

OFFERS OF COMPROMISES AND SCHEMES OF ARRANGEMENTS
IN SOUTH AFRICAN COMPANY LAW

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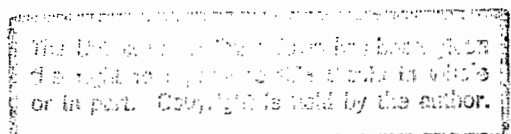
by

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"Research dissertation presented for the approval of Senate in fulfillment of part of the requirements for the degree of Master of Laws in approved courses and a minor dissertation. The other part of the requirement for the degree was the completion of a programme of courses."

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dedicated

to

my father, Winfried
my mother, Renate
my grand-mother, Theresia

with the highest of all gratitude

A lobster seller who cooks the live lobster in boiling water before handing them to the purchaser explains to the old lady that he is not at all cruel as he has been doing it for 20 years and the lobsters have long ago become used to this treatment!

Sir Edward Coke (1552-1634):

How long soever it hath continued, if it be against reason, it is of no force in law.

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INTRODUCTION

0.1 An Outline of the Research Problem

There are many different reasons why people want to acquire companies. Although takeovers are an extremely dangerous and high risk game, they are becoming more and more numerous in the modern business world.

An acquiror, however, tries to minimize his risk by trying to take over a company with a scheme of arrangement applying section 311 of the South African Companies Act, which gives him the necessary tool to takeover a 'clean' company without unknown creditors. That means that such a scheme must be a compromise or arrangement 'between the company and its creditors' before it can be sanctioned by court and therefore becomes binding on all the creditors, whether they are known or unknown. At least 3/4 of the creditors votes and numbers must support the arrangement.

To draft a scheme for this reason alone, however, would not be a big problem. What makes these takeovers so sophisticated is that every acquiror also wants to profit from the assessed loss of the target company, which is often available.

Therefore to draft a scheme, which, on the one hand complies with section 311 of the Companies Act, and on the other hand, does not comply with section 20 (1) (a) (ii) of the Income Tax Act in order to profit from the assessed loss, makes the scheme industry difficult.

0.2 Research Aims

This thesis outlines the general legal procedure of a scheme and tries to figure out a ratio behind the court's discretion of sanctioning such a scheme. This is made even more important as schemes are becoming more sophisticated and therefore more expensive. Acquirors entering into a scheme want to see the scheme succeed, and therefore they want to have a reasonable understanding of why the court could prevent a scheme.

This thesis also investigates the whole development of the scheme industry and puts special emphasis on the changes of the different schemes of arrangements after the judgment *in ex parte Kaplan & Others NNO: in re Robin Consolidated Industries Limited*. A discussion is given of both the problems and the solutions which have been found by practitioners. Attempts are made to find the right scheme and solution to combine section 311 of the Companies Act and section 20 (1) (a) (ii) of the Income Tax Act. Lastly it explains how the application of section 103 (2) of the Income Tax Act can be prevented. A recommendation is made as to which scheme should be followed at this point in time, in order to make a safe and tax-benefitting acquisition.

0.3 Overview of the thesis

The first part of the thesis (**Chapter 1**) gives the reader an overview of the issues and the distinction between the definition of arrangement and compromise.

The second part of this thesis (**Chapter 2**) presents an exact status of the legal procedure, which needs to be followed in order to get a scheme of arrangement sanctioned. It starts with the application to court (**Chapter 2, part 1**), provides the reader with further information about the summoning of meetings (**Chapter 2, part 2**) and finally gives a complete overview of the court's discretion in the sanctioning of a scheme (**Chapter 2, part 3**).

This is followed by explanations of the development of the different schemes of arrangements (**Chapter 3**), starting with the standard scheme in *ex parte Kaplan & Others NNO: in re Robin Consolidated Industries Limited* (**Chapter 3, part 2**) leading up to the most recent development of the invention of the new Cape scheme (**Chapter 3, part 5**).

The last part, of this thesis, deals with preserving the assessed loss (**Chapter 4**), while acquiring a company under the scheme of arrangement of section 311 of the Companies Act. This focuses especially with section 20 (1) (a) (ii) (**Chapter 4, part 2**) and section 103 (2) (**Chapter 4, part 6**) of the Income Tax Act. Furthermore, an explanation is given as to how the different schemes will be effected by section 20 (1) (a) (ii) (**Chapter 4, part 3 and 4**). Finally recommendations are made for the solution to the problem of subordination of creditors claims and insolvency of the company (**Chapter 4, part 5**).

1. DEFINITIONS

1.1. Introduction

Something of an industry has grown up around the judicially controlled compromise procedure governed by section 311 of the Companies Act 61 of 1973. Schemes to effect such compromises have become more sophisticated with time. Correspondingly, the explanatory documentation that must accompany them has become even more intimidating and mystifying to all but the very experts.¹

Section 311(1) provides that 'where any compromise or arrangement is proposed between a company and its creditors or any class of them or between a company and its members or any class of them, the Court may, on the application of the company or any creditor or member of the company, or, in the case of a company being wound up, of the liquidator, or if the company is subject to a judicial management order, of the judicial manager, order a meeting of the creditors or class of creditors, or of the members of the company or class of members (as the case may be), to be summoned in such manner as the Court may direct'.²

The history and purpose of this section shows that it is appropriate in cases where the normal mechanism for reaching agreement between members on the one hand and the company on the other hand are not available due to the content of the particular scheme. Normally the members meeting together formally in general meetings achieve the goal and the majority vote effectively produces results which are binding on the minority. The range of subjects which can be dealt with in this way is, however, rather limited. Generally

¹ Larkin MP 'No Compromise on Compromises' (1987) 17 BML 30.

² Section 311 (1) of the Companies Act 61 of 1973.

speaking, this meeting cannot pass resolutions which directly affect a member's proprietary rights in his shares. For that, his personal assent is essential and this machinery creates the fiction of assent where it is lacking or where dissent is achieved.³

The section may be called upon when it is not otherwise possible to make some arrangement or compromise which would be in the interests of the company and the other party or parties to the arrangement. This could be used whether the company is a going concern or is in the course of winding up its assets.⁴

Section 311, therefore, is intended to provide "machinery (i) for overcoming the impossibility or impracticability of obtaining the individual consent of every member of the class intended to be bound thereby; (ii) to prevent in appropriate circumstances a minority of class members frustrating a beneficial scheme".⁵

Before I consider the legal procedure together with the different schemes of arrangements or offers of compromises, I wish to mention an issue which has remained undisputed in jurisdiction: Before a judge is able to summon meetings, he must be sure that the proposal meets the basic requirements of Section 311 of the Act⁶; which is that the scheme which is proposed can be subsumed under the terms 'arrangement' or 'compromise' .

³ *Ex parte NBSA Centre Limited* 1987 (2) SA 783 (W) at 787.

⁴ Palmer's Company Law, Vol. 2, 12013 (Sweet & Maxwell, London).

⁵ Paterson and Ednie, Australian Company Law, 2ed, Vol II; *Norfolk Island and Byron Bay Whaling Co Ltd* (1970) 1 NS WR 221; 90 WN (P 1) NSW 351.

⁶ Reference to 'the Act', means the Companies Act 61 of 1973.

1.2. Arrangement

Neither the term 'arrangement' nor the term 'compromise' is defined under section 1 of the Act - containing the general definitions. However, the Act states⁷ that "the expression 'arrangement' includes a reorganization of the share capital of the company by the consolidation of shares of different classes or by the division of shares into the shares of different classes or by both these methods." This does not help much in defining the word, however, because it just includes a specific type of transaction rather than sets any borders within which to define the term.

It is apparent that 'arrangement' is construed by the English courts⁸ as a word of very wide import, covering almost every type of legal transaction, as long as there is some element of give - and - take, and that the approval of the company (or companies) concerned is given, either through its board or through the members in general meetings.⁹ The compensation advantage constitutes a 'rearrangement' of rights 'in the broad sense'.¹⁰ That means that there is still an 'arrangement' where members rights are changed from a direct interest in a company to an indirect one by an exchange of their shares, for shares in a company of which their company is to become a wholly-owned subsidiary. It is even considered sufficient to achieve the requirement of an 'arrangement' if the members are given a monetary compensation for their rights.¹¹ What is not accepted, however, is that members rights disappear totally without any compensation, because this is regarded as confiscation and lies outside the legitimate sense of the term 'arrangement' in the context of

⁷ Section 311 (8).

⁸ *Re Savoy Hotel Ltd* [1981] Ch 351 at 359 D-F.

⁹ Gower at 694-695.

¹⁰ Blackman par 59.

¹¹ *Ex parte Satbel (Edms) Bpk: in re Meyer v Satbel (Edms) Bpk* 1984 (4) SA 347 (W) at 359; *Ex parte NBSA Centre Limited* 1987 (2) SA 783 (W) at 792.

section 311.¹² However, there have been some different opinions on this subject, for example, in one case the statement was made that "if some shareholders agree to their shares being expropriated by another shareholder, why should that not be an 'arrangement' within the ambit of s 311?"¹³ This case remained, however, isolated.

Another question which had to be solved was how close the meaning of 'compromise' and 'arrangement' were. Younger J., for example, refused to sanction a scheme on the grounds that there was no dispute or difficulty to be resolved by the compromise or arrangement.¹⁴ This was, however, reversed by the Court of Appeal, stating that the term 'arrangement' should not be limited to something analogous to a compromise. An arrangement has no limitations like a compromise, and Fry LJ said:¹⁵

"In my opinion, the power to compromise does not include the power to give up one chose in action, namely, a secured debenture, in exchange for another chose in action of a totally different kind, namely, a preference share, in the absence of all dispute as to the rights of the creditor, of all difficulty in enforcing those rights, and of any suggestion that the full fruits of these rights could not be

¹² *Ex parte Federale Nywerhede Bpk* 1975 (1) SA 826 (W) at 834 citing Brightman J. in *Re NFU Development Trust Ltd* [1973] 1 All Er 135 at 140:

"the word arrangement in this section implies some element of give and take. Confiscation is not my idea of an arrangement. A member whose rights are expropriated without any compensation advantage is not, in my view, having his rights rearranged in any legitimate sense of that expression."

