Aantekeninge/Notes

Share issues and shareholder protection

1 General

The issue of shares, and the power to issue the shares is an important power in a company. For the company it is important as the shares are used to acquire capital for the company, or for that matter in the pursuit of a legitimate company purpose, like issuing a sufficient number of shares to enable an eventual listing on the Johannesburg Stock Exchange Ltd or to facilitate Broad Based Black Economic Empowerment ownership, to name but a few of many. For the (existing) shareholder this power is also important, as it can be used to change the existing shareholding in a company with the consequential effect on the balance of control in the company (accepting all shares in issue and to be issued have voting rights) in respect of existing shareholders or even shifting control to persons outside the company who were not shareholders prior to the issue. There are a myriad of other issues that come into play, but those mentioned above are perhaps the most important ones. With the perfect division between ownership and control in a company format, there needs to be some control over who issues the shares (see Berle & Means *The Modern Corporation and Private Property* (1968) 66). As the management and control of the business and affairs of the company is usually (whether by charter such as the Memorandum and Articles under the Companies Act 61 of 1973 (1973 Act) or by statute such as in Companies Act 71 of 2008 (2008 Act), with the board, it follows that the powers of the board must be regulated. There is a certain level of control in this respect in terms of the (erstwhile as well as present) common law, but statutory intervention and control was also deemed necessary (see Delport *Die verkryging van kapitaal in die Suid-Afrikaanse maatskappyereg, met spesifieke verwysing na die aanbod van aandele aan die publiek* (LLD thesis University of Pretoria (1987) 228). This note is intended to highlight the most important issues in the control over the power of the directors to issue shares. While most, if not all of these issues warrant a study on its own, especially in light of the 2008 Act, it will be attempted to merely point out the more pertinent of the potential problems.

2 The 1973 Act – an Excursus

In terms of the 1973 Act, the power of the board to manage was, based on the superiority of the shareholders in general meeting, delegated under the provisions of the articles of association of the company (see Delport (ed) *Henochsberg on the Companies Act 71 of 2008* 248; Pretorius, Delport, Havenga & Vermaas *Hahlo's company law through the cases* (1999) 336-337; Havenga "Directors' exploitation of corporate opportunities and the Companies Act 71 of 2008" 2013 *TSAR* 257 on the significance of the source of the delegation). The Model articles in Table B of Schedule 1 to the 1973 Act provided for example in article 60: "The business of the company shall be managed by the directors …".

This power of the directors, also to issue shares, was however restricted by the 1973 Act. The most important sections of the 1973 Act that regulated the issue of shares were sections 221 and 222. Section 221 basically provided that irrespective of any provision in the Memorandum or Articles, the directors shall not have the power to allot or issue the shares without the prior permission of the company in general meeting. This applied only in respect of shares and convertible instruments other than shares were excluded. This authority could be conditional or unconditional general authority to allot shares in their discretion, or it could be a specific authority in respect of a particular allotment or issue. If it was a general authority, which was usually a standard term in the agenda of the annual general meeting, it was only effective until the next general meeting but it could be varied or revoked at any time by a general meeting.

Section 222 sought to regulate "insider" issues, and applied in addition (or actually to the exclusion) of section 221. Therefore, if the shares (or debentures convertible into shares at the option of the directors or entities under their control) were allotted to directors, or to a body corporate that is accustomed to act in accordance with the directions of the directors (of the issuing company) or if the directors of such a body corporate is accustomed to act in that manner, or if the directors of the issuing company is entitled to control 20% of the voting rights in that body corporate or to a subsidiary of such a body corporate, special provisions apply. This allotment and issue had to be approved by a prior special resolution specifically approving the allotment or issue unless the allotment or issue is in terms of an underwriting contract, or on the same terms and conditions as have been offered to the public, or if it is on a *pro rata* basis in accordance with existing holdings to *all* the shareholders or debenture holders in the company and the same terms and conditions apply to all the offerees (s 222(1)(a)-(d) 1973 Act). Section 222 applied to the exclusion of section 221, in the sense that if the section 222 circumstances were present, section 222 applied. However, section 222 was wider than section 221 because the former included the issue of debentures convertible into shares, while the latter only regulated the issue of shares. Therefore, the power to issue shares is subject to the authority in section 221, but not if debentures convertible into shares were issued.

