is very much in line with international trends as the case in the US laws<sup>47</sup>. The solvency and liquidity tests provide safeguards for minority shareholders and creditors of the company for the purposes of a repurchase of shares (S85 of the companies Act).

As already stated in *Trevor v Whitworth* that "the risk that the capital would be lost in ordinary business activities is one which the creditor had to bear and the company is under no legal obligation to recover the loss it suffered in the course of the company's trading".

The solvency and liquidity tests have been incorporated as a substitute for the capital maintenance principle and are considered to be adequate safeguards for minority shareholders

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<sup>47</sup> Model Business Corporation Act

and creditors. Consideration should also have been given to permitting a company to give financial assistance for the purchase of its shares by a third party subject to adequate safeguards for the creditors and minority shareholders. Whilst it is indisputable that one of the functions of company law is to protect minorities, proposed regulation cannot be justified merely by a direct invocation of the need to protect minorities; there are competing considerations that need to be carefully balanced to ensure that minorities do not end up in a position from which they are able in effect to hold their company liable.

### **3.6 Liability of the directors for breach**

The new Act has brought a long-awaited reduction of the absolute restrictions, providing private companies with an unambiguous procedure to comply with in circumstances where the directors felt that such financial assistance is in the company's best interest and in line with their fiduciary duties towards the company. However, the Act makes strong recommendations for directors to take fiduciary responsibility to ensure that they are not acting recklessly when recommending that the company provides financial assistance. This means that the directors must also consider any liabilities that may arise, including any contingent liabilities.

S44 (5) provides that if the decision by the board to provide financial assistance is void and has been declared void in terms of this section read with section 218(1), a director is liable to the extent set out in section 77(3)(e)(iv)

### **3.7 Conclusion**

This prohibition was notionally aimed at preventing the abuse of company resources to the detriment of creditors and minority shareholders. However, it is now generally accepted that the prohibition is no longer useful and, in the present environment, is not only unnecessary, but is even harmful. In any event, there are other, more effective, ways of protecting the interest of creditors and shareholders. The solvency and liquidity tests, initially introduced into our law have proven to be effective in this regard.

Perhaps the new section should also take into account other issues for shareholders should also be provided a right to contest the general meeting's approval of a transaction involving financial assistance. What if they are not satisfied? Will that be an end? The board consists of those in control of the company, is it not bringing abuse of control?

Most importantly is the fact that, this section strengthens the directors' fiduciary responsibilities, to ensure that they are not acting recklessly when recommending that the company provides financial assistance.

Whilst it is clear that the introduction of the procedure set out in sections 44 and 45 of the new Act has brought a degree of flexibility to the previously unworkably rigid financial assistance prohibition rule under South African law, it. However, the introduction of the said procedure has only passed the buck onto the company's directors, who now find themselves placed under substantial pressure in the context of leveraged buyout transactions, seeing that they are effectively charged with initiating the proverbial green light for any proposed financial assistance transactions. This may clearly be an unenviable predicament for directors the be in, particularly when faced by deal-makers mounting pressure on the board of directors to have such transactions approved, since the directors' interest in conducting the necessary due diligence and obtaining the desired levels of comfort before approving such transactions may mistakenly be interpreted as recalcitrance on their part.

All being said, it is only time that will tell to what extent the amendment to the outright prohibition has served to accommodate the structuring of such transactions. It is also important that practitioners and directors require developing clearer parameters of comfort that will serve to pave the way towards complying with the legal requirements necessary for the approval of such transactions.

# CHAPTER 4

## ACQUISITION OF SHARES BY COMPANY OR SUBSIDIARY S48

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### 4.1 Introduction and background

An acquisition by a company of its own shares was prohibited as a result of the common law capital maintenance doctrine. As indicated in the introductory chapter, the capital maintenance doctrine was initially established by one of the landmark English cases of company law, by the decision of the House of Lords in *Trevor v Whitworth*<sup>48</sup> that a company might not purchase its own shares, on the ground that “*neither the paid-up nor the nominal capital of the company shall be reduced otherwise in the manner permitted by an Act of Parliament.*” According to the capital maintenance concept, the issued share capital of a company is seen a guarantee fund intended for the payment of claims of a company, with the result that the issued share capital of a company may not be reduced, nor may it be returned to shareholders except where the companies Act or common law authorises it.