¹³ *Re NFU Development Trust Ltd* [1973] 1 All Er 135 at 140.

¹⁴ *Re Guardian Assurance Co* [1917] 1 Ch 431, where the scheme required that each shareholder of the petitioning company should transfer some of his shares to another company and its shareholders.

¹⁵ *Mercantile Investment and General Trust Co v International Co of Mexico* (1891) [1893] 1 Ch 484n., 491.

obtained. Such a transaction might be described as an exchange possible as a barter, or an arrangement."

Nevertheless, 'arrangements' under section 311, which are said to be 'of the widest character', find their limitations therein that the scheme cannot authorize something which is contrary to the general law or wholly *ultra vires* the company. Where, therefore, the Act provides a specific procedure, as in the case of the reduction of capital¹⁶, this procedure must be followed to make a transaction effective and that procedure cannot be evaded by means of a scheme of arrangement.¹⁷ Where this procedure is not followed, as a scheme involving a reduction has not been sanctioned but the petition was stood over to enable the company to comply. However, it has been held not to be *ultra vires* to provide that one class of shareholders be paid a sum of money in consideration of their foregoing a possible right under articles which were ambiguous.¹⁸

1.3 Compromise

The term 'compromise' actually offers few difficulties with regards to its meaning. In one of the leading English cases¹⁹ on this subject, the court came to the conclusion that there can be no compromise unless there is some dispute over rights, for example, as to the power to enforce rights, or as to what those rights are. Each of the parties involved must give up some ground, but there must be a *quid pro quo*, not a gratuitous giving up of a right.²⁰ There is

¹⁶ See 'Reduction of Capital' under Section 83-90 of the Act.

¹⁷ *Du Preez and Another v Garber: in re Die Boerebank Bpk* 1963 (1) SA 806 at 813.

¹⁸ Palmer's Company Law, Vol. 2, 12.012.

¹⁹ *Sneath v Valley Gold Ltd.* [1893] 1 Ch 477 (CA) 494.

²⁰ *Re NFU Development Trust Ltd* [1973] 1 All Er 135.

more or less the same view in South Africa, however, Slomowitz AJ remarked, that ²¹

"... it has been said of the schemes of arrangement contemplated by s 311 that they are of the widest character and the only limitations are that an arrangement must not authorize something contrary to the general law or ultra vires the company... – I can perceive no reason why the same ought not to be said of the compromises permitted by the section."

²¹ *Kleena Industries v Senator Ins Co Ltd* 1982 (2) 458 (W) at 462.

2. LEGAL PROCEDURE

2.1 Application to Court

Section 311 of the Act outlines the fact that either the company itself or any creditor or member as well as the liquidator, in the case of a company being wound up, has *locus standi* to apply for the summon of a meeting to get a scheme of arrangement or compromise approved. Thus, someone who was a former director of a company has, as such, no *locus standi*, unless he is also a member or a creditor of it.²² However, one has to distinguish between *locus standi* in order to make an application and to propose a compromise or arrangement. Even in the case of a company in liquidation, there is nothing to prevent a former director of the company who is neither a member nor a creditor of it, from putting forward such a proposal.²³ Where the proposal takes the form of an 'offer' by the company in liquidation through its former director, such an 'offer' is not binding on the company.²⁴

Before applying to Court, however, a draftsman – normally the company's attorney – has to draft the scheme because it has to be submitted in writing which must form part of the papers in the application.²⁵ It is not considered part of the proper function of the Court in general to draft or settle an offer of compromise or scheme of arrangement; Court, however, gives out guidelines of what such documents should contain and sets out certain procedures which should be followed in making such applications. Nevertheless, this is not the only acceptable path and so any deviation from it

²² *Ex parte Lipschitz: in re Gor Garage (Pty) Ltd* 1963 (1) SA 375 (G), a former member has no *locus standi* to bring in the application.

²³ *Ex parte Cassim: in re Bradford Clothing Manufacturers (Pty) Ltd* 1966 (3) SA 362 (D) at 363.

²⁴ Henochsberg on the Companies Act, Vol. I, 5ed, (1996) at 607.

²⁵ *Ex parte Union Whaling Co* 1973 (3) SA 550 (W).

A much discussed question is whether or not a proposed statement in terms of section 312 (1) (a) of the Companies Act must be accompanied by the application. Since the Court in considering an application should be satisfied that sufficient information has been gathered and can be furnished to the creditors to enable them to assess the relative merits of the proposal and of the alternatives thereto, a draft of the statement needs to be placed before the Court at the stage of an application for leave to convene meetings. In the present case,³⁰ Stegmann J requested the appellants to place the section 312 (1) statement before him:

"In my opinion, it would be a salutary practice, in all such applications, for a draft of a statement to be placed before the Court at the convening stage. This would not cause duplication, as much of the information usually contained in the founding affidavit would have to be set out in the section 312 (1) statement. This information could be incorporated into the founding affidavit, by an appropriate reference to the draft statement".

The 'Court' with jurisdiction is according to section 12 (1)³¹ in conjunction with the definition under section 1 (1)³² of the Act the Supreme Court within the area of jurisdiction of which the company's registered office is situated or where the company's main place of business is situated. Where either the registered office or the main place of business of the company is within the area of jurisdiction which is common to both a Provincial Division and a Local Division of the Supreme Court, there is concurrent jurisdiction in both those Courts to entertain the application.³³

³⁰ *Ex parte de Villiers and Another NNO: in re Carbon Developments (in liquidation)* 1993 (1) SA 493 (A) at 508.

³¹ Section 12 (1) of the Companies Act 61 of 1973.

³² Section 1 (1) of the Companies Act 61 of 1973.

³³ Henochsberg on the Companies Act, Meskin (ed), 5th edition (1985) 612.

If the proposal would cause injustice, or if it's vague and the applicant has misinterpreted it, or if the proposal contains terms which are inappropriate in the circumstances or ambiguously worded, or if the statement in terms of section 312 (1) (a) proposed to be sent to creditors or members is before the Court and is deficient, the Court may refuse to order the meeting or meetings to be convened.³⁴

2.2 Summoning of Meetings

At the stage of an application for leave to convene meetings the Court is primarily concerned with the probable response to the offer of the creditors.

"If the Court, in deciding whether to order the calling of a meeting or meetings, on a consideration of all the information at its disposal, comes to the conclusion that there is a reasonable probability that the requisite majority of the creditors of the company may accept the offer, it will generally speaking order a meeting of creditors to be convened; on the other hand, if it is not so satisfied it will refuse to make such an order."³⁵

Assuming that the Court wants to summon a meeting, its order should provide for the period of the notice of the meeting or meetings to be given to the members or creditors, as the case may be. It is, however, essential, to consider a necessary timeframe to enable the creditors or members to consider the

³⁴ *Ex parte Seafare Investment Ltd* 1970 (2) SA 417 (C); *Ex parte De Wet NO: in re Atlas Motion Picture Co (Pty) Ltd* 1978 (1) SA 375 (W).

³⁵ Per Trengove J in *Ex parte Bruyns NO: in re Mammoth Construction and Drilling Co (Pty) Ltd (under provisional liquidation)* 1973 (3) SA 721 (T) at 722 B-C.

offer, determine their attitude whether to be present or represented by proxy and make the necessary arrangements.³⁶

The order should also require notice of the meeting or meetings to be published, in one or more newspapers, depending on the circumstances. Where the company is winding up, the publication of the notice is required, otherwise it can be dispensed ordinarily.³⁷ The power conferred by section 311 of the Companies Act on the Court to summon a meeting in such a manner as it may direct, involves a power to fix the date of the meeting, to direct and settle the form of the notice and of the proxy to be sent with it, and to appoint the chairman, to authorize him to convene the meeting or meetings, and to direct him to report the results of the meetings to the court.³⁸ The Court has, for example, refused to order a meeting where one creditor, having a claim exceeding one-quarter of the total liabilities, objected and where the Court felt that there were numerous objectionable features in the proposal.³⁹ Furthermore the Court has also refused the order of a meeting where the proposal was simply a repetition of one that had already been rejected by creditors.⁴⁰

It is for the Court to determine what class meetings are to be called. However, the determination of those of the creditors who are to be summoned to each class meeting, as constituting creditors in that class, rests with the applicant for the order directing the calling of the meetings.

"Where there are different classes of creditors their interests will usually differ and may even clash, and the effect of a suggested compromise will usually also vary from class to class. The impact of

³⁶ *Rennie v Ruca Style (Pty) Ltd* 1973 (4) SA 266 (C) at 271.

³⁷ Henochsberg on the Companies Act, Meskin (ed), 5th edition (1985) 616.

³⁸ Blackman MS par 69.

³⁹ *Ex parte Singh: in re Orkin Brothers (Pretoria) Ltd* 1950 (1) SA 471 (T).

⁴⁰ *MS Mall (Cape) (Pty) Ltd: in re Archies Stores (Pty) Ltd* 1952 (1) PH EK (C); *Wells v New Wolhuter Gold Mines Ltd* 1939 (1) PH EG (W).

such a compromise, for example, be favourable or minimal as far as secured and/or preferent creditors are concerned, but may be very severe on concurrent creditors and may even be different as between creditors in the same class. That, to my mind, is the reason why section 311 (2) of the Act contemplates separate meetings by the different classes of creditors and requires that an arrangement be agreed to separately by each class of creditors."⁴¹

The same opinion has been expressed in a previous case⁴² in England, where the judgment reads as follows:

"... In the interest of fairness and to ensure a useful and facile interchange of ideas, it is therefore, in my judgement, essential that only creditors with a sufficiently close identity of interests should be gathered together in one meeting; and that, to my mind, is what section 311 (1) and (2) of the Act contemplates....."