Although the provisions of sections 221 and 222 are now history, some remarks may be necessary to place the 2008 Act in context. It is interesting to note that provision is made in section 222 for companies under the control of "shadow directors", one of two provisions in the 1973 Act recognising and regulating these "directors" (see Locke "Shadow directors: Lessons from abroad" 2002 *SA Merc LJ* 420; Idensohn

"The regulation of shadow directors" 2010 *SA Merc LJ* 326; *Henochsberg* 28). A *pro rata* issue was excluded from the requirements of section 222, but only if the offer was made to all shareholders of the company. An issue in a particular class or multiple classes but not all of the shareholders did not fall within this exclusion. Section 222 provided for shares or debentures convertible into shares, which was much wider than the ambit of section 221. Options on shares or debentures convertible into shares were also covered in insider issues, albeit in section 223.

Any other (additional) regulation of the issue of shares was either in terms of the common law, or in terms of the Memorandum or Articles or a contract, express or implied, between the company and shareholders. Regulation in terms of the common law was mainly on the level of the fiduciary duties of directors. The board was tasked to act *bona fide* in the best interests of the company and for a proper purpose. Issue of shares to change power bases in a company or to frustrate a takeover was a breach of fiduciary duties (see Delport (1987) 273; *Henochsberg* 295). In respect of these duties it may be mentioned that the take-over Code reconfirmed the unacceptability of frustrating take-over through share issues in the case of companies that fell within the ambit of the Code (see r 19 of the *Securities regulation code on take-overs and mergers* under the 1973 Act and similar provisions in s 126 2008 Act). This was *ex abundanti*, as the common law clearly already provided for it.

It should, however, be noted that in terms of the common law as under the 1973 Act, the fiduciary duties (except for the duty to act *bona fide*, could be excluded as opposed to the liability for non-compliance with the duty which could not be excluded (see s 247 1973 Act. But *cf Movitex Ltd v Bulfield* 1988 BCLC 104 (Ch)). The requirement that the allotment had to be authorised by a general meeting (whether by ordinary resolution in terms of s 221 1973 Act or a special resolution under the circumstances as in s 222 1973 Act), created the opportunity that the authorisation could be seen as an exclusion of the fiduciary duties. Therefore, if the general meeting gave specific authority to issue shares for the purpose other than to acquire capital, the fiduciary duty on the directors to use their power for a proper purpose, that is to acquire capital, was clearly excluded.

The effect of non-compliance with sections 221 and 222 was that the directors committed an offence (ss 221(4), 222(2)(a) 1973 Act). Whether the issue was void (or voidable) was not certain. It would seem that the mere fact that section 221 or 222 was not complied with would not make the contravening issue impeachable. The hindsight of *Dulce Vita v Chris van Coller* ([2013] ZASCA 22) would seem to suggest that this view was correct if the focus was on the fact that non-compliance was an offence (see also *Lupacchini v Minister of Safety and Security* 2010 6 SA 457 (SCA) for the principles in respect of voidness of an action contrary to an Act). However, the non-compliance with fiduciary duties in respect of an issue to a *mala fide* allottee could have had the effect that the issue was void