This doctrine has been criticised as an outdated concept in many foreign jurisdictions as well as in South Africa. The reasons for such criticisms were based on the fact that in stead of complying with the stringent requirements of section 79, companies could simply use section 90 to make payments to shareholders including payment of dividends whether out of capital or profits to its shareholders provided that this is authorised by its articles of association and that it satisfies the liquidity and solvency tests. Section 90 replaces or removes the common law capital maintenance concept and the common law principle that dividends may be paid out of distributable profits.

The new Companies Act No 71 of 2008 is also moving away from the common law capital maintenance concept. The Act also regulates relationships between groups of companies. A group of companies is defined as two or more companies that share a holding company or subsidiary relationship. A holding company, in relation to a subsidiary is in turn defined as a

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<sup>48</sup> (1887) 12 App CAS 409

juristic person or undertaking that controls that subsidiary. Subsidiary relationships that form part of the basis on which groups are defined and regulated are dealt with extensively in section 3 of the Act.

## **4.2 Regulation of acquisition of shares by a company or subsidiary**

### **4.2.1 Company acquisition**

In terms of section 48 (2) (a) of the Companies Act 71 of 2008, a company may acquire its own shares. However, the requirements of section 46 with regard to distributions must be satisfied. The new regime imposes the solvency and liquidity tests which a company must satisfy immediately after completing such a distribution.<sup>49</sup> In terms of section 46 a company may by resolution of the board, if so authorised in its MoI, acquire shares issued by it section 48 (2) (a). This is different from the old Act which requires special resolution of creditors. The acquisition is only possible if it reasonable appears that the company will satisfy the solvency and liquidity test immediately after completing the proposed distribution; section 46(1)(b) and confirmation by the board that it has applied the two tests; section 46(1)(c). A company cannot acquire shares to such an extent that there will only remain redeemable or convertible shares in issue; section 48 (3) (b)

Before a company can issue shares under section 48, requirements in terms of section 46 with regard to distributions must first be satisfied. Firstly, the board of directors of a company must authorise the acquisition by a resolution after satisfying both the solvency and the liquidity tests. This resolution must further be confirmed by the board through another resolution in terms of section 46 (c), which confirms that the board has reasonably concluded that the company will satisfy the solvency and liquidity test immediately after completing the preoposed distribution. However after the resolution has been confirmed by the board the transaction must be fully carried out within 120 business days failing which the process will start afresh. However, the Act allows the company, to apply for a court order, if the company is unable to fulfil its obligations and has the burden of proving that the fulfilment of the obligations would put it in breach.

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<sup>49</sup> S46 (1) (b)

#### 4.2.2 Subsidiary acquisition

Most importantly, the Act also regulates acquisition by subsidiaries of their holding company's shares subject to compliance with the solvency and liquidity test. With regard to the definition of a subsidiary this Act changes from the current 1973 Act. The 1973 Act requires a holding company to hold a majority of the voting rights in a company, or have the right to appoint or remove directors holding a majority of the voting rights at meetings of the Board, or has the sole control of a majority of the voting rights in it. In the new Act the holding company does not have to own shares in the company as ownership of voting rights is no longer required to constitute a subsidiary relationship. The determination whether a company is a subsidiary depends on either two forms of control. First is the ability of the holding company to directly or indirectly exercise, or control the exercise of, a majority of the general voting rights at a general meeting. Second is the right to appoint or elect, or control the appointment or election of, directors of that company who would control a majority of the votes at a board meeting. Last, all the general voting rights associated with issued securities of the company are held or controlled by persons contemplated above. Therefore, if the holding company has the rights or control by virtue of a contract (e.g. a shareholders agreement) then that will constitute a subsidiary relationship.

Section 48 (2) (b) regulates the acquisition of shares by the subsidiary in the holding company. In terms of the new Companies Act, subsidiaries are not being permitted to hold more than 10% of the shares of any class in the capital of their holding company. The voting rights for such shares cannot be exercised as long as the company is a subsidiary. The acquisition also falls within the definition of a distribution in section 1 and becomes subject to section 46, which regulates distributions. In addition, the new Act also provides that a subsidiary of a company may not acquire shares of that company, if, as a result of that acquisition, there would no longer be any shares of the company in issue other than shares held by one or more subsidiaries of the company; or convertible or redeemable shares.