The question as to when the court may dispense with a meeting was perfectly described in the *Massing & Ingham* case⁴³:

"...Section 103 [now s 311 of the Companies Act of 1973] defines strictly what the court may do when any arrangement of this kind is proposed. All the court may do in a case like this is to order a meeting of the members of the company or class of member, as the case may be, to be summoned in the way the court directs. Then, under s 103 (2), if the required majority is obtained at the meeting or meetings the arrangement shall, if sanctioned by the court, be binding. Thus, there is only one way in which the court may proceed before sanctioning a compromise or arrangement of this kind and that is by first ordering a meeting or meetings, as the case may be. In

⁴¹ *Ex parte Venter: in re Rapid Mining Supplies (Pty) Ltd* 1976 (3) SA 267 (O) at 275.

⁴² *In re Hellenic & General Trust Ltd* [1975] 3 All Er 382 (CH) [318] at 591.

⁴³ *Ex parte Massing & Ingham (Pty) Ltd* 1942 WLD 204 at 208-209.

the case of a single person holding all the shares of a defined class a meeting may be dispensed with, i.e. his consent should be taken as equivalent to a meeting because one person cannot hold a meeting. In the case where it is possible to hold meeting, that is to say, where there are two or more shareholders, a meeting must be held even if it appears from the evidence that they must all necessarily consent..."

In order to satisfy the statutory requirements the notice convening the meeting must be accompanied by the following :

- a) The statement explaining the effect of the compromise or arrangement in terms of section 312 (1) (a) of the Companies Act;
- b) Although not prescribed by the Act, the terms of the proposed compromise or arrangement. It would seem to be obvious that the compromise or arrangement to be considered by the creditors or members must accompany any notice of a meeting;
- c) A copy of the order summoning a meeting of creditors and members;
- d) According to section 311 (2), a form of proxy must be sent with the notice of meeting to enable any creditor or member who is unable to attend personally to appoint a representative to act on his behalf.

2.3 The Court's sanctioning of a scheme of arrangement

The first question concerns *locus standi* to seek the Court's sanction or to apply for sanction. Although it is not expressly stated in the Act, the applicant must be at least someone who is able to apply to the Court for summoning a meeting. This is under section 311 (1) 'the company or any creditor or member of the company, or in the case of a company being wound up, ... the liquidator ...the judicial manager'. Thus someone who was a former director of a company has, as such, no *locus standi*, unless he is also a member or a creditor of that company.⁴⁴

Under section 311 (5) of the Companies Act⁴⁵:

"the Court, in determining whether the compromise or arrangement should be sanctioned or not, shall have regard to the number of members or members of a class present or represented at the meeting referred to in subsection (2) voting in favor of the compromise or arrangement and to the report of the Master referred to in subsection (4)".

Over a century ago, Fry LJ posed the question as to the circumstances in which a Court should sanction a resolution approving a compromise or arrangement under the relevant provisions of the 1870 Joint Stock Companies Arrangement Act in England. He stated as follows⁴⁶:

"I shall not attempt to define what elements may enter into the consideration of the Court beyond this, that I do not doubt for a

⁴⁴ *Ex parte Lipschitz: in re Gor Garage (Pty) Ltd* 1963 (1) SA 375 (G), a former member has no *locus standi* to bring in the application.

⁴⁵ The companies Act No. 61 of 1973.

⁴⁶ *In re Alabama, New Orleans, Texas and Pacific Junction Railway Company* [1891] 1 Ch 213 (CA) at 247.

moment that the Court is bound to ascertain that all the conditions required by the statute have been complied with; it is bound to be satisfied that the proposition was made in good faith; and, further, it must be satisfied that the proposal was at least fair and reasonable, as that an intelligent and honest man, who is a member of that class, and acting alone in respect of his interest as such a member, might approve of it. What other circumstances the Court may take into consideration I will not attempt to forecast."

Fry LJ mentioned three very important factors to be considered for sanctioning a scheme of arrangement or offer of compromise. These are the compliance with the statutory provisions, the fairly representation of the class and the possible approval of an intelligent man. They will be examined closely in the following section.

2.3.1 The statutory provisions must have been complied with

The Court has to be satisfied that the requirements of the Act and the terms of the order of Court summoning the meetings have been complied with. The jurisdiction of the Court to confirm it and so bind all the creditors and members concerned is dependant on this.

The statutory provisions expressly mention the majority in value and number of members or member of a class present and voting. Although Courts will not insist upon complete observance of all formalities, as I will show below, a Court does not have the power to assume the right of the class of members or creditors to decide whether they approve the scheme. Therefore, if a class whose interests are effected by a scheme or compromise neither assents to the scheme or compromise, nor approves it at the meeting, in accordance with

section 311, the Court cannot confirm the scheme even if it considers that the class concerned is being fairly dealt with, or that it would approve it. This argument was upheld in a case⁴⁷, where most of the creditors had abstained from voting at the meeting held pursuant to the order of Court, and it was agreed that the calling of a further meeting would be a waste of time as the creditors would undoubtedly agree. Comey J refused to make an order deeming the compromise to have been agreed to by the requisite majority of creditors. Not only had this dispute not been substantiated, but also the Court, actually, had no power to make such an order.

Contrary to a view expressed by Trollip J⁴⁸ there would seem to be no substance in the contention that the section 311 subsection (2) would be complied with if the necessary majority agreed to the arrangement at some stage after the meeting was held and concluded. First of all, subsection (2) states expressly that such agreement must be manifested by voting at the meeting and that it must be given at the meeting. Secondly, if a meeting has been held already and the scheme was rejected, it would seem that its decision cannot be changed in a later decision. Therefore it is not only essential to actually hold the meeting,⁴⁹ but also the creditors, or class of creditors must agree to the arrangement at the meeting.

⁴⁷ *Ex parte Le Coultre: in re Morris Taxi Service (Pty) Ltd* 1962 (2) SA 338 (D) at 341-342.

⁴⁸ *Du Preez and Another v Garber: in re Die Boerebank Bpk* 1963 (1) SA 806 at 817.

⁴⁹ See however the exemption in *Massing & Ingham Ex parte Massing & Ingham (Pty) Ltd* 1942 WLD 204 at 208-209:

"...Section 103 [now s 311 of the Companies Act of 1973] defines strictly what the court may do when any arrangement of this kind is proposed.....In the case of a single person holding all the shares of a defined class a meeting may be dispensed with, i.e. his consent should be taken as equivalent to a meeting because one person cannot hold a meeting...."

If a class of creditors is not affected by the arrangement then the Court not only may dispense the meeting⁵⁰ but ought to do so, because then such creditors are not even part of the scheme of arrangement or offer of compromise, and therefore ought not to be allowed to vote or play a role in the section 311 procedure.

In my opinion the statutory provisions also require compliance with the provisions of section 312⁵¹. Section 312 (1) (a) states that with every notice sent to the creditors or members summoning the meeting the explanatory statement must be included. The statement must explain the effect of the compromise or arrangement [s 312 (1) (a) (i)] together with all the relevant information material in regard to the value of the shares and debentures concerned [(ii)] and indication of any material interests of the directors of the company [(iii)]. All the information must be perfectly fair and must contain everything reasonably necessary for the intended purpose⁵². What is regarded as sufficient information is not always easy to figure out and there are no guidelines to be followed; everything depends on the complexity of the facts and the kind of creditor to be enlightened.

In *Ex parte Voysey Bond Property Investments* four respects were outlined by Leon J⁵³ in which it was claimed that a statement under section 312 to debenture holders did not contain adequate information to enable debenture holders to adequately consider the proposal. These were:

- "(1) no copy of the guarantee therein referred to is attached;
- (2) the financial relationship of the company VIP Ltd. to the company Ninety West Street is not disclosed;

⁵⁰ *Du Preez v Garber* supra at 816.

⁵¹ *Ex parte Venter: in re Rapid Mining Supplies (Pty) Ltd* 1976 (3) SA 267 (O) at 275; *Ex parte Voysey Bond Property Investments* 1987 (2) SA 134 (D) at 140-141.

⁵² *Ibid.* at 275.

⁵³ *Voysey Bond Property* supra at 141.

(3) there is no clarity as to what amount of liability to debenture holders will accept by the figure of 16 per cent of the loan liabilities of Ninety West Street Ltd., or whether the company Ninety West Street Ltd. has accepted the arrangement should it be passed;"

Where the above mentioned formalities have not been fully complied with in several aspects, the Court⁵⁴ held that it would "not insist upon absolute or meticulous observance of all those terms and requirements, but will generally act on a substantial compliance therewith, if no prejudice or possible prejudice to any one's legal interests has resulted from the non-observance of any of the prescribed formalities. The reason is that the object of those formalities is to ensure that the creditors and members are sufficiently informed of the compromise or arrangement, and are afforded a reasonable opportunity of considering and discussing it and of accepting or rejecting it". And Trollop J went on to say that if that object has been attained through a substantial compliance with the prescribed formalities, and the statutory majority of creditors and members have agreed to the compromise or arrangement, it would be then be unnecessary formalism for the Court to refuse to assume jurisdiction in the matter.

Therefore it was decided that⁵⁵ 'the Court will not be astute to find technical defects in the proceedings' where the necessary majority for the compromise or arrangement have, in fact, been given. In this circumstance, it is correct, in my view, that a scheme of arrangement is sanctioned, although a person other than the chairman appointed by the Court presided at the meeting and reported the result to Court.⁵⁶

⁵⁴ *Du Preez v Garber* supra at 814.

⁵⁵ *Re Dynevor, Dyffryn and Heath Abbey Collieries Company* (1879) 11 Ch D 605.

⁵⁶ *Ex parte Chenille Corporation of South Africa (Pty) Ltd and Another: in re Chenille Industries (Pty) Ltd* 1962 (4) SA 459 (T) at 461-462.

It is, however, always difficult to draw an exact line. For example, a Court⁵⁷ sanctioned a scheme of arrangement which did not comply with the terms of the order of Court regarding notice of meetings, whereas a different Court refused sanction in a similar case because of the possibility of prejudice to creditors.⁵⁸

2.3.2 The class must have been fairly represented

The Court must be satisfied that those members or creditors who attended the meetings are fairly representative of the class and that the statutory majority did not coerce the minority in order to promote interests adverse to those of the class whom they purported to represent. This requirement is, in fact, an offshoot of the first.⁵⁹

We face great difficulties in determining what is meant by a 'class' under the provision of section 311, because it is not defined in the Companies Act. This leads us to the question of who is actually entitled to define the different classes? Is it the applicant who has to put the classes together in his application, or does the final discretion lie with the Court who must finally summon the meetings. Thus is a difficult question, but it would seem that although section 311 provides that the Court orders the meetings, it is the responsibility of the applicant to see that the class meetings are properly constituted, and if he fails then the necessary agreement is not obtained and the Court has no jurisdiction to sanction the scheme of arrangement.⁶⁰

⁵⁷ *Ex parte Simjee* 1956 (4) SA 733 (N); *Spanish Tartar References Ltd* 1924 WN 222.

⁵⁸ *Ex parte Meer* 1950 (3) SA 780 (D).

⁵⁹ *Palmer's Company Law*, Vol II, 1992, 12036.

⁶⁰ *In re Hellenic & General Trust Ltd* [1975] 3 All Er 382 (CH) [318] at 385.

The applicant who has to distinguish the different classes needs a guideline. Such a guideline was first formulated in an old case in Britain where Bowen LJ stated:⁶¹

"That the word 'class' used in the statute is vague, and to find out what is meant by it we must look at the scope of the section, which is a section enabling the Court to order a meeting of a class of creditors to be called. It seems plain, that we must give such a meaning to the term 'class' as will prevent the section being worked as to result in confiscation and injustice, and that it must be confined to those persons whose rights are not so dissimilar as to make it impossible for them to consult together with a view to their common interest."

Bowen LJ was therefore of the opinion that you have to put people with the same rights together in one class. However this is not the only opinion on this subject. In a few cases⁶² it was decided, that people with the same interest although not the same rights should be put together in one class. One of the leading cases here is *ex parte Venter: in re Rapid Mining Supplies (Pty) Ltd* 1976 (3) SA 267 (O) at 275-276, where it is stated that: "...The class to which a creditor belongs must be determined not only by the nature of his claim (i.e. preferent, secured or concurrent) but also by the rights or interests generated by that claim." This has not been followed⁶³, however, today it is well

⁶¹ *Sovereign Life Assurance Co v Dodd* (1892) 2 QB 573 (CA) at 583.

⁶² *Ex parte Venter: in re Rapid Mining Supplies (Pty) Ltd* 1976 (3) SA 267 (O); *In re Hellenic & General Trust Ltd* [1975] 3 All Er 382 (CH) [318].

⁶³ See *Rosen v Bruyns NO* 1973 (1) SA 815 (T) at 820F-821A:

"In the argument advanced by the appellant such great stress was laid on the 'interest' of the creditor that sight was lost of the basis of the classification, which is the dissimilarity of rights. With great respect it seemed to me that, in some of the instances quoted here, a similar excessive emphasis on interest could be perceived. Such an approach may lead to the constitution of meetings of creditors who hold similar views about the acceptance of the offer because of their common interest,

established in the South African law that the test is one of 'commonalty of right'⁶⁴. In one case however it was said that rights, interests and problems of all those categories of creditors have to be fundamentally the same to all of them; at any rate they must not be so different that they ought to have been divided into separate classes in order to be able to discuss their particular difficulties more effectively.⁶⁵

It has been held that holders of matured life insurance policies form a class distinct from the holders of life insurance policies not yet matured.⁶⁶ Definitely, secured, preferent and concurrent creditors are, in my opinion, creditors of different classes and for them different meetings have to be invariably convened.⁶⁷ The question of whether these classes can be further divided into more classes, depends, as stated, on the dissimilar rights of the people. It was held in a recent British case⁶⁸ that where the claims of some of the concurrent creditors are subordinated, they form a separate class. This decision, therefore, concurs with a decision in South Africa which stated that "...there may be, for example, different classes of concurrent creditors, and,

which may have little to do with their rights; this is undesirable, because it is clearly envisaged that creditors with conflicting interests but similar rights should come together to discuss the acceptance of the offer of compromise. The presence of an interest which does not flow from the creditor's legal rights may have to be examined when dealing with the question..."

⁶⁴ Blackman MS, *Compromises, Arrangements, Reconstructions and Amalgamations*, in *The Law Of South Africa*, Joubert (ed), Vol 4 Part 3 ('Companies'), First Reissue (1996) at 62.

⁶⁵ *Du Preez v Garber* supra at 820.

⁶⁶ *Sovereign Life Assurance Co v Dodd* (1892) 2 QB 573 (CA).

⁶⁷ See however *Ensor NO v South Pine Properties (Pty) Ltd and Another* 1978 (2) SA 755 (N) at 763;

"This particular classification, the most obvious and ordinarily the minimum required, is not however exhaustive in all cases, and a narrower division is sometimes necessary."

⁶⁸ *Re British Commonwealth Holdings plc* 1992 BCLC 322.

although such classes would in effect be merely sub-classes within the main class, they would have to be treated as separate classes and would have to meet separately.⁶⁹ A concurrent creditor with the right of recourse against sureties can certainly not form a separate class.⁷⁰

It was held that an arrangement is 'more than fair' if the shareholders receive the true net asset value of the shares, because normally investment trust companies which are listed on the stock exchange stand between 20 per cent and 25 per cent below the net asset value, and therefore the net asset value is more than the shareholders can obtain elsewhere.⁷¹ The single fact that the scheme is approved by the statutory majority at the meeting is a strong indicator that it is a fair one. This indication is, however, reversed if a substantial proportion of that majority are in a position to gain more from the scheme than other members of the class – by reason of their interests in some other capacity, e. g. where creditors give up something for shareholders and some of the creditors are also shareholders, the interests of those persons as shareholders may be sufficient to obtain a greater benefit in that capacity for them than they sacrifice as creditors.⁷² In this special case, Court has to examine the scheme of arrangement with additional conscientiousness, and if a minority of creditors object, the Court will consider whether or not it is proper to count the votes of the persons with the conflicting interests. This principle is expressed by Lindley M. R. as follows:⁷³

“...the power conferred by it must, like all other powers, be exercised subject to those general principles of law and equity which are applicable to all powers conferred on majorities and enabling them to bind minorities. It must be exercised, not only in the manner required

⁶⁹ *Ex parte Ruskin: in re Peace Distributors (Pty) Ltd* 1959 (2) SA 747 (W) at 749.

⁷⁰ *Ensor NO v South Pine Properties (Pty) Ltd and Another* 1978 (2) SA 755 (N).

⁷¹ *In re Hellenic Trust & General Trust Ltd*, *supra*, at 388.

⁷² *Palmer's Company Law*, Vol II, 1992, 12038.

⁷³ *Allen v Gold Reefs of West Africa Ltd* [1900] 1 Ch 656 at 671.

by law, but also bona fide for the benefit of the company as a whole, and it must not be exceeded. These conditions are always implied, and are seldom, if ever expressed."

2.3.3 Fair and Reasonable as an intelligent man might approve it

A proposer, who applies to the Court for sanctioning a scheme of arrangement or offer of compromise has to be sure that the offer is fair and reasonable as an intelligent man might approve it. Does this mean that a creditor is only allowed to vote as a businessman would vote and for no other reasons? This view has been rejected, it being said, that provided that the member or creditor acts in regard to his interests as a creditor, and not for some improper or ulterior reason he is entitled to vote as he pleases.⁷⁴ This rejection is expressed even better in *ex parte Thruster Manufacturing Industries (Pty) Ltd*. 1983 (4) SA 364 (E) at 376 by Mullins J:

"A creditor's right to vote one way or the other is not fettered by or subject to rules or principles. It is a free and arbitrary decision, which may be influenced in the case of each creditor in one way or the other by tenuous or even irrational factors. The Court in no way interposes its view on the decision of the creditors, save in so far as it must be satisfied, before sanctioning the offer, that it is such that an intelligent and honest businessman might reasonable approve."

However, this statement appears to contradict itself, because if the creditors, who are 'free' in their vote do not vote as honest businessman, then the Court would not sanction the scheme, even if it is approved.

⁷⁴ *Ex parte Utility Shoe Manufacturing Co: in re ABC Store (Pty) Ltd (in liquidation)* 1948 (4) 1 (W) at 5-6; *Ex parte Ruskin: in re Peace Distributors (Pty) Ltd* 1959 (2) SA 747 (W) at 748-749.

Although the term 'reasonable man' is often used in jurisdiction, it is difficult to define what it means. A definition was attempted long ago by Lindley LJ in a leading English case, cited above and this has, infact, been used a number of times⁷⁵:

"(T)he Court has to look at the scheme and see whether it is one as to which persons acting honestly, and viewing the scheme laid before them in the interests of those whom they represent, take a view which can be reasonably taken by businessman. The Court must ... see whether the scheme is a reasonable one or whether there is any reasonable objection to it, or such an objection to it as that any reasonable man might say that he could not approve of it."

Fry LJ went on to say⁷⁶:

"... that the Court ... must be satisfied that the proposal was at least fair and reasonable as that an intelligent and honest man, who is a member of that class, and acting alone in respect of his interest as such a member, might approve of it."

But Bowen LJ added⁷⁷,

"... that the Court should not ... allow an arrangement to be forced on any class of creditors, if the arrangement cannot reasonably be supposed by sensible business people to be for the benefit of the class as such."

Maugham J was of the same opinion, when sanctioning a scheme of arrangement or offer of compromise and held:⁷⁸ "(W)hat I have to see is whether the proposal is such that an intelligent and honest man, a member of

⁷⁵ *In re Alabama, New Orleans, Texas and Pacific Junction Railway Company* [1891] 1 Ch 213 (CA) at 239.

⁷⁶ *Ibid.* at 247.

⁷⁷ *Ibid.* at 243.

⁷⁸ *In re Dorman, Long and Co Ltd* [1934] 1 Ch 635 at 657.

the class concerned and acting in respect of his interests, might reasonably approve." This, however, means that the Court decides what is usually in the best interests of a business man and what a business man would approve. This test, however, fails, in my opinion, because the gap between a business man and a judge is too big, especially in the areas of risk-taking and investment decisions. This is why I agree with Broom J, to the effect that the compromise was not one that business men could reasonably come to:

"As to that, the Court is bound to take into account the fact that the overwhelming majority of creditors accept the compromise, and business men can usually be credited with knowing their best interests."

Lindley LJ expressed a similar view:⁷⁹

"If the creditors are acting on sufficient information and with time to consider what they are about, and are acting honestly, they are, I apprehend, much better judges of what is their commercial advantage than the Court can be. I do not say it is conclusive, because their might be some blot in a scheme which had passed that had been unobserved and which was pointed out later."

This approach has, however, been criticized by Gower⁸⁰ for proclaiming a 'facile but fatal rule'. The author's comment continue thus:

"This dictum, that creditors ... know best, is repeated in almost every case ... and it affords, of course, a perfect answer to any suggestion that the Court should do more than ensure that the formal requirements have been complied with. Unhappily it is based on the fundamentally false assumption that a vote of a meeting necessarily represents the informed opinion of the majority of members of the class concerned, unprejudiced by any conflicting interests."

⁷⁹ In *re English, Scottish and Australian Chartered Bank* [1893] 3 Ch 385 (CA) at 409.

⁸⁰ Gower L. B. C., *Principles of Modern Company Law*, 3rd edition at 641.

In *Ensor NO v South Pine Properties* Didcott J⁸¹ rejected this criticism, supporting Lindley's LJ⁸² view: but nevertheless emphasizing that it is not the Court's only function to apply a rubber-stamp to the creditors' decision once the formal requirements for the sanction of the compromise or arrangement had been met. Linley LJ stated⁸³:

"While therefore I protest that we are not to register their decisions, but to see that they have been properly convened and have been properly consulted, and have considered the matter from a proper point of view, that is with a view to the interests of the class to which they belong and are empowered to bind, the Court ought to be slow to differ from them. It should do so without hesitation if there is anything wrong; but it ought not to do so, in my judgment, unless something is brought to the attention of the Court to show that here has been some material oversight or miscarriage."

This leads us into the most important and most difficult question concerning schemes of arrangements and offers of compromises: What is the Court's function in the section 311 procedure, and how wide is its discretion?

2.3.4 Discretion of the Court

Section 311 (2) of the Companies Act clearly requires a very substantial, almost an overwhelming, majority of each class of creditors in favour of a compromise or arrangement as a prerequisite to its binding all creditors – including expressly dissenting majorities in various classes. It is clear that the

⁸¹ *Ensor NO v South Pine Properties and Another*, supra, at 767.

⁸² *In re English, Scottish and Australian Chartered Bank* [1893] 3 Ch 385 (CA) at 409.

⁸³ *Ibid.* at 409.

Court is bound to have regard to such majorities if attained, and that an overwhelming majority in favour of the proposed compromise is very often regarded as a strong indication that it is reasonable and beneficial to the interests of all classes of creditors. Such an overwhelming majority is, however, not conclusive of the matter and does not necessarily result in the compromise being sanctioned.⁸⁴

The single fact that a scheme of arrangement deprives creditors of rights or is prejudicial in some way to their interests, is not by itself an obstacle to its confirmation, if the statutory majority of such creditors approve it. It lies in the nature of a scheme or compromise that it can never be perfectly satisfactory to all creditors - especially when a company is in liquidation due to being unable to pay its debts.

Before sanctioning a scheme the court must be satisfied that it is in the interest of the company as a whole, and that this is especially so where the scheme involves an expropriation of a member's shares.⁸⁵ This test is twofold, first it assesses whether the resolution in fact benefited the company as a whole, and second whether the majority acted bona fide. The 'company as a whole' refers to 'the corporation as a general body', rather than the company as a corporate entity.⁸⁶

These principles, laid down before, should be regarded as no more than considerations which Courts have found proper to take into account in particular cases, rather than laying down the correct method of approach in all cases.⁸⁷ They are guides to, but not fetters on, the Court's discretion.⁸⁸ Thus

⁸⁴ *Ex parte Venter: in re Rapid Mining Supplies (Pty) Ltd* 1976 (3) SA 267 (O).

⁸⁵ *Ex parte JR Stark & Co (Pty) Ltd* 1983 (3) SA 41 (W).

⁸⁶ *Shuttleworth v Cox Bros & Co (Maidenhead) Ltd* [1927] 2 KB 9 at 26.

⁸⁷ *Mahomed v Kazi's Agencies (Pty) Ltd and Others* 1949 (1) SA 1162 (N) at 1172.

expressed most clearly by Solomon J⁸⁹, when he said that section 103 (2) appeared to him 'to give a complete discretion to the Court in regard to sanction or otherwise.' This makes it clear that the Court does not only sit to 'rubber stamp the scheme, even if it has been passed by the requisite majorities'.⁹⁰ It has to be satisfied that the scheme is one that, on its merits, it ought to be rendered binding on all the creditors concerned – whether or not they attended the meeting. The onus to establish that the scheme ought to be sanctioned is on the applicant seeking sanction.⁹¹

What I have not mentioned yet as a general principle, but is already well-accepted in several decisions by Courts sanctioning a scheme, is that the Court is supposed to look behind the commercial implications of a scheme at the question of whether it is detrimental to commercial morality and to the interests of the general public.⁹² "The Court has to exercise a discretion. It is bound to regard not merely the interests of the creditors. It has a duty with regard to commercial morality in this country."⁹³ Every practitioner knows that by using terms like 'interests of the general public' and 'commercial morality', which are difficult to define, a lot of different situations can be subsumed by Court and therefore this principle would give a very wide discretion to Court.

⁸⁸ *Du Preez and Another v Garber: in re Die Boerebank Bpk* 1963 (1) SA 806 at 823; see also *re Saratoga Investments (Pty) Ltd* [1941] NPD 117 where Selke J has suggested that

"even if these general are correct there must still remain a residuum of unfettered discretion in the Court."

⁸⁹ *Ex parte Judicial Managers Goldfields Building Society* [1934] WLD 45 at 47.

⁹⁰ *In re English, Scottish and Australian Chartered Bank* [1893] 3 Ch 385 (CA) at 409.

⁹¹ *Ex parte Voysey Bond Property Investments Ltd* 1978 (2) SA 134 at 140; Gower L. B. C., *Principles of Modern Company Law* 5ed, 1992, at 696.

⁹² *Ex parte De Villiers NO: in re MSL Publications (Pty) Ltd* 1990 (4) SA 59 at 69.

⁹³ *In re Telescriptor Syndicate Ltd* [1903] 2 Ch 174 at 180-181, cited in *Ensor NO v South Pine Properties (Pty) Ltd and Another* 1978 (2) SA 755 (N) at 770.

Broome J, however, correctly, I believe, restricts that principle and by saying:⁹⁴

"There is no doubt that questions of commercial morality and the interests of the public at large are relevant ... But I do not think that the matter can be put higher than this: that the Court ought not to sanction a compromise where the probable result of such a course will be to allow evil-doers to go unpunished."

The discretion of Court to sanction a scheme is very wide and can even overrule the majority vote of creditors.⁹⁵ What the Court cannot do however is to sanction a scheme which was not approved by the requisite majority.

2.3.5 Conclusion

In order to get a scheme of arrangement or offer of compromise approved by Court several requirements and principles need to be fulfilled. These were gradually built up in different cases through the last century. The most important one is, of course, the compliance with the statutory requirements of section 311 subsection (1) to (8) and section 312. This means that the scheme must be approved by an overwhelming majority⁹⁶ present and voting at the meeting. This requirement includes all the necessary formalities of summoning the meetings and reporting to the court. Court does not, however, insist on absolute meticulous observance of all those terms and therefore reject every scheme which is lacking on one of the formalities. The scheme must be fair, the creditors acted bona fide, and the scheme must be set up that a

⁹⁴ *Mahomed v Kazi's Agencies (Pty) Ltd and Others* 1949 (1) SA 1162 (N) at 1171.

⁹⁵ *In re Dorman Long and Company Ltd* [1934] Ch 635 at 673.

⁹⁶ A majority in number representing three-fourths in value of the creditors or class of creditors; or a majority representing three-fourths of the votes exercisable by the members or class of members (section 311 (2) (a) and (b)).

reasonable man of business would normally approve it. Furthermore the Judges have to consider commercial morality and the public interest as principles to sanction a scheme. However, all these principles are only guidelines for lawyers how to draft a scheme of arrangement in order to make it successful and sanctioned by court. This does not mean, however, that they are fetters to the courts discretion and that they can prevent the courts from rejecting a scheme of arrangement. court's discretion is very wide and definitely seems to be more or less unlimited. The court is not even bound if the scheme is approved by every member or creditor. However if Court is unhappy about a scheme of arrangement there is the tendency to try to find that there has been some flaw in the procedure rather than to exercise the discretionary power.

3. SCHEMES OF ARRANGEMENTS

3.1 Introduction

Schemes of arrangements are used in practice to acquire a company, which is normally under provisional liquidation. The avoidance of a possible dissenting and uncooperative minority of creditors, and the quick and easy procedure together with the often enormous tax benefits⁹⁷ - make this mechanism under section 311 extremely advantageous to the business world.

The initial scheme⁹⁸ which was used in the early 1960's, was a very unsophisticated one. A third party, who was normally a director of a company in provisional liquidation, or under judicial management, would make an offer to all the creditors of the company to purchase all the claims. This would entitle secured and preferred creditors to receive no less than they would in the case of the winding-up of a company, and concurrent creditors to receive a dividend in excess of what they would receive on the winding up. The creditors, therefore, would cede all the claims to the third party for cash. This scheme was used for decades and seemed to work well for all role-players. The proposer could obtain control over a 'clean' company⁹⁹ with its assessed loss, purchase all creditors' claims and, frequently some or all of the company's stock and equipment. The company would be discharged from liquidation and the shareholders would still receive some compensation for their lost shares.

⁹⁷ See Chapter 4.

⁹⁸ See *Friedman v Bond Clothing Manufacturers (Pty) Ltd* 1965 (1) SA 673; compare also with *Investments (Pty) Ltd v Crown Furniture Manufacturers (Pty) Ltd; Ex parte Luck NO: in re Crown Furniture Manufacturers (Pty) Ltd* 1963 (2) SA 271.

⁹⁹ A 'clean' company means that the proposer which takes over the target company need not be concerned that after the take-over a unknown creditor appears, who would throw a complete different light on the acquisition, because section 311 is binding on all creditors

The secured and preferred creditors would get the same amount as on a winding-up procedure but much earlier.¹⁰⁰ The concurrent creditors would also get a dividend¹⁰¹ in excess of what they would have got under a winding-up process. Lawyers could make a lot of money with a simple scheme and judges would merely need to 'rubber-stamp' a standard form of a scheme, thus reducing their workload.

*During ex parte Millman & Others NNO: in Re Multi-Bou (Pty) Ltd & Others*¹⁰² case, the judge stated that a halt was called to this practice, when it was pointed out – at the hearing of one such application – that the scheme did not constitute a compromise between the company and its creditors, for it did not entail any adjustment of rights between them as creditors and debtor, which is the distinctive feature of a compromise.

In order to solve this problem, a new scheme was drafted, which I will describe below and to which I will refer to as 'the standard scheme'.

3.2 'The standard scheme'

The 'standard scheme' was developed in Natal¹⁰³ and has to overcome the problems I just mentioned above. It has been structured in the following manner: There has to be a compromise included in the scheme between the company and its creditors whereby the claims of all creditors are reduced –

¹⁰⁰ Two years is the normally expected time to wind-up a company.

¹⁰¹ Normally between 5-15% more than on a winding-up.

¹⁰² *Ex parte Millman & Others NNO: in Re Multi-Bou (Pty) Ltd & Others* 1987 (4) SA 405 (C), ('Multi-Bou Case') at 409.

¹⁰³ *Ex parte Strydom NO: in Re Central Plumbing Works (Natal) (Pty) Ltd; Ex parte Spendiff NO: in Re Candida Footwear Manufacturing (Pty) Ltd; Ex parte Spendiff NO: in Re Jerseyside (Pty) Ltd* 1988 (1) SA 616 (D) at 618.

usually by one cent to each rand, in order to secure the scheme between the company and its creditors. This would satisfy the judicial requirements of section 311.¹⁰⁴

Selikowitz J describes the structure of the 'standard scheme' as follows:¹⁰⁵

"The 'standard scheme' is essentially one in which the offeror makes a sum of money available to a 'receiver' who is required to distribute it, as a dividend, to the creditors of the company in liquidation. In return for the dividend, the creditors lose all further rights against the company. Their claims, however, persist, and are ceded or are deemed to have been ceded to the offeror who thereby acquires a loan account effectively equal to the company's total existing liability. It is also usual that the claims of the creditors are reduced by a nominal amount (for example one cent in the rand). The last provision was developed in an effort to establish that the scheme was, in fact, one between the company and its creditors - as required by s 311 of the Companies Act - and not merely between the offeror and the creditors. It is also common for the scheme to be made conditional upon the offeror gaining control of the company and the liquidation order being set aside. The effect of the 'standard scheme' is to vest control in the offeror who acquires a 'clean' company, i.e. one without outside creditors. The offeror can then seek to take advantage of any assessed losses in the company and can use his

¹⁰⁴ See *ex parte Millman & Others NNO: in Re Moulty-Bou (Pty) Ltd & Others* 1987 (4) SA 405 (C) at 408-409; Blackman MS, *Compromises, Arrangements, Reconstructions and Amalgamations*, in *The Law Of South Africa*, Joubert (ed), Vol 4 Part 3 ('Companies'), First Reissue (1996) par 63; Henochsberg on the Companies Act, Meskin (ed), 5th edition (1996) (Butterworth Publishers) at 604.

¹⁰⁵ *Namex (Pty) Ltd v Commissioner for Inland Revenue* 1992 (2) SA 761 (C).

loan account to draw income from the company with tangible tax benefits."

This is the general framework of the 'standard scheme', – often dealt with, and sanctioned by, the court. However, Coetzee DJP put an end to this kind of scheme in his judgment [*ex parte Kaplan & Others NNO: in re Robin Consolidated Industries Limited* 1987 (3) SA 413 (W)], also known as the 'Robin Case'.

3.2.1 The 'Robin' Case

The 'Robin' judgment brought a lot of uncertainty into the scheme of arrangement industry. What had happened was that a well-approved and usually sanctioned procedure was suddenly stopped by a Full Bench of the Witwatersrand Local Division. Questions were raised as to what the reason was to stop a so beneficial system for the business world. The Full Bench considered different questions from which the most important ones led to the rejection of the scheme.

The first and most crucial question was, whether the scheme was an arrangement 'between the company and its creditors'. This was the exact point which the lawyers had already considered in order to overcome the difficulties of the 'initial scheme' and they had hoped to find the solution in the reduction of the claims of one cent per rand. Nevertheless, in this case, this scheme was again brought under judicial scrutiny.

The Court held that the central characteristic of an 'arrangement' under section 311 is *plainly contractual* and the contractual parties, as provided by the statute, were, in this case, only two namely: the company and its creditors (regarding the creditors or a class of creditors collectively as one party). It is,

nevertheless, true that it is possible that more than two parties can be validly involved in an arrangement without putting it beyond the pail for that reason. However, even in a tripartite agreement, the agreement could not cease to be one between the two original contracting parties, despite the addition, for other purposes, of the third party. 'But the moment that, on a proper construction of their contract, the third person is the *true party*¹⁰⁶ to the contract to the exclusion of one of the others, it can no longer be said to be a contract between these latter two parties.'¹⁰⁷

Applying this analysis to the scheme in *ex parte Kaplan & Others NNO: in re Robin Consolidated Industries Limited*, it was correctly held that stripping the arrangement of its large numbers of ancillary provisions (required to put it in operation) it was nothing else than a purchase of the creditors claims by the offeror. Thus it was neither a tripartite arrangement nor an arrangement between the company and its creditors, but merely one between the offeror and the creditors. For this reason the Court held that it had no power to order a meeting to consider an arrangement which was not one between the company and its creditors.

What about the reduction of creditors' claims by one cent in the rand? Does it not turn the whole scheme into a valid arrangement between the company and its creditors? The Full Bench considered this question very carefully and finally came to the conclusion, that two parts of any arrangement or compromise need to be distinguished. Thus, its basic content, which can stand alone and be the subject of an order under section 311, and secondly, its administrative element, which are the conditions devised for the effective implementation of the scheme. These conditions are ancillary to its basic content and, on their own, they were meaningless.

¹⁰⁶ Original italics.

¹⁰⁷ *Robin Case supra* at 419.

In *ex parte Kaplan & Others NNO* the totality of the basic content of the standard scheme was the reduction of creditors' claims by one cent in the rand and the further provision that the reduced claims be ceded to a third party for a consideration, had absolutely nothing to do with the implementation of the reduction. The court pointed out that it is for the implementation of the cession and not for the reduction aspect of the scheme that the myriad of ancillary conditions were included in the standard scheme. These, the court held, were clearly divisible from the reduction aspect and constitute an arrangement between the creditors and a stranger rather than the company.¹⁰⁸ This means that the reduction clause is all that is left in the agreement – which is of little interest to anyone and thus the reduction scheme becomes exposed as a useless device which cannot accomplish anything.

The Court also examined the question of the continued insolvency of the company under this type of scheme – an issue which I shall deal with at a later point.¹⁰⁹

The next scheme was hurriedly laid down before the court in order to overcome the defect of the 'Robin judgment'.

3.2.2 The 'Multi-Bou' Case¹¹⁰

The scheme, which, I will refer to as 'the partial cession scheme', was brought before the Cape Provincial Division attempted to give the company an active role, so that it was an arrangement between the company and its

¹⁰⁸ Getz K and Jooste RJ 'Section 311 of the Companies Act: Preserving the Assessed Loss' Revenue Law Jooste (ed.) 56, first published as Acta Juridica (1995), Juta & Co. Ltd. at 59.

¹⁰⁹ See Chapter 4.5.

¹¹⁰ *Ex parte Millman & Others NNO: in Re Multi-Bou (Pty) Ltd & Others* 1987 (4) SA 405 (C), ('Multi-Bou Case').

creditors. The draftsman tried to achieve such an effect by making a so called partial cession of the claims. The creditors would cede 99% of their claims to the offeror or proposer against a cash payment and the remaining 1% would be borrowed by the company on loan account from the proposer, and then distributed to the creditors. Both amounts would be paid to a receiver who would be responsible for the distribution to the creditors, on sanction of the scheme. It is obvious that in this situation, the company's consent to the cessions of the claims is a vital prerequisite, as a partial cession of a claim requires the agreement of the debtor to afford it legal force, effect and validity. The company, therefore, plays an essential role, and the arrangement could be qualified as one between the company and its creditors according to section 311.

The court, however, held that the cession of 99% of the creditors' claims could not be regarded as an isolated transaction distinct from other provisions of the scheme. Under these circumstances, what is actually ceded is the entire balance of the claim of each creditor and not a part of it, and therefore the consent of the company is not required and so the claims can be ceded without its consent.

Berman J, delivering the judgment of the full bench, further rejected the scheme with the following argument: 'It seems to me, however, quite apart from the foregoing, there is another ground upon which the scheme must be found wanting, It was Mr. Brand's submission that the scheme, although on the face of it based upon a partial cession, was in truth and in fact nothing but the standard scheme in another form; it was a sham. a disguised or simulated transaction, structured to bear the appearance and give the impression of an arrangement between the company and its creditors, when in substance it remained an arrangement between the third party and the creditors.'¹¹¹

¹¹¹ *'Multi-Bou at'*, supra, 415.

3.2.3 The 'Natal' Case¹¹²

After the 'standard scheme' was rejected in the Cape Province and in the Transvaal, proposers and companies put the question of the 'standard scheme' in front of a Natal Court in order to find a gap between the different Courts. Although Friedmann J and Wilson J agreed with Coetzee DJP and Berman J that you have to distinguish between the basic content and the ancillary provisions in the 'standard scheme', they raised the question about the difference between the so-called 'deemed' cession instead of an actual cession of the creditors' claims.

The term 'deemed' is often used in legal parlance and it has sometimes been said to be nearly indispensable. Its usual meaning is that expressed by Cave J in his often quoted dictum:¹¹³

"Generally speaking when you talk of a thing being deemed something you do not mean to say that it is that which it is deemed to be. It is rather an admission that it is not what it is deemed to be and that, notwithstanding it is not that particular thing, nevertheless ... it is deemed to be that thing."

In this case the court concluded that there is no difficulty in conceptualizing within the framework of a scheme, a 'deemed cession'. In such a case they would regard as a cession as having taken place even though it had not. The company has to accept a new creditor instead of the old one – as if the old creditor had ceded its claim to the new creditor. "This concept can only be given any legal effect by the actions of the company in recognizing a

¹¹² *Ex parte Strydom NO: in Re Central Plumbing Works (Natal) (Pty) Ltd*, supra, 1988 (1) SA 616 (D).

¹¹³ *R v Norfolk Country Council* 65 LT 222.

state of affairs as existing which does not in fact exist."¹¹⁴ It is true that the word 'arrangement', as used in the section 311, permits the contractual use of a deeming mechanism. This means that the company has to play an active role in the scheme of arrangement. In addition, the scheme is not only notionally and linguistically, but also in its basic content, an arrangement between the company and its creditors and can be brought within the statutory requirements of section 311.

This was, however, rejected in *Namex (edms) Bpk v Kommissaris van Binnelandse Inkomste*¹¹⁵ because 'the Natal approach', as it was stated, was based on a confusion between the results which the acquirer seeks to bring about, and the statutory mechanism intended to give effect thereto. The words 'deemed cession' are used in schemes to indicate the dissenting minority are bound just as if they had agreed. This means that the legislature is understood to have deemed them to have agreed to a compromise or arrangement. There is no doubt that this explanation of how section 311 works is inaccurate; It definitely does not deem the dissenting creditors to have agreed to any arrangement. Furthermore, neither the parties to a contract nor the Court, have the power to deem somebody to have done something. This is only a legislative power. It is, however, unclear what exactly it is that is deemed. Assuming that the company does not undertake to delude itself, what is apparently meant is that the 'deeming' provision vests the company with a power to transfer the claims against it from its creditors to the offeror. If this is so, then the 'deeming' aspect is nothing but an illusion.¹¹⁶

¹¹⁴ *'Multi-Bou'*, supra, 621.

¹¹⁵ *Namex (edms) Bpk v Kommissaris van Binnelandse Inkomste* 1994 (2) SA 265 (A) at 281-282; rejected by two of the judges where as the majority did not deal with this point as cited in Henochsberg on the Companies Act, Meskin (ed), 5th edition (1996) (Butterworth Publishers) at 605; see chapter 3.2.4.

¹¹⁶ Blackman MS, Compromises, Arrangements, Reconstructions and Amalgamations, in *The Law Of South Africa*, Joubert (ed), Vol 4 Part 3 ('Companies'), First Reissue (1996) par 63.

The case in *ex parte Millman & Others NNO: in Re Multi-Bou (Pty) Ltd & Others* was different, in that there was an actual cession. In *ex parte Kaplan & Others NNO: in re Robin Consolidated Industries Limited*¹¹⁷ case, where it had a 'deemed' cession and was nevertheless, disapproved by Court, was rejected on the basis that the Court had emphasized the final effect of the arrangement, namely the acquisition by the offeror of the creditors' claims by the acquirer, but had overlooked the means by which this effect was achieved: namely a 'deemed' cession.¹¹⁸

With respect to this discussion the following view of the Corporate Law Reporter is of note. Disagreeing with the above mentioned case, he states:¹¹⁹

"The very point of s 311, as recognized by the court itself, is that once its provisions have been complied with, the relevant classes of shareholders or creditors are duly bound by an arrangement or compromise, whether or not they wish to be. Accordingly, in our view, once the court sanctions a scheme duly proposed in terms of s 311 an actual cession, by operation of law, takes place."

3.2.4 The 'Namex' Case¹²⁰

In one of the more recent cases concerning schemes of arrangements, the Appellant Division had the opportunity to clarify all open points to give the business world a guide as to how to handle section 311 and to bind the Provincial Courts. However, only two of the five judges involved were of the opinion that 'the standard scheme' could be sanctioned in terms of section 311.

¹¹⁷ 1987 (3) SA 413 (W)

¹¹⁸ *Ex parte Strydom*, supra, 622-623.

¹¹⁹ (1988) 3 Corporate Law Reporter 19.

¹²⁰ *Namex (edms) Bpk v Kommissaris van Binnelandse Inkomste* 1994 (2) SA 265 (A)

The majority did not pass any judgment on the matter.¹²¹ This, however, means that the decision could not bind a full bench of a Provincial Court¹²² and thus, the 'Robin' and the 'Multi-Bou' judgments, which prohibit the 'standard scheme' remain.

The two Judges, which represented the minority in this case, agreed with Coetzee AJP in *ex parte Kaplan & Others NNO: in Re Robin Consolidated Industries Limited* that the reduction of the claims of one cent per rand did not turn the scheme automatically into one between the company and its creditors, but that such a diminution, in fact, involves the company and must thus be considered in the context of other provisions. Nevertheless, the minority held that the reduction of the creditors' claims by a nominal amount became unnecessary for the sanctioning of the 'standard scheme', because the company's apparently passive role could be ascribed to the fact that on provisional liquidation the control over the company rests with the provisional liquidator. The company, however, although it does not appear to do so plays an active role in terms of section 311. Thus a 'standard scheme' is one between the company and its creditors and does not need the diminution. This has a positive impact on the tax situation.¹²³

The argument that a reduction of a nominal amount could be achieved without the company's co-operation was also rejected by the minority in *ex*

¹²¹ See *Namex*, *supra*, 271:

"This was so because the scheme contained a clause which made provision for the setting aside of an agreement concluded between the provisional liquidator of the appellant and another company in terms of which certain assets of appellant were sold to the other company, which clause doubtless required the consent of the appellant and involved it as a necessary and active party to the arrangement."

¹²² See *Fellner v Minister of the Interior* 1954 (4) SA 523.

¹²³ see Chapter 4.

*parte Millman & Others NNO: in Re Multi-Bou (Pty) Ltd & Others.*¹²⁴ Here it was held that the settlement, or partial settlement, of a debt required the co-operation of the debtor and that it appeared that the passage rested on a misinterpretation of the remarks of Coetzee AJP¹²⁵ in *ex parte Kaplan & Others NNO: in Re Robin Consolidated Industries Limited.*¹²⁶

3.3 The preference share scheme

The preference share scheme was proclaimed by Coetzee DJP as the solution to overcome the defects of the 'standard scheme'. While rejecting the 'standard scheme' as an arrangement between the company and a third party rather than with its creditors, Coetzee DJP stated:¹²⁷

"The conversion into capital is the real answer. Conversion really means the creation of new share capital and the issue of shares to the offeror. If any new scheme or variation of the existing one is devised whereby the offeror provides the company with the funds to 'compromise' with its creditors, thus becoming an arrangement *between* the company and its creditors, this should obviously be part of the overall scheme. It could be a condition precedent to the

¹²⁴ *'Multi-Bou'* case, supra, 411 F:

"Nor does the agreement of the creditors to reduce their claims against the company by one cent in the rand in any way involve the company in the transaction between the creditors and the third party, for an instruction to the company to reflect reductions in creditors' claims in its books of account does not constitute an arrangement between the company and its creditors."

¹²⁵ *'Robin'* case, supra, 426 B-C.

¹²⁶ Getz K and Jooste RJ 'Section 311 of the Companies Act: Preserving the Assessed Loss' Revenue Law Jooste (ed.) 56, first published as Acta Juridica (1995), Juta & Co. Ltd at 61-62.

¹²⁷ *'Robin'* case, supra, 427 F-H.

sanctioning of the scheme. The Court will examine such separate contract to determine whether it is a real capitalization".

The salient features of this new scheme and the manner in which it involves the company and its creditors in order to fulfill the statutory requirements of section 311 of the Companies Act will now be examined. The proposer makes a capital sum available to the receiver, who has to distribute the sum on behalf of the company among the creditors, which is again more than they would get a winding-up situation. In consideration of the right of creditors to receive the capital sum, all creditors claims against the company, minus the aggregate amount *would be capitalized* by the company on the basis of creating and allotting and issuing in renounceable form to all creditors, on a pro rata basis, such number of preference shares as will have an aggregate issue value equal to the face value of the reduced claims. All creditors, however, who are entitled to receive such preference shares, shall be deemed to have renounced their entitlement in favour of any person nominated by the company. The company shall be entitled to issue such share to any person determined by the company in its sole discretion. The arrangement will further have the effect that the company will be solvent and that the company will have no more liabilities.

In summary: the actual effect of the arrangement would be the conversion into share capital of the reduced claims of the creditors and the creditors would be deemed to have renounced their entitlement to the issue and allotment of the shares in favour of a nominee appointed by the company.

The crucial point, which had to be decided by Court was whether this scheme of arrangement required the participation of the creditors and the company in terms of section 311 of the Act. *In Sackstein NO v Boltstone (Free*

*State) (Pty) Ltd (in liquidation)*¹²⁸ the Court decided in favour of the scheme. The reason for accepting the scheme to be one between the company and its creditors can be summarized as follows: There can be no doubt that the creditors are involved directly because they have to agree to the conversion of their claims into share capital. Furthermore, they have to renounce their entitlement to the issue and the allotment of the preferent shares to them, in exchange for the receipts of the dividend.

In this case, the Court decided that the company was involved and that it took such an active role in the arrangement that it could be sanctioned. First of all, the company had to pass a resolution consenting to the transfer of the entire share capital to the nominee of the proposer. Secondly, the company had to pass a resolution to capitalize the claims of the creditors on the basis of creation, and to allot redeemable preferent shares. Thirdly, the company itself had to issue the shares. Fourthly, it had to transfer the shares to the nominee of the proposer. Finally, the company had to pay out the capital sum to the creditors through the receiver. Obviously all those acts could only be done by the company itself and therefore the scheme would be one between the company and its creditors.

The scheme design seemed to be a near-perfect fit for the requirements of section 311. It was, nevertheless, criticized in *ex parte Strydom NO: in Re Central Plumbing Works (Natal) (Pty) Ltd*¹²⁹ because of the scheme's doubtful future. Actually the Court held that there was an easy way to recreate the presanction position by the way of reduction of share capital to what it was before. This is, no doubt true, but the argument of the Court in *Sackstein NO v Boltstone (Free State) (Pty) Ltd (in liquidation)*¹³⁰ was, justified, when it

¹²⁸ *Sackstein NO v Boltstone (Free State) (Pty) Ltd (in liquidation)* 1988 (4) SA 556 (O) ('Boltstone Case').

¹²⁹ *Ex parte Strydom NO: in Re Central Plumbing Works (Natal) (Pty) Ltd*, supra, 623 I - 624 B.

¹³⁰ 'Boltstone' case, supra, 560.

mentioned that the issue was not whether the arrangement could be undone in the future, but whether it was a genuine one at the current time.

The 'preference share' scheme has already been approved in a significant number of unreported judgments in the Transvaal and in some unreported judgments in the Cape Province. However, *Sackstein NO v Boltstone (Free State) (Pty) Ltd (in liquidation)* was the first reported one.¹³¹

3.4 The excluded creditors scheme

Although it seemed that the lawyers finally found a solution to overcome the judgments *in ex parte Kaplan & Others NNO: in Re Robin Consolidated Industries Limited* and *ex parte Millman & Others NNO: in Re Moulti-Bou (Pty) Ltd & Others*, it is not yet decided if the preference share scheme also preserves the assessed loss. This question, which I will try to answer in the next Chapter,¹³² was the reason for a new scheme being invented. It was reported in the '*A & G Fashion*' case¹³³.

The 'excluded creditor' scheme, as the name implies, tries to exclude a certain number of creditors, which have, in terms of value, the greatest percentage of claims against the company. This means, for example, that if a company owes its creditors 10 million Rand, of which 8 million Rand are owed to three major banks and the remaining 2 million to 40 other creditors, the proposer tries to negotiate individually with the three banks and makes a scheme of arrangement in terms of section 311 only with the other 40 creditors.

¹³¹ Getz K and Jooste RJ 'Section 311 of the Companies Act: Preserving the Assessed Loss' *supra* at 64.

¹³² See Chapter 4.

¹³³ *Cooper v A & G Fashion (Pty) Ltd; Ex parte Millman NO* 1991 (4) SA 204 (C).

The proposer deals with the excluded creditors by way of a separate agreement of cession between himself and the creditors to which the company is no party. However, in order to reach an agreement with the excluded creditors, they often demand a higher dividend than that paid to the other creditors, because they are aware that it is important for the proposer to get the claims ceded outside the scheme in order to set-off this amount as assessed loss against his income. In practice, it is difficult to persuade the excluded creditors to cede their claims outside the scheme for the same consideration payable to the scheme creditors, unless the excluded creditors have some vested interest in seeing the scheme succeed. In addition, the excluded creditors often insist on ceding and being paid for their claims irrespective of whether the scheme is sanctioned. This, however, is an unacceptable risk for the proposer, who can only make payment conditional upon sanction. However, the real scheme creditors, if they know that the other creditors receive a higher dividend, are often not willing to enter into a scheme of arrangement. Their claims cannot be subject to the set-off because they fall into section 20 (1) (a)(ii) of the Income Tax Act¹³⁴. Furthermore, this scheme is only possible where a small number of creditors have, in terms of value, a great percentage of all the claims, which is not always the case.

The 'excluded creditor' scheme, therefore, is a beneficial but not always possible scheme of arrangement.

¹³⁴ Income Tax Act 58 of 1962; for detailed information see chapter 4.

3.5 The new Cape scheme

Finally, a scheme has been invented which overcomes all the difficulties of the aforesaid schemes and which brings new confidence into the scheme of arrangement industry has been invented. This scheme, which was approved by Stegmann J in the *MSL*¹³⁵ case is a hybrid of the 'standard scheme' and the Natal scheme, and has the following salient features. The company acquires on loan account the 'capital sum' from the proposer. The company proposes a pro rata distribution to the creditors, via the receiver. After the creditors have received their dividends, they have no further claims against the company in respect of the balance of their claims. The creditors are deemed to have ceded the balance of the claims to the proposer, who is deemed to have acquired and purchased all the balance of the claims. Furthermore, the company would insist on the subordination¹³⁶ on the claims acquired by the proposer. In this way it is held that it is the company itself – via the receiver – which pays the dividend to the creditors and that such payment does not constitute the purchase price paid by the proposer in acquiring the claims. Thus the new Cape scheme is a scheme between the company and its creditors. The company plays an important role and has material interest in the scheme, because enforceable rights and obligations flow from the totality of the scheme as between the company and its creditors. The fact that a third party is also involved in the scheme is not a problem. The courts¹³⁷ have accepted several times that a third party can be involved, as long as it does not exclude one of the main parties (company or creditors) from the scheme. The company is not merely

¹³⁵ *Ex parte De Villiers NO: in re MSL Publications (Pty) Ltd* 1990 (4) SA 59 (W); the *MSL* case was in material respects similar to the new Cape scheme.

¹³⁶ See Chapter 4.5.

¹³⁷ *Ex parte Kaplan & Others NNO: in Re Robin Consolidated Industries Limited* 1987 (3) SA 413 (W) at 419; *Ex parte Millman & Others NNO: in Re Multi-Bou (Pty) Ltd & Others* 1987 (4) SA 405 (C) at 411.

used as conduit; it is plainly involved in the payments to its creditors. It is accepted that a simple part-payment of a debt would not constitute a compromise or arrangement.

"However the scheme involves much more than part-payment of a debt. The company, when paying a portion of its debts could not ordinarily attach conditions to the payment. In the new Cape scheme, by contrast, the creditors, in order to receive the part-payment are required to accept the deemed cession of the balance of their claims to the proposer. The company, by undertaking to pay its creditors a portion of their claims and by recognizing the proposer as its new creditor, becomes a party to the arrangement."¹³⁸

3.6 Conclusion

Section 311 gives the possibility of modifying rights without the need for unanimity. In essence, section 311 provides the effective machinery to overcome the difficulties of negotiating individually with every creditor or member, where the individual agreement of all of them is necessary for a proposal, which is binding on the company and on them. Especially up to 1987, this section was often used to take-over a 'clean'¹³⁹ company with an essential amount of assessed loss. The famous '*Robin*' Case, however, seemed to put the take-overs under section 311 to an end. The lawyers found different ways to get around but nevertheless the number of schemes of arrangements under section 311 reduced dramatically not least because the schemes got more and more expensive through the additional work which was necessary to get them approved.

¹³⁸ Getz K and Jooste RJ 'Section 311 of the Companies Act: Preserving the Assessed Loss' *supra* at 75.

¹³⁹ See fn 101.

4. PRESERVING THE ASSESSED LOSS

4.1 Introduction

In most cases, the impetus behind acquiring a company which is in financial difficulties, or already insolvent, is the fact that the company has a sizable assessed loss, which can obviously be used for tax purposes if the company's financial difficulties can be alleviated.

What is this 'assessed loss' and how can it be used by the acquiror of the company? Section 20 (1) (a)¹⁴⁰ of the Income Tax Act¹⁴¹ gives every person the possibility to gain a benefit from the assessed loss¹⁴², namely,

"For the purpose of determining the taxable income derived by any person from carrying on any trade within the Republic, there shall be set off against the income so derived by such person-

(a) any balance of assessed loss incurred by the taxpayer in any previous year which has been carried forward from the preceding year of assessment : Provided that-

(i) no person whose estate has been voluntarily or compulsorily sequestrated shall, unless the order of sequestration has been set

¹⁴⁰ Except where otherwise stated, effective in this form the date of promulgation of the Income Tax Act 94 of 1983: 13 July 1983.

¹⁴¹ Income Tax Act No 58 of 1962, as amended up to and including Act 46 of 1996, further referred to as the Act.

¹⁴² The assessed loss is defined in the Income Tax Act under section 20 (2) as:

"For the purpose of this section 'assessed loss' means any amount by which the deductions admissible under section 11 to 19, inclusive, exceeded the income in respect of which they are so admissible, or, if the context so requires, means an assessed loss as determined under the provision of section 30."

aside, be entitled to carry forward any assessed loss incurred prior to the date of sequestration;...."

A taxpayer pays tax on his 'taxable income', which is defined under section 1 of the Income Tax Act, as 'gross income (other than exempt income) minus allowable deductