

THE MAINTENANCE OF CAPITAL AND THE
COMPANIES BILL 2007

RICHARD JOOSTE

Professor of Law, University of Cape Town

1. INTRODUCTION

The Companies Amendment Act 37 of 1999 brought about a significant mind-shift in relation to the concept of the maintenance of capital of a company. Prior to this Act, in an attempt to protect shareholders and minority shareholders, an extremely tight rein was kept on the ability of a company to part with its capital other than in the course of its business operations. Before the Amendment Act came into force this meant that, generally, a company could not acquire its own shares, a subsidiary could not acquire shares in its holding company, and dividends could not be paid out of capital. As a result of the 1999 Amendment Act all these transactions are now allowed subject to the basic requirement that the solvency and liability of the company must not be affected (see ss 85, 89 and 90 of the Companies Act 61 of 1973).

The Companies Bill 2007 ('the Bill'), published early in 2007, continues in this liberal vein. However, the provisions in question are fraught with problems. The objective of this note is to piece together the proposed law in an understandable form and then to comment on the proposed provisions.

The prohibition in s 38 of the Companies Act 61 of 1973 relating to a company giving financial assistance for the purchase of its own shares or those of its holding company is also a manifestation of the maintenance of capital principle. This prohibition, however, will not be addressed in this note.

The first observation to make when one looks at the new provisions in the Bill is that, unlike the current Companies Act, the Bill does not dedicate separate sections to each of the three areas under examination, namely buy-backs, the acquisition of shares by a company in its holding company, and the return of capital to shareholders other than by way of a buy-back. In what follows no attempt will be made to deal with the three areas together. Greater clarity on the proposed law and the issues surrounding it can, it is submitted, be achieved through discrete treatment. Such an approach may involve a certain amount of overlapping but that is perhaps justified in the interests of clarity.

2. BUY-BACKS

2.1 *Structure of the Bill*

The provision in the Bill enabling a company to acquire its own shares is s 51(3). It provides:

'(3) A company may not acquire its shares, or cause its subsidiary to acquire the company's shares, from any or all of the holders of a particular class of shares

unless, in addition to meeting the requirements set out in section 48, the acquisition is authorized by the company's or subsidiary's Memorandum of Incorporation, or has been —

- (a) authorized by a special resolution of the shareholders of the company or of its subsidiary, as the case may be, in the case of a purchase from one or more individual shareholders; or
- (b) authorized by an ordinary resolution of the shareholders of the company or of its subsidiary, as the case may be, in the case of a general purchase from all holders of the class of shares concerned.'

Section 51(3) thus sets out the requirements that must be met in order for a company to acquire its own shares. It states certain requirements and provides that in addition, the requirements of s 48 must be complied with. Section 48 provides as follows:

'48 Distributions must be authorized by the board

(1) No distribution may be made by a company unless —

- (a) it has been authorized by the company's board; and
- (b) immediately after giving effect to the authorization, the company would satisfy the solvency and liquidity test, as set out in section 4.

(2) If, after being authorized in terms of subsection (1), or reconsidered in terms of this subsection, a distribution is not completed within 120 business days after —

- (a) in the case of an authorization —
 - (i) the date on which the company announces the resolution authorizing the distribution, in the case of a widely held company; or
 - (ii) the date on which the company first makes a payment to a shareholder in terms of the resolution, in the case of a closely held company; or
- (b) in the case of a re-consideration, the date of that re-consideration the board must reconsider the solvency and liquidity test with respect to that distribution, and be satisfied that the company again satisfies that test before the company may proceed with or continue the distribution.'

It is to be noted that the payment for an acquisition is included within the definition of 'distribution' in s 1 of the Bill, which provides:

'"distribution" means a direct or indirect —

- (a) transfer, by a company in respect of its shares, of money or other property of the company, other than its own shares, whether in the form of a dividend, as consideration for the acquisition of any of its shares, a payment in lieu of a capitalisation share, or otherwise; or
- (b) incurrence or forgiveness of a debt by a company to or for the benefit of one or more holders of any of its shares, in respect of any of its shares.'

One sees from the above provisions that all acquisitions require

- a board resolution; and
- satisfaction of a solvency and liquidity test.

In addition to these requirements, an acquisition requires one of the following:

- authority in the company's Memorandum of Incorporation; or
- a special resolution 'in the case of a purchase from one or more individual shareholders'; or

- an ordinary resolution ‘in the case of a general purchase from all of the holders of the class concerned’.

The solvency and liquidity test is set out in s 4 as follows:

‘4. Solvency and liquidity test

(1) For any purpose of this Act, a company satisfies the solvency and liquidity test at a particular time if, considering all reasonably foreseeable financial circumstances of the company at that time —

- (a) the company’s total assets equal or exceed its total liabilities; and
- (b) it appears that the company will be able to pay its debts as they became due in the course of business for a period of —
 - (i) 12 months after the date on which the test is considered; or
 - (ii) in the case of a distribution contemplated in section 48, 12 months following that distribution.

(2) For the purposes contemplated in subsection (1) —

- (a) the board or any other person applying the solvency and liquidity test to a company may consider
 - (i) only financial information that satisfies financial reporting standards; and
 - (ii) any fair valuation of the company’s assets and liabilities, or other valuation that is reasonable in the circumstances, subject to paragraph (b); and
- (b) unless the Memorandum of Incorporation of the company provides otherwise, a person applying the test in respect of a distribution contemplated in section 48 is not to regard as a liability any amount that would be required, if the company were to be liquidated at the time of the distribution, to satisfy the preferential rights upon liquidation of shareholders whose preferential rights are superior to those receiving the distribution.’

A restriction is placed on an acquisition by s 51(4), which provides:

‘If, as a result of a re-acquisition by a company of any shares, or, the acquisition of the company’s shares by its subsidiary, as contemplated in subsection (1)(a) or (b), there would no longer be any shares in issue other than convertible or redeemable shares, the company or subsidiary may not reacquire or acquire those shares, despite the authorization of that re-acquisition or acquisition, either in the Memorandum of Incorporation, or by shareholders’ resolution.’

An acquisition results in a reduction of the stated capital. Section 51(6) provides:

‘If a company has acquired its own shares, as contemplated in this section, the company must reduce the stated capital for the class of shares so acquired by an amount derived by —

- (a) First, dividing the stated capital contributed by issued shares of that class by the number of those shares; and
- (b) Second, multiplying the result in paragraph (a) by the number of shares in that class so acquired.’

The shares that have been acquired must be cancelled. Section 52 provides:

‘Status of shares redeemed or purchased by company

Shares of a company that have been issued and subsequently —

- (a) re-acquired by that company; or
 - (b) surrendered to that company in the exercise of appraisal rights in terms of section 165,
- must be returned to the same status as shares of the same class that have been authorized but not issued.'

Section 51(7) deals with the unenforceability of the acquisition where the prescribed requirements and restrictions are not met. It provides:

'A contract with a company providing for the acquisition by the company of shares issued by it is enforceable against the company, except if the company cannot execute the contract without being in breach of subsections (1)-(5).'

Section 51(8) places the burden of proving that the acquisition is in breach of any of the prescribed requirements or restrictions on the company. It provides:

'In an action brought on a contract contemplated in subsection (7), the company has the burden of proving that execution of the contract is or will be in breach of subsections (1)-(5).'

Section 51(9) provides that where a company has not paid in full for the shares acquired and the company goes into liquidation, preference shareholders rank above the shareholders who have not been paid in full. It provides:

'Until the company has fully performed its obligations in terms of a contract referred to in subsection (7), shareholders who dispose of their shares retain the status of claimants entitled to be paid as soon as the company is lawfully able to do so or, on liquidation, to be ranked subordinate to creditors and shareholders whose claims are in priority to the claims of the class of shares which they disposed of to the company, but in priority to the claims of the other shareholders.'

Liability arising from an acquisition that is not in accordance with the prescribed requirements or restrictions is dealt with in s 49, which applies to all distributions (as has been seen above, the payment made for an acquisition is a 'distribution'). Section 49 provides:

'Liability with respect to distributions

(1) If a director —

- (a) voted for or assented to an authorization of a distribution that did not satisfy the requirements of section 48; and
- (b) in so doing, failed to satisfy the duty of a director to the company, as set out in section 91, the director is jointly and severally liable, with all other such directors, to reimburse the company the amount, if any, by which the value of the distribution exceeded the amount that could have been distributed without contravening section 48.

(2) If a company re-acquires any shares contrary to section 48 or 51 —

- (a) the company may apply to the Court for an order reversing the acquisition, and the court may order —
 - (i) the person from whom the shares were acquired to return the amount paid by the company, and
 - (ii) the company to issue to that person an equivalent number of shares of the same class as those acquired; and

- (b) any director who would be liable in terms of subsection (1) is jointly and severally liable with all other such directors —
 - (i) to pay the costs of all parties in the court in a proceeding contemplated in this subsection; and
 - (ii) to restore to the company any amount paid for the acquisition, and not recovered from shareholders in terms of this subsection.
- (3) An action to enforce a liability imposed by this section —
 - (a) may not be instituted more than three years after the date of completion of the acquisition; and
 - (b) is subject to the power of the court to relieve a director of liability, as provided for in section 93(4) and (5).’

The duty of a director as set out in s 91 and referred to in s 49(1)(b) is, in summary, a duty to act with reasonable care and skill and to act honestly and in good faith.

2.2 *Commentary on the buy-back provisions*

Terminology

The words ‘acquire’, ‘purchase’ and ‘reacquire’ are all used in the Bill to refer to a buy-back (see ss 49(2) and 51(3)-(8)). Consistency is called for. Strictly speaking, ‘the company does not “purchase” its shares. A company cannot acquire rights against itself. Its “acquisition” of the shares puts an end to those rights’ (M S Blackman, R D Jooste & G K Everingham *Commentary on the Companies Act* (2002) 5–43, hereafter *Commentary*). As has been stated:

‘[A] share is a bundle of rights. Where a company buys its own shares, one of these rights will be a right of action against itself. Obviously, the company cannot be the owner of a claim against itself. . . . How can one acquire a right against oneself? To state the proposition is to demonstrate the absurdity. One possibility is that the acquisition of the share operates like the assignment of a debt to the debtor — it acts as a release of those rights.’

(Bernard McCabe ‘The desirability of a share buy-back power’ (1991) 3 *Bond LR* 115 at 120–1; and see Robert Dugan ‘Repurchase of own shares for New Zealand’ (1987) 17 *Victoria Univ of Wellington LR* 179 at 182.) What is involved is ‘the taking back by a company of shares issued by it and, in return, the payment by the company of money or assets to the shareholder or shareholders concerned’ (*Commentary* 5–43). It is difficult to think of one word that aptly describes what is involved. Perhaps a word such as ‘acquire’ could be used throughout, and a subsection could be inserted defining the particular meaning that the word has in the context.

Authorization

In terms of the Bill, if the acquisition in question is authorized by the company’s Memorandum of Incorporation, no resolution at all of the members is required, ordinary or special (see s 51(3)). As long as the acquisition is authorized by the board and the solvency and liquidity test is satisfied, that will suffice (‘board’ is defined in s 1 as meaning ‘the board of directors’). The current legislation (see s 85(1) of the Companies Act)

requires a special resolution for all acquisitions. Not involving the members in such a potentially far-reaching decision is questionable. Thus it has been stated:

‘A share repurchase entails a change in the ownership of the company’s shares, and unlike a dividend payment, may thus be used to change control of a company or, for that matter, to prevent a change of control; or it may be used to manipulate the market price of the company’s shares. Share repurchases clearly have a greater potential for unequal treatment of shareholders. In short, the share repurchase power may be abused and it may, unless safeguards are provided, enable one group of shareholders to obtain an unfair advantage over other shareholders. It is for these reasons that the legislature must be more concerned with share repurchases than with dividends or other payments. It is not enough to protect creditors — shareholders and the investing public must also be protected. This is clearly acknowledged and recognised in the JSE Securities Exchange Listings Requirements on share repurchase.’

(F H I Cassim ‘The reform of company law and the capital maintenance concept’ (2005) 122 *SALJ* 283 at 287–8.) There is, however, a distinct and troubling trend in the Bill as a whole to bestow more power on the board of directors than at present. Fortunately the Bill does not repeat an absurdity in the Act: s 85(1) of the current Act provides that, if so authorized by its articles, ‘a company may by special resolution . . . approve the acquisition of shares issued by the company’. Section 85(1) does not specify that the acquisition being regulated is an acquisition by the company. Strictly speaking, an acquisition of a company’s shares by anyone, and not only the company itself, is regulated by s 85(1).

Section 51(3) of the Bill requires that a company be ‘authorized’ to acquire shares issued by it. In the absence of the authorization the acquisition is not merely beyond the authority of the directors, but is also beyond the powers of the company. Accordingly, it may be that where shareholder authorization is required, neither the rule in *Royal British Bank v Turquand* (1855) 5 E & B 248 nor the doctrine of estoppel will afford vendor-shareholders any protection where the company is not so authorized. Clarity is called for. (It is to be noted that in *Faren v Sun Service SA Photo Trip Management (Pty) Ltd* 2004 (2) SA 146 (C) it was held that neither the *Turquand* rule nor estoppel can apply where the directors of a company have made a disposal of assets without obtaining the approval of the members in general meeting as required by s 228 of the current Act. The opposite view was taken in the earlier case of *Levy v Zalrut (Pty) Ltd* 1986 (4) SA 479 (W). See further *Commentary* 5–62 and 8–325ff.)

The wording of s 51(3) of the Bill is such that, even if the Memorandum of Incorporation prohibits an acquisition, the acquisition is possible if there is the authorization required by s 51(3)(a) or (b). It is doubtful whether this is intended, and it should be rectified.

The point has been made that ‘it seems logical that the decision [to repurchase] should be taken by members who will remain in the company rather than by those who are seeking to leave it’ (*The Purchase by a Company*

of its Own Shares: A Consultative Document (1980) Cmnd 7944 (report by Professor L C B Gower, Research Adviser on Company Law to the Department of Trade) para 44 (hereafter *Gower Report*). In other words, where the offer is a selective offer, the persons to whom the offer is to be made ought not to vote on the resolution approving it. There is, however, nothing in the Bill to prevent the shareholders to whom the offer is to be made from voting on the special resolution approving the repurchase (as far as listed companies are concerned, however, Rule 5.89(iii) of the Listing Requirements of the JSE takes care of the matter). The same applies to the current Act. It is submitted that the votes of those shareholders whose shares are acquired should not be able to carry the resolution. Accordingly, what should be included is a provision stating that a resolution to confer, vary, revoke or renew authority is not effective if any member of the company holding shares to which the resolution relates, exercises the voting rights carried by any of those shares in voting on the resolution and the resolution would not have been passed if he or she had not done so.

It appears that preference shareholders, who do not have the right to vote at general meetings, have no say in an acquisition, whether it be an acquisition of preference or ordinary shares. As the rights of the preference shareholders may be affected, it is considered that they should have a say in the matter. The position in the current Act is unclear. Whether s 194 of the current Act entitles preference shareholders the right to vote in these circumstances is a moot point (see *Commentary* 5–65).

It is not clear what situations are being referred to in s 51(3)(a) and (b). Section 51(3)(a) applies ‘in the case of a purchase from one or more individual shareholders’. But are not all purchases from one or more individual shareholders? Is it intended that ‘individual’ is to be given the meaning given to the word in s 1 of the Bill, which is that it means a natural person? That, of course, would be nonsensical — why would a distinction be drawn here between natural and non-natural persons? The meaning in s 51(3)(b) of ‘in the case of a general purchase’ is also not clear. Possibly s 51(3)(a) and (b) are drawing a distinction between a targeted offer and a general offer to shareholders, but that is not what the provisions say. Section 51(3)(a) and (b) need amendment.

Section 51(4) of the Bill is very similar to s 85(9) of the current Act, both providing that an acquisition is prohibited if it would result in the company’s being left with only ‘redeemable’ or ‘convertible’ shares. In the current Act neither ‘redeemable’ shares nor ‘convertible’ shares is defined. In the Bill ‘convertible shares’ means:

- (i) any non-voting shares in a company that —
 - (i) are reasonably likely in future to become voting shares, or
 - (ii) become voting shares if the holder of those shares so elects at some time after acquiring the shares; or
- (j) options in voting shares in the company. . . .’

The rationale behind s 51(4) of the Bill and s 85(9) of the current Act appears to be to prevent a situation arising where a company as a result of an

acquisition is left with no shares or only non-voting shares. If this is the rationale, it is odd that only convertible non-voting shares are referred to in s 51(4). It is possible that a company could have convertible voting shares, and thus on conversion the company could be left with only shares that are non-voting. An amendment is required.

Presumably in the current Act 'redeemable' shares means redeemable preference shares and, in the Bill, the term refers to any class of shares which is redeemable. The Bill, unlike the Act, does not limit 'redeemable' shares to redeemable preference shares (see s 35(5)(b) of the Bill).

No procedural requirements

Section 87 of the current Act lays down rules governing the procedure to be followed by a company proposing to acquire its own shares. For example, in certain instances a written circular in the prescribed form must be sent to each registered shareholder (s 87(1)(a)). Section 87 also provides, inter alia, for pro-rating where a general offer is over-subscribed, and gives the Stock Exchange the power to lay down additional requirements. There is no equivalent to s 87 in the Bill, which is unwise considering that the procedure for a buy-back, as laid down in s 87, is 'of fundamental importance in preventing the abuse of the repurchase power and discrimination against shareholders holding the same class of shares' (Cassim op cit at 290).

Cancellation of shares

Section 52 of the Bill is similar to s 85(8) of the current Act, both requiring the shares that have been acquired to be cancelled and restored to the status of authorized shares. A question arises as to when the shares can be said to be 're-acquired' ('acquired' in the current Act). It seems that they should be regarded as acquired not when the contract is entered into, but when they have been paid for and the company would otherwise (ie but for the subsection) have become entitled to exercise the rights attached to the shares (see *Commentary* 5–72). Other jurisdictions have provisions to this effect, and it would be prudent for us to follow suit (see eg s 66(2) of the New Zealand Companies Act 1993). Perhaps also, as is done elsewhere (see *Commentary* 5–96), it should be provided that all rights attaching to shares are suspended once a company has entered into a buy-back agreement relating to them.

Reduction of capital

Section 51(6) of the Bill requires a reduction of the 'stated capital' when shares are acquired. (This is a necessary corollary of the cancellation of the acquired shares which is required by s 52 of the Bill.) However, nowhere in the Bill is 'stated capital' defined, and in fact there is no reference anywhere else in the Bill to 'stated capital'. Section 85(6) of the current Act is similar to s 51(6) of the Bill, requiring a reduction of the stated capital where no par value shares are acquired. Clarity on what is meant by 'stated capital' in the Act is provided by s 77(1), which states that '[t]he whole of the proceeds of an issue of shares having no par value shall be paid-up share capital of a company and shall be transferred to an account to be called the "stated capital account"'. A similar provision is required in the new legislation.

It would seem that apart from a redemption of redeemable shares, s 51(6) of the Bill provides the only means by which the share capital of a company can be reduced. There is no provision in the Bill providing for a general power to reduce the stated capital of a company. As Lord Halsbury said in *Ooregum Gold Mining Co of India v Roper* [1892] AC 125 (HL) at 133, ‘the whole structure of a limited company owes its existence to the Act of Parliament, and it is to the Act of Parliament one must refer to see what are its powers, and within what limits it is free to act’.

The reduction of capital affects shareholders’ rights, and one must assume that this would not be allowed without providing some protection. As Galgut J put it in *Ex parte Vlakfontein Gold Mining Co Ltd* 1970 (2) SA 180 (T) at 183, one of the duties of the court when asked to confirm a reduction of capital was ‘to consider whether the proposed reduction is fair and equitable as between the shareholders and particularly as between different classes of shareholders’.

It must be borne in mind that if one goes back to the origins of company law in South Africa, one finds that the English Companies Act 1862, as enacted, made no provision for the reduction of share capital. Shortly thereafter the position was changed. As Lord Herchell explained, ‘[e]xperience appears to have shown that circumstances might occur in which a reduction of the capital would be expedient. Accordingly, by the Companies Act, 1867, provision was made enabling a company under strictly defined conditions to reduce its capital’ (*Trevor v Whitworth* (1887) 12 App Cas 409 at 415–16). Generally, the ‘strictly defined conditions’ required the confirmation of the court. In this regard, Lord Herchell said (*ibid*): ‘Nothing can be stronger than [the] carefully-worded provisions [in the Companies Act 1867 governing the reduction of share capital] to show how inconsistent with the very constitution of a joint-stock company, with limited liability, the right to reduce its capital was considered to be.’

Reduction provisions similar to the English provisions were to be found in the old ss 83–90 of the Companies Act. Although it is possible to argue that the Bill, unlike the current Act, does not have its origin in English law, it is submitted that the arguments similar to those for the view that the current Act contains no general reduction provision (see R D Jooste ‘Can share capital be reduced other than by way of a buy-back?’ (2005) 122 *SALJ* 294) support the view that the Bill contains no such provision. It is submitted that the new legislation should provide for a general power to reduce share capital with built-in protection for shareholders.

Solvency and liquidity

Section 48(1)(b) requires the solvency and liquidity test to be satisfied ‘immediately after giving effect to the authorization’ (the ‘authorization’ being the board resolution referred to in s 48(1)(a)). ‘Effect’ is given to the authorization presumably when a ‘distribution’ to the selling shareholders is made (see the definition of ‘distribution’ in s 1 of the Bill), bearing in mind that payment for an acquisition may be in instalments, so there could be

more than one distribution in respect of the same acquisition. The current Act provides that the test must be satisfied at the time of any payment in respect of the acquisition (see the words ‘after the payment’ in s 85(4)(a) and (b) of the current Act).

Section 48(2) of the Bill, which requires reconsideration of the test where the distribution is not completed within a certain period, is puzzling. There appears to be no need for the provision in the light of the fact that s 48(1)(b) requires satisfaction of the test immediately after a distribution, whether it be payment in full for the acquisition or only an instalment. No such ‘reconsideration’ is required by the current Act.

In terms of s 4(1)(b)(ii) of the Bill, the liquidity test is satisfied only if it appears that the company will remain liquid for a period of 12 months following the distribution. No period is specified in s 85(4) of the current Act (cf Rule 5.90(g) of the Listing Requirements of the JSE which specifies a 12-month period), leaving it uncertain as to how long the company must remain liquid. The Bill provides certainty in this respect.

The solvency test in the Bill takes into account the company’s ‘assets’ and ‘liabilities’. Section 85(4) of the current Act refers to the company’s ‘consolidated assets’ and ‘consolidated liabilities’. The current Act does not define ‘consolidated’. Presumably the word refers to the situation where the company in question has subsidiaries and is required to produce consolidated financial statements for the group. In such event, for the purpose of the solvency test the group’s assets and liabilities would be the company’s ‘consolidated’ assets and liabilities. It is not clear, however, why the word ‘consolidated’ is used and why it has been jettisoned in the Bill. Possibly it is because the investment in the subsidiaries would, in any event, be taken into account in determining the assets of the holding company, and therefore the removal of the word ‘consolidated’ prevents the possibility of a double counting.

Section 4(1)(b) refers to debts that become due ‘in the course of business’. Section 85(4)(a) of the current Act uses the words ‘in the ordinary course of business’. The word ‘ordinary’ has been dropped. So in the Bill, as long as debts become due in the course of business, they must be taken into account even though the debts did not become due in the ordinary course of business. Therefore, it seems that debts not normally incurred by the company must be taken into account as long as they are related to the company’s business. It seems prudent to include all debts.

The solvency and liquidity test in s 85(4) of the current Act is failed ‘if there are reasonable grounds for believing’ that the company will not be solvent or liquid. The test in s 4 of the Bill is formulated differently: s 4(1) provides that the test will be satisfied ‘if, considering all reasonably foreseeable financial circumstances of the company at the time . . . it appears’ that the company will be solvent and liquid. It is not clear whether anything turns on the different formulation.

It is to be noted that, both in the Bill and the current Act, the question is not whether the directors or other persons within the company believe on

reasonable grounds that the tests are satisfied; it is whether as a matter of fact there are reasonable grounds for believing. The term ‘believing’, as indicated above, is not used in s 4(1) of the Bill but the notion appears to be the same in s 4(1).

The solvency and liquidity test in the exemption (introduced in 2007) in s 38(2A) of the current Act from the prohibition on a company giving financial assistance for the purchase of its own shares, or shares in its holding company, is complied with if ‘the company’s board is satisfied’ that the company is solvent and liquid. Thus the board’s actual belief that this is so satisfies the test, irrespective of how unreasonable the belief may be. The test is thus different from the test used in the Bill in relation to both buy-backs and financial assistance (see s 40 of the Bill). Despite the different contexts it is difficult to understand the inconsistency.

As is the case in the current Act (s 85), s 4 provides no clarity as to whether contingent debts / liabilities must be taken into the reckoning in determining the solvency and liquidity of the company. It is of note that contingent liabilities must be taken into account in applying the solvency test in s 38(2A) of the current Act (see immediately above). Section 38(2B) expressly requires contingent liabilities to be taken into account. Why the legislature should see fit to include contingent liabilities in s 38(2A) but not in s 4 is puzzling.

An objection to s 85(4) of the current Act is that it gives no indication as to what enquiry must be made in order to determine whether the solvency and liquidity test has been satisfied. Section 4 of the Bill is not very helpful in this regard either. Section 4(2) simply says that the directors may consider ‘(i) only financial information that satisfies financial reporting standards; and (ii) any fair valuation of the company’s assets and liabilities, or other valuation that is reasonable in the circumstances . . .’. Other jurisdictions do make provision in this regard (see for example s 8.30 of the American Revised Model Business Corporation Act).

Section 4(2)(b) of the Bill *expressly* provides that, unless the Memorandum of Incorporation of a company provides otherwise, the preferential rights of preference shareholders upon liquidation of the company are not to be regarded as a liability for the purposes of the solvency and liquidity test. The current Act does not appear to give preference shareholders any protection (see *Commentary* 5–70 and 5–128), although this is not expressly stated as it is in the Bill. Preference shareholders deserve protection — ordinary shareholders should not be preferred above them.

It is difficult to understand why the legislature has, in s 51(9), given some protection to the claims of preference shareholders on winding-up, but has given those claims no protection outside winding-up. Where, in a repurchase, a company has reduced its assets to the level of its liabilities, the preference shareholder’s preferred claim on winding-up will be worthless.

Liability of directors

The liability of a director referred to in s 49(2) of the Bill arises if the company acquires shares ‘contrary to section 48 or 51’. Thus not only may

liability arise if the solvency and liquidity test is not satisfied, but also if the acquisition is contrary to the Memorandum of Incorporation or is not properly authorized. This can be contrasted the buy-back provisions in the current Act (s 86), in terms of which a director can incur liability only if the solvency and liquidity test is not satisfied. The tougher approach in the Bill is commendable.

In terms of s 48(2)(b)(ii) of the Bill a director is only liable to the company for any amount paid for the acquisition which is not recovered from the shareholders in question. So the company must first take action against the shareholders for recovery and only then, if recovery is not made in full, may the company take action against the director. The current Act (s 86(1)) appears to enable the company to recover from the directors without first attempting to recover from the shareholders (s 86(1) assumes that the company itself has a right to recover. See *Commentary* 5–74).

It is also significant that, whereas liability in terms of s 49 of the Bill arises only if the director fails to act with reasonable care and skill and honesty, and in good faith (s 49(1)(b)), in terms of the current Act liability arises if the director ‘allows’ the company to acquire the shares contrary to the solvency and liquidity requirement (s 86(1)). The tougher approach in the Bill, referred to above, is unfortunately softened by this prerequisite for liability.

Neither the current Act nor the Bill gives a director, who has had to restore to the company any amount paid for the acquisition, the right to recover from the shareholders from whom the shares were acquired.

Section 86(5) of the current Act expressly preserves ‘any liability which any person may incur under this Act or any other law, or the common law’. Regrettably, there is no such provision in the Bill.

It appears, although it is not stated, that the director who incurs liability in terms of s 49 of the Bill is a director of the acquiring company, and a director of the acquiring company’s holding company is not also included. So liability is not extended as it is in s 86(6) of the Act, which provides: ‘For the purposes of this section and section 89 “director of a company” includes any director of a holding company of such company’. An extension of liability is called for, considering that more often than not it is the directors of the holding company who are the real culprits.

Recovery from shareholders

Where an acquisition is made by a company contrary to the solvency and liquidity requirements, s 86(3) of the Act gives shareholders and creditors of the company a right of action against the shareholders from whom the shares were acquired. Regrettably, there is no such provision in the Bill.

Section 51(2) of the Bill provides that ‘the court *may* order’ the person from whom the shares were acquired to return the amount paid by the company (my emphasis). The court thus has a discretion. It is arguable that an innocent or bona fide vendor-shareholder ought to receive *specific* protection. It is far better for legislation to clarify the liability of the parties instead of leaving it to the discretion of the courts. It could thus be

specifically provided, for instance, that the vendor-shareholder would not incur any liability to repay to the company any money paid to him or her for the shares if he or she acted in good faith and without any knowledge or suspicion that the directors were acting in contravention of the provisions, or where it would be unfair to require him or her to make repayment of the purchase price. However, although it is arguable that shareholders who receive payment in good faith should be protected, apart from possible recovery by the company from the directors (the creditors are given no right of action against the directors), to protect the good-faith recipient of the payment would be to prefer him to the company's creditors (see *Commentary* 5–77).

Enforceability of buy-back

It has been pointed out that since s 51(7) expressly provides that the contract 'is enforceable against the company', it could be argued that the maxim *expressio unius est exclusio alterius* applies, and therefore the contract is not enforceable by the company (see Ellis Magner 'The power of a company to purchase its own shares: A comparative approach' (1984) 2 *Company and Securities LJ* 79 at 108). This surely is not intended and should be clarified.

Section 51(9) of the Bill (which is the same as s 88(3) of the current Act) states that until the company has fully performed its obligations, 'shareholders who dispose of their shares retain the status of claimants entitled to be paid as soon as the company is lawfully able to do so'. The effect is that the executory contract remains in force. It has been pointed out that 'this provision makes sense if, but only if, it is subject to the terms of the contract and that it would be preferable to clarify the section' (Magner *op cit* at 108).

Publicity

Neither in the current Act nor in the Bill is publicity required in relation to the contract for the acquisition of the shares. With regard to the need for publicity, the view expressed by Professor Gower bears considering (*Gower Report* 18–19):

'If companies were permitted to enter into executory contracts or to obtain options to buy their shares it would be necessary to ensure that publicity was given to the fact that the shares were subject to the contract or option. . . . The contract or option to buy would be personal to the shareholder and a purchaser from him without notice of the contract or option would obtain a good title but for the fact that if the directors have power to refuse transfers, they would obviously refuse to register him. Hence he ought to be able to find out that the shares are under contract or option; and so should any one dealing with the company — especially anyone minded to become a shareholder — for the contract may materially affect the true net worth of the company. Provision would obviously need to be made requiring notice to be given to the Company Registry whenever a company acquired any of its own shares. But in addition it is suggested that whenever it entered into a contract or acquired an option to do so it should also give such notice. It is also suggested that the company should be required to maintain at its registered office a register (analogous to

the register of directors' holdings and dealings required under s 29 of the 1967 Act) of all acquisitions, contracts, or options which would show, *inter alia*, the price paid, and that the register (and perhaps copies of the contracts themselves?) should be available for inspection at least by any member or debenture holder. This would be a valuable additional protection against improper or improvident behaviour by the directors and would help to some extent in the determination of a fair price since it would be possible to obtain details of any past purchases.'

Gifts and inheritances

It is unclear whether s 51(3) of the Bill applies to the acquisition by a company of its shares through a gift to, or an inheritance by, the company. It is also unclear whether s 85 of the current Act applies to gifts and inheritances. It appears from the reference in s 51(3) of the Bill to s 48, which deals with 'distributions', and s 51(3)(a) and (b), which refer to a 'purchase', that donations and inheritances are not included. However, an interpretation that requires authority in the Memorandum of Incorporation for an acquisition by way of a gift or inheritance is not unarguable. Providing clarity as to whether gifts and inheritances are included would not be difficult, and has been done in other jurisdictions (s 37 of the Canada Business Corporation Act, 1985 expressly provides that a corporation may accept from any shareholder a share of the corporation surrendered to it as a gift, but no provision is made for the cancellation of such shares when acquired by the corporation). It is submitted that, considering the rationale for the cancellation of shares of a company acquired by the company itself, it should be provided that shares acquired by a company by way of a gift or inheritance should be cancelled.

Buy-backs of redeemable shares

It is unclear whether a company can acquire redeemable shares in terms of s 51(3) or whether it has to follow the redemption procedure prescribed in the terms of issue of the redeemable shares (the Bill does not contain a provision, like s 98 of the current Act, governing the redemption of redeemable preference shares). A similar question arises under the current Act: it is not clear whether a company can purchase its own redeemable preference shares or whether it has to follow the redemption procedure laid down in s 98 of the Act. Clarity is called for. It is to be observed that, whereas the current Act only permits redeemable *preference* shares, the Bill appears to permit redeemable shares of any class.

3. SUBSIDIARIES ACQUIRING SHARES IN THEIR HOLDING COMPANY

3.1 *Structure of the Bill*

The Bill permits a company to acquire shares in its holding company. Section 51(1) provides: 'Subject to subsection (2), a subsidiary of a holding company may acquire shares in the holding company.' However, there is a restriction:

s 51(2) provides that '[n]ot more than 10%, in aggregate, of the number of any class of shares of a holding company may be held by, or for the benefit of, subsidiaries of that holding company'.

Where a company 'causes' its subsidiary to acquire the company's shares, s 51(3) of the Bill requires compliance with the same requirements (see above) that must be met when a company acquires its own shares (s 51(3) provides: 'A company may not . . . *cause* its subsidiary to acquire the company's shares'; my emphasis).

Section 51(4), which applies where a company acquires its own shares, is also made applicable to a purchase by a subsidiary of shares in its holding company. Section 51(4) provides:

'If, as a result of a re-acquisition by a company of any shares, or, the acquisition of the company's shares by its subsidiary, as contemplated in subsection (1)(a) or (b), there would no longer be any shares in issue other than convertible or redeemable shares, the company or subsidiary may not reacquire or acquire those shares, despite the authorization of that re-acquisition or acquisition, either in the Memorandum of Incorporation, or by shareholders' resolution.'

Section 51(5) extends the application of s 51(3) and s 51(4). It provides:

'Subsections (3) and (4) apply equally to the purchase of a company's shares by a person who —

- (a) is related to the company at the time of purchase; or
- (b) is one of a group of inter-related persons, one of whom is related to the company at the time of purchase.'

Section 2(1) of the Bill determines when persons are 'related' or inter-related'. It provides:

'(1) For all purposes of this Act —

- (a) an individual is related to another individual if they —
 - (i) are married, or live together in a relationship similar to marriage; or
 - (ii) are separated by no more than three degrees of natural or adopted consanguinity or affinity, unless, in respect to any matter arising under this Act, there is sufficient evidence to conclude that the two persons act independently of one another;
- (b) an individual is related to a juristic person if the individual directly or indirectly controls the juristic person, as determined in accordance with section 3;
- (c) a juristic person is related to another juristic person if —
 - (i) either of them directly or indirectly controls the whole or part of the business of the other;
 - (ii) either is a subsidiary of the other; or
 - (iii) a person directly or indirectly controls the whole or part of the business of both of them; and
- (d) three or more persons are inter-related if the first and second such persons are related, the second and third such persons are related, and so forth in an unbroken series.'

3.2 *Commentary on the provisions governing the purchase of shares in a company by its subsidiaries*

Authorization

As is the case in the current Act (s 89), the authorization required by the Bill (s 51(3)) for an acquisition of shares by a subsidiary in its holding company is the same as is required for the acquisition by a company of its own shares. The current Act requires a special resolution in all cases, whereas if the Memorandum of Incorporation authorizes the acquisition the Bill requires no authorization from the shareholders, either by ordinary or special resolution. It is questionable that the shareholders are not involved in such an important decision (the same point is made earlier regarding the acquisition by a company of its own shares.)

It is to be noted that compliance with the requirements set out in s 48 and s 51(3) and (4) of the Bill is necessary only if the holding company 'causes its subsidiary' to acquire the holding company's shares. So if the subsidiary makes the acquisition independently of its holding company, such compliance is not required. It is possible in theory, but unlikely in practice, that this might happen. No such distinction is drawn in the current Act.

With the emphasis on inducement by the holding company, one would have expected that not only the subsidiary but also the holding company would have to comply with the requirements in s 48 and s 51(3) and (4). As has been stated:

'If this were not the case, the directors of the holding company could, as the representatives of the majority shareholder holding company and without any say from the holding company's shareholders, circumvent the safeguards of a direct share re-acquisition and indirectly manipulate the holding company's share capital structure by simply causing its subsidiary company to acquire the shares of its holding company.'

Reconciliation between the factual and legal nature of this transaction would call for the approval of both the holding company and the subsidiary company in their respective general meetings. A similar type of reasoning would apply in the context of compliance with other safeguards such as the solvency and liquidity measures for share re-acquisitions.'

(D Bhana 'The company law implications of conferring a power on a subsidiary to acquire the shares of its holding company' 2006 *Stell LR* 232 at 238–9. Bhana's comment is made in relation to s 85 of the current Act.)

There is no indication that a subsidiary cannot acquire shares in its holding company by way of gift or inheritance (subject to the 10% limit). In such case, unless the shares are donated to the subsidiary by the holding company (in which case the acquisition is 'caused' by the holding company), the requirements set out in the Bill in s 51(3) are not applicable.

Extension of application of provisions

Section 51(5) of the Bill is mystifying. It extends the application of s 51(3) far beyond what might be expected, given the wide scope of the meaning of 'related' and 'inter-related' persons. The following examples illustrate the absurdity of s 51(5):

- If Company X controls the whole or part of the business of Company Y and Company X acquires shares in Company Y, Company X must comply with s 51(3). This is so because Company X and Company Y are 'related' to each other in terms of s 2(1)(e)(i) of the Bill. If Company Y controls the whole or part of the business of Company Z and Company X acquires shares in Company Z, Company X must comply with s 51(3). This is so because Company X and Company Z are interrelated in terms of s 2(1)(d) of the Bill.
- If Company X is the holding company of Company Y and Company X acquires shares in Company Y, Company X must comply with s 51(3). This is so because Company X and Company Y are 'related' to each other in terms of s 2(1)(c)(ii) of the Bill. If Company Y has a subsidiary, Company Z, and Company X acquires shares in Company Z, Company X must comply with s 51(3). This is so because Company X and Company Z are interrelated in terms of s 2(1)(d) of the Bill.

The original intention (see General Notice 724 GG 18868 of May 1998, proposed amendment 9) was that s 89 of the current Act should also govern a purchase by a company of its holding company's shares in a fellow subsidiary (for example, Company H is the holding company of Company X and Company Y, and Company X acquires Company H's shares in Company Y) because 'not only does it make possible trafficking in the shares in the group, but such a purchase is, in effect, a return to the holding company of its investment in the subsidiary acquiring the shares' (*Commentary* 5–99). No reason was given in the Explanatory Memorandum to the Bill as to why this was not done ('Perhaps the reason was that such purchases have never been prohibited or otherwise regulated': *Commentary* 5–99). It will be recognized that such a purchase is regulated by the 2007 Bill because the fellow subsidiaries are 'inter-related' persons (because Company X is related to Company H and Company H is related to Company Y, Company X and Company Y are interrelated; see s 2(1)(d) of the Bill). The Bill, however, goes much further than appears necessary, as shown by the above examples.

The applicability of s 51(4) of the Bill in the context of a company acquiring shares in its holding company is mystifying, to say the least. When a company acquires shares in its holding company, the shares are not cancelled (as in the case where a company acquires its own shares). There is accordingly no possibility that the holding company could be left with only convertible or redeemable shares. The prohibition in s 51(4), therefore, can have no application. This anomaly is not present in the current Act.

Limit

There is uncertainty in the Bill (s 51(2)) regarding the limit on the number of shares that subsidiaries may purchase in their holding company. Is the limit ten per cent of each class or ten per cent of the total shares, irrespective of class of share? For example: Company X has three classes of shares, A shares, B shares and C shares. One hundred of each have been issued. Is the maximum limit on the number of shares that subsidiaries of Company X can

acquire in Company X (i) ten A shares, ten B shares and ten C shares, or (ii) thirty shares, irrespective of their class? In terms of the current Act (s 89) the answer is the latter. It appears that in the Bill the answer is the former. The limit is to curb the holding company's ability to traffic in its own shares indirectly, and therefore it should be made clear that the limit is ten per cent of the total shares, irrespective of class of share.

It is clear from s 51(2) of the Bill that, in determining the number of shares held by subsidiaries in their holding company, shares acquired by the subsidiaries before they became subsidiaries of the holding company must be taken into account. The position is different in the current Act, where the view is adopted that such shares do not have to be taken into account (see *Commentary* 5–98).

It appears that shares acquired by a subsidiary as a trustee or in a representative capacity must be taken into account in terms of the Bill in determining the percentage holding. This is anomalous. The same anomaly is to be found in s 89 of the current Act.

It also seems that, in terms of the Bill, shares acquired by subsidiaries in their holding company by way of a capitalization issue must be taken into account in determining whether the ten per cent limit has been exceeded. The same applies to the current position. In order to remove any doubt, this should be expressly stated to be the position.

It may be noted that nowhere has it been explained how the limit of ten per cent was arrived at. In this regard one sees that in the initial draft Companies Amendment Bill preceding the Companies Amendment Act, 1999 the Co-ordinating Research Institute for Corporate Law originally proposed a general prohibition on a subsidiary's acquiring its holding company's shares except to a nominal extent of one per cent of the issued share capital of the holding company. The published proposed amendment, which was adopted in the current s 89, recommended a ten per cent limitation (General Notice 724 GG 18868 of 8 May 1998). This modification was not explained (see Bhana *op cit* at 240).

Voting rights

A major difference between the Bill and the current Act, and a significant flaw in the Bill, is that no restriction is placed by the Bill on the voting rights attaching to the shares acquired by subsidiaries in their holding company. In terms of s 39 of the current Act, with minor exceptions, the voting rights attaching to the shares may not be exercised. It is anomalous that the Bill should propose that a company can be put in a position in which it can vote its own shares.

Liability of directors

Where a company acquires shares in its holding company contrary to the solvency and liquidity requirements, there are specific provisions in the current Act imposing liability on directors, including directors of the holding company (s 89 of the current Act makes s 86 applicable *mutatis mutandis*).

A serious omission in the Bill is that it contains no specific provisions in this regard. It is not clear whether this has happened inadvertently or whether the intention is that the general remedies provided for by the Bill are adequate to deal with the situation. It is submitted that the former is the more likely explanation. One would expect that the liability provisions applicable in the buy-back context, including the extension of liability to directors of the holding company, would be equally applicable here (see further in this regard Bhana *op cit*). It is to be noted that a payment made by a company for shares in its holding company is not a 'distribution' as defined (this is so despite the fact that acquisitions of shares in a company by its subsidiary are dealt with in Part C of the Bill, which is headed 'Part C — Distributions by the company'). Accordingly, s 49(1), which governs liability with respect to distributions, is not applicable (as has been seen, a buy-back is a distribution and accordingly s 49(1) is applicable to a buy-back).

Treasury shares

As with the current Act, the Bill, by allowing a subsidiary to acquire shares in its holding company, makes possible full-blown trafficking by a company of its own shares through its subsidiary. No doubt this will result in many buy-backs being structured as purchases by a subsidiary (see *Commentary* 5-100-5-101. Secondary Tax on Companies (STC) can also be avoided in this way (see para (c) of the 'dividend' definition in s 1 of the Income Tax Act 58 of 1962 and s 64B of that Act).)

In this regard, the following remarks made by Coetzee J in *The Unisec Group Ltd v Sage Holdings Ltd* 1996 (3) SA 259(T) at 265-6 are pertinent:

'The rapid development of the group of companies-concept since the first world war produced a mixed bag of results. The group usually consists of one or more pyramids of interrelated companies in which all or the majority of the shares of some are held by others with the parent or holding company at the apex. Economic and administrative advantages flow from this arrangement, on the one hand, but, on the other, it is clearly capable of abuse, particularly in regard to the important principle that a company may not traffic in its own shares. Through this principle, the group concept drives a coach and horses. In addition, the true financial state of the holding company can be effectively masked from the eyes of its shareholders and indeed distorted in the separate accounts of the companies in the group.'

(The Bill and the current Act, by allowing companies to acquire shares in their holding companies, appear to be unperturbed at the 'round-tripping' of dividends which becomes possible as a result. See *Commentary* 5-100-5-101.) Coetzee J's concern could possibly be allayed by a requirement that the financial statements must draw specific attention to the true state of affairs.

Solvency and liquidity

The comments made earlier regarding the solvency and liquidity test in the Bill in relation to acquisitions by a company of its own shares are equally apposite in the context of acquisitions by a subsidiary of shares in its holding company.

4. DISTRIBUTIONS GENERALLY

4.1 *Structure of the Bill*

The subject matter dealt with under this heading is payments (referred to as ‘distributions’ in the Bill) by a company to its shareholders qua shareholders other than in respect of an acquisition of their shares. A distribution must, in terms of s 48, be authorized by the board of directors and must meet the solvency and liquidity test in s 4. The definition of ‘distribution’ and the provisions of s 48 are set out under heading 2.1 above.

Liability with respect to distributions is provided for in s 49(1):

‘(1) If a director —

- (a) voted for or assented to an authorization of a distribution that did not satisfy the requirements of section 48; and
- (b) in so doing, failed to satisfy the duty of a director to the company, as set out in section 91, the director is jointly and severally liable, with all other such directors, to reimburse the company the amount, if any, by which the value of the distribution exceeded the amount that could have been distributed without contravening section 48.’

4.2 *Commentary on the provisions governing distributions*

Meaning of distribution

The definition of ‘distribution’ in the Bill has a wide scope, and is wider than the definition of ‘payment’ in s 90 of the current Act. Payments by a company for the acquisition of its own shares and redemption payments are not excluded as they currently are from the definition of ‘payment’ in s 90(3) of the Act. The difference in definitions is attributable to the fact that in the current Act, unlike in the Bill, buy-backs and redemptions are regulated by separate provisions.

The wording ‘direct or indirect payment’ in s 90(3) of the current Act presumably covers ‘the incurrence or forgiveness of a debt’ referred to in part (b) of the definition of ‘distribution’ in the Bill.

The definition of ‘distribution’ does not specifically refer to a payment in redemption of redeemable shares, but it clearly falls within the wide scope of the definition. So distributions on a redemption are treated just like any other distribution, and there is accordingly no provision like s 98 of the current Act which permits redemptions of redeemable preference shares only out of profits or a fresh issue of shares. This has important consequences both for the existing holders of redeemable shares and for the company, at least where shares are redeemable at a fixed date or at the option of the holder of shares after a fixed date. First, it gives existing holders of such shares greater rights than they bargained for. Secondly, it subjects the company to the possibility, which did not previously exist, of having its capital funds being reduced without any decision on the part of the company. The company can be forced to redeem even though it has no profits and is unable or unwilling to make a fresh issue of shares (as long as it is solvent and liquid) (see *Commentary* 5–275 where this reasoning is used in an attempt to explain why

the legislature retained s 98 in 1999, when the Act was amended so as to abolish the capital maintenance rule).

Greater clarity as to what constitutes a ‘distribution’ is perhaps called for, and in this regard decisions in New Zealand and America are helpful. In New Zealand it has been held (in *Re DML Resources Ltd (in Liquidation)* [2004] 3 NZLR 490 (HL) at 505) that the concepts captured by the elements of the definition of ‘distribution’

‘are the transfer of property (or the incurring of a debt) by the company; the corresponding provision of a benefit to or for its shareholders; and receipt of the benefit by, or on behalf of, the shareholder in its capacity as a shareholder. A link must be established between the outflow of wealth from the company and the benefit received by or on behalf of a shareholder.

The use of the expressions “direct or indirect” and “to or for” the benefit of the shareholder serve to confirm the necessary link between the negative impact on the net value of the company and the positive impact on the net value of the shareholder. They also emphasise that the inquiry is one of substance rather than form. An analysis based on the substance of the transaction lessens the likelihood of a shareholder using its influence, as an insider, to mask the true nature of the transaction to avoid compliance with the distribution rules.’

The common theme of the American decisions is the need to apply the distribution provisions if wealth is passed from a company to its shareholders, without adequate consideration, at a time when the company is insolvent (see *Re Munford Inc* 97 F 3d 456 (1996) 460; *C-T of Virginia Inc v Barrett* F 2d 606 (1992) 610–13; *Wiebolt Stores Inc v Schottenstein* 94 BR 488 (1988) 510–12. See also *DML Resources* (supra) and *Commentary* 5–117).

The term ‘in respect of its shares’ in both parts (a) and (b) of the definition of ‘distribution’ in the Bill presumably refers to the notion that the distribution is to a shareholder qua shareholder. This is clearer in part (a) than in part (b), the latter being generally quite unintelligible. Section 90(3) of the current Act is far more satisfactory in this regard — the payments are only s 90 payments if they are to a shareholder ‘by virtue of the shareholder’s shareholding in the company’.

Like s 90 of the current Act, s 48 of the Bill, read with the definition of ‘distribution’ in s 1, draws no distinction between distributions of capital and distributions of profits. Section 90 of the current Act puts an end to the ‘capital maintenance rule’, and the Bill continues in the same vein.

No reduction of capital

Distributions, whether or not they involve payments out of capital, leave the company’s stated capital unaffected. The shareholders’ rights to return of their capital on winding-up therefore remain intact. As mentioned in the commentary on buy-backs, the only distribution that results in the stated capital being reduced appears to be where there is a buy-back or where redeemable shares are redeemed.

Unequal distributions

Neither the Bill nor the current Act provides that ‘distributions’ or ‘payments’ must be declared at a uniform rate on all shares of the same class. It appears that as a general principle a uniform rate is required, but an express provision to this effect is perhaps called for (see *Commentary* 5–136–5–137 and the cases cited there).

Authorization

Section 90 of the current Act does not indicate who has the authority to make the ‘payments’ regulated by the section. It simply refers to ‘the company’. It appears that in the absence of a provision to the contrary in the articles, it is for the members in general meeting by ordinary resolution to authorize the making of such payments (see *Commentary* 5–118). The Bill, in contrast, takes the matter out of the members’ jurisdiction and gives the authority to make distributions, in all instances, to the board of directors (see s 48(1) of the Bill). Not involving the members in such an important decision is considered to be unjustified.

In terms of the common law every company has, subject to any restrictions which may be imposed by its memorandum, an implied or inherent power to apply its profits to the distribution of dividends (see *Patakh Centre (Pty) Ltd v Stern* 1978 (1) SA 259 (D) at 263), and the rights of shareholders to such dividends are governed by the memorandum and articles of association of the company (see e.g. *Wood v Odessa Waterworks Co Ltd* (1889) 42 ChD 636 at 642). Section 90 of the current Act, however, permits ‘payments’ only if the company is ‘authorized thereto by its articles’, and now the Bill (s 48(1)) gives authority solely to the board of directors to make distributions. This presumably puts an end to the company’s inherent right to pay dividends (see *Commentary* 5–135–5–136). Presumably the authority of the directors in this regard is subject to what is stated in the Memorandum of Incorporation, although s 48(1) of the Bill does not say this. It is assumed that the Memorandum of Incorporation could limit distributions to distributions of profits and thus prohibit the distribution of capital (in which event, presumably the common law governing what constitutes legally distributable profit would come into play).

It is clear in the current Act (s 90) that a company can be prevented by its articles from making a distribution of capital to its shareholders. There is no clarity in the Bill as to whether the Memorandum of Incorporation can limit the company in this way.

Liability of directors

The liability of directors in terms of the Bill is limited to the amount ‘by which the value of the distribution exceeded the amount that could have been distributed without contravening section 48’ (s 49(1)). So, if the solvency and liquidity test is not satisfied, they are not necessarily liable for the full amount of the distribution, although they could be. Section 90 of the current Act, strangely, imposes no liability on directors for failing to comply

with the solvency and liquidity requirements. The statutory position of directors in relation to ‘payments’ is therefore different from their position with regard to repurchases (see above). Recourse therefore would have to be had to general remedies against directors, including the common law.

Recovery from shareholders

Section 90(4) of the current Act provides for liability of the shareholder to whom a payment has been made contrary to s 90, but the Bill is silent as regards liability of the shareholder. The Bill, in this respect, therefore goes to the opposite extreme. Whereas the current Act provides for strict, unlimited liability of the shareholder, the Bill provides for no liability at all. Note that in terms of s 90 it would seem that the shareholder is liable regardless of whether he knew or ought to have known that the payment was made in contravention of s 90(2) (see *Commentary* 5–129).

Section 56(1) of the New Zealand Companies Act 1993 provides that a distribution may be recovered by the company from the shareholder, unless (a) the shareholder received the distribution in good faith and without knowledge of the company’s failure to satisfy the solvency test; (b) the shareholder has altered his position in reliance on the validity of the distribution; and (c) it would be unfair to require payment. Section 56(6) of the New Zealand Act provides that if, in an action brought against a shareholder, the court is satisfied that the company could, by making a distribution of a lesser amount, have satisfied the solvency test, the court may permit the shareholder to retain an amount equal to the value of any distribution that could properly have been made. Under the American Revised Model Business Corporation Act, a shareholder who receives a payment not knowing of its invalidity is entitled to retain it (s 8.33(b)(2); and see *Commentary* 5–130).

Solvency and liquidity

The comments made earlier regarding the solvency and liquidity test in the Bill in relation to acquisitions by a company of its own shares are equally apposite in the context of ‘distributions’.

5. CONCLUSION

The above examination of the Bill in the context of buy-backs, acquisitions of a company’s shares by its subsidiaries and distributions to shareholders generally, has revealed anomalies, inadequacies and inconsistencies. Many of the flaws encountered would, it is submitted, have been eliminated if a comprehensive explanatory memorandum of each and every provision in the Bill had been compiled (this is common in proposing fiscal legislation). The attention to detail and focus that this would have required would have exposed many of the problems highlighted. Such memoranda would also have assisted interested parties in commenting on the provisions of the Bill, and would have served as an ideal medium for educating the public in regard to a new company law regime that differs radically from the one currently in

operation. It is further suggested that if each of the three areas examined in this note had been separately addressed and provided for in the Bill, the confusion and difficulties encountered would have been reduced.