The Act also provides for related party provisions in terms of section 2. For instance, the purchase of a company's shares by someone "related" to the company will now also require the "buy-back approvals". "A" is related to "B", inter alia, if A directly or indirectly controls B, if A directly or indirectly controls "the whole or part of the business" of B or if C controls the whole or part of the business of both A and B.



With a share buy-back, the amount for which the directors could be liable is the purchase price of the acquisition less any amount recovered from the shareholders concerned. Section 86 of the old Companies Act does already provide for personal liability of directors who allow buy-backs in contravention of the solvency and liquidity requirements.

Moreover, the acquisition may not be in such a way that there are no shares of the company in issue other than shares held by one or more subsidiaries of the company or convertible or redeemable shares<sup>50</sup>. A subsidiary of a company may also acquire shares of that company<sup>51</sup>. The acquisition should not be more than 10% in aggregate of the number of issued shares or a class of them and that there are no voting rights attached to those shares as a result the company will remain a subsidiary<sup>52</sup>.

### 4.3 Solvency and liquidity test

In the New Companies Act, the existence and permanence of the company is determined by it meeting both the solvency and liquidity test as discussed in Chapter 2. This test brings together the two financial concepts of success and survival, or failure, the solvency and liquidity<sup>53</sup>. Solvency is the total financial state and position of the business. It relates to the net worth or net asset value of the business, where assets are valued on the basis of their market values and realisable values. The balance sheet should reflect the solvency position of the business. Liquidity is the other side of the solvency coin and is used in the following different ways:

- First, it is used to describe the nature of a company's asset holdings or mix, i.e. how easily assets can be converted into cash.
- Secondly, it is used to describe the relationship between a company's liquid assets and its short-term liabilities, i.e. ability of a company to meet its short-term financial obligations when and as they become due.

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<sup>50</sup> S48(3) (a) and (b)

<sup>51</sup> S48 (2) (b)

<sup>52</sup> S48(2)(b) (i) and (ii)

<sup>53</sup> Hendriese J W supra n30, 4, the impact of the new companies act and business legislation on boards and directors – responsibilities and risk paper for corporate governance conference on 10 to 11 September 2009, **Dr**

#### **4.4 Enforceability of contracts to acquire shares.**

An agreement with the company to acquire shares is enforceable against a company subject to section 48(2) and (3).<sup>54</sup> If the company is unable to fulfil its obligations under the agreement with the company to acquire shares as a result of these subsections, the company can apply to court for an order and must prove that the fulfilment of the obligations would be in breach of these subsections. If the court is satisfied, after considering the financial circumstances of the company, a court order may be granted.<sup>55</sup>

If the company acquires shares in contravention of section 46, the company may within two years after acquisition, apply to court for an order reversing the acquisition.<sup>56</sup> The court may then order the person from whom the shares were acquired to return the amount paid by the company and the company to issue to that person an equivalent number of shares of the same class as those acquired.<sup>57</sup>

The burden to prove a possible contravention of section 48 (5) (b) rests with the company; the company must apply to court for an order.<sup>58</sup> The court must be satisfied that the company is prevented from fulfilling its obligations of the agreement because its just and equitable having regarded the financial circumstances of the company. The court must also ensure that the person to whom the company is required to make payment is paid at the earliest possible date compatible with the company satisfying its obligations (s48(5)(c)).

#### **4.5 Liability of directors for breach**

Section 48 (7) of the new Act, deals with liability of directors. If the shares are acquired in contravention of section 46, the directors are liable to a certain extent as set out in section 77 (3) (e) (vii), if they were present at the meeting and failed to vote against the acquisition despite knowing about the contravention.<sup>59</sup> For as long as they participated in making a decision of acquisition according to section 74, the directors are liable.

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<sup>54</sup> S48 (4)

<sup>55</sup> S48(5) (C)

<sup>56</sup> S48(6)

<sup>57</sup> S48(6) (a) and (b)

<sup>58</sup> S48(5)(a)

<sup>59</sup> S48(7) (a) and (b)

If the shares are acquired in contravention of the solvency and liquidity requirement 46(1) (b) its the directors of a company will be liable to the company for any amounts so paid and not recovered by the company. The action is at the instance of a company but a director can, if liable, apply to the court for an order compelling a shareholder or former shareholder to repay the money paid out in contravention of this section. An acquisition in contravention of section 46 or s48 will also entitle the company at the time of the acquisition, to apply to court for an order reversing the acquisition, not more than two years after the acquisition. This is different from s86 (3) of the old Act which entitled a shareholder or creditor to seek recourse. The new section has decreased the time for institution of action to 2 years after acquisition. Whereas (section 86(4)). Of the old Act provided a period of 3 years

#### **4.6 Conclusion**

Even though share repurchase was provided in terms of s85 of the Companies Act of 1999, the new provisions have gone a step further. Section 85 of the Companies Act required the authority of a special resolution for share buy-backs whereas, acquisitions under the new Act only need the approval of only an ordinary resolution if made from all shareholders of the class concerned. Most importantly the new Act makes provisions for a subsidiary to acquire shares of a holding company which for as long as it is not more than 10% of the number of issued shares of any class and there are no voting rights attached to it. The subsidiary was prohibited in terms of the previous Act to acquire shares from its holding company. The reason for this fact was that the relationship between a holding and a subsidiary company is designed to regulate abuse of control and to ensure that there is disclosure of the group financial information. Hence a transaction like this was totally prohibited.

One common factor to be noted is the link of s48 to s46 which regulates distribution to shareholders. Section 46 provides for distributions to be made to without restricting or qualifying the cause for such distributions if they are authorised by the MoI, subject to the restrictions contained in this section.

South African law brought a reasonable solution with regard to the rigid capital maintenance doctrine. Even though it has kept the regime, but it has brought some flexibility for companies and its stakeholders in terms of applying the provisions. The Companies Act provides for liability directors for contravention with s48 and s46. The company can also apply to court

within two years after acquisition to reverse the acquisition if it there was a contravention of these sections. However, this is likely to cause uncertainties to the acquirers as they might be concerned with the legalities of the transaction might be worried about returning the payments made to them if there is a contravention.

# CHAPTER 5

## CONCLUSION

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### 5.1 Introduction

As indicated in Chapter 1 that, the maintenance of capital doctrine restricts shareholders' ability to withdraw their capital investment from the companies. In the past companies sought to do capital restructurings which may as a result some of the value adding transactions were frustrated because of the ambiguity and complexity of the application of this rule.

This movement away from the rigid capital rules towards a more flexible approach has been long awaited in South African law. The effect of the provisions of the new Companies Act, is a more realistic provision which seeks to bring some sort of balance or stability between protecting companies and their stakeholders from potential mischief of losing the company's share capital whilst allowing a degree of flexibility in circumstances where the target company's financial situation would not be adversely affected by the leveraging of its assets. Of prime significance of the new legislation will be the empowering of companies to provide financial assistance for the purchase of its own shares or of those of their holding companies.

### 5.2 Solvency and liquidity approach

Solvency and liquidity has been recommended across the board application all forms of distribution. Even though, the approach would in theory offer better protection to creditors than the rigid capital maintenance regime, it may give rise to considerable concerns on the part of directors, due to the increase in their potential liabilities. Directors may have to rely on professional advice more frequently to avoid being held liable for improper distribution and this would increase the cost of running business.

The business sector is likely to find the application of the solvency and liquidity approach to the distribution of dividends objectionable, in particular. The previous rules that dividend should be declared out of distributable profit have worked well and provided certainty. Moreover, the remedies where payment of a distribution that did not satisfy both test is recoverable in the first

instance from the directors would also be objectionable because the section does not give any liability to the shareholders who have received the payment .and its not clear if they will have to keep the payment or not. It would also create great uncertainty to the shareholders in their receipts of dividends.

Some features of the old Act with regard to capital maintenance may provide better safeguard against improper distribution (e.g. court sanction is required in case of reduction of capital other than re-designation of the nominal value of shares to a lower amount), as compared with relying on the tests based on the judgement of directors . While using the tests as the principal rule for protection of creditors is appealing in theory, the concerns and potential shortcomings, especially those noted above, would outweigh any benefits arising from the adoption of such an approach.

### **5.3 Share capital and the regulation of distributions by companies**

The new Act still restricts distributions by a company it is pursuant to a legal obligation or a court order or the board has authorised it. It is safe to say that restriction on distributions to by a company is likely to benefit both the creditors and shareholders of a company. For instance, there are several other conditions which prevent asset transfers that leave a company insolvent, such as the solvency and liquidity requirements that must be satisfied as well as the resolution by the board as the board might be reluctant to make distributions due to the personal liability provisions. The solvency and liquidity approach presents another restriction as the board must first be “satisfied” before making any distribution.

The capital regime provided by s46 can be understood as providing conditional restrictions. This can be understood as adding a ‘creditor protection’ term/or norm as critics call it into the MoI again. This undermines the fact that companies might have extensive flexibility in setting the conditions under which the maintenance of capital rules will restrict distributions.<sup>60</sup> Moreover, consideration should be made with regard to the size of a company’s share capital and share premium account, which the shareholders are free to set. This conditional restriction

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<sup>60</sup> Mtwebana K F “*Towards a bigger flexible structure of the share capital: A comparison of the company law of South Africa and Switzerland with regard to the current debate and developments in the EU*” LLM thesis, University of Cape Town, [http://lawspace2.lib.uct.ac.za/dspace/bitstream/2165/245/1/FuchsMtwebanaK\\_2005.pdf](http://lawspace2.lib.uct.ac.za/dspace/bitstream/2165/245/1/FuchsMtwebanaK_2005.pdf)

allows us to explain a number of its salient features. Firstly, this shows us the reasons why distributions to shareholders are restricted, rather than just dividends. Secondly, it makes us to see that unjustified transfers of assets to parties other than shareholders are not restricted, provided the company is solvent. Lastly, distributions are allowed if the conditions relating to distributable profits are satisfied.

Maybe the intention of the new Act is still simply be to prohibit all asset transfers to shareholders in order protect the interests of the creditors. On the other hand, there may be circumstances in which such transfers would be necessary and effective. “Where a company has surplus cash and no good projects in which to invest, it is efficient for the money to be returned to shareholders for investment elsewhere, rather than be ploughed into an underperforming project hence an efficient restriction would prohibit some but not all such payments”.<sup>61</sup>

Therefore, I support the view that the principle of “capital maintenance is maintaining no more than the subordination of the shareholders’ claim to capital”.<sup>62</sup> As discussed in chapter 1, that as a result of contribution of capital, a shareholder is granted the rights, limitations, preference etc and whilst the company is a going concern the have a right to such dividends as may from time to time be declared by the directors; and should the company be liquidated and to a pro rata share of capital and surplus, insofar as these exceed the company’s liabilities. As capital is not repayable by a going concern, some legal scholars think of it as an indefinitely deferred claim which is payable only in liquidation such, it is subordinate to the claims of the company’s creditors. Hence any protection any protection is weakened by the fact that there is no guarantee that the assets will not be finished through trading losses.

#### **5.4 Financial assistance for the acquisition of securities**

It should be noted that the prohibition of financial assistance was argued to have been riddled with uncertainties that transacting parties could only safely navigate their way around by

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<sup>61</sup> Amour J supra n 33, p26

<sup>62</sup> Mulbert P O (2006) “A synthetic view of different concepts of creditor protection or high level framework for corporate creditor protection”: EGCI Law working paper. <http://ssrn.com/abstract=883625>.

purchasing costly legal advice.<sup>63</sup>It is not apparent whether the new provisions suggest an improved capital regime as there are still many conditional restrictions.

The new s44 provides for the financial assistance for subscription of securities but this does not include the lending of money by a company whose main business is the lending of money. At the first glance to this section, it seems like, the section has removed the capital maintenance but when you take a closer look at the section it contains a lot of conditional restrictions to the giving of financial assistance by a company. The financial assistance is limited to an employee share scheme which is not wide enough. Secondly, it must be pursuant to a special resolution of shareholders and a resolution of the board. The Act does not include further confirmation by the shareholders as to the solvency and liquidity of the company. This means that the shareholders are at the mercy of the board of directors for decision making in this regard.

Most importantly is the fact that, this section strengthens the directors' fiduciary responsibilities, to ensure that they are not acting recklessly when recommending that the company provides financial assistance. Some critics have maintained that the capital maintenance should be left on contract. One argument in favour of general company law rules is that the supply by the state of such rules saves creditors the costs of writing terms for themselves. For this to generate benefits, the rule supplied must be one that at least a majority of parties would prefer.

As indicated throughout the document, the capital maintenance rules in the new Act are much more flexible in certain transactions but seem to be more restrictive than they are aiding market transactions. A starting point might be to avoid the weaknesses of the current system. However, it has been argued that it is possible for shareholders to avoid capital maintenance rules, but only by undercapitalising their companies' initially. Would it not be better if the companies could choose whether or not the capital maintenance regime should apply to their companies?

In assessment of these issues, regard should also be given to the strengths of the capital maintenance doctrine. One advantage is that, as a part of the MoI, it is possible to have

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<sup>63</sup> Peterson G A and Hawker N W, *Does corporate law matter? Legal capital restrictions on stock distributions*, Legal scholars have generally criticised the concept because "not only does it fail to protect creditors, it also imposes significant costs in corporations. One commentator suggested that from accounting and legal profession's point of view, increased professional fees was one of the benefits of using legal capital to restrict dividends.



remedies against shareholders. These would not be available to a creditor simply taking a loan agreement from the company. The fact that shareholders might be liable to repay unlawful distributions would reduce their incentive or that of directors acting in their interests to take or make such payments in the first place. This could lead to savings where evaluation costs, for example, are high.

The new Act also provides for “other financial assistance”, which includes lending money, guaranteeing a loan or other obligation, and securing any debt or obligation. This includes direct or indirect assistance to a director or officer of the company or of a related or inter-related company, or to a related or inter-related company or corporation. The new Act still brings restrictions in this regard, for instance, the financial assistance must be authorised by the board pursuant to a special resolution of shareholders within the previous two years, which adopted the financial assistance. The board must also be satisfied that the company would satisfy the solvency and liquidity tests and any conditions set out in the MoI with regard to financial assistance.

As mentioned in other sections, the solvency and liquidity seems to be another theme of the capital rules as presented by the Act. This may point the way to a possible role for company law in the protection of creditors. Why can't this be left on contract? We might imagine that some parties would want particular agreed restrictions, perhaps offering remedies against shareholders or directors. Others would wish to leave the matter solely to market contracting with their creditors. The matter could be left to the parties to decide.

Others critics have supported this approach of corporate insolvency. Provided that it is made clear to persons dealing with the company what sort of restrictions it is subject to, then those setting it up have appropriate incentives to decide whether such restrictions are effective. The role of company law would merely be to facilitate their doing so. We could be able so safely say that these methods might be able to enhance effectiveness. Other roles exist for general company law including disclosure laws and insolvency law. However, in an environment where the majority of creditors are at least to some extent, able to price transactions according to risk, then general rules – such as minimum capital requirements designed to protect creditors are

likely to be effective.<sup>64</sup> This is not to say that law cannot assist in reducing externality problems, but rather that the relevant rules should be more specifically targeted at the groups in question.

With regard to the liability of directors, the new Act has absolute restrictions towards directors and no clear liability measures towards other stakeholders. Even though the new statutory provisions are intended to providing private companies with an unambiguous procedure to comply with in circumstances where the directors felt that such financial assistance is in the company's best interest, This brings a burden for directors to comply with their fiduciary duties towards the company at all times and to confirm their decisions. This however, makes strong recommendations for directors to take fiduciary responsibility to ensure that they are not acting recklessly when recommending that the company provides financial assistance. This means that the directors must also consider any liabilities that may arise, including any contingent liabilities.

One of the main shortcomings of the new Act is that it fails to introduce any legal clarity in relation to the consequences arising from a breach of the prohibition. As a result, the provisions continue to stand fragmentary in their failure to directly address the consequences of such breach. The good thing is that transactions that are declared to be void are considered to be unenforceable and the directors of the company also face personal liability on the basis of the general and fiduciary duties owed towards the company's stakeholders. However, it should be mentioned that the UK provisions take the director's liability a step further by exposing them to criminal sanctions and possible imprisonment in case of default<sup>65</sup>.

