FINANCIAL ASSISTANCE: THE NEW APPROACH

By:
STEVEN PINNOCK
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Supervisor: Professor Richard Jooste
Department of Commercial Law, University of Cape Town

DECLARATION

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Contents

1 Introduction

Several jurisdictions, including South Africa, regulate the granting by a company of financial assistance for the acquisition of its own shares. Some permit financial assistance unconditionally, others regulate financial assistance according to strict conditions and others prohibit it subject to minor exceptions. After statutorily being introduced into company legislation in the early part of the 20th Century, there are still questions as to why this law is still so prominent, and whether such regulation or prohibition is a necessary component of company law in the modern commercial environment, or more specifically the South African commercial environment where the prohibition has been an impediment to Black Economic Empowerment (BEE) deals. The prohibition against financial assistance has been criticised by numerous academics and practitioners, and many jurisdictions have over time amended their laws dealing with financial assistance to make it less burdensome and restrictive.[1] South Africa finally relaxed its financial assistance prohibition contained in section 38 of the Companies Act[2] in 2007 when the Corporate Laws Amendment Act[3] came into operation with the introduction of the US modelled solvency and liquidity test.

One of the issues regarding to the relevance of the financial assistance prohibition is how best to protect the relevant stakeholders that the prohibition aimed to protect. The most likely candidates for protection are the creditors of the company, followed by shareholders, particularly minority shareholders, from the risk of looting the company assets by the new owners or financial failure following a debt heavy takeover that is known as a leveraged buy out (LBO) or management buyout (MBO). Financial assistance has for a long time been associated with the capital

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[1] For criticism of the outright prohibition against financial assistance see the following: F Cassim 'The Reform of Company Law and the Capital Maintenance Concept' (2005) 122 *SALJ* 283 at 291; Barraclough 'Italian Lawyers Face New Acquisition Finance Test' (2003) 22 *Int'l Fin. L. Rev.* 42; Salès 'French Financial Assistance Rules Hinder Leveraged Finance' (1996) 15 *Int'l Fin. L. Rev.* 10; Gray 'Reform of the Financial Assistance Provisions in the CBCA- Type Model Statutes' (2002) 37 *Can. Bus. L.J.* 186; Gower *Principles of Modern Company Law* 5 ed (1992) 227

[2] Act 61 of 1973.

[3] Act 24 of 2006.

maintenance rules, and has been considered as an offshoot of the capital maintenance rule that prohibited companies from acquiring and trafficking in their own shares. The capital maintenance rules were derived from the principle that a company may not purchase its own shares, and in doing so return capital funds back to shareholders.[4] There is however, great support for the view that financial assistance lies beyond the realm of the capital maintenance principle.[5] It therefore became necessary to relax the prohibition to allow for the honest business undertakings to proceed unhindered, while still maintaining a level of necessary protection.

The objective of this paper is to examine how South Africa has approached the reform of the financial assistance prohibition. For comparative purposes it will be useful to look at how other jurisdictions have approached the regulation and to examine where South Africa is heading in terms of the 2008 Companies Bill, which is expected to become the new company law regime in the near future. In this examination firstly the history of the current prohibition in the 1973 Companies Act will be traced, along with the associated link with the capital maintenance doctrine; secondly the position of comparable or important jurisdictions will be outlined, including the United Kingdom, Canada, Australia, and New Zealand; and thirdly the amendment to section 38 and the financial assistance provision in the 2008 Bill will be analysed to see which direction South Africa is heading in terms of financial assistance.

2 Financial Assistance and the Capital Maintenance Relationship

I. Capital Maintenance

[4] *Trevor v Witworth* (1887) 12 App. Cas 409 HL.

[5] In this regard see for example E Ferran 'Creditors' Interests and "Core" Company Law' (1999) *The Company Lawyer* Vol. 20 No 10; F Cassim (note 1); J Armour, 'Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law' (2000) 63 *Mod. L. Rev.* 368; Blackman *et al. Commentary on the Companies Act* (2002) Vol 1.At p4-57; Ferran *Company Law and Corporate Finance* (1999) p372; Gower *Gower And Davies' Principles of Modern Company law* 7th ed (2003) p259; *Mount View Charolais Ranch v Haverland* [1974] 2 W.W.R. 289 Alberta Supreme Court , Appeals Division. Alberta ;The Alberta Institute of Law Research and Reform *Financial Assistance by a Corporation: s42 of the Alberta Business Corporations Act* Rp 05/1989; Report of the Company Law Committee 1962 Cmnd. 1749 (Jenkins Report).

The contributed or paid up capital of a limited liability company is colloquially described as a fund to which the creditors of a company must look to for the satisfaction of their claims against the company, and that fund must be maintained.[6] Judges in the nineteenth century considered that capital maintenance rules were 'necessary to protect creditors against the "extra" risks associated with limited shareholder liability.'[7] The risk is that shareholders may cause a company to make distributions at the expense of creditors. Capital maintenance rules are aimed at ensuring that the company does not return its contributed capital to its shareholders other than legally authorised methods in terms of the legislation. The capital maintenance rule emerged towards the end of the nineteenth century, and was revealed in the English case of *Trevor v Witworth.*[8] The case concerned the issue whether a limited liability company could in law acquire its own shares, regardless of any power authorised in its articles or memorandum. When a company acquires its own shares it is returning contributed capital back to the shareholders and the share capital of the company is therefore reduced. The following quote by Lord Herchell describes the right of a company to legally reduce its capital:[9]

> 'What is the meaning of the distinction thus drawn between a company without limit on the liability of its members and a company where the liability is limited, but, in the latter case, to assure to those dealing with the company that the whole of the subscribed capital, unless diminished by expenditure upon the objects defined by the memorandum, shall remain available for the discharge of its liabilities? The capital may, no doubt, be diminished by expenditure upon and reasonably incidental to all the objects specified. A part of it may be lost in carrying on the business operations authorised. Of this all persons trusting the company are aware, and take the risk. But I think they have a right to rely, and were intended by the legislature to have a right to rely, on the capital remaining

[6] Cilliers and Bendade 'Corporate Law' 3rd Edition 2000. p322.
[7] John Armour, 'Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law' (2000) *Mod. L. Rev.* 63. 355 at 367.
[8] (1887) 12 App. Cas 409 HL.
[9] Ibid at 415-416.

> undiminished by any expenditure outside these limits, or by the return of any part of it to the shareholders. Experience 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 [Act of 1948, ss 66-71]. Nothing can be stronger than these carefully-worded provisions 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.'

The rule that emerged from *Trevor v Witworth*[10] is that the capital of a company cannot be returned to shareholders without a reduction of the share capital in accordance with the Act. The capital maintenance rule is therefore not a rule of the common law; it is derived from a strict interpretation of statute.[11] The 1862 English Companies Act was amended in 1867 to empower companies to formally reduce their share capital strictly in accordance with the Act.[12] Any transaction that was not authorised in the Act and which resulted in the return of capital back to shareholders was illegal and unenforceable.[13] Creditors expect that the capital of the company will be expended for purposes within the powers of the company. Therefore the capital maintenance principle does not maintain that there should be a minimum level of capital funds available at all times, as capital may be lost in the course of business operations that are incidental to the objects of the company.[14] The creditors rely on the fact that the share capital subscribed to and reflected in the share capital accounts will not be distributed to shareholders without an adjustment to the share capital accounts in accordance with the statutory reduction provisions.

From this general capital maintenance rule more specific rules were statutorily introduced pertaining to the raising, alteration and distribution of capital and are

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[10] Ibid.
[11] Blackman *et al* (note 5) At p5-105.
[12] Blackman *et al.* (note 5). Companies Act 1867 30 & 31 Vict c 131. One of the requirements for a reduction of capital was the sanction by a court.
[13] Blackman *et al.* (note 5) At p5-106.
[14] Trevor v Witworth (note 4).

also known as legal capital rules. These rules include minimum subscribed capital requirements; the prohibition against dividend distributions out of capital; the prohibition on purchases by a company of its own shares; a subsidiary becoming a member of its holding company; and the issue of par value shares at a discount.[15] The financial assistance prohibition is closely associated with the principle that a company may not acquire its own shares.

South Africa adopted its 1926 Companies Act[16] largely on existing English Company legislation, which resulted in the importation of the legal capital rules into South African legislation. The strict adherence to the philosophy of legal capital concepts has become less common throughout foreign jurisdictions in the late 20th Century, with many commonwealth nations abandoning the strict capital rules in favour of a permissive capital and distribution regime moulded on American state corporation law. Capital maintenance and the legal capital rules are largely a result of nineteenth century legal history[17] and early twentieth century legislation, but as the last century waned their prominence faded, particularly in the U.S. and other Commonwealth nations. The legal capital rules are largely thought to be inefficient and ineffective as a means of creditor protection.[18] In the US the Revised Model Business Corporations Act (RMBCA) updated the Model Business Corporations Act in 1984 and substantially altered the way in which the law dealt with the regulation of corporate distributions, and did away with the legal capital concepts. As of 2004 there were some 37 US states that adopted or substantially adopted the approach in the RMBCA.[19] Only two US states, Delaware and New York still make use of legal capital concepts, but to a much limited extent than the

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[15] Blackman (note 5). p5-107.

[16] Act 46 of 1926.

[17] J Kuestermans. 'Countertrends in Financial Provisions for the Protection of Corporate Creditors: The Model Business Corporations Act and the E.C.C Corporate Directives.' (1985-1986) 14 *Denv. J. Int'l L. & Pol'y* 275. At 277.

[18] See J Armour, 'Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law' (2000) 63 *Mod. L. Rev.* 368; J Armour 'Legal Capital: An Outdated Concept?' (2006) 7 *European Business Organization Law Review*; E Ferran, '*The Place for Creditor Protection on the Agenda for Modernisation of Company Law in the European Union*, '(2005), No 51 ECGI Law Working Paper; L Enriques and J Macey, 'Creditors Versus Capital Formation: The Case against the European Legal Capital Rules' (2001) 86 *Cornell LR* 1165.

[19] A Engert. '*Life Without Legal Capital: Lessons From American Law*' Working Paper (2006). p19. Available at SSRN: http://ssrn.com/abstract=882842.[Accessed 24 January 2008]. The 4th edition Annotated RMBCA comments that 29 states have adopted the RMBCA.

capital requirements of the European jurisdictions. Many Commonwealth nations still rely on legal capital structures, but have adopted a corporate distribution model that is more permissive and based on the US styled solvency tests.[20] The European Community is still bound by the 2nd Company Law Directive,[21] which retains many of the capital maintenance rules and legal capital structures, but has recently been slightly relaxed to allow for capital reductions in certain circumstances.[22]

South Africa retained its adherence to the strict capital maintenance regime until 1999, following which the Companies Act[23] now allows companies to make distributions in the form of share repurchases and permits companies to pay dividends out of capital, provided the company remains 'balance sheet' solvent and retains its ability to pay its debts as they fall due. These are known as the solvency and liquidity tests. Therefore dividend payments are no longer restricted to distributable profits and payments out of capital are possible. With the power to repurchase their own shares companies are also permitted purchase shares in their holding company, subject to authorisation in the company's articles and a special resolution.[24] The financial assistance prohibition was retained until its relaxation in 2007 with the introduction of the solvency and liquidity test.

Capital maintenance and other legal capital rules are widely criticised as being costly, ineffective and inefficient at protecting creditors. According to John Armour the functionality of the capital rules is 'to reduce post contractual opportunistic behaviour by companies to transfer wealth from creditors to shareholders.'[25] Creditors assess the risk and required return on their trade and investment by incorporating legal capital into the assessment before contracting.[26] It is therefore

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[20] For example: Australia, Canada and New Zealand and South Africa.
[21] Second Council Directive 77/91 as of December 13 1976, OJ [1977] L 26/1. The Directive applies to public companies of Member countries.
[22] Directive 2006/68/EC.
[23] Act 61 of 1973.
[24] Sections 85 -89 of the Companies Act 61 of 1973.
[25] John Armour (*Legal Capital* note 18) p12.
[26] D Kershaw '*Involuntary Creditors and the Case for Accounting-Based Distribution Regulation.*' London School of Economics and Political Science Working Paper 16/2007. Available at: http://ssrn.com/abstract=1033325. [Accessed 4 December 2007] p5.

possible to describe the maintenance of capital rules as a 'collective' contractual covenant that restricts the behaviour of companies in favour of its creditors.[27]

The economic rationale of having statutory legal capital rules are the 'contractual costs savings'; that is the costs saved by parties to contracts by not having to negotiate contractual covenants that offer a minimum level of creditor protection. However the savings will only be beneficial if the capital restrictions imposed are the same as what creditors would opt to contract into. According to empirical evidence in the UK, where capital maintenance and legal capital rules are still imposed, contractual financial covenants impose restrictions based on gearing and financial ratios not tied in to profits or net assets, which the capital maintenance rules do.[28] More recent studies suggest that covenants in the UK are moving from balance sheet-based measurements, which suggests that creditors rely more on measures such as gearing and cash flow than the relationship of net assets to undistributable capital.[29]

A further limitation on the contractual costs savings hypothesis is that of the claims involuntary creditors, such as delict (tort) victims, or Revenue authorities; and the contractual relationships with smaller trade creditors, who may have little power of negotiation, are not protected. These claims arise with no reference to or reliance on amounts stated and maintained in the capital accounts. Further more, reliance on the maintenance of capital rules to 'maintain' what capital is contributed is dependent on the actual capitalization of the company. Therefore the protection offered by the maintenance of capital is only relative to the capitalization of the company. South African company law has no minimum capital rule, which means a company can in effect be capitalized by minimal share capital and thereby expose creditors to great risk. Voluntary creditors who contract with thinly capitalized companies can impose stricter financial covenants than those supplied

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[27] J. Armour (*Share Capital* note 7) p368.
[28] Ibid.
[29] Ferran E, '*The Place for Creditor Protection on the Agenda for Modernisation of Company Law in the European Union*', ECGI Law Working Paper No. 51 2005. p7.

by company law or choose not to contract, while involuntary creditors do not have this option.[30]

Another limitation of legal capital is that it is measured according to historical values and bears little relationship to the present net worth or the financial well being of the company. Armour states that "legal capital rules are a form of primitive regulatory technology which, as a matter of theory, is likely to generate more costs than benefits."[31] It is based on these arguments that legal capital rules and capital maintenance are considered ineffective and inefficient. The reform initiatives of capital maintenance are aimed at improving both its efficiency and its effectiveness at protecting creditors.

The 1999 amendment to the Companies Act[32] did not invade the prohibition against financial assistance as one would have thought likely due to its close relationship with capital maintenance and share repurchases. However it cannot be considered that the prohibition was merely overlooked, the 1999 amending act did alter the ambit of the prohibition by adding exception (d) under S38(2). It is therefore apparent that parliament considered that the concerns over the financial assistance prohibition warranted its retention instead of its reform parallel to the reform of the capital maintenance rules. To understand the association of financial assistance with the capital maintenance doctrine it is useful to trace the prohibition's history and arrival in South Africa's statute book.

II. The History of Financial Assistance Prohibition

The prohibition against financial assistance is common in corporate statutes in commonwealth countries, and is found in European jurisdictions. Generally the different prohibitions found are couched in similar terms and covers similar types of transactions. The differences in the variations of the prohibition in recent years are due to reform initiatives that individual jurisdictions have undergone, often in hand

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[30] Kershaw (note 26) p5; Armour (*Share Capital* note 7) p368.
[31] Armour (*Legal Capital* note 18) p12.
[32] By Act 37 of 1999.

with the reform of share capital and capital maintenance regulation. Some countries have opted to abolish the prohibition completely;[33] while others have relaxed the prohibition by introducing solvency requirements.[34] The new English Companies Act[35] abolishes the prohibition for private companies, while public companies are still subjected to the prohibition subject to certain conditions that only allows financial assistance if net assets are not reduced, or to the extent that net assets are reduced, that the assistance is funded by distributable reserves.[36] This limitation is imposed by the minimum requirements of the European Community Second Company Law Directive.[37] American state corporation laws do not have financial assistance provisions, but the law of fraudulent transfer and preference law play important role *vis-à-vis* distributions and leveraged buy outs together with the corporate statutes.[38]

As pointed out above, the capital maintenance rules regulating capital were developed by the end of the nineteenth century, but there was no financial assistance prohibition at that time. Shortly into the 20th Century it became apparent that there was a hole in the capital maintenance framework of company legislation. In 1926 in England, the Greene Committee[39] in its Report to Parliament on the amendment of company law noted the concern of improper practices that had arisen. The Committee described the situation where:[40]

> 'A syndicate agrees to purchase from the existing shareholders sufficient shares to control a company, the purchase money is provided by a temporary loan from a bank for a day or two, the syndicates nominees are appointed directors in place of the old board and immediately proceed to lend to the syndicate out of the company's funds (often without security) the money to pay off the bank.'

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[33] Canada Model Business Corporations Act R.S.C. 1985. c. C-44.
[34] New Zealand Companies Act 1993 No 105.
[35] Companies Act 2006 c.46.
[36] Sections 677 to 682.
[37] EC 2nd Directive (note 11) Art23.
[38] Engert (note 19) at p26 and p29.
[39] English Company Law Amendment Committee 1926 Cmd. 2657.
[40] Ibid. Para 30.

The committee stated that this type of transaction 'offends against the spirit if not the letter of the law which prohibits a company from *trafficking in its own shares* and is open to the gravest abuses' (emphasis added)[41] Following this report the English Companies Act was amended in 1928 to create a statutory offence for the granting of financial assistance for the purchase of its own shares.[42] It is often considered that the financial assistance prohibition is an extension of the prohibition against companies from purchasing their own shares, as the granting of financial assistance is one form of evading this rule.[43] Instead of using company resources to distribute capital to shareholders in the form of a buyback and affect the control of the company, the resources are used to dilute ownership by assisting the transfer from certain shareholders to new shareholders or an existing shareholder. In takeover situations by an outside acquirer or as a management buyout, the effect of share trafficking by the company is a reorganisation of the issued share capital of the company and therefore ownership.[44]

It would appear that South Africa, which adapted most of its Company law from the English legislation, followed suite and adapted the prohibition without formulating its own policy for the financial assistance prohibition and its possible rethinking.[45] The prohibition was inserted in the 1926 Companies Act[46] only in 1939.[47] Revision of the prohibition in the 1926 Act occurred in 1952 to prohibit not only financial assistance for the purchase of shares, but also for a subscription of shares. This follows the route the English Companies Act took following the decision in *Re V.G.M. Holdings Limited*[48] where it was held that the interpretation of 'purchase of shares' did not include a subscription for shares. In 1945, following the *VGM Holdings* case the

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[41] Ibid.
[42] Companies Act 1929 c.23. E Ferran *Company Law and Corporate Finance* (1999). p374.
[43] Cassim (note 1) At 291.
[44] Blackman *et al.* (note 5) At p5-45.
[45]The Companies Act 46 of 1926 was based on the Transvaal Companies Act 31 of 1909, which was in turn based on the English Companies (Consolidation) Act of 1908. Available at World Bank Country Reports: http://siteresources.worldbank.org/GILD/ConferenceMaterial/20157439/South%20Africa%20CR%20-%20Final%20Version%20%20(Per%20LK%204-8).pdf [Accessed 19 December 2008]
[46] Act 46 of 1926.
[47] As section 86(bis)(2) by s52 of the Companies Amendment Act 23 of 1939. The prohibition had also been adopted in Canada in 1927, in New Zealand in 1933 and in Australia in 1937. See Cassim, F 'Unravelling the Obscurities of Section 38(2)(d) of the Companies Act' 122 (2005) *SALJ* 493 at 495.
[48] *Re V. G. M. Holdings, Limited.* [1942] Ch. 235

Cohen Committee Amendment Report[49] to Parliament in the UK dealt with the prohibition in one paragraph where it proposed an amendment to the prohibition to include a subscription of shares in itself or its holding company.[50] Copying these changes in the UK the Millin Company Law Amendment Enquiry Committee (Millen Committee) in South Africa recommended in 1948 to adopt this minor change and include a subscription of shares in the prohibition, and the prohibition was thus amended in 1952.[51]

The current form of section 38(1) arose as a result of an investigation started in 1963 by the Commission of Enquiry into the Companies Act and was chaired by Acting Justice van Wyk de Vries to investigate reform and consolidation of the 1926 Companies Act. The commission published its Main Report in 1970.[52] A surprising and unfortunate feature of the report is the very little attention paid the topic of financial assistance. This is surprising due to the fact that in 1962 in the UK the Jenkins Report on Company Law[53] dealt extensively with financial assistance and suggested major reform of the prohibition. The van Wyk de Vries Commission did not investigate the topic, and the only reference to the prohibition was made in the context of defining the impact of the definition of control in the parent-subsidiary relationship.[54] The report stated:[55]

> 'The making of loans for or provision of financial assistance by a company for the purpose of acquiring shares in its controlled company is from the point of view of "trafficking" undesirable apart from the aspect of the possible indirect depletion of the capital of the controlling company [section 86 *bis* (2)].'

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[49] (Cohen Committee) Report of the Committee on Company Law Amendment 1945. Cmd. 6659
[50] Ibid. Para 170.
[51] (Millin Commission) Company Law Amendment Enquiry Commission 1948. J.G No. 69-1948. Para 47.
[52] (van Wyk de Vries Commission) Commission of Enquiry into the Companies Act R.P. 45/1970.
[53] Jenkins Committee, Report of the Company Law Committee 1962 Cmnd. 1749.
[54] (van Wyk de Vries Commission). Para 46.19(c).
[55] Ibid.

The van Wyk de Vries Commission's Supplementary Report published in 1972, indicates that little further investigation into the matter was undertaken.[56] There was only concern with a possible exemption for building societies transacting with companies that owned immovable property. This type of transaction was intended to avoid transfer duty costs, but the fiscal authorities intended on tightening up certain legislation in this regard and the proposal was not followed further. The van Wyk de Vries Commission's report led to the introduction of the consolidated Companies Act No 61 of 1973, and section 38 was introduced as follows:

> 38 (1) No company shall give, whether directly or indirectly, and whether by means of a loan, guarantee, the provision of security or otherwise, any financial assistance for the purpose of or in connection with a purchase or subscription made or to be made by any person of or for any shares of the company, or where the company is a subsidiary company, of its holding company.
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> (2) The provisions of subsection (1) shall not be construed as prohibiting-
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> (a) the lending of money in the ordinary course of its business by a company whose main business is the lending of money; or
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> (b) the provision by a company, in accordance with any scheme for the time being in force, of money for the subscription for or purchase of shares of the company or its holding company by trustees to be held by or for the benefit of employees of the company, including any director holding a salaried employment or office in the company; or
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> (c) the making by a company of loans to persons, other than directors, *bona fide* in the employment of the company with a view to enabling those persons to purchase or subscribe for shares of the company or its holding company to be held by themselves as owners
>
> (3) (a) Any company which contravenes the provisions of this section, and every director or officer of such company, shall be guilty of an offence.

[56] (van Wyk de Vries Commision) Supplementary Report and Draft Bill. R.P. 31/1972. Para 84.01

> (b) For the purpose of this subsection "director", in relation to a company, includes any person who at the time of the alleged contravention was a director of the company.
>
> (4) It shall be a defence in any proceedings under this section against any director or officer of a company if it is proved that the accused was not a party to the contravention.

Section 38 remained unchanged until 1999 when the Company law Amendment Act 37 of 1999 introduced the exception (d) to s 38(2):

> (d) the provision of financial assistance for the acquisition of shares in a company by the company or its subsidiary in accordance with the provisions of section 85 for the acquisition of such shares.

The prohibition therefore survived the 1999 elimination of the capital maintenance regime, even though it came into being as an extension of the share trafficking prohibition. The prohibition was finally relaxed by the introduction of the solvency and liquidity test in subsection (2A) in 2007.

III. The Financial Assistance – Capital Maintenance Relationship

It is submitted that it is the reference to the 'share trafficking' abuse by the Greene Committee[57] that is the historic link that the financial assistance prohibition has with the principle in the *Trevor v Witworth*[58] case, and that the relationship stems from the creditor protection objective that both rules have in common and the abuses that arise from share trafficking.[59] However, while the prohibition shares a common objective with this principle and the capital maintenance principle in general, the prohibition possesses other objectives that have limited relationship with these rules. It is unfortunate that case law and legislative responses have been slow to revisit this misconception. In South Africa, the *Lipschitz NO v UDC Bank LTD*[60] case is a

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[57] (note 39)
[58] (note 4) See Cassim (note 1) at 291.
[59] Such abuses include market manipulation. There are also minority shareholder concerns which don't concern the capital maintenance principle. See Ferran 'Creditors' Interests and "Core" Company law' (1999) *The Company Lawyer* Vol. 20 No 10 p319.
[60] 1979 (1) SA 789 (A).

leading authoritative interpretation of the section, but it specifically refers to the mischief the prohibition seeks to prevent as the rule in the *Trevor v Witworth.*[61] It would have been worthwhile to explore whether the financial assistance prohibition was purely an extension of the rule in *Trevor v Witworth.*

Before the *Lipschitz NO v UDC Bank LTD* case was decided *Mount View Charaolais Ranch Ltd v Haverland*[62] was decided by the Alberta Supreme Court in Canada which rejected the notion that the financial assistance prohibition is an extension of the rule in *Trevor v Witworth.*[63] In 1942 Lord Greene, who chaired the Greene committee, presided over the case of *Re VGM Holdings Ltd*[64] wherein he stated the following:[65]

> Those whose memories enable them to recall what had been happening after the last war for several years will remember that a very common form of transaction in connection with companies was one by which persons - call them financiers, speculators, or what you will - finding a company with a substantial cash balance or easily realizable assets such as war loan, bought up the whole or the greater part of the shares of the company for cash and so arranged matters that the purchase money which they then became bound to provide was advanced to them by the company whose shares they were acquiring, either out of its cash balance or by realization of its liquid investments. That type of transaction was a common one, and it gave rise to great dissatisfaction and, in some cases, great scandals. I think that it is not illegitimate to bear in mind that notorious practice in considering the ambit of the section.

Lord Greene makes no mention of the abuse that arises from the purchasing and trafficking by a company of its own shares.[66] It seems that the concern here relates primarily to asset-strippers who strip the company of its resources to the detriment

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[61] Ibid. at 798.
[62] [1974] 2 W.W.R. 289, Alberta Supreme Court, Appeals Division.
[63] At paragraph 47.
[64] *Re V. G. M. Holdings, Limited.* [1942] Ch. 235.
[65] Ibid. At 239.
[66] It must be mentioned that the case dealt with the question whether the word 'purchase' covers a subscription of shares. Where financial assistance is granted to a third party for a subscription of shares this results in "phantom" capital being contributed. A purchase of shares covers shares already issued.

of the creditors and minority shareholders. The *Mount View Charaolais Ranch Ltd v Haverland*[67] case picked up this point and mentioned that the transactions Lord Green refered to in the *V.G.M* case were not affected by any extension of the principle set out in the *Trevor v Witworth* case.[68] The 1962 Jenkins Committee[69] expressed doubts as to the financial assistance prohibition being an extension of the rule that a company cannot acquire its own shares. The report highlighted the fact that the prohibition had proved to be '*an occasional embarrassment to the honest without being a serious inconvenience to the unscrupulous*,' and that a balanced approach to reconsidering the prohibition was needed to assist the former while striking at the latter.[70] The report went on to say:[71]

> 'The reason why a limited company may not buy its own shares is that in doing so it would part outright with the consideration for the purchase and thereby reduce its capital. A company which lends money to a person to buy its shares simply changes the form of its assets and if the borrower is able to repay the loan the company's capital remains intact.'

The report considered that had the prohibition merely been an extension of the share repurchase rules then it was 'doubtful whether such a prohibition was worth retaining'[72] The granting of financial assistance does not necessarily erode the capital base of the company. The danger to the capital depends entirely on the risk profile of the person receiving the assistance, and the type of transaction. If the company on lends funds to the acquirer to allow the purchaser to pay off bank debt used in the acquisition then all that has happened on the balance sheet is a conversion of a cash asset into a receivable asset. If the transaction takes the form of the target company using its assets as security for the debt of the acquirer, then the liability is a contingent one, and the risk to the capital structure is again dependant on the risk of default of the acquirer.

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[67] (note 62).
[68] Per Prowse JA, at para 44.
[69] (Jenkins Report) Report of the Company Law Committee 1962 Cmnd. 1749.
[70] Ibid. Para 175.
[71] Ibid. Para 173.
[72] Ibid.

A transaction that does have a direct effect on the capital structure is the use of a corporate gift to fund a share acquisition or subscription. In this type of transaction the amount received for a subscription is an entirely illusory one, and the capital accounts are a misrepresentation of the financial affairs.[73] The latter transaction is directly related to the capital rules concerning the raising of capital, but if the financial assistance prohibition is mainly concerned with capital maintenance, then there is little justification for the extremely broad sweep of the prohibition, as most of the prohibited type transactions do not involve the return of capital funds to shareholders or an unauthorised capital reduction.

The Jenkins committee emphasised that the cases of malpractice that involved financial assistance had in common the state of affairs where the acquirer gains control of a company with large liquid assets and is indebted to pay for the control but cannot do so other than out of the acquired company's funds.[74] This is the same set of facts as described by Lord Greene in *VGM Holdings*[75] above. The acquirer would use the funds of the acquired company to discharge his obligations, and by the time the facts are ascertained it would be too late to pursue the remedies, as the acquirer would have disposed of his assets, become insolvent or disappeared.[76] Such malpractice harms both minority shareholders and creditors. After identifying the mischief which the prohibition aimed to avoid the committee recommended that the general prohibition be replaced with a provision that made it unlawful for a company to provide financial assistance unless two conditions were met before giving the assistance; a special resolution and a statutory declaration of solvency by the directors filed with the Registrar of Companies.[77] The special resolution requirement was to serve as a minority shareholder protection, while the solvency declaration by the directors reassured creditors as to the solvency of the company. A substantial penalty was recommended in the event that there were no reasonable grounds for the directors' declaration.[78]

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[73] Ferran (note 59) p319. This is also referred to as "phantom" capital.
[74] Jenkins Report (note 53) Para 176.
[75] (note 48).
[76] Jenkins Report (note 53) Para 176.
[77] Ibid. Para 178
[78] Ibid. Para 179.

The recommendations of the Jenkins committee were not enacted by the time the restrictive European Community 2nd Directive on Company law[79] was enforced, but the Companies Act of 1985 provided a 'whitewash procedure' that allowed private companies to grant financial assistance under strict conditions, including statutory declarations of solvency. Finally, in 2006, this whitewash provision was abolished and since then private companies are no longer prohibited from granting financial assistance.[80]

As stated above, in South Africa there was little initiative taken to investigate a possible reform of the prohibition. A recommendation tabled by the Joint Council of the Societies of Chartered Accountants (S.A.) in 1964 followed the recommendations of the Jenkins Report.[81] The Joint Council proposed that financial assistance be unlawful unless it was approved by a special resolution and there was a statutory declaration of solvency by the directors. The declaration would describe the form the assistance would take, the person to whom it was to be given and the purpose for which it was to be used; and that the directors had made a full enquiry into the affairs of the company and had formed the opinion that the company would be able to pay its debts as they fell due.[82] However the van Wyk de Vries Commission's report was followed and section 38 was enacted with minor alteration from its s 86*bis*(2) form.

The little attention given to financial assistance by the van Wyk de Vries Commission does however reveal that the prohibition was something more than just an extension of the *Trevor v Witworth* principle, but this was never investigated. The

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[79] Second Council Directive 77/91 'Formation of Public Limited Liability Companies and the Maintenance and Alteration of their Capital' The 2nd Company Law Directive was adopted in 1976 with a view to co-ordinate, for the protection of the interests of members and third parties, the national provisions applicable to public limited liability companies in the following areas: formation of companies, minimum share capital requirement, distributions to shareholders, increase in capital, reduction in capital. Article 23 of the directive prohibited companies from advancing funds, or making loans, or providing security, with a view to the acquisition of its shares by a third party.

[80] English Companies Act 2006. Sections 677 – 682.

[81] Joint Council of the Societies of Chartered Accountants (S.A.). *Memorandum on Recommendations for the Amendment of the Companies Act, 1926.* 1964.

[82] Ibid. Para 184.

commission noted that the granting of financial assistance for shares (in its controlling company) 'is from the point of view of "trafficking" undesirable, *apart from the aspect* of the possible indirect depletion of the capital of the controlling company'(emphasis added).[83] This statement indicates that the committee detected at least two unsatisfactory aspects relating to financial assistance: share trafficking and the *possible* depletion of the company's capital. Considering that the committee was aware of the rationale behind the prohibition as being more than an extension of the share trafficking rule it is questionable why the issue was not investigated further, bearing in mind the severe inconvenience the prohibition had on innocent and beneficial transactions.

The Committee's Supplementary Report, published in 1972, indicates that little further investigation into the matter was undertaken. There was only concern with a possible exemption for building societies transacting with companies that owned immovable property.[84] This type of transaction was intended to avoid transfer duty costs, but the fiscal authorities intended tightening up certain legislation in this regard and the proposal was not followed further. The Commission stated that it was not opposed to the representations of the building societies, despite the fact that such an example would "breach a fundamental principle of company law."[85] This fundamental principle was not elaborated on in the Supplementary Report, but in the explanatory section of the publication the Commission briefly stated that 'section 86*bis*(2) is concerned with the possible indirect depletion of capital.'[86] This 'possible depletion of capital' is noted in the *Lipschitz NO v UDC Bank LTD*[87] case, wherein Miller JA stated: [88]

> 'the purpose of the Legislature in specifically including the giving of a guarantee and the provision of security in the concept of "financial assistance" was to guard also against a company's merely exposing its funds to possible

[83] (van Wyk de Vries Commission). Para 46.19(c).
[84] (van Wyk de Vries Commision) Supplementary Report and Draft Bill. R.P. 31/1972. Para 84.01
[85] Ibid.
[86] Ibid. Volume 2. p32
[87] 1979 (1) SA 789 (A).
[88] Ibid at 801C.

> risk (as distinct from actually employing or depleting its funds) for the purpose of or in connection with the purchase of its shares.'

While the transactions may involve a possible depletion of the assets, there is no attempt to distinguish this from actual depletion of capital as is the case where capital is being distributed. An examination of these issues could have at least opened the door to a less restrictive prohibition that did not hamper many viable transactions.

As has been shown previously, the financial assistance prohibition reaches further than the capital maintenance provisions. While the protection of creditors is at its forefront, it is not exactly comparable to return of capital to shareholders at the expense of creditors. Indeed the provision of financial assistance does not necessarily deplete the assets of a company. What does happen is that a company may straddle itself with excess debt or become contingently liable in the future for claims that can affect solvency, and hence the claims of old creditors. This is defined by Armour as "LBO risk."[89] It is not the old shareholders that benefit from financial assistance, but the purchasers. These new shareholders, who may hold management positions as well, are most placed to behave opportunistically, and the coupling of these congruent management and shareholder interests and high gearing can result in high financial agency costs; that is the risk that managers make decisions that are adverse to the interests of creditors but potentially beneficial to shareholders (or themselves).[90] While the lenders to the leveraged venture may be in a place to protect themselves by imposing covenants, it is the old creditors and involuntary creditors who are exposed to the actions of the firm's new controllers.

[89] J. Armour (*Share Capital* note 7) At p369.
[90] Ibid.

3 Financial Assistance Regulation in Foreign Jurisdictions

Many of the countries that adapted the prohibition from English Company law have since revised and evolved their prohibition, or have abolished the prohibition outright. Since South Africa has recently undergone a reform of the prohibition and is currently in the process of drafting a new prohibition for a new company law regime it is useful to explore the position of jurisdictions elsewhere that employ financial assistance regulation. By doing so it is possible to identify strengths and weaknesses and draw comparisons with the draft model in the 2008 Companies Bill.

I. Europe Union and England

As England is the origin of the prohibition and is still regulated by a restrictive prohibition it is the obvious starting point for comparison. However the existence of the prohibition in the UK since the 1970's has been directly affected by the European Community 2nd Directive on Company law.[91] Member countries of the EU are required to legislate according to the minimum standards set out in the directives. Member states are therefore free to create their own company laws, but within the requirements set out by the directive. The 2nd Directive creates a dual system of company law as the directive only applies to public companies, which allows member countries to apply less restrictive laws to private companies.[92]

The 2nd Directive has been a strict prohibitive blanket on financial assistance transactions since its creation in 1976, but has recently been amended in 2006 to allow for a less restrictive financial assistance regime. The prohibition was structured widely, with the only exceptions for the financial institutions acting in the normal course of business and employee share schemes. Even these exceptions were restricted by the net asset level specified in art 15(1)(a), which is subscribed capital plus undistributable reserves. The exception in sub-article 3 refers to certain investment companies acquiring their own shares on behalf of investors. The rigid

[91] Second Council Directive 77/91/ECC
[92] Ibid. Art 1.

approach of this version was justified by the Commission of the EU as it served to prevent the circumvention of the prohibitions of the acquisitions of own shares (share trafficking) and the prevention of abusive practices that were potentially harmful to minority shareholders and creditors.[93] The commission recognised however that there may be special cases where it is in the company's interest to provide financial assistance, and the Art 23 has thus been relaxed to allow for these special cases while still prioritising the protection of creditors and minority shareholders.[94]

The position of the amended EU 2nd Directive on Company Law can be briefly summarised as follows: Member countries may permit public companies to provide financial assistance for the acquisition of their own shares by a third party provided certain requirements are met. The most restrictive of these requirements is found in Art 23(5), which limits the amount of permissible financial assistance to an amount where net assets are not reduced below the amount of the subscribed capital plus reserves unavailable for distribution (undistributable reserves). In addition the company is required to create in its balance sheet a reserve unavailable for distribution equal to the aggregate financial assistance.[95] The other conditions concern disclosure and due diligence to ensure the company operates under transparent and fair conditions. It is management responsibility to ensure the transaction is under fair market conditions and to investigate the credit rating of third parties who receive assistance.[96] The transaction must be approved by a two-thirds majority of the general meeting after the presentation by management of a report containing relevant information set out in paragraph 3.[97] Included in the report is a risk analysis of the solvency and liquidity of the company.

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[93] Commission of the European Communities. Comission Working Document - Proposal for Amending Council Directive 77/91/EEC. Brussels, 21.9.2004. COM(2004) Final. P5.
[94] Ibid.
[95] Ibid. Art 23 (1) Para 5.
[96] Ibid. Para 2.
[97] Ibid. Para 3.

It is within this framework that the English Companies Act falls under. It is ironic that the prohibition of the country from which the Jenkins Report[98] originated from bears no resemblance to the recommendations therein, while other jurisdictions have in time evolved their prohibitions substantially in line with the Jenkins report's recommendations. The Jenkins Report was released in 1962, but the consolidation of the Companies Act only took place in 1985, by which time the EU 2nd directive applied to English Company law. The 1985 Act[99] however provided for the first time a "whitewash" provision, which permitted financial assistance by private companies under strict conditions.[100] The 2006 consolidation of the English Companies Act[101] now abolishes the regulation of financial assistance for private companies and permits public companies to do so under strict conditions. The English Companies Act's financial assistance prohibition[102] is complicated and technical prohibition, containing many exemptions and exceptions. It is beyond the scope of this paper to set the prohibition out in its full entirety and provide a detailed analyse as it runs for several pages, but some of the core provisions will be identified.

The term "financial assistance" is defined in section 677, and is substantially similar to the definition in the 1985 Act. The prohibition against public companies granting financial assistance is provided in section 678:

I. Where a person is acquiring or proposing to acquire shares in a public company, it is not lawful for that company, or a company that is a subsidiary of that company, to give financial assistance directly or indirectly for the purpose of the acquisition before or at the same time as the acquisition takes place.

Subsection 2 provides for an exemption on prohibited financial assistance if there is a principle purpose for giving financial assistance other than for the acquisition of

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[98] (note 53)
[99] Companies Act 1985 c.6
[100] Sections 151 -158. A requirement was that net assets could not be reduced or if it was reduced then the assistance must be given out of distributable reserves. A special resolution was required as well as a statutory declaration of solvency.
[101] 2006 c.46.
[102] Sections 677 – 683.

shares or the purpose is for the acquisition of shares but only incidental to a larger purpose.[103] The assistance must be given in good faith and in the interests of the company.[104] Subsection 3 concerns post acquisition financial assistance; it prohibits post acquisition financial assistance if at the time the assistance is given the company is a public company.[105] Section 679 follows the same structure as s 678 but prohibits a public company that is a subsidiary of a private company from giving assistance to a person acquiring shares in the private company. This closes up any loopholes created by the repeal of the regulation of financial assistance to private companies. An offence is created by section 680 for the contravention of sections 678 and 679. The offence is deemed to be committed by the company and any officer of the company who is in default.[106]

The exceptions to prohibited financial assistance are labelled as unconditional and conditional exceptions, and are provided in section 681 and 682 respectively. The unconditional exceptions in s 681 re-enacts the unconditional exceptions of s 153(3) of the 1985 Companies Act. Section 681 states that ss 678 and 679 do not prohibit nine transactions which are listed in S 681(2). These transactions are legally permitted under company law, and include *inter alia* a distribution of the company's assets by way of a dividend lawfully made[107], a reduction of capital under chapter 10;[108] and a redemption of shares under chapter 3 or a purchase of shares under chapter 4.[109] The conditional exceptions under s 682 also re-enact the exceptions of s 153 of the 1985, and concern the provision of loans as part of the ordinary course of business and employee share schemes. Section 682 applies to private companies so far as they are part of a corporate group that includes public companies and are regulated by the prohibition in s 679. However the excepted transactions listed in s 682(2) are still restricted for public companies; the financial

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[103] It has been commented on that the ruling in Brady v Brady [1989] A.C. 755 still applies and therefore these exemptions have a very narrow scope. See Morse *et al. Palmers Company Law: Annotated Guide to the Companies Act 2006.* 1st Edition. London. Sweet & Maxwell. P532.
[104] S 678(2).
[105] S 678(3).
[106] S 680(1).
[107] S 681(2)(a)(i).
[108] S 681(2)(c).
[109] S 681(2)(d).

assistance must not reduce net assets or if net assets are reduced the assistance must be provided out of distributable profits.[110]

Guidance is given for calculating the allowable financial assistance under s 682. Net assets are defined as 'the amount by which the aggregate of the company's assets exceeds the aggregate of its liabilities.'[111] Sub-section 4 mandates that the amounts of assets and liabilities stated in the accounting records of the company immediately before the financial assistance is granted is to be used. 'Accounting records' are not defined in the act but s 386[112] provides that there is a duty to keep adequate accounting records that are sufficient to:[113]

> (2) (a) to show and explain the company's transactions,
> (b) to disclose with reasonable accuracy, at any time, the financial position of the company at that time, and
> (c) to enable the directors to ensure that any accounts required to be prepared comply with the requirements of this Act (and, where applicable, of Article 4 of the IAS Regulation).

Contingent liabilities must also be taken into account when determining the amount of liabilities. Sub-section 4 states that liabilities include:

> any amount retained as reasonably necessary for the purpose of providing for a liability the nature of which is clearly defined and that is either likely to be incurred or certain to be incurred but uncertain as to amount or as to the date on which it will arise.

The restriction on public companies to provide assistance limited to distributable profits must be read in conjunction with section 683 which defines distributable profits:

> in relation to the giving of any financial assistance—

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[110] Section 682(1)(b)(i) and (ii).
[111] Section 682(3).
[112] Section 386(1).
[113] Section 386.

> (a) means those profits out of which the company could lawfully make a distribution equal in value to that assistance, and
> (b) includes, in a case where the financial assistance consists of or includes, or is treated as arising in consequence of, the sale, transfer or other disposition of a non-cash asset, any profit that, if the company were to make a distribution of that character would be available for that purpose (see section 846);

The circumstances which a public company can grant financial assistance are therefore very restricted. The English financial assistance law falls in line with the framework of the EU 2nd Directive on Company Law and is still tied down by capital maintenance and legal capital rules. The limitation of financial assistance to distributable profits can in instances be harsh for a target company in financial stress as it restricts the ability to be acquired by more efficient owners or managers. However it would appear that the English prohibition (and the 2nd Directive in general) is not a bar to leveraged buyout activity. Many schemes have been formulated and devised to avoid the effect of the directive.[114] The fact that private companies are permitted to provide financial assistance is a key factor in the growth in numbers of LBO's and MBO's in Europe, as was evidenced by the "whitewash" procedure granted to UK private companies in the 1980's which resulted in a significant increase in MBO activity subsequent to the 1985 Companies Act.[115] However as pointed out the English Companies' Act prohibition is unique, and many of the Commonwealth nations that initially adopted the prohibition following the 1929 English Companies Act have evolved their prohibition on very different models.

II. Canada

Canada is an example of a country that initially adopted the prohibition following the outcome of the Greene Committee,[116] but over the course of the 20th Century has

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[114] Ellis Ferran, '*Regulation of Private Equity Backed Leveraged Buyout Activity in* Europe'. ECGI Law Working Paper 84/2007. p21.
[115] Ibid. p22.
[116] The Companies Act Amending Act, 1930, S.C. 1930, c. 9, adding s. 56D to R.S.C. 1927, c. 27. Canada first adapted the prohibition in 1930 following the 1929 English Act.

substantially altered its stance to the problem. Corporate law in Canada, like the United States, is legislated by States, and like the US there is a Model Business Corporations Act (CBCA) drafted at Federal level which many states adapt and modify according to their policies. For practical purposes it is useful to study the Model Act as many states have adopted substantially similar legislation.

The original prohibition on financial assistance was substantially relaxed when the 1975 CBCA was enacted. The solvency requirements of the model act was based on the Jenkins Report in the UK, although the shareholder approval requirement was not adapted. The financial assistance prohibition in Canada and many of its states were fairly unique in that the prohibition did not only regulate assistance for the purposes of a share acquisition but also related party assistance, i.e. financial assistance to shareholders and directors for any purpose. The relevant provisions of section 44 of the 1975 CBCA read as follows:

> 44.(1) **[Prohibited loans and guarantees]** Subject to subsection (2), a corporation or any corporation with which it is affiliated shall not, directly or indirectly, give financial assistance by means of a loan, guarantee or otherwise
>
> (a) ..., or
>
> (b) to any person for the purpose of or in connection with a purchase of a share issued or to be issued by the corporation or affiliated corporation,
>
> where there are reasonable grounds for believing that
>
> (c) the corporation is or, after giving the financial assistance, would be unable to pay its liabilities as they become due, or
>
> (d) the realizable value of the corporation's assets, excluding the amount of any financial assistance in the form of a loan and in the form of assets pledged or encumbered to secure a guarantee, after giving the financial assistance, would be less than the aggregate of the corporation's liabilities and stated capital of all classes.

(2) **[Permitted loans and guarantees]** A corporation may give financial assistance by means of a loan, guarantee or otherwise

(a) to any person in the ordinary course of business if the lending of money is part of the ordinary business of the corporation;

(b) ...;

(c) to a holding body corporate if the corporation is a wholly-owned subsidiary of the holding body corporate;

(d) to a subsidiary body corporate of the corporation; and

(e) to employees of the corporation or any of its affiliates

(i) ...

(ii) in accordance with a plan for the purchase of shares of the corporation or any of its affiliates to be held by a trustee.

(2.1) **[Wholly-owned subsidiary]** A corporation is a wholly-owned subsidiary of another body corporate for the purposes of paragraph (2)(c) if

(a) all of the issued shares of the corporation are held by

(i) that other body corporate,

(ii) that other body corporate and one or more bodies corporate all of the issued shares of which are held by that other body corporate, or

(iii) two or more bodies corporate all of the issued shares of which are held by that other body corporate; or

(b) it is a wholly-owned subsidiary of a body corporate that is a wholly-owned subsidiary of that other body corporate.

(3) **[Enforceability]** A contract made by a corporation in contravention of this section may be enforced by the corporation or by a lender for value in good faith without notice of the contravention.

Companies were therefore excluded from providing financial assistance if there were reasonable grounds for believing that the company would be unable to satisfy the solvency and liquidity test. This is a combination of objective and subjective approach- reasonable grounds are purely objective while the belief that there are reasonable grounds is a subjective requirement that the directors would have had to held. The solvency requirement that assets be greater than liabilities plus stated capital of all classes (i.e surplus) is a stricter requirement than the balance sheet solvency found today in South African company law, which only requires assets greater than liabilities (i.e. net assets). The exceptions to prohibited financial assistance include the 'ordinary course of business' exception for lending companies as well as the employee share schemes. Paragraphs (c) and (d) of subsection 2 concerning 'upstream' and 'downstream' financial assistance were added to the prohibition in 1975 and 1978 respectively to 'facilitate borrowing arrangements that are commonly made in today's business world.'[117] These two added exceptions highlight the fact that restrictive prohibitions can hamper legitimate financing arrangements.

In 1987, six years after the state of Alberta adopted its Corporations Act[118] with the almost identical financial assistance provision as the CBCA, a report was released by the Alberta Institute of Law Research and Reform (AILR) to investigate the possible reform of the prohibition.[119] At that time many practitioners and lenders were experiencing difficulty in applying the provision, particularly with the solvency test. The difficulty arose in determining the asset value as a 'realizable value' was required, which was an unfamiliar term with no legal precedent to provide a definition.[120] Secondly, 'realizable value' connotes some measure of a current value, while traditional generally accepted

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[117] Canada Department of Industry. '*Canada Business Corporations Act Discussion Paper: Financial Assistance and Related Provisions.*' March 1996. Available at: http://strategis.gc.ca/pics/cl/fa-eng.pdf [Accessed 12 April 2008]

[118] Alberta Business Corporations Act S.A 1981, c. B-15.

[119] Alberta Institute of Law Research and Reform, The 'Financial Assistance by a Corporation: s42 of the Alberta Business Corporations Act' Rp 05/1987

[120] Alberta Institute of Law Reform and Research. 'Financial Assistance By a Corporation: Section 42, The Business Corporations Act (Alberta)' Rp. 5/1987. p95.

accounting practice used historical values for financial reporting.[121] A 'realizable value' is a current value, but not necessarily a fair value, as used by South Africa's company law solvency tests. Practitioners were faced with the problems of evaluating the assets either on a cash sale basis or a sale of a business as a going concern, which can result in different values. A further issue was that in 1988 the Canadian Institute of Chartered Accountants (CICA) issued an auditing opinion that accounting practitioners should not provide an opinion on matters related to solvency.[122] Therefore directors were inadequately equipped to evaluate matters relating to solvency.

A final report was released in 1989 which recommended several options for reform.[123] The report concluded that the best alternative for achieving the purposes of the prohibition could be met with a combination of the existing shareholder and creditor protection in the personal and derivative actions in the act, as well as in trust law and the law of fraudulent conveyance and fraudulent preference.[124] The director's fiduciary duty to act in the best interests of the company was also thought to adequately provided protection against delinquent directors in providing financial assistance in dubious circumstances.[125] The institute was also of the opinion that securities legislation would be the ideal place for regulation, as most of these transactions arise in takeover situations and is better supervised by securities regulators rather than shareholders and creditors.[126]

These recommendations were not adapted, as it wasn't until 1996 that the report into reform was released by the Canadian Department of Industry, which built on the report from the AILR.[127] The result of the report was options for

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[121] Alberta Law Reform Institute. 'Financial Assistance By a Corporation: Section 42, The Business Corporations Act (Alberta)' Rp. 54/1989. p10.
[122] Canada Department of Industry. (note 116) P2.
[123] Alberta Law Reform Institute. 'Financial Assistance By a Corporation: Section 42, The Business Corporations Act (Alberta)' Rp. 54/1989.
[124] Ibid. p2
[125] Ibid.
[126] Ibid. p4.
[127] Canada Department of Industry. (note 117) p3.

reform as recommended by the AILR; either repeal in its entirety as there are existing laws better suited to regulate financial assistance or amendment of the provision to fix the deficiencies of the law. In 2001 bill S-11[128] amending the CBCA was introduced to the Senate and the House of Commons and subsequently received assent in June 2001. The result was the repeal of the prohibition. The reason given for the repeal was that the wording of the 1975 act caused legal and accounting practitioners considerable difficulty in providing clients with unqualified opinions.[129] Furthermore it was considered that the directors' statutory fiduciary duties to act in the best interest of the corporation provided adequate safeguards for such transactions.[130] Therefore as of 2001 there is no reference to financial assistance in the CBCA.

It is rather unique that Canada opted for such an approach, as the remaining provisions relating to share capital suggests that capital maintenance is still a concern. The power for companies to purchase their own shares is permitted subject to the company satisfying the solvency test of assets being greater than liabilities plus stated capital of all classes.[131] However, as pointed out above it is the States that have the power to legislate corporate statutes, and financial assistance is still subject to very minimal regulation in most states. For example the Alberta Business Corporations Act was amended in 2000 to permit the granting of financial assistance subject to the condition that the transaction is disclosed to shareholders.[132]

III. Australia

Australia has not been idle in its recognition of the problems with the original prohibition, and has attempted to streamline the provision to make it less complicated. The prohibition was adopted from British legislation in 1937, and

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[128] Bill S-11 2001 An Act to Amend the Canada Business Corporations Act and the Canada Cooperatives Act and to Amend Other Acts.
[129] Canada. Parliament Library Research Branch. '*Legislative Summary 389: Bill S-11.*' p4.
[130] Ibid.
[131] Canada Business Corporations Act R.S, 1985, c. C-44. Section 34(2)
[132] R.S.A. 2000. c.B-9 Section 45.

remained unchanged in the Uniform Companies Acts of 1961-1962.[133] The legislators were aware of the issues highlighted by the Jenkins Committee and incorporated many of the ideas of the report into the 1981 Companies Code.[134] The prohibition contained in the 1981 Act was unduly long and overly complex, and caused many interpretational and practical problems. The key point of the provision, apart from the expanded list of exemptions, was that companies were permitted to provide financial assistance by way of a special resolution.[135] The notice of the special resolution was required to be accompanied by a statement by the directors that set out which directors voted for and against the resolution and their reasons, and that after taking into account the financial position of the company the transaction would not likely prejudice materially the interests of the members or creditors of the company.[136] There were further requirements that a copy of the notice was sent to the Companies Commission, all debenture holders or their trustees, and the notice be published in a newspaper within the territories the company is carrying on its business.[137] The most stringent complication was the requirement that the court approval of the transaction.[138]

A significant aspect of the reform of the financial assistance prohibition in the 1981 Act was new rule in section 130, which provided that a contract that contravened section 129 would not be invalidated, but was voidable at the option of the company. Although this provision overcame the old legislation's problems presented by the rendering the contracts illegal it was open to abuse as it ensured that companies would opt not to void contracts and expose potential liabilities of the directors.[139] The financial assistance provisions were retained by the 1989 federal Corporations Act up until the new Corporations Code regime came into being in 1998, and the 2001 Corporations Code retains the 1998 provisions in Part 2J.3 – Section 260A.

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[133] Keith Fletcher, 'F A, After 75 Years.' (2005) 17 *AJCL* 323.
[134] Companies Act No 89 of 1981. Section 129 and 130.
[135] Ibid. Section 129(10).
[136] Ibid. Section 129(10)(c).
[137] Ibid. Section 129(10)(d)-(k)
[138] Ibid. Section 129(11).
[139] Fletcher. (note 133)

The overhaul of the entire Corporations Act was investigated by the Corporations Law Simplification Program in 1994, and in that year the Simplification Task Force published a Proposal for the simplification of the share capital rules.[140] In the report the Task Force indicated that the law would move to regulate share capital on a solvency basis instead of the traditional rules on share capital, in line with the trends in Canada and New Zealand. In the report the rules on financial assistance were to be streamlined. One of the reasons given was that the financial assistance provision was unduly complicated, as it ran for several pages of detailed and difficult definitions and exceptions.[141] The new approach, as enacted in 1998 and retained in 2001, favours the permissive approach subject to conditions, instead of the previous regime of compliance with the onerous disclosure requirements.[142] The permission to grant financial assistance is provided in section 260A as follows:

> **260A Financial assistance by a company for acquiring shares in the company or a holding company**
>
> (1) A company may financially assist a person to acquire shares (or units of shares) in the company or a holding company of the company only if:
>
> (a) giving the assistance does not materially prejudice:
>
> (i) the interests of the company or its shareholders; or
>
> (ii) the company's ability to pay its creditors; or
>
> (b) the assistance is approved by shareholders under section 260B (that section also requires advance notice to ASIC); or
>
> (c) the assistance is exempted under section 260C.
>
> (2) Without limiting subsection (1), financial assistance may:
>
> (a) be given before or after the acquisition of shares (or units of shares); and
>
> (b) take the form of paying a dividend.

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[140] Corporations Law Simplification Program, Simplification Task Force, Attorney-General's Department. Share Capital Rules Proposal for Simplification. November 1994.
[141] Ibid.
[142] Fletcher. (note 133)

(3) Subsection (1) extends to the acquisition of shares (or units of shares) by:

(a) issue; or

(b) transfer; or

(c) any other means.

The ability to grant financial assistance is therefore allowable in three circumstances; firstly the giving of assistance must not materially prejudice the interests of the company or shareholders and the ability of the company to pay its creditors. The second allowable circumstance is if the shareholders approve the assistance by special resolution under s 260B. This is an independent requirement of the first condition, and is questionable as it would appear that the shareholders can therefore approve a transaction that would materially prejudice the interests of creditors, shareholders and the company itself. The third circumstance is if the transaction is an exempted transaction under s 260C. The solvency requirement that the assistance does not materially prejudice the company's ability to pay its creditors is a cash flow solvency or liquidity test. There is no concern for the values of assets compared to liabilities as in the balance sheet solvency test; all that is relevant is that the company can pay its creditors after the giving of the assistance.

Section 260B requires that the financial assistance must be approved by a special resolution of the general meeting of the company, and bars the person acquiring shares from participating in the vote.[143] Alternatively the resolution may be passed by all the ordinary shareholders at the general meeting.[144] There are additional requirements of a special resolution by the company's holding company if the holding company is a listed domestic company or an unlisted domestic holding company that is not a subsidiary of another domestic company.[145] There is no specific information disclosure requirement, but a statement setting out all information known to the company that is material to

[143] Section 260B(1)(a).
[144] Section 260B(1)(b)
[145] Section 260B(2) and (3).

the decision on how to vote on the resolution is required to accompany the notice for the general meeting.[146] The notice of the meeting and any relevant document pertaining to the financial assistance that will accompany the notice must be sent to the Australian Securities and Investment Commission (ASIC).[147] If the resolution is approved the company must lodge a statement with the ASIC at least 14 days before granting the financial assistance,[148] and the copy of the special resolution must be lodged with the commission within 14 days of it being passed.[149]

The exemptions to financial assistance under section 260A are found in section 260C, and contain the usual ordinary business dealings and employee share scheme exemptions with some general exemptions relating to permissible transactions or other transaction allowable under other parts of the corporations act. The Corporations code retains the rule that a transaction of financial assistance in contravention of section 260A is not invalidated and the company is not guilty of an offence.[150] However a person who is involved in the company's contravention will be in contravention of S260D(2) which provides for a process of a court declaration of contravention[151] and a pecuniary penalty (of a civil nature) of up to AU$200 000.[152] The penalty may only be imposed if the contravention materially prejudices the interests of the corporation or its members; or materially prejudices the corporation's ability to pay its creditors; or is serious.[153]

IV. New Zealand

Prior to 1993 the New Zealand Companies Act had imported the prohibition from English law that was in all respect substantially identical to the South

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[146] Section S60B(4).
[147] Section 260B(5).
[148] Section 260B(6).
[149] Section 260B(7).
[150] Section 260D(1)
[151] Section 260D(2) read with s 1317E.
[152] Section 1317G.
[153] Section 1317G(1)(b).

African provision in section 38 (before the 2006 amendment). The capital maintenance doctrine was applied in New Zealand, but by the end of the 1980's there were investigations into the reform and modernisation of New Zealand Company law. A report of the New Zealand Law Commission in 1989[154] favoured a company law regime that relied heavily on the form of the Revised Model Business Corporations Act of the United States and the Dickerson Report[155] which preceded the reform of the Canadian Model Business Corporations Act. These two sources had earlier abandoned the legal capital rules for a regime based on solvency and liquidity. The report considered that the solvency approach sufficiently addressed the concerns of creditor protection, while shareholder protection was met with the requirements that the financial assistance be in the best interests of the company and benefit the shareholders not receiving the assistance and the terms of the assistance be fair and reasonable to them.[156] The 1993 Companies Act subsequently replaced the blanket prohibition with a much more permissive financial assistance provision regulated by objective criteria of solvency and disclosure to shareholders.

Types of Financial Assistance

A fundamental feature of the New Zealand provision is that there is no requirement of a shareholder's resolution. Provided certain conditions are met the board has the authority to grant financial assistance. Section 76(1) provides three circumstances in which financial assistance may be given: firstly by the consent in writing of all the shareholders (unanimous assent); secondly if the procedure in section 78 is followed (special financial assistance); and thirdly if the assistance is given in accordance with section 80 (Financial assistance not exceeding 5% of shareholder funds.)[157] For each of these three circumstances, the conditions of section 76(2) are imposed, which require that the assistance allowable under s 76(1) may only be granted if the board has previously

[154] New Zealand Law Commission. 'Company Law Reform and Restatement' NZLC R9. (1989).
[155] Canadian Department of Consumer and Corporate Affairs, Proposals For a New Business Corporations Law For Canada - V.1- Commentary.
[156] NZLC R9. p102.
[157] Companies Act 1993. Section 76(1)(a)-(c).

resolved that (a) the company should provide the assistance; (b) the giving of the assistance is in the best interests of the company, and (c) the terms and conditions under which the assistance is given is fair and reasonable. Section 76 further requires the directors' resolution to set out the grounds for the directors' conclusion regarding the above requirements as well as the directors who voted in favour of the resolution to sign a certificate as to those matters.[158] If it becomes apparent to the directors that the above requirements can no longer be met at a stage after the resolution but before the granting of the assistance then the company is prohibited from granting the assistance.[159]

Special Financial Assistance

As mentioned above, s 76 provides three circumstances under which financial assistance may be granted. The first circumstance, unanimous assent, will generally find application in closely held corporations that have few members. The second circumstance of special financial assistance is more relevant to the larger widely held corporations where there is a clearer distinction between management and ownership of corporations. The procedure for special financial assistance gives the authority to grant financial assistance exclusively to the directors. For a company to grant assistance the board must have previously resolved that the assistance is of benefit to the shareholders not receiving the assistance, and that the terms and conditions are fair and reasonable to those shareholders not receiving the assistance.[160] Although it would be expected that if the terms and conditions are fair and reasonable, it would be fair and reasonable to all interested persons, but the requirement that the assistance be of benefit to the shareholders not receiving the assistance appears to be unduly restrictive. Can a transaction designed to benefit a third party in acquiring shares with company resources benefit those shareholders who did not receive such an opportunity? The requirement could be interpreted as an extension of the fiduciary duty to act in the interests of the company, as if a transaction is in the best interests of the company, the shareholders should all benefit, theoretically.

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[158] Section 76(3) and (4).
[159] Section 76(5).
[160] Section 78(1)

For special financial assistance the directors are required to give disclosure to all shareholders not less than 10 working days before the assistance is given, and 12 months after the disclosure has been sent the company is prohibited from providing assistance.[161] The disclosure document is required to contain information of the 'nature and terms of the financial assistance to be given, and to whom it will be given; and if the financial assistance is to be given to a nominee for another person, the name of that other person; and the text of the directors resolution together with further information and explanation as may be necessary to enable a reasonable shareholder to understand the nature and implications for the company and its shareholders of the proposed transaction.'[162] During the intervening time after receiving the disclosure document concerned shareholders (or the company) may apply to court for an order restraining the proposed assistance on the grounds that it is not in the best interests of the company and is not of benefit to the shareholders not receiving the assistance; or the terms and conditions of the transaction is not fair and reasonable to the shareholders not receiving the assistance. [163]

Financial Assistance not exceeding 5% of Share Capital

The third circumstance allows directors to provide a minimum amount of financial assistance at their discretion if three conditions are met: firstly the amount of financial assistance may not exceed 5 per cent of capital and reserves; secondly the company receives fair value in connection with the assistance; and thirdly, within 10 days of providing the assistance, notice of the transaction must be sent to all shareholders containing the following particulars:[164]

> (i) The class and number of shares in respect of which the financial assistance has been provided:
> (ii) The consideration paid or payable for the shares in respect of which the financial assistance has been provided:
> (iii) The identity of the person receiving the financial assistance and, if that person is not the beneficial owner of the shares in respect of

[161] Section 78(5).
[162] Section 79.
[163] Section 77(7).
[164] Section 80

which the financial assistance has been provided, the identity of that beneficial owner:

(iv) The nature and, if quantifiable, the amount of the financial assistance.

Solvency

There is a further requirement that in order to grant assistance under any of the three circumstances in s 76(1) the company must satisfy solvency requirements. Section 77(1) provides:

> **77(1)** A company must not give any financial assistance under section 76 of this Act unless the board of the company is satisfied on reasonable grounds that the company will, immediately after the giving of the financial assistance, satisfy the solvency test.

The board is therefore required to be satisfied that immediately after the company has granted assistance the company will be able to satisfy the solvency test. Although the requirement that the board be satisfied is inherently subjective, this is qualified by the requirement of reasonable grounds, which is inherently objective. The solvency test is a stand alone provision in section 4, and applies to all the capital reduction and distribution provisions of the act as well as a few other related transactions. The meaning of the solvency test is set out as follows:

> **4 Meaning of solvency test**
>
> (1) For the purposes of this Act, a company satisfies the solvency test if—
>
> (a) The company is able to pay its debts as they become due in the normal course of business; and
>
> (b) The value of the company's assets is greater than the value of its liabilities, including contingent liabilities.
>
> (2) Without limiting sections 52 and 55(3) of this Act, in determining for the purposes of this Act (other than sections 221 and 222 which relate to amalgamations) whether the value of a company's assets is greater than the value of its liabilities, including contingent liabilities, the directors—

(a) Must have regard to—

(i) The most recent financial statements of the company that comply with section 10 of the Financial Reporting Act 1993; and

(ii) All other circumstances that the directors know or ought to know affect, or may affect, the value of the company's assets and the value of the company's liabilities, including its contingent liabilities:

(b) May rely on valuations of assets or estimates of liabilities that are reasonable in the circumstances.

(3) Without limiting sections 221 and 222 of this Act, in determining for the purposes of those sections whether the value of the amalgamated company's assets will be greater than the value of its liabilities, including contingent liabilities, the directors of each amalgamating company—

(a) Must have regard to—

(i) Financial statements that comply with section 10 of the Financial Reporting Act 1993 and that are prepared as if the amalgamation had become effective; and

(ii) All other circumstances that the directors know or ought to know would affect, or may affect, the value of the amalgamated company's assets and the value of its liabilities, including contingent liabilities:

(b) May rely on valuations of assets or estimates of liabilities that are reasonable in the circumstances.

(4) In determining, for the purposes of this section, the value of a contingent liability, account may be taken of—

(a) The likelihood of the contingency occurring; and

(b) Any claim the company is entitled to make and can reasonably expect to be met to reduce or extinguish the contingent liability.

The New Zealand Act employs the dual solvency requirements of the liquidity and the balance sheet tests. This cumulative approach to solvency has been described as the preferred option for regulating distributions and payments, as monitoring the company's cash flow and balance sheet can provide useful information as to funds available for distributions and capital transactions such as buy-backs, redemptions

and financial assistance.[165] However for all its efficiency the test is not perfect and there is no consistent rule for determining funds available for such transactions.[166]

The strength of a solvency test lies in the rules that accompany the actual test and provide guidance for determining values and what factors need to be considered. Section 4(2) provides two alternative methods of determining the values. 4(2)(a) requires that directors must have regard to the financial statements that comply with the financial reporting standards[167] and to take cognisance of all other circumstances that directors know or *ought to know* that may affect the values of the assets and liabilities, including contingent liabilities. This requires directors to have financial knowledge of the company's position with reference to the financial statements, and to be aware of any circumstance not accounted for in the statements that may affect the values therein. This is an objective ground; it is difficult to base a financial conclusion that is wholly contradictory to the company's own financial statements which are the responsibility of the directors. However the alternative method for valuation in s 4(2)(b) allows for valuations or estimates that are "reasonable in the circumstance." Therefore although reference to financial statements is not required under this method, the valuation or estimate must still be based on reasonable and objective grounds. This is useful where the financial statements cannot be said to provide a fair and accurate representation of the specific circumstances involving the company, but still requires directors to act reasonably. This solvency test is modelled very closely on the distribution requirements of the Model Business Corporations Act of the United States.

The New Zealand solvency test also provides a guide on the measurement of contingent liabilities. Section 4(4) allows directors to take account of the likelihood of the contingent liability occurring and any claim the company is entitled to make to reduce or extinguish the contingent liability. The financial statements do not reflect

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[165] Frtiz Ewang, 'Regulating share capital transactions and creditor protection: A multi-faceted model' 2007 *AJCL* 21.

[166] Ibid.

[167] New Zealand Accounting Standards comply with the International Accounting Standards Board's standards. See New Zealand Accounting Standards Review Board at http://www.asrb.co.nz. For example New Zealand basis its NZ IAS 16 *Property Plant and Equipment* on the IAS 16 (2003) *Property Plant and Equipment*.

contingent liabilities on the balance sheet, but the notes to the balance sheet are required to disclose all contingent liabilities, unless the possibility of an outflow of resources embodying economic benefits is remote.[168] In the application of the solvency test to other distribution transactions a company that faces a potentially expensive contingent liability that is less than probable to occur (but not quite remote enough to warrant non-disclosure) can therefore discount the value of the liability by the probability of its occurrence or reduce the value by any amount considered to occur. However, for the purposes of financial assistance, section 77(6) provides that liabilities include the *face value* of all liabilities, contingent or otherwise, incurred by the company in connection with the financial assistance. Therefore even if the probability of a contingent liability defaulting is remote, such as security in favour of a third party (the receiver of financial assistance); the face value of the security will have to be accounted for when determining the company's solvency for the financial assistance transaction. Section 77(6) also further tightens the solvency test by excluding from the value of assets any financial assistance granted in the form of loans.

An active requirement of behalf of the directors is that those who voted in favour of the resolution to provide assistance must sign a solvency certificate stating that in their opinion the company will, immediately after the assistance is given; satisfy the solvency test and the grounds for that opinion.[169] The requirement of a solvency certificate setting out the grounds for directors' opinions is useful as it provides a form of evidence as to the boards' belief and the reasonableness of it; and it places and active requirement on the directors to be aware of the all the relevant circumstances . It is an offence to contravene this requirement of singing the solvency certificate . Directors are prohibited from allowing a transaction to proceed if in the intervening time between the board resolution and the granting of the assistance the directors cease to be satisfied that the company will satisfy the solvency test.[170]

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[168] International Accounting Standard 37 '*Provisions, Contingent Liabilities, and Contingent Assets*' Para 86.
[169] Section 77(2).
[170] Section 77(3).

Consequences for breach

Any transaction in breach of the provisions regulating financial assistance does not affect the validity of such transaction[171], but person who are in violation of the relevant provisions are guilty of offences. Directors who breach the relevant provisions are liable to fines not exceeding NZ $5000.[172]

4 Reform of Financial Assistance in South Africa – Current and Future Perspective

There is a good case for arguing that issues of compatibility and competition necessitated that South Africa reformed its prohibition in line with trends from foreign jurisdictions. A factor that also provided the impetus for the reform of s 38 was that it was considered as an obstacle to Black Economic Empowerment (BEE) transactions and the policy to speed up the transformation the economy. An issue that arises in relation to the reform of the financial assistance prohibition is whether there is any benefit in the prohibition, or if it is an ineffective and inefficient piece of legislation that was perhaps introduced without much policy consideration and is more appropriate for an era that was more cautious towards complex financing arrangements. Before the introduction of the "whitewash" procedure in the UK Companies Act 1981 that allowed private companies to provide financial assistance there was minimal LBO activity.[173] Subsequent to the introduction of the "whitewash" procedure this changed, and there is empirical evidence in the UK that shows the losses experienced by creditors due to LBO failures were minimal compared to the gains from operational performances.[174] This suggests that a ban on such leveraged activity is an obstacle to efficiency.

The methodology of LBO's and the private equity industry in general is to buy the target, reshape management and increase profitability and efficiency before selling in the mid to long term future at a substantial profit. Common strategy is to purchase

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[171] Section 81
[172] Section 374
[173] Armour. (*Share Capital* note 7) At p374.
[174] Ibid.

underperforming firms with good potential and sell at a date in the future when the firm is more profitable. Furthermore, companies undergo complex and costly financing and restructuring arrangements that purposively avoid the prohibition. Therefore there is evidence to suggest that the prohibition is ineffective at preventing firms undergoing transactions the prohibition seeks to prevent, and that preventing such transactions is a bar to increased operational performances.

The question whether the solvency approach is appropriate for South African Company law is best answered by understanding exactly what the abolishment of capital maintenance meant for Company Law in South Africa. Before the 1999 amendments distributions and capital reduction transactions were restricted according to the capital maintenance rules. Post 1999 the pure capital maintenance doctrine has been abandoned. As stated earlier, companies can make payments out of capital without having to reduce the capital accounts. Instead, distributions out of capital and profits alike are subject to solvency requirements. It must be noted that the current Act is still deeply entrenched by legal capital principles and capital maintenance related provisions. However a total reconsolidation of the companies act is under way and the 2008 Companies Bills,[175] which omits outdated capital maintenance provisions.

The function of solvency tests, as stated by Heaton: 'is to allow a borrower to increase its debt capacity *ex ante* by protecting creditors *ex post* from actions that make it less likely that the firm will pay its debts.'[176] Therefore, unlike capital maintenance, the ability to make a distribution or provide financial assistance is not dependent on profitability or paid up capital, but on the ability to discharge obligations to creditors, which is the primary concern of creditors; and an excess of assets over liabilities to satisfy all the claims in the event of debt default. The creditors do not have to rely on any representation of the debtor's historical financial information, such as issued share capital recorded in the financial statements; rather the law prohibits transactions that jeopardize the claims of the creditors.

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[175] 2008 Companies Bill.
[176] J Heaton 'Solvency Tests' 62 *Bus Law* (2006-2007) 983 at 984.

As the capital maintenance regime has been replaced by a regime that permits distributions and capital reductions based on solvency, it is hard to reason why an inefficient and ineffective provision such as the prohibition cannot be subject to the same requirement. Company law now has a regime that permits transactions subject to solvency, and financial assistance is no longer pegged to capital maintenance. Permitting such transactions in the market is likely to be highly beneficial in circumstances where the claims of existing creditors are appropriately safeguarded. Companies will be able to increase their gearing and restructure by efficient LBO's, subject to the safety cushion of the tests and the authorisation by special resolution. Furthermore transactions that facilitate BEE enterprises in acquiring a minority stakes in the corporate enterprises may have no solvency implications at all for the company providing assistance. Solvency tests coupled with directors' duties and strengthening other areas of the corporate framework should provide adequate safeguards to the concerns raised in the past. All this, however, only holds true if the new permitted financial assistance regime itself is efficient and effective. The solvency tests should be clear and easily applicable to any situation. The lesson from Canadian experience is that uncertainty from the interpretation of the solvency tests can be costly when the lawyers and accountants have to be involved excessively in such transactions.[177]

In addition to, or as an alternative to the solvency approach, jurisdictions may opt for an approach based on shareholder approval by resolution or special resolution. This is a second feature of the new relaxation in section 38(2A) as shareholder approval of the terms of the assistance by special resolution is required. The imposition of solvency tests is to protect the interests of creditors, but these are not designed with shareholder interests in mind (although it does serve as an additional layer of shareholder protection), so the additional safeguard by way of shareholder approval

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[177] Alberta Law Reform Institute. *Financial Assistance By a Corporation: Section 42, The Business Corporations Act (Alberta)* Report No. 54. 1989. P11. An article on the 1985 UK Companies Act mentions that small private firms would spend up to £40,000 on legal and accounting fees to just maneuver around the prohibition in a MBO transaction.: " D Jordan '*The Companies Act Section 151- The Nightmare is Nearly Over.*' The Lawyer 4 November 2002 Available at http://www.thelawyer.com/cgi-bin/item.cgi?id=91304 [Accessed 25 September 2007]

is for the interests of all shareholders. It has however been suggested by Professor Ellis Ferran that to permit financial assistance only when authorised by shareholders could be unduly restrictive.[178] This is particularly in regard to financial assistance that has minimal consequence on solvency or dilution of ownership.

An attractive solution is the permission to allow financial assistance that is below a specified percentage of net assets without shareholder approval, such as the 5 per cent allowance in the New Zealand Companies Act.[179] Cassim submits however that the special resolution safeguard is essential to prevent directors from misusing company resources, and suggests an approach based on the New Zealand Companies Act but with the additional requirement of shareholder approval.[180] This would entail in addition to the solvency requirement, *inter alia*, that the company be authorised in its constitution to give financial assistance; the financial assistance be approved by a special resolution; a declaration by the directors that the terms of the assistance are fair and reasonable to shareholders who have not received the assistance; and disclosure to shareholders of the nature, amount and terms of the assistance, together with the names of the recipients of the assistance (a deterrent to 'white knight transactions').[181] While the Corporate Laws Amendment Act did not include all these additional requirements; the Companies Bill 2008 adopts a regime that substantially follows this model.

I. The Reformed Section 38: Sub-section (2A)

a. The Solvency Tests

The Corporate Laws Amendment Act of 2006, which came into force on the 14th of December 2007, finally introduced the much awaited relaxation to the prohibition by introducing a two limbed solvency and liquidity test and a special resolution

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[178] E Ferran. (*Creditor's Interests* note 5). At 321.
[179] Ibid.
[180] F Cassim. (note 1) At 293.
[181] Ibid. These are similar to the disclosure requirements recommended by the Jenkins Committee. 'White knights" are anti takeover measures whereby assistance in company acquisition is granted to a party considered friendly to management interests so as to prevent a hostile takeover.

requirement. Companies are therefore permitted to provide financial assistance if they have enough liquidity to satisfy obligations as they become due and have an excess of assets over liabilities. However, the introduction of the permitted assistance does not come free from any problems, specifically with regards to interpretation and application of the solvency tests. The drafting of the relaxation suffers from a lack of consistency, as one would expect drafting consistent with the solvency tests introduced for sections 85 and 90 in 1999.

The exception to prohibited financial assistance contained in section 38(2A) is headed as follows:

> 'Subsection (1) does not prohibit a company from giving financial assistance for the purchase of or subscription for shares of that company or its holding company, if-
>
> (a) the company's board is satisfied that...'

The first requirement is that the board is satisfied that the company meets the solvency tests. Stated as such there is an obvious subjective element to the test. This is at odds with the drafting provided for in the other solvency test sections. Both sections 85(4) and 90(2) provide that:

> 'A company shall not make any payment in whatever form... ...*if there are reasonable grounds for believing* that-...' (emphasis added)

The requirement of the existence of reasonable grounds for believing is a combination of an objective and subjective test. It is unclear if this inconsistency is an unintended oversight by the drafters, and what significance this will have in practice. If the drafting was intentional then it would appear that the drafters opted for a less strict requirement in section 38 than is provided for in the share repurchase and shareholder payments sections. The board may be satisfied that the company will continue to retain its liquidity and have net assets even though there may be reasonable grounds for believing otherwise. On such an interpretation board satisfaction is not mutually exclusive of the existence of reasonable grounds for believing otherwise. If the test were formulated consistently with the other tests, it

would require that if there are reasonable grounds for believing that a company would be able to meet the solvency requirements the company would still not be able to provide assistance if at the same time there are reasonable grounds for believing otherwise.

The combined objective and subjective requirement demands more than mere satisfaction on behalf of the board that the tests are met; there must objectively be no reasonable grounds for believing the solvency test will not be met. However, regardless of the demerits of the subjective test that has been formulated, the directors actions will still be measured against their fiduciary duties and in such a circumstances a court may not be convinced by purported board satisfaction. The drafters would have done better to have borrowed from the New Zealand financial assistance provision, which permits financial assistance where:

> '...the board of the company is satisfied on reasonable grounds that the company will, immediately after the giving of the financial assistance, satisfy the solvency test.'[182]

This is further backed up by the requirement that the directors who vote in favour of the financial assistance must sign a certificate of solvency stating that in their opinion the company does satisfy the solvency requirements, and provide the grounds for that opinion.[183] This would reduce the risk that directors could fabricate grounds for allowing such transactions when litigation arises.

b. Balance Sheet Test

The first limb of the solvency test is provided in s 38(2A)(a)(i); which requires that the board is satisfied that-

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[182] Section 77(1) New Zealand Companies Act 1993 No 105.

[183] Ibid. Section 77(2). The solvency certificate was also a requirement of section 156 of the 1985 UK Companies Act concerning financial assistance by private companies, with a further requirement that the auditors of the company attach a report on the state of affairs of the company and are not aware of any indication that the director's opinion is unreasonable.

> '[s]ubsequent to the transaction, the consolidated assets of the company fairly valued will be more than its consolidated liabilities;...'

This is reinforced with section 38(2B) which provides:

> 'For the purposes of paragraph (2A)(a), the directors must account for any contingent liabilities which may arise to the company, including any contingent liability which may result from giving the assistance'

What the test requires is that the financial assistance does not deplete assets to an amount equal to or less that the liabilities. While the question of the value of assets over liabilities may appear straightforward, it is more complicated than appears. Although board would be well advised to pay attention the financial statements, a simple glance the company's balance sheet will not show the true position. According to the test the consolidated assets of the company must be fairly valued. There are differing methods of valuing assets, each of which could be considered fairly value. In the US, the courts have had difficulty in deciding how to value assets in bankruptcy cases, as assets can be valued on a going concern basis, or a liquidation basis.[184] An asset may be fairly valued according to its going concern value, or it can be a liquidated sale and yet still be fairly valued at the liquidated value. It should however be reasonable to expect that the traditional accounting principle that requires accounting for entities on the assumption that the entity is a going concern entity (i.e fair market value) will most appropriate. To value the assets of a company on the liquidation basis would be inconsistent with the fact that the company is operating and transacting by the provision financial assistance, or undergoing a share re-purchase transaction in terms of section 85. The solvency test is a mechanism of protection against insolvency, not a mechanism to measure insolvency.

Even if assets are valued on a going concern basis, there are still various methods by which assets are recorded on the balance sheet, such as historical cost, book

[184] Heaton (note 176) At 991.

value, realizable value[185] and market value. The Corporate Laws Amendment Act granted legal backing to accounting standards issued by the Financial Reporting Standards Council which are required to be comparable to the standards issued by the International Accounting Standards Board (IASB).[186] Although only the newly introduce widely held or public interest companies are required to comply with these standards, the South African Generally Accepted Accounting Principles have been in line with International Accounting Standards for several years, and JSE listed companies have been compelled to comply with International Financial Reporting Standards (IFRS) since 2005. Hence it is that many companies in South Africa have been valuing assets according to International Accounting Standard (IAS) 16; *Property Plant and Equipment.*[187] While the trend in International Financial Reporting may be accounting for fair value, not all assets on the balance sheet are valued at fair value. IAS 16 provides a choice in the measurement of property, plant and equipment after recognition on the balance sheet , either at cost less accumulated depreciation and accumulated impairment losses (cost model), or at a re-valued amount if the fair value can be reliably established (revaluation model).[188] Therefore directors will need to be well aware of the accounting policies used by the company and have financial knowledge when using the balance sheet to determine the value of its assets.

Further financial literacy is called for when valuing property that is subject to a finance lease. A finance lease is described in IAS 17 as a lease that transfers substantially all the risks and rewards incidental to ownership of an asset.[189] This is particularly pertinent to leases of land and buildings, which in certain companies could constitute a substantial amount of assets. Lessees in terms of IAS 17 are required to recognize a financial lease as an asset and a liability on the balance

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[185] This is the term used that is used in the solvency requirements for share repurchases and distributions in the Canadian Model Business Corporations Act and other state corporation acts of Canada.
[186] Companies Act. Section 440S(2).
[187] The standards issued by the International Accounting Standards Board (IASB) are *International Financial Reporting Standards (IFRS).* The IASB has adopted the standards issued by its predecessor the Board of International Accounting Standards known as *International Accounting Standards (IAS).* Therefore international accounting standards are comprised of the *IFRS* and *IAS* statements.
[188] IAS 16. Paragraphs 30-31.
[189] IAS 17. Paragraph 4.

sheet at either fair value or the present value of minimum lease payments, whichever is lower.[190] Thus in the initial stages of the lease the lessee has an asset which is not in legal terms owned by the lessee. During the lifetime of the leased asset a depreciation charge is recognised, while the lease payments are apportioned to a finance charge and a reduction of the outstanding liability.[191] Therefore while the initial effect of recognizing a finance lease is zero on the balance sheet, over time the lease will have either a positive or negative net effect. When solvency is viewed from a legal perspective of assets actually owned by the company and liabilities claimed against it, there is no asset that the lessee owns, and the liability is only a current liability to pay for the rental when it falls due. This is another difficulty of valuing assets on a liquidation basis, as the financial statements do not reflect value according to legal form but rather economic substance.

A notable issue concerning the balance sheet test for financial assistance contained in the Companies Act is that there is no exclusion of the financial assistance itself from the value of assets, particularly if the financial assistance takes the form of a loan. In this transaction, there is no increase in liabilities or contingent liabilities that may push the company towards insolvency, and on the asset side, all that has happened is that cash has been swapped for a loan asset. The risk to the company does not arise from excessive leverage and finance costs, but is fully dependent on the credit risk of the person receiving the loan. This exclusion is currently in the New Zealand Companies Act 1993[192]and was found in the Canadian Corporation statutes before the repeal of their financial assistance provisions.[193] The Canadian legislation went further than excluding the value of loans from assets, the value of any assets pledged or encumbered to secure a guarantee had to be excluded as well. This was a cause of practical problems for companies under Canadian legislation, as the balance sheet solvency test required an excess of assets over liabilities plus stated capital of all classes. In effect this

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[190] Ibid. Para 20.
[191] Ibid. Paras 25-27.
[192] Section 77(6)
[193] See for example s42 of the Alberta Business Corporations Act 1981.

requires that there be retained earnings sufficient to cover the financial assistance. Group companies undergoing financing arrangements were severely restricted, as certain transactions involve floating charge debentures, which secure all the assets of the corporation.[194]

The exclusion of financial assistance and secured assets from the balance sheet test may be indicative of a more specific concern of financial assistance, and that is the concern of the debt laden purchaser and asset plunderer.[195] Here the risk is the default of that acquirer, where the write off of the debt asset owing by the acquirer could be the cause of a depletion of assets and the subsequent excess of liabilities over assets. A balance sheet test that does not exclude the value of these assets is more concerned with the debt capacity of the company providing the financial assistance. The concern here is rather that the value of liabilities, including possible contingent liabilities that arise from the provision of security or guaranties, does not burden the company's finances, rather than the concern of asset plundering. This is indicative of a policy that is more concerned with the risk of LBO failure than the scandals mention the *Re VGM Holdings Ltd* Case.[196]

While there is uncertainty concerning the valuation of assets, there has been little concern over the valuation of liabilities in the literature. While the balance sheet test requires assets to be fairly valued, there is no mention of any valuation basis for liabilities. This is potentially problematic, as the fair value of a liability is not the same its face value. This anomaly is addressed in the 2008 Companies Bill which requires liabilities to be fairly valued.[197] Financial reporting practice requires that liabilities be fairly valued.[198] A fair value of an amount due and payable at some point in the future would inevitably amongst other factors involve the face value being discounted to a present value amount. Therefore in the case of liabilities as opposed to assets the amount stated on the balance sheet of financial statements would reflect a more accurate picture of the fair value. However while assets

[194] The Alberta Institute of Law Research and Reform (note 122). At p97
[195] See the *VGM Holdings* extract (note 58).
[196] (note 53).
[197] 2008 Companies Bill. Section 4(1)(a).
[198] IAS 39. *Financial Instruments: Recognition and Measurement*. Paragraph 43.

valued at fair value would often involve some measure of the present value of its future cash flows, the wording of the provision would seem to indicate that liabilities are to be valued at face value. Heaton states that it is imperative for debts to be valued at face value if the solvency test is to have any meaning, due to the fact that:

> If holders of claims are fully informed of the debtor's affairs and the asset values are less than the face amount of the claims, they would never value their claims at more than the value of the assets. Likewise, the fully informed debtor would never be willing to pay claimants more than claimants would be willing to take. Thus, the value of the claims would never exceed the value of the assets and insolvency could never occur. If [debts were valued at market value], insolvency could never occur, which is an absurd result.[199]

While there is no local case law on the solvency test, the US case law involving the measurement of liabilities for the solvency test arises often in the bankruptcy proceedings.[200]. In insolvency proceedings it is obviously inappropriate to value liabilities according to a market valuation that will take into account the financial difficulty of the company and write the valuation down to an amount that will be expected to be met. It is possible however that a valuation method other than the face value of the liability is appropriate for company law purposes. For a solvency test under company law the test is not applied by the creditors who are assessing the face value of their claims to the fair value of assets to see if there is case for liquidation. It is applied by the company's directors from the perspective of the company in assessing the value to give to assets and the value of present and future claims against it. The balance sheet itself is a statement of the company's financial position. From a purely financial perspective, the value of the debt according to the company's financial position should be less than its face value according to the time value of money. Hence a company can be willing to cede its receivables accounts at a price lower than face value to another entity who will receive a higher cash amount in the future. Indeed a fair valuation of a liability for

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[199] Heaton (note 176) p994, quoting *Hanna v. Crenshaw (In re ORBCOMM Global L.P.)*, 2003 Bankr. LEXIS 759, *8.

[200] See *Hanna v. Crenshaw (In re ORBCOMM Global L.P.)*, 2003 Bankr. LEXIS 759 and cases cited within.

accounting purposes is the amount which the liability could be settled between knowledgeable, willing parties in an arms length transaction.[201]

c. Valuation Guidance

The subjective test requires the directors of the company to be satisfied of the firm's solvency as going concern. There is no requirement of applying a specific valuation method, but knowledge of the financial position and a reasonable reliance on the accounting records and advisors would be expected by directors in applying such a test.[202] The United States RMBCA allows directors applying the solvency test to base their determination on either on financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances or on a fair valuation or other method that is reasonable in the circumstances.[203] The objective solvency test in the New Zealand Companies Act also requires directors to have regard to the most recent financial statements and all other circumstances the directors might know or ought to have known that the affect the valuation.[204] There is a deficiency in this regard in the current South African section, as no guidance or mandatory valuation procedures are provided for. Since directors are required merely to be satisfied of solvency, there is scope for abuse by taking decisions on unreasonable grounds.

d. Contingent Liabilities

A further difficulty with liabilities lies not with measurement, but with the recognition of liabilities that are uncertain to materialise, which are termed contingent liabilities. Section 38(2B) provides that for the purposes of the solvency tests, contingent

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[201] IAS 39. Para 9.
[202] See F, Cassim, 'The New Statutory Provisions on Company Share Repurchases: A Critical Analysis'116 SALJ (1999) 760 at 767: writing on the balance sheet test in s 85 states that 'directors would be well advised to rely on opinions and reports of auditors and accountants including the most recent annual financial statements.'
[203] MBCA S6.40(d).
[204] New Zealand Companies Act 1993. S4(2)(a).

liabilities that may arise must be accounted for.[205]Again a case of inconsistent drafting has led to uncertainty. The specific inclusion of contingent liabilities in the solvency test removes future uncertainty in accounting for these liabilities in respect of financial assistance; however it still does not clarify the position of contingent liabilities in the solvency tests in sections 85 and 90, as there is no mention of contingent liabilities in those tests. It has in the past been assumed that contingent liabilities should be taken into account when determining the solvency of a company for the purposes of the tests provided in sections 85 an 90.[206] If the legislature had for section 38(2A) used wording consistent with sections 85 and 90, then it would be easier to understand what the intention was concerning contingent liabilities. If there was no mention of contingent liabilities, it would be safe to continue on the reasonable and logical assumption that they should be accounted for. As there is an inclusion in the new section, then it is logical to assume that contingent liabilities should not be accounted for in sections 85 and 90 as there is no similar provision.

Contingent creditors have been defined in case law as 'one who by reason of some existing *vinculum juris* has a claim against a company which may ripen into an enforceable debt on the happening of some future event or on some future date.'[207] A *vinculum juris* is 'a legal obligation which creates a right enforceable by a court of law, and can arise from contract, delict or any legally recognised way.'[208]
Section 38(2B) provides that the company must account for contingent liabilities, including contingent liabilities that arise as a result of the financial assistance granted. Obviously this is meant to include the provision of security, guarantees and indemnities that are a common feature of transactions involving financial assistance. In these transactions there is a *vinculum juris* arising from contract, to which the liability will arise due to an uncertain future event, such as default by a third party or any loss arising from a transaction. It would have been useful if the

[205] It is interesting to note that the Corporate Laws Amendment Bill introduced to parliament in 2006 originally provided that the Directors must "consider", not "account", for contingent liabilities. To "account" for contingent liabilities is stricter than to "consider", as a Director may consider a contingent liability but not account for it due to the low probability of its occurrence.
[206] See Blackman *et al.* (note 5) p5-127. And Cassim (Share repurchases note 202) p767.
[207] *Gillis-Mason Construction Co (Pty) Ltd v Overvaal Crushers (Pty) Ltd* 1971 (1) SA 524 (T) at 528C.
[208] Blackman *et al* (note 5) Volume 3. p14-131.

legislature had provided for a legal definition of a contingent liability, as the legal concept of a contingent obligation is narrower than the definition provided by accounting practice. IAS 37 defines a contingent liability as follows:[209]

> (a) a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or
>
> (b) a present obligation that arises from past events but is not recognized because:
>
> (i) it is not probable that an outflow of economic resources embodying economic benefits will be required to settle the obligation; or
>
> (ii) the amount of the obligation cannot be measured with sufficient reliability

The contingent liability definition in IAS 37 contemplates obligations arising from past events that are contingent on the happening on some future event, such as a default on a debt by a third party which is guaranteed by the company; or obligations that are in existence but are probable that they will not be required to be settled; and obligations that cannot be quantified. Financial Accounting makes a distinction between contingent liabilities and provisions, as contingent liabilities are not recognised on the balance sheet while provisions are. Contingent liabilities are disclosed in the notes to the balance sheet unless the possibility of any outflow in settlement is remote. [210] IAS 37 defines a provision as a liability of uncertain timing or amount.[211] In the case of a provision, a liability is certain to arise, the only issue being the timing of the liability arising or the exact amount. As the probability of existence of the liability is more probable than not (i.e. more than 50 per cent) provisions are therefore provided for as a liabilities in the balance sheet, measured at fair value.

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[209] IAS 37 *Provisions, Contingent Liabilities, and Contingent Assets.* Para 10.
[210] Ibid. Para 86.
[211] Ibid. Para 10.

The significance of the inclusion of contingent liabilities in the solvency test is important in the case of financial assistance, as the transaction itself gives rise to a contingent obligation that if had to occur would deplete the resources of the company. However there are circumstances where the legally recognised contingent liability may not be relevant for the purposes of solvency. IAS 37 on the other hand, provides that contingent liabilities will not be disclosed in financial statements if the possibility of an outflow of resources embodying economic benefits is remote.[212]

Section 4(4) of the New Zealand Companies Act 1993 provides that when valuing a contingent liability, account may be taken of the likely hood of the contingency occurring, and any claim the company is entitled to make to reduce or extinguish the liability. By using the New Zealand example, a company that faces a potentially expensive contingent liability that is less than probably to occur (but not quite remote enough to warrant non-disclosure) can discount the value of the liability by the probability of its occurrence. The Act further qualifies this valuation method of liabilities for the purpose of financial assistance by providing that any liability, contingent or otherwise, incurred in connection with the giving of the financial assistance must be valued at face value.[213] This is understandable in line with the prudence to be given when providing security on a third party debt to enable that party to acquire shares in the company, where the risk of default can have severe financial implications on the company and its solvency.

By including contingent liabilities in a solvency test the claims involuntary creditors whose claims may not be certain at present are protected. For example a company may have pending litigation against it for product liability or possible tax liabilities that according to its (legal) advisors the company has only a thirty per cent probability of being liable. This will not be recognised as a liability in the financial statements, but when assessing the solvency for a proposed transaction, such a contingent liability will have to be accounted for. If the liability does in fact occur

[212] Ibid. Para 28.
[213] Section 77(6).

then the company's capital will still be preserved if the transaction was unable to proceed due to the company failing the solvency test. More importantly, the claims of secured creditors are protected by this safeguard.

e. Preference Shareholders

A further feature of the balance sheet test is the ommission to provide for the protection of preference shareholders. The preferential rights on dissolution are meaningless if the company is allowed to make payments and distributions or provide financial assistance in respect of ordinary shares according to a balance sheet test that does not account for these rights of preference shares. For example a share buyback may satisfy the solvency test but if in the future the company does enter insolvency, then the value of the preference shares will be affected, while the ordinary shareholders who sold their shares back to the company have in effect received liquidation distribution in preference to the preference shareholders. This problem is addressed by the New Zealand Companies Act[214] and the American Model Business Corporations Act (MBCA). Section 52(4)(b) of the New Zealand Companies Act provides that

> Liabilities includes the amount that would be required, if the company were to be removed from the New Zealand register after the distribution, to repay all fixed preferential amounts payable by the company to shareholders, at that time, or on earlier redemption (except where such fixed preferential amounts are expressed in the constitution as being subject to the power of directors to make distributions)...

and section 6.40(c)(2) of the MBCA provides

> '[T]he corporation's total assets would be less than the sum of its total liabilities plus (unless the articles of incorporation permit otherwise) the amount that would be needed, if the corporation were to be dissolved at the time of the distribution, to satisfy the preferential rights upon

[214] 1993 No. 105.

> dissolution of shareholders whose preferential rights are superior to those receiving the distribution.'

The effect of this is to treat the rights on dissolution of preference shareholders as liabilities when determining the amount available for a distribution according to the solvency test. There is domestic case law on this matter, in *Choice Holdings Ltd v Yabeng Investment Holding Co Ltd*[215] it was held that to consider a redeemable preference shareholder as a contingent creditor would render 'nugatory the Act's own distinctions between shareholders and creditors in relation to winding-up proceedings.'[216] The obligation to redeem may have the characteristics of a debt obligation, but the rights associated with it flow from the rights attached to the shares and are not of a contractual nature. It will fall to the company's constitution to protect the rights of preference shareholders where the balance sheet test fails to do so. In terms of South African law the policy in affording preference shareholders this protection has been made clearer by the 2008 Companies Bill, which, for the purposes of distributions provided for under paragraph (a) of the distribution definition, specifically excludes from the value of liabilities any amount to satisfy the preferential rights on liquidation, unless the memorandum of incorporation provides otherwise.[217] As financial assistance does not fall under the relevant paragraph of the distribution definition, the preferential rights upon liquidation will have to be taken into account for the purposes of the solvency test.

f. Liquidity Test

The liquidity limb, or also known as the 'ability to pay test' or 'equity solvency test' is not concerned with measuring solvency according to numeric values but rather takes a more pragmatic approach to solvency according to commercial reality. Creditors are not directly concerned with the value ascribed to assets and liabilities but are more concerned with the fact of receiving payment according to payment

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[215] 2001 (3) SA 1350 (WLD).
[216] Ibid. At para 22.
[217] 2008 Companies Bill. Section 4(2)(c).

terms. The liquidity test matches the firm's obligations and the firm's cash flow at the contracted payment date and avoids results which other tests that could indicate insolvency when the firm can reasonably be expected to pay its debts as they come due, or to indicate solvency when the firm cannot pay its debts as they come due.[218] Section 38(2A)(a)(ii) provides that the company may provide financial assistance if the board is satisfied that:

> 'Subsequent to providing the assistance and for the duration of the transaction, the company will be able to pay its debts as they become due in the ordinary course of business.'

The test does not value the company's debts as the balance sheet test values liabilities, but asks whether the debts are able to be paid in the ordinary course of business. The ordinary meaning of a debt is an amount of money which is due and owing,[219] and this is narrower than a liability. It would however be unhelpful to formulate a definition of a debt in contrast to a liability when the mechanism of the test is forward looking as opposed to the financial position calculated according to the balance sheet test. Liabilities that may not be defined as a debt in the ordinary meaning may nevertheless become due and payable in the near future in the ordinary course of business. The test is whether the firm will be able to pay debts in the ordinary course of business, not whether the firm will be able to pay its debts that are currently due and payable. A further point is that s 38(2B) requires contingent liabilities to be taken into account for the purposes of the solvency and liquidity tests. It has been submitted that for the purposes of liquidity, accounting for contingent and prospective liabilities is not to regard them as being due and payable, but rather they should be considered as factors having a bearing on the ability of the company to pay its debts as they become due in the ordinary course of business.[220]

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[218] Heaton (note 176) At 984.
[219] *Koekekoer v Taylor and Steyn* (1981) (1) SA 267 (W) 270-271.
[220] Cilliers et al. '*Corporate Law*'. 3rd Edition 2000. p504

The test is that of liquidity, at the basic level the test asks "whether the expected cash flows can be matched to maturing debt obligations in the period that the debt obligation matures."[221] It is however not enough to merely consider cash on hand and projected cash flows. Cash expected to be available at a particular time may be relevant but not determinative.[222]Furthermore cash flows are notoriously difficult estimate.[223] There are various factors internal and external to the company that make projections of cash flow unreliable the further into the future the projection is made. It was stated in a New Zealand case that "the inference of insolvency cannot be drawn from a temporary lack of liquidity, but rather the debtor's inability, utilising such cash resources as he has or can command through the use of his assets, to meet his debts as they fall due which indicates insolvency."[224] The ability to pay debts as they become due should be determined by reference to the facts and considering, *inter alia* assets and liabilities and the nature of them, and the nature and circumstance of the companies activities.[225] It is a question of commercial reality, considering all the relevant circumstances, whether a company will be able to pay its debts.[226]

The wording 'in the ordinary course of business' is similar to the wording in the solvency test in section 4 of the New Zealand Companies Act 1993, which states "in the normal course of business." The New Zealand Act adapted the wording from section 6.40(c)(1) Model Business Corporations Act of the United States, which provides 'in the usual course of business.'[227] There is no practical difference in the meaning of "ordinary", "normal' and "usual" in practice so it is helpful to draw from the experiences of the other jurisdictions for interpretation. The test whether a transaction is in the ordinary course of business is objective, that is having regard to all the circumstances the transaction is one which would normally have been entered into by solvent business men.[228] In *Downs Distributing Company Pty*

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[221] Heaton (note 176) p20.
[222] *Dunn v Shapowloff* (1978) 3 ACLR 775 CA(NSW) at 784.
[223] Heaton (note 176) At 984.
[224] *Sandell v Porter* (1966) 115 CLR 666 at 670.
[225] *Dunn v Shapowloff* (note 222).
[226] Blackman *et al* (note 5) p5-124-1.
[227] New Zealand Law Commission *Company Law Reform: Transition and Revision* NZLC R16 (1990) at 3.
[228] *Henriks NO v Swanepoel* 1962 (4) SA 338 (AD) 345.

Limited v Associated Blue Star Stores Pty Limited[229] Rich J, stated that a transaction would be in the ordinary course of business if:

> 'The transaction fell into place as part of the undistinguished common flow of business done, that it formed part of the ordinary course of business carried on, calling for no remark and arising out of no special or particular occasion.'

These tests for 'in the ordinary course of business' arose in liquidation or insolvency cases to determine whether a transaction fell foul of insolvency or winding up provisions. In the context of financial assistance, or the provisions in sections 85 and 90, what is required is that the provision of financial assistance or payment of a distribution under sections 85 or 90 will not impede the ability of the company to pay its debts. The test in s 38(2A)(a)(ii) provides that the company must be able to pay its debts in the ordinary course of business for the duration of the transaction and subsequent to the transaction. The cost of financing an acquisition must not prevent the ability to pay debts as they become due.

An issue that arises is that during or subsequent the provision of the assistance the company, in order to pay debts as they become due, is required to obtain a further source of funds, either by debt or equity finance. Can it be inferred from undergoing such a transaction that the company would not be able to pay its debts in the ordinary course of business? While such transactions generally are ordinary business transactions; but for the assistance, such finance would not be required. The required finance is not in the ordinary course of that business, that is, the business purpose as provided under the company's constitution. It was however stated in the *Downs Distributing Company*[230] case that '"in the ordinary case of business" does not require that the transaction shall be in the course of any particular trade, vocation or business.'[231] Rich J went on to say that 'It speaks of the

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[229] (1948) 76 CLR 463 (HC of Aust).
[230] Ibid.
[231] Per Rich, J

course of business in general.'[232] While there is authority for such an approach in South African Insolvency law, [233]Blackman *et al* submits that in the context of the liquidity test (in section 90) it would seem more appropriate to apply a test that is more subjective of the company, such as "in the ordinary course of *that* business", which was the test in section 34(1) of the Insolvency Act.[234]As stated above, the case law providing authority on "in the ordinary course of business" derives from insolvency and bankruptcy proceedings, so there is a case for argument against such an objective interpretation in terms of Company Law.

g. Section 38(2A) Summary

The relaxation of the financial assistance prohibition, while gladly welcomed, is not without its deficiencies. Allowing directors to base their decisions on a subjective test is open to manipulation. A business judgement rule formulated for financial assistance would provide greater ease of mind for directors, while the test itself could be applied according to objective criteria. The solvency tests are poorly constructed, and lack clarity on financial interpretation and application. Until certainty is provided on its application there may be transaction costs involved that could harm business efficiency. The further requirement of a special resolution may be counter productive in cases where the implications of providing financial assistance are minimal. A threshold requirement for the authorisation by a special resolution would greatly ease efficiency, including a general authorisation that can stand valid for a period of time, as the Companies Bill allows for.[235] Until the consolidation and reform of the Company Law is completed sometime in the future the relaxed prohibition should be viewed as an interim measure to ease the transition to a more efficient financial assistance provision.

II. Financial Assistance in the 2008 Bill

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[232] Ibid.
[233] *Joosab v Ensor NO* 1966 (1) SA 319 (A)
[234] No. 24 of 1936. See Blackman et al. (note 5) p5-126.
[235] Section 44 of the Companies Bill 2008 allows a special resolution for a general authorization to be valid for 2 years.

The version of the relaxation of the prohibition as contained in s 38(2A) has a short expected life span, due to the reworking of the company law framework as introduced by the Companies Bill of 2007 and the subsequent Companies Bill of 2008. However the ideological shift away from the old capital maintenance regime remains the same, to permit financial assistance as well as distributions to shareholders subject to solvency requirements. The differences in the 2007 and 2008 versions are more of a wording and structural difference than major policy differences. For ease of reference the full section 44 of the 2008 Bill is quoted below:

Financial assistance for subscription of securities

44. (1) In this section, "financial assistance" does not include lending money in the ordinary course of business by a company whose primary business is the lending of money.

(2) To the extent that the Memorandum of Incorporation of a company provides otherwise, the board may authorise the company to provide financial assistance by way of a loan, guarantee, the provision of security or otherwise to any person for the purpose of, or in connection with, the subscription of any option, or any securities, issued or to be issued by the company or a related or inter-related company, or for the purchase of any securities of the company or a related or inter-related company, subject to subsections (3) and (4).

(3) Despite any provision of a company's Memorandum of Incorporation to the contrary, the board may not authorise any financial assistance contemplated in subsection (2), unless—

(a) the particular provision of financial assistance is—

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

(ii) pursuant to a special resolution of the shareholders, adopted within the previous two years, which approved such assistance either for the specific recipient, or generally for a category of potential recipients, and the specific recipient falls within that category; and

(b) the board is satisfied that—

(i) immediately after providing the financial assistance, the company would satisfy the solvency and liquidity test; and
(ii) the terms under which the financial assistance is proposed to be given are fair and reasonable to the company.

(4) In addition to satisfying the requirements of subsection (3), the board must ensure that any conditions or restrictions respecting the granting of financial assistance set out in the company's Memorandum of Incorporation have been satisfied.

(5) A decision by the board of a company to provide financial assistance contemplated in subsection (2), or an agreement with respect to the provision of any such assistance, is void to the extent that the provision of that assistance would be inconsistent with—

(a) this section; or
(b) a prohibition, condition or requirement contemplated in subsection (4).

(6) If a resolution or an agreement has been declared void in terms of subsection (5) read with section 218(1), a director of a company is liable to the extent set out in section 77(3)(e)(iv) if the director—

(a) was present at the meeting when the board approved the resolution or agreement, or participated in the making of such a decision in terms of section 74; and
(b) failed to vote against the resolution or agreement, despite knowing that the provision of financial assistance was inconsistent with this section or a prohibition, condition or requirement contemplated in subsection (4).

a. Authorisation

The first obvious difference is that financial assistance is no longer limited to the purchase or subscription of shares, but applies to securities and options. Securities

have the meaning set out in section 1 of the Securities Services Act,[236] and includes shares held in a private company. This should be seen as a policy aimed at the prevention of company resources being used to enhance the interests of persons subscribing in company securities at the expense of current company creditors and shareholders. This is a wider agenda than the narrower capital maintenance doctrine which sought to prevent subscribed share capital being returned; the entire company resources are being protected, not just the prevention of capital reduction.

The second notable difference relates to structure, the financial assistance provision is no longer couched as a prohibition subject to exceptions, but is worded as an authorisation subject to conditions. The first subsection contains the usual exception to the meaning of financial assistance by a company providing assistance in the ordinary course of business and whose primary business is the lending of money. The authorisation is contained in the second subsection which permits the board to authorise financial assistance to the extent that it is authorised the company's Memorandum of Incorporation. Subsection 4 stipulates that the financial assistance must satisfy any conditions or restrictions in the Memorandum of Incorporation.

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[236] Act No. 36 of 2004. "securities"- (a) means-

(i) shares, stocks and depository receipts in public companies and other equivalent equities, other than shares in a share block company as defined in the Share Blocks Control Act, 1980 (Act No. 59 of 1980);
(ii) notes;
(iii) derivative instruments;
(iv) bonds;
(v) debentures;
(vi) participatory interests in a collective investment scheme as defined in the Collective Investment Schemes Control Act, 2002 (Act No. 45 of 2002), and units or any other form of participation in a foreign collective investment scheme approved by the Registrar of Collective Investment Schemes in terms of section 65 of that Act;
(vii) units or any other form of participation in a collective investment scheme licensed or registered in a foreign country;
(viii) instruments based on an index;
(ix) the securities contemplated in subparagraphs (i) to (viii) that are listed on an external exchange; and
(x) an instrument similar to one or more of the securities contemplated in subparagraphs (i) to (ix) declared by the registrar by notice in the Gazette to be a security for the purposes of this Act;
(xi) rights in the securities referred to in subparagraphs (i) to (x);

(b) excludes-

(i) money market instruments except for the purposes of Chapter IV; and
(ii) any security contemplated in paragraph (a) specified by the registrar by notice in the Gazette;

The new provision still draws on the old terminology currently in section 38 to provide meaning to financial assistance. It is still phrased as a loan, guarantee, the provision of security or otherwise. Therefore instead of providing new and uncertain terminology to the definition of financial assistance we can rely and build on the jurisprudence contained in case law for its interpretation. A new feature of the provision is its attempt to regulate financial assistance by a company for the acquisition of shares or securities in a related person by using the defined parameters of related and inter-related persons. The current section 38 prohibits a company providing financial assistance for the acquisition of shares only in itself or its holding company. A related person is someone defined according to s 2(1)(a) to (c), and an interrelated person is defined under s 2(1)(d). Section 2 provides:

Related and inter-related persons, and control

2. (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 a marriage; or

(ii) are separated by no more than two degrees of natural or adopted consanguinity or affinity;

(b) an individual is related to a juristic person if the individual directly or indirectly controls the juristic person, as determined in accordance with subsection (2);

(c) a juristic person is related to another juristic person if—

(i) either of them directly or indirectly controls the other, or the business of the other, as determined in accordance with subsection (2);

(ii) either is a subsidiary of the other; or

(iii) a person directly or indirectly controls each of them, or the business of each of them, as determined in accordance with subsection (2); and

(d) two 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.

A key feature of the relationship provision is the element of control, provided in section 2(2).[237] It is obvious that the new bill regulates financial assistance by a company in connection with the purchase or subscription of shares or securities in a much wider group of related persons, not just the company or its holding company as set out in s 38(1) of the current legislation. This is understandable from a group veil piercing perspective where it may be undesirable to permit holding companies to cause subsidiaries to jeopardize their solvency and therefore creditors for the benefit of a third party in acquiring another member of the group. However this has implications on intra group transactions and group restructurings. For example, the current prohibition does not render it unlawful for a holding company H or its subsidiary X to provide financial assistance to another subsidiary Y to enable Y to acquire subsidiary Z. While the bill does not render it unlawful, this transaction will have to comply with the conditions of section 44, including the solvency tests and the special resolution requirement, unless the company providing the assistance is the group's finance provider and the assistance is in the ordinary course of its business, but not all groups will have such a member. More importantly, the definition of a related person wider than the subsidiary definition, thus catching companies not part of a group structure. These types of transaction would normally

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[237] Section 2(2):

For the purpose of subsection (1), a person controls a juristic person, or its business, if—

(a) in the case of a juristic person that is a company—

(i) that juristic person is a subsidiary of that first person, as determined in accordance with section 3(1)(a); or

(ii) that first person together with any related or inter-related person, is—

(aa) directly or indirectly able to exercise or control the exercise of a majority of the voting rights associated with securities of that company, whether pursuant to a shareholder agreement or otherwise; or

(bb) has the right to appoint or elect, or control the appointment or election of, directors of that company who control a majority of the votes at a meeting of the board;

(b) in the case of a juristic person that is a close corporation, that first person owns the majority of the members' interest, or controls directly, or has the right to control, the majority of members' votes in the close corporation;

(c) in the case of a juristic person that is a trust, that first person has the ability to control the majority of the votes of the trustees or to appoint the majority of the trustees, or to appoint or change the majority of the beneficiaries of the trust; or

(d) that first person has the ability to materially influence the policy of the juristic person in a manner comparable to a person who, in ordinary commercial practice, would be able to exercise an element of control referred to in paragraph (a), (b) or (c).

be sufficiently regulated by director's duties and disclosure requirements if there was a conflict of interest. However s 2(3) does provide for an exemption of the operation of s 2(1) by a Court; the Companies Tribunal; or the Companies Panel on application if the person can show that: 'in respect of that particular matter, there is sufficient evidence to conclude that the person acts independently of any related or inter-related person.'[238]

It would appear that the bill also retracts the exemption contained in the current s 38(2)(d). Currently a subsidiary may provide financial assistance to its parent company to assist the parent in acquiring its own shares, and a parent company may provide assistance to its subsidiary to enable the subsidiary to acquire shares in the parent.[239] Due to the fact that there is no exemption of this transaction in the bill the transaction will in the future have to comply with the regulations of the financial assistance provision, as well as the share repurchase provisions of s 48 of the bill. The related person provision provides a double layer of regulation for these transactions where previously there was only one. The inclusion of related individuals widens the net of transactions that has to meet the requirements of section 44. Where an individual is the owner of more than one holding company or is the founder of trust then transactions between groups or between companies controlled by trusts of the individual or his or her relative will need to be carefully scrutinized to ensure compliance with s 44. With the aim of the reform of financial assistance to free such transactions from the net of regulation it is unfortunate that the bill in this regard seems to be adding to the burden instead of easing it.

The essence of the new dispensation for financial assistance is that the companies are authorised to provide assistance subject to the provisions of the act and any restrictions or conditions in the Memorandum of Incorporation. Any power to provide assistance in the Memorandum of incorporation is still subject to the requirements of the act.[240] In addition to complying with the conditions and regulations of the Memorandum, the financial assistance must be pursuant to either an employee

[238] Section 2(3).
[239] S 38(2)(d) Companies Act 61 of 1973.
[240] Companies Bill 2008. S 44(3).

share scheme as provided in section 97 or to a special resolution.[241] The special resolution must have been adopted in the previous two years, and applies in the case of a specifically identified recipient of the assistance, or is a general authorisation to grant assistance to a category of persons. If it is a general authorisation the recipient must fall into the category of persons authorised to receive assistance. This is a useful mechanism for companies wanting to perform a BEE transaction, as the identified category of persons can be formulated according to the requirements of BEE legislation. Companies can therefore adopt a special resolution authorising the granting of assistance to the category identified, and the company will have two years to implement the transaction. The 2007 bill previously permitted the special resolution to be adopted for a period of five years before the authorisation expired. It is likely that this change from the 2007 bill to the two year limit in the 2008 bill is to prevent companies implementing resolutions that were adopted previously when circumstances may have been different and recent changes may have made it unfavourable to grant assistance, either to a specified recipient or generally.[242]

Subsection three provides three conditions that must be met before a company may provide financial assistance. Firstly the assistance must be according to an employee share scheme or in terms of the special resolution. The further two requirements are that the board is satisfied that the terms of the assistance are fair and reasonable to the company, and that immediately after providing the assistance the company will satisfy the solvency and liquidity test. The requirement that the terms of the proposed financial assistance is fair and reasonable to the company is unfamiliar in South African Company law, but it is found in the financial assistance provision of the New Zealand Companies Act[243] and in the Canadian Business Corporations act in the provision dealing with disclosure of interests in transactions by directors, including financial assistance to directors.[244] This test mixes the subjective opinion of the board with the objective standards of fair and reasonable.

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[241] S 44(3)(a)
[242] The financial crisis of 2007 and 2008 and the global economic slow down is an example.
[243] Companies Act 1993 No 105.. S76(2)(c).
[244] Canadian Business Corporations Act. R.S. 1985. Section 120(7)(C).

Although there is no domestic case law on the matter, guidance can perhaps be received from s 37 of the current Companies Act. Section 37 regulates loans and security provided by a subsidiary to its holding company. A director who authorises such loans are liable for any damage sustained by the provision of the loan or security if the terms and conditions at the time of proving the loan or security were not "*fair*" to the company or failed to provide reasonable protection for its business interests."[245]Guidelines are provided in s 37(3)(c) to determine whether the transaction was "fair" or provided reasonable protection:

> (c) In enquiring, for the purposes of paragraph (a), whether or not any terms or conditions were fair to the company or failed to provide reasonable protection for its business interests, regard shall be had, without prejudice to the generality of the enquiry, to—
>
> (i)whether, in view of the financial position of the parties, the loan should have been made or the security should have been provided at all;
>
> (ii)in the case of a loan, whether security has been or should in the circumstances have been provided therefor, and whether any security provided therefor is adequate;
>
> (iii)the consideration for the loan or security, including any interest or other benefit received therefor;
>
> (iv) the term of the loan or security; and
>
> (v) the manner of repayment of the loan or discharge of the security

The requirement of "fair and reasonable" will inevitably require the directors to act in accordance with the fiduciary duties and the duty of care and skill, so as not to place the company in a precarious position. The question whether a transaction is fair and reasonable has arisen in American precedent: "it involves determination of the particular factual circumstances of the agreement, and application of the standards of fairness and good faith required of a fiduciary to these facts.'[246] Directors will have to make an appraisal of all the relevant facts their powers in accordance with their

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[245] Companies Act 61 of 1973. S 37(3)(a).
[246] *Tenzer v Superscope Inc.* 1985 Cal. LEXIS 293.

fiduciary responsibilities. This will in all probability require a degree of "*quid pro quo*" as it should be expected that normal commercial standards should apply, I.e. interest, security on loans etc. The word "*reasonable*" may qualify the requirement of fairness to some extent, particularly in the context of BEE transactions. The terms of such financial assistance may not necessarily be comparable to non-BEE commercial transactions, but provided there is a degree of fairness involved, such transactions should be interpreted according to the standards of reasonableness.

b. 2008 Bill Solvency and Liquidity Test

The solvency test has been moved and reworked into a separate section that applies if a particular provision makes the test applicable, such as dividend payments, share buybacks and financial assistance. Section 44(3)(b)(i) of the bill makes it a condition that the company's board is satisfied that the immediately after providing the assistance the company will satisfy the solvency and liquidity tests. The bill appears to have inherited from the current Companies Act the inconsistency in the application of the solvency test between distributions and financial assistance. Section 44 provides that the board must be satisfied that immediately after the provision of financial assistance the company will satisfy the solvency and liquidity tests.

Solvency and liquidity test

4. (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 assets of the company or, if the company is a member of a group of companies, the aggregate assets of the company, as fairly valued, equal or exceed the liabilities of the company or, if the company is a member of a group of companies, the aggregate liabilities of the company, as fairly valued; and

(b) it appears that the company will be able to pay its debts as they become due in the ordinary course of business for a period of—

(i) 12 months after the date on which the test is considered; or

(ii) in the case of a distribution contemplated in paragraph (a) of the definition of 'distribution' in section 1, 12 months following that distribution.

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

(a) any financial information to be considered concerning the company must be based on—

(i) accounting records that satisfy the requirements of section 28; and

(ii) financial statements that satisfy the requirements of section 29;

(b) subject to paragraph (c), the board or any other person applying the solvency and liquidity test to a company—

(i) must consider a fair valuation of the company's assets and liabilities, including any reasonably foreseeable contingent assets and liabilities, irrespective of whether or not arising as a result of the proposed distribution, or otherwise; and

(ii) may consider any other valuation of the company's assets and liabilities that is reasonable in the circumstances; and

(c) unless the Memorandum of Incorporation of the company provides otherwise, a person applying the test in respect of a distribution contemplated in paragraph (a) of the definition of 'distribution' in section 1 is not to be regarded 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 upon liquidation are superior to the preferential rights upon liquidation of those receiving the distribution.

The solvency test is still subject to the board's subjective satisfaction as the current s 38, which therefore imposes the mixed subjective and objective elements of the test. The new section does add an objective standard to the board's opinion as there must be a consideration of all reasonably foreseeable financial circumstances of the company at the time the test is taken. If the board undergoes the test without due consideration of financial circumstances that objectively, should have been taken into account, then the solvency test is not satisfied. This objectivity will prevent directors from hiding behind false claims that the test was honestly satisfied, and will impose a higher standard of diligence. The section further provides objective standards in subsection 2(a) as the financial information to be considered must be based on the accounting records that satisfy the Bill's requirements in section 28, and financial statements that meet section 29's requirements. Financial statements are to comply with prescribed financial reporting standards, which are in turn required to be consistent with the International Financial Reporting Standards of the International Accounting Standards Board.[247] There is now a consistent source of information to which companies will apply the test, and a failure to use valid information will render the test invalid.

c. Balance Sheet Test

The balance sheet test in section 4(1)(a) requires the assets of the company, fairly valued, to equal or exceed the liabilities of the company as fairly valued, or in the case where the company is in a group of companies, the aggregate assets of the company must be equal or exceed the aggregate liabilities of the company. The word "aggregate" was introduced by the Portfolio Committee amendment to the 2008 Bill, and replaced the word "consolidated." "Consolidated" is the word used in the current Companies Act without any supporting definition, and was omitted from the draft 2007 Companies Bill. It may be that the use of the word "consolidated" was to clarify that the assets and liabilities of subsidiary companies are to be taken

[247] Section 29(5)(b).

into account, but this is redundant as for the purposes of the company's accounts the value of investments in subsidiaries as assets of the company will be represented net of any liabilities. It has been suggested that the use of the term 'consolidated' should be understood to refer to the group as a whole, as a single separate entity for the purposes of the solvency tests.[248] This is not the traditional accounting definition of consolidated, and is counter the fundamental company law principle of separate legal identity. Without an explicit requirement for such a view on company groups, or in the very least a group veil piercing mechanism, it would be surely be against one of the most fundamental company law principles, the separate legal persona, to do so. By removing the word "consolidated' and replacing it with "aggregate" there is still no clarification on what assets and what liabilities other than those legally attributed to company can be included. Replacing the accounting terminology of "consolidated" with "aggregate" indicates a group veil piercing intention by the drafters, but the drafting could have been more explicit in this regard, as it could have been phrased as such: "...if the company is a member of a group of companies, the aggregate assets of the *group*"

Section 4(2)(b)(i) adds that the board must consider a fair valuation of the company's assets and liabilities. This is superfluous as section 4(1)(a) already requires assets and liabilities to be fairly valued. It is doubtful whether any meaning can be read into the inconsistency of the terms "fair valuation" and "fairly valued." Section 4(2)(b)(i) clarifies the position on contingent liabilities, as the board is required to consider any reasonably foreseeable contingent liabilities. This includes any contingent liabilities arising from the proposed assistance. The inclusion of contingent liabilities ties up the inconsistency that arose when the 2007 Bill did not include contingents, whereas the new solvency test in s 38 of the current act does.

The test requires the board to consider any contingent assets that are reasonably foreseeable. The International Financial Reporting Standards (IFRS) which is prescribed as the financial information used for the solvency tests defines a contingent asset as a possible asset whose existence will be confirmed only by the

[248] PA Delport 'Company Groups and the Acquisition of Shares' (2001) 13 *S. Afr. Mercantile L.J.* 121 at 123.

occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.[249] The uncertainty that surrounds the occurrence of contingent assets makes it unlikely that they will be reasonably foreseeable, and once they do become reasonably foreseeable the correct treatment would be its recognition as an asset. Furthermore, there is no definition of a contingent asset provided in the Bill and it is unfamiliar to the current Companies Act as well as Company legislation in other jurisdictions. Nevertheless the Bill does not mandate that the board must account for contingent assets, but must consider them. This allows for the board to exercise judgement in applying the test as to whether to account for uncertain events or not.

The provision in section 4(2)(b)(ii) that allows for a board to consider any other 'valuation of the company's assets and liabilities that is reasonable in the circumstances' is inherited from the solvency test of the American Model Business Corporations Act.[250] According to the commentary on the MBCA the purpose of this is to 'comprehend wide variety of possibilities that might not be considered to fall under a "fair valuation" or "current value" method but might be reasonable in the circumstances of a particular case.'[251] While directors may consider alternative valuations, section 4(2)(b)(i) still mandates the fair valuation consideration before any other valuation.

The rights of preferential share holders are not given recognition as liabilities for the purposes of financial assistance. It is however open for the Memorandum of Incorporation to recognise these as liabilities for the purposes of a distribution as defined in paragraph (a) of the distribution definition, but financial assistance does not fall under the definition of a distribution.[252]

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[249] IAS 37. Para 10.
[250] 1984 MBCA. Section 6.40(d)
[251] American Bar Association Committee on Corporate Laws. *Model Business Corporation Act Annotated.* 2005. P6-62.
[252] Paragraph (a) of the definition is as follows:
(a) transfer by a company of money or other property of the company, other than its own shares, to or for the benefit of one more holders of any of the shares of that company or of another company within the same group of companies, whether—
(i) in the form of a dividend;
(ii) as a payment in lieu of a capitalisation share, as contemplated in section 47;

d. Liquidity Test

The liquidity test has been drafted in less clumsy terms that the current legislation, and has added a time limitation of 12 months. The test requires that the board is satisfied that it appears the company will be able to pay its debts as they become due in the ordinary course of business for a period of 12 months after the date the test was considered. The date the test is considered for the provision of financial assistance under s 44(3)(b)(i) is immediately after providing the assistance. There is no inconsistency with the current legislation with regard to the phrase 'in the ordinary course of business,' but the time provision may limit the application of the test where under the current act it would still be applicable. The current Act stipulates the company must be able to pay its debts in the ordinary course of business subsequent to the transaction and for the duration of the transaction.[253] A typical financial assistance transaction may last far longer than 12 months. However for the sake of business certainty and to limit the problems of applying the liquidity test for indefinite periods a 12 month limitation is welcome and in line with other jurisdictions. Directors would be hesitant to authorise such transactions if liability might attach several years down the line.[254]

e. Duties and Liability

The new financial assistance provision no longer makes it a criminal offence if a company acts in contravention of the provision. The criminality of the current

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(iii) is consideration for the acquisition—

(aa) by the company of any of its shares, as contemplated in section 48; or

(bb) by any company within the same group of companies, of any shares of a company within that group of companies; or

(iv) otherwise in respect of any of the shares of that company or of another company within the same group of companies, subject to section 164(19)

[253] Companies Act. S38(2A)(a)(ii)

[254] See Ellis Ferran's critique of the proposed amendment to the European Company Law Directive 77/91/EEC Article 23 on financial assistance that permits assistance if the company can satisfy solvency requirements for 5 years. Article 1.2(4)(iv) of the draft Directive Proposal COM (2004) provided: "the company must be able to maintain its liquidity and solvency for the next five years, as credibly demonstrated by a detailed cash flow analysis based on the information at the time of the approval of the transaction;" Ferran 'Simplification of European Company Law on Financial Assistance' *European Business Organization Law Review*, (2005) 6, 93. This proposal was amended and the adopted version (Directive 2006/68/EC, in force from April 2008) requires only a written report by the directors to the shareholders which indicates the risks involved for the solvency and liquidity of the company.

section is redundant as criminal proceedings rarely follow.[255] The current act does not specify that a transaction or agreement to provide financial assistance is void, but it widely held that such a transaction is completely void.[256] Section 44(5) of the bill now renders a board decision to provide assistance, or an agreement for the provision of assistance, void to the extent that it is inconsistent with section 44, or the conditions and restrictions imposed by the Memorandum of Incorporation.[257]The use of the phrase 'to the extent that' suggests that an agreement or transaction may be still be valid if there are components of the agreement are divisible or severable from the offending sections.

However, if an agreement or transaction is void in terms of s44(5), there is still an additional requirement imposed by section 218(1) before any liability of directors can follow. S44(6) provides that if an agreement or transaction is void under subsection 5, and read with s218, then liability in to the extent of s77(3)(e)(iv) will attach. Section 218(1) provides:

> Nothing in this Act renders void an agreement, resolution or provision of an agreement, resolution, Memorandum of Incorporation or rules of a company that is prohibited, void, voidable or may be declared unlawful in terms of this Act, unless a court declares that agreement, resolution or provision to be void.

Directors' liability can therefore only follow on a court declaration that the transaction was void. Once a transaction has been declared void in terms of section 44(5) and 218(1) then s77(3)(e)(iv) makes a director liable for any loss, damages or costs sustained by the company as a direct or indirect consequence of the director having being present at a meeting or participated in making the decision or failing to vote against the decision to provide financial assistance, if it was known that the assistance was inconsistent with section 44 or the Memorandum of Incorporation. There appears to be a redundancy in the wording

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[255] Cilliers et al (note 219) At p335.
[256] UDCBank v Lipshitz (note 87) at 802 -803.
[257] Companies Bill 2008. S44(5) (i) and (ii).

of S46(6) (a) and (b) as the requirements that the director was present and participated or failed to vote against the decision is repeated in s77(3)(e)(iv). The new imposition of liability makes it clear that directors can no longer hide behind apathy and the abstention from voting on such issues. Directors will have to use their fiduciary duty to act honestly in a matter they believe is in the interests of the company, which may require no more than voting against the transaction.

The Bill, in addition to the provisions on director's conduct and liability, further adds to the standards of director's conduct and governance as it codifies the common law fiduciary duties and the duty of care and skill.[258] Directors are therefore statutorily required to act in good faith and for a proper purpose, and to act in the best interests of the company.[259]The bill includes a business judgement rule for the duty to act in the interests of the company and to act with a degree of care and skill, by allowing directors to avoid liability if the person took reasonable steps to become informed of the matter and may rely on the information presented by others in a professional capacity, such as board committees or accountants.[260] These statutory rules places an additional layer of protection than that already provided by the requirements of s 44 and the solvency test in s 4 and hence it will be less easy to manipulate avoidance of liability when directors act wrongfully or inappropriately in a financial assistance transaction.

7 Conclusion

The reform of the financial assistance prohibition has been a long overdue. Its existence has been overshadowed by the criticism it has attracted due to it's over zealous reach and impediment to honest business transactions. The reliance on capital maintenance rules has left South African company law stagnant and overly regulated at the expense of efficiency. A casualty of this has been the conceptualization of the financial assistance prohibition as a necessary part of the

[258] Section 76 and 77.
[259] Section 76(3)(a) and (b)
[260] Section 77(4) and (5).

capital maintenance doctrine. If the financial assistance law had received the same attention it received from England in the 1960's or Canada in the 1980's then the local version of the prohibition could have been relaxed many years ago, even before the abolishment of capital maintenance in 1999. While the relaxation is welcomed the reform has missed an opportunity to bring some certainty to the prohibition. While most transactions may proceed unhindered, there will be the few that require judicial interpretation. The poorly drafted and inconsistent solvency test may cause some interpretation and application headaches that could have been avoided. With the international trend in adopting IFRS as the basis for financial reporting the legislation fails to adequately bridge the gap between legal and financial terminology in an area where these concepts merge; that is the area of corporate finance. The reform of corporate finance forms the basis of the switch from a capital maintenance regime to a solvency regime.

The new section 38(2A) will be short lived, as the Companies Bill when enacted as legislation will usher in a new era of corporate law for South Africa that regulates corporate finance by solvency instead of outdated and ineffective legal capital rules. The financial assistance provision will be regulated by shareholder approval and allows for authorisation in the company constitution, as well as the solvency tests. However, the permitted financial assistance will remain heavily regulated; a feature that does not show in the American legislation that serves as the mould for the new company law. Without adequate reform in the insolvency regime and a litigation system that favours the enforcement of fiduciary duties for the benefit of shareholders and (to an extent) creditors, the regulation of financial assistance will be a prominent part in the future of South African Company Law.

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