(*Letseng Diamonds Ltd v JCI; Trinity Asset Management (Pty) v Investec Bank Ltd* 2007 5 SA 564 (WLD); confirmed on appeal in *Trinity Asset Management (Pty) Ltd v Investec Bank Ltd* 2009 4 SA 89 (SCA)). This was a contradiction as committing an offence is *per se* non-compliance with fiduciary duties. In respect of *bona fide* allottees there was much debate whether the *Turquand* rule would protect them in the situation where no authority was given in terms of section 221 (or s 222 for that matter, but because insiders are involved in the latter situation, the possible application of the *Turquand* rule was very limited) (*Levy v Zalrut Investments* (*Pty*) *Ltd* 1986 4 SA 479 (W) 485; *Ben-Tovim v Ben-Tovim* 2001 3 SA 1074 (C); *Farren v Sun Service SA Photo Trip Management* (*Pty*) *Ltd* [2003] 2 All SA 406 (C) 441. And see *Ally NO v Courtesy Wholesalers* (*Pty*) *Ltd* 1996 3 SA 134 (N)). The matter was eventually settled in *Stand 242 Hendrik Potgieter Road Ruimsig* (*Pty*) *Ltd v Gobel* (2011 5 SA 1 (SCA)) where it was decided that *Turquand* does not apply. The effect of this would be that the directors did not have the authority to issue the shares and the purported act for and on behalf of the company would be void due to lack of authority (see Blackman *et al Commentary on the Companies Act* (2002) 301; Delport (1987) 238). The allottee was, however, not without remedy as against the company, as section 97 authorised the Court to validate an allotment and issue that was invalid by virtue of any provision of the 1973 Act, or any other law or of the Memorandum or articles of the company or otherwise (see *Ex parte Durban Deep Roodepoort Ltd* 2002 6 SA 537 (W)).

3 The Companies Act 71 of 2008

The 2008 Act brought about various changes, some of them rather surprising, to the position in terms of the 1973 Act and the common law that applied then. Section 7 of the 2008 Act provides that the purposes of the Act are, *inter alia*, to:

> (i) balance the rights and obligations of shareholders and directors within companies;
>
> (j) encourage the efficient and responsible management of companies …

This is presumably based on the Department of Trade and Industry (DTI) policy paper, *South African Company law for the 21st century – Guidelines for Corporate Law Reform* (*GG* 26493 20040623) that stated that the mission, as far as transparency is concerned is that: "(c) The law should protect shareholder rights, advance shareholder activism, and provide enhanced protections for minority shareholders." These sentiments were stated as follows in the explanatory memorandum of the 2007 Bill (11):

> In addition, the interests of minority shareholders continue to be protected by requiring shareholder approval for share and option issues to directors and other specified persons, or financial assistance for share purchase, or any financial assistance to a director or related person.

Section 7 is an important basis for the application of the 2008 Act because the courts (and any institution administering the 2008 Act) must promote the spirit, purpose and objects of the 2008 Act and if any provision of the 2008 Act, or other document in terms of the 2008 Act, read in its context, can be reasonably construed to have more than one meaning, the meaning that best promotes the spirit and purpose of this 2008 Act must be preferred, and will best improve the realisation and enjoyment of rights (see ss 5(1), 158(1)(b) 2008 Act; see also *inter alia Swart v Beagles Run Investments 25 (Pty) Ltd* 2011 5 SA 422 (GNP) parr 18, 41; *Welman v Marcelle Props 193 CC* [2012] ZAGPJHC 32 parr 16, 25; *Employees of Solar Spectrum Trading 83 (Pty) Ltd v Afgri Operations Ltd* unreported case 6418/2011 2012-05-08 (GNP) par 12; *Mouritzen v Greystone Enterprises (Pty) Ltd* 2012 5 SA 74 (KZD) par 18; *Henochsberg* 46(1).

This purpose was clearly not kept in mind with section 38 that provides:

> (1) The board of a company may resolve to issue shares of the company at any time, but only within the classes, and to the extent, that the shares have been authorised by or in terms of the company's Memorandum of Incorporation, in accordance with section 36.

The fact that s 36 provides:

> (2) The authorisation and classification of shares, the numbers of authorised shares of each class, and the preferences, rights, limitations and other terms associated with each class of shares, as set out in a company's Memorandum of Incorporation, may be changed only by –
>
> (a) an amendment of the Memorandum of Incorporation by special resolution of the shareholders; or
>
> (b) the board of the company, in the manner contemplated in subsection (3), except to the extent that the Memorandum of Incorporation provides otherwise.

makes it even more surprising as the board has virtually total power over the capital of the company. The one redeeming feature of section 36 that is not present in section 38 is that the former is an alterable provision (see s 15 (2) 2008 Act).

Section 38 (2) further provides:

> If a company issues shares –
>
> (a) that have not been authorised in accordance with section 36; or
>
> (b) in excess of the number of authorised shares of any particular class,
>
> the issuance of those shares may be retroactively authorised *in accordance with section 36 within 60 business days after the date on which the shares were issued*.

The words in italics were added by s 26 of the Companies Amendment Act 3 of 2011 which would have the effect that not only the shareholder, but also the directors can ratify the "void" issue, which further extends the power of the directors over the share issues, unless it is excluded as being an alterable. The apparent indiscriminate use of the words "board of a company may resolve" in section 38(1) and "a company issues shares" in section 38(2) further complicates the issues (see s 66 2008 Act; *Henochsberg* 248 in respect of the "board" and the "company").

Whether the restrictions in the 2008 Act on the power of the directors are effective in regulating the powers of the directors will be addressed below.

The power to issue shares is restricted by the 2008 Act based on qualitative (s 41(1), (2) 2008 Act) and quantitative criteria (s 41(3) 2008 Act). The qualitative criteria addresses the type of allottee and provides that if shares or securities convertible into shares is issued or any options (in terms of s 42 2008 Act) or rights exercisable for securities is granted to a director, future director or prescribed officer of the company or any person related or inter-related to such a person or any nominee of such a person, the action must be approved by a special resolution of the company (s 41(1) 2008 Act). In respect of the use of "securities" in section 41(3) it is submitted that the category is too wide. All shares are securities, but not all securities are shares. Securities is defined in section 1 as any shares, debentures or other instruments, irrespective of their form or title, issued or authorised to be issued by a profit company. There are also securities other than shares, as defined in section 43 that presumably, according to previous versions of the 2007 Bill, are debentures. If one accepts that all shares have voting rights, which is not always the case, then the inclusion of shares is, possibly, understandable. The inclusion of securities, which includes shares in any case, does not make much sense, as these can be any "instrument", debentures and otherwise. While debentures can have voting rights (see s 43(3) 2008 Act), this is not the default position, and the overbreadth of section 41 must be questioned as the shareholder concurrence by way of a special resolution if there is no issue about control is unnecessary. The logical and sensible solution would have been to use only "voting" securities in the qualitative category. While these restrictions are much wider than that in terms of section 222 of the 1973 Act, the reference to related or interrelated parties has the opposite effect, as in terms of section 222 of the 1973 Act only *de facto* control was required while section 41 of the 2008 Act now requires *de iure* control (see *Henochsberg* 28(1)). A special resolution is not required in terms of section 41(1) or (2), in broadly similar situations as in section 222 of the 1973 Act, if:

the issue of shares, securities or rights is –

(a) under an agreement underwriting the shares, securities or rights;

(b) in the exercise of a pre-emptive right to be offered and to subscribe shares, as contemplated in section 39;

(c) in proportion to existing holdings, and on the same terms and conditions as have been offered to all the shareholders of the company or to all the shareholders of the class or classes of shares being issued;

(d) pursuant to an employee share scheme that satisfies the requirements of section 97; or

(e) pursuant to an offer to the public, as defined in section 95 (1) (*h*), read with section 96.

These exclusions cause some more uncertainty, however. It refers to "shares, securities or rights", but shares are included in the definition of securities in any case. Section 41(2)(c) refers to "holdings", and the context would indicate that "shareholding" is intended, but the syntax of the sentence leaves room for doubt. If a non *pro rata* offer is made to existing shareholders, without the right to renounce that offer, the issue in terms of the offer will be subject to a special resolution, as the particular offer will not be an offer to the public (s 96(1)(c) 2008 Act).

The quantitative criteria in s 41(3) provides that an issue of shares, securities convertible into shares, or rights exercisable for shares in a transaction, or a series of integrated transactions (as defined in s 41(4)(b)), requires approval of the shareholders by special resolution if the voting power of the class of shares that are issued or issuable as a result of the transaction or series of integrated transactions will be equal to or exceed 30% of the voting power of all the shares of that class held by shareholders immediately before the transaction or series of transactions (as calculated as provided for in s 41(4)(c)). The "securities" category has been left out of this provision – although its makes sense to a certain extent, it is a mistake, as securities such as debentures can have voting power. So an issue of debentures that can dilute the voting to the same extent as shares is not included. Again, the logical and sensible solution would have been to include "voting" securities as is suggested in respect of s 41(3). Issues of shares within classes cannot exceed the 30% threshold, but the special resolution must apparently be taken by all the shareholders, which can clearly lead to shareholders in a class or classes taking the special resolution to the detriment of a particular class. This is the only logical explanation as the Act does not provide for "special resolutions of a class" (see s 65). The remedy for this type of abuse could be s 163 (see Henochsberg 568; *Grancy Property Limited v Manala* (665/12) [2013] ZASCA 57 (10 May 2013); *Count Gotthard SA Pilati v Witfontein Game Farm (Pty) Ltd and Others* [2013] 2 All SA 190 (GNP); *Peel v Hamon J&C Engineering (Pty) Ltd* 2012/00994 16 November 2012 (GSJ)), but in common law the remedy is not as clear, especially because the majority shareholder, or any shareholder for that matter, does not have a fiduciary duty towards the minority.

Non-compliance with the share issue requirements in terms of the 2008 is somewhat more complicated than in terms of the 1973 Act. The basic principle in the new Act is that: "Subject to any provision in this Act specifically declaring void an agreement, resolution or provision of an agreement, Memorandum of Incorporation, or rules of a company, nothing in this Act renders void any other agreement, resolution or provision of an agreement, Memorandum of Incorporation or rules of a company that is prohibited, voidable or that may be declared unlawful in terms of this Act, unless a court has made a declaration to that effect regarding that agreement, resolution or provision (s 218(1)). This would obviously not affect ordinary authority situations, like in the case of s 41. Therefore if a board issues shares without the approval of the shareholders because it is either issued to insiders (s 41(1)) or it exceeds the voting restriction (s 44(3)), the validity of the share issue is in question on the basis of the lack of authority as it would seem that s 41 restrictions are in respect of authority rather than capacity. This is the only logical deduction as s 38 provides that "[t]he board of the company may resolve to issue shares" and the references in s 41 to an issue of shares must be read in this context.

On the basic principles of *Turquand*, a common law rule that (apparently) survived the transition from the 1973 Act to the 2008 Act as s 20 (8) would want us to believe, one could have argued that the issue is valid. However, *Stand 242 Hendrik Potgieter Road Ruimsig* (*Pty*) *Ltd v Gobel* 2011 5 SA 1 (SCA) is a persuasive argument against this. It could have been and interesting argument, as the related parties in s 44(1) may or may not, depending on the particular relationship, be *bona fide*. Section 20(7), which may be termed a statutory reincarnation of the common law *Turquand* rule provides: "(7) A person dealing with a company in good faith, other than a director, prescribed officer or shareholder of the company, is entitled to presume that the company, in making any decision in the exercise of its powers, has complied with all of the formal and procedural requirements in terms of this Act, its Memorandum of Incorporation and any rules of the company unless, in the circumstances, the person knew or reasonably ought to have known of any failure by the company to comply with any such requirement." (see *Henochsberg* at 96 and also Richard Jooste "Issues relating to the regulation of "distributions" by the 2008 Companies Act" 2009 *SALJ* 627 at 647).

This rule has serious consequences for companies with careless drafters of Memorandums of Association, but what is at issue here is rather the effect on the holder of a (purported) share issue without shareholder authorisation under s 41. If the (insider) persons to whom the shares are issued and in respect of which a special resolution is required in terms of s 41(1) are directors, then that person can obviously not use s 20(7). However, s 41(1) also requires the resolution if it was issued to future directors, prescribed officers, of future prescribed officers or any person related or interrelated to the company, the directors of prescribed officers of the company (not incumbents) and to nominees of the company. There is an argument that as least some prescribed officers will be privy to the issue process, but clearly this will not apply to all (see *Henochsberg* 27 on prescribed officers). For these "outside" prescribed officers, related companies etc, *bona fides* is required, unless they knew or should reasonably have known that there is no authority to issue the shares. Whether one could be *bona fide* on the one hand but reasonably could have known on the other is perhaps not possible. The question then remains why the legislature has deemed it necessary to include both the requirements of *bona fides* and knowledge (see definition of "knows" in s 1. If the elements of that definition that incorporates reasonableness are added to the "reasonably ought to have known" in s 20(7), then it becomes an almost impossible double objective test). It will be a question of fact, but to prove *bona fides* and/or lack of knowledge in a related or interrelated company would not be difficult. Fortunately an attempt to give an answer on these issues falls outside the scope of this note, but it must be added that the wording of s 20(7) may well have an application totally different from that of the common law Turquand rule (see *Henochsberg* 96(1)).

In respect of s 41(3) the same principles apply, except that the application of s 20(7) will be more clinical, as s 41(3) does not categorize the allottees according to insider status – it is merely a mathematical calculation in respect of voting power. However, the fact that ss 41(1) and 41(3) operate conjunctively makes for complicated situations. Section 41 provides for approval by the shareholders of the particular share issues. Unless ratification is expressly excluded it is submitted that it would be possible, as non-compliance does not void the transaction (see also discussion in *Henochsberg* at 404 in respect of a disposal of assets in terms of s 112).

An aspect in terms of the 2008 Act that could lead to inequitable results, is that there is no possibility to apply to Court to validate a share issue that is otherwise not valid as was the case under s 97 of the 1973 Act. There are many share issues that may potentially be void, as illustrated above in respect of s 41(1) and (3) where neither s 20(7) or 20(8) will apply (in addition to other potentially void issues such as a contravention of s 38 without subsequent ratification). If the common law *Turquand* could have applied, the contract would have been valid. Section 20(7) on the other hand apparently merely creates a presumption of validity/regularity and is therefore possibly rebuttable. Ratification in terms of the common law would, as was argued above, be possible, but if that is not the case, the transaction would be void as the directors did not have the authority to issue the shares due to lack of authority. As this is a lack of authority due to provisions of the Act, and not due to restriction in the Memorandum of Incorporation, the provisions of s 20(2) which allows a ratification in respect of the latter, will not be applicable.

The consequences of an issue of shares in contravention of fiduciary duties is, on the other hand, clearer in terms of the 2008 Act, but this is not good news for directors. While an exclusion of fiduciary duties, but not liability for contravention of those duties as provided for in s 247 of the 1973 Act was possible, neither is possible in terms of the 2008 Act. Section 78 provides in this respect that any provision of an agreement, the Memorandum of Incorporation or rules of a company, or a resolution adopted by a company, whether express or implied, is void to the extent that it directly or indirectly purports to relieve a director of a duty contemplated in s 75 or s 76 or of liability contemplated in s 77. The exception in *Movitex Ltd v Bulfield* 1988 BCLC 104 (Ch) is therefore well and truly gone.

4 Conclusion

The power of directors to issue shares (or certain securities) is important for the company as well as for the (existing) shareholders. Abuse of this power can have serious consequences on the existing power balance in a company. The protection of shareholder interests and minority shareholder rights are, at best, marginally better than that of the 1973 Act. However, some of the protections will only be effective if the powers of the board is excluded in alterable provisions of the Act, and this is only possible if the shareholders know and understand their rights. If the alterable provisions are left unaltered, the shareholders have little pro-active protection.

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