However, the fact that a company is permitted to giving financial assistance for the purchase of its shares by an inter-related company subject to adequate safeguards for the creditors and shareholders is exceptional.

It is argued that the *raison d'etre* of the prohibition has been lost in time and there are now other laws (*inter alia*, the rules regulating directors' fiduciary duties and the distribution of profits) that do a better job of addressing the concerns that originally gave rise to the need for such prohibition, thus rendering the prohibition redundant in practice. Interestingly, the scope of new Act is not limited solely to private companies. It also caters for dealings from the financial assistance prohibition in relation to public companies.

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<sup>64</sup> Booth R A “*Capital Requirements in the United States Corporation Law*” University of Maryland , <http://ssrn/abstract=86468>

<sup>65</sup> Uk Companies Act supra

## 5.5 Acquisition by a company or a subsidiary of securities

It is good that the new Act makes provisions for a company or subsidiary to acquire its securities. However, the requirements of this section are tied with s46 that deals with distributions by a company. As indicated in the discussions above, this section puts conditional restrictions on distributions to shareholders. Even though the previous Act provided the share repurchase in terms of section 85, the section did not include acquisition by the subsidiaries. Even though it limits the number of shares than can be acquired, it is clear that this prevents abuse and control by limiting the number of shares.

It seems like in all the new provisions related to capital rules are underpinned by the capital regime as evidenced by a number of conditional restrictions provided by the new Act. Those conditional restrictions include the fact that before a company can issue shares under s48, requirements in terms of section 46 with regard to distributions must first be satisfied. The other issue is that authorisation by board is subject to the solvency and liquidity tests. This resolution must further be confirmed by the board through another resolution in terms of section 46 (c), which confirms that the board has reasonably concluded that the company will satisfy the solvency and liquidity test immediately after completing the proposed distribution. These many confirmations are also going to present a lot of frustration to the companies wanting to proceed with their transactions as they will need the directors to repeatedly make resolutions. The limit that requires a transaction to be completed within 120 business days failing which the process will start afresh will also add to the frustrations.

It seems like the legislature still intends to maintain the outdated doctrine judging by the many conditions that must be fulfilled. As it is the same case to all other transactions the solvency and liquidity approach brings some problems with regard to the time at which the board must be satisfied and the actual interpretation of being satisfied as indicated above.

A loser look should be given to the section that imposes major responsibilities and liabilities to the directors of a company in case of contravention because in the case of a contravention, the action is at the instance of a company (noting that directors act on behalf of the Company) to apply to the court for an order compelling a shareholder or but former shareholder to repay the money paid out in contravention of section 48(6). This will bring a lot of confusion as shareholders might refuse to comply and reverse the claim to the directors because the same

director who is liable has the powers through a court order to reverse the transaction not more than two years after the acquisition.

## 5.6 Conclusion

The conclusions that can be drawn about the capital rules as provided by the new Act are as follows;

Firstly, it can be said with reasonable certainty that the rules relating to capital, as they are proposed, are far from being effective, however, they are much better in many instances than the previous legislations and there is room for improvement.

Secondly, and more cautiously, the rules with regard to the common law doctrine of maintenance of capital are still evidenced but with less complex provisions of application.

Thirdly, the new provisions of the companies Act with regard to the capital maintenance are probably a step in the right direction. The document suggests the abolition of the par value shares.

Fourthly, it brings a procedure for a court order in the distributions by a company under section 46 with a guarantee provided by the directors. This would reduce the restrictiveness of the capital maintenance rules, and as such is also likely to be an efficient move.

Fifthly, the company law doctrines such as the capital rules may not serve the interests in which they were created for, which is to protect creditors, but the evidence shows that these rules ultimately do affect the wealth of a company whether negatively or positively. The good thing is shareholders are also protected by the new rules, without leaving the fact that directors have many decisions than before.

Lastly, the main element brought by the new Act is the solvency and liquidity approach for distributions by companies. This is an attractive idea because the maintenance of a balance between creditors and shareholders requires that company law should at least give effect to the basic bargain that creditors make when they lend money to companies, namely that their interests should rank ahead of those of equity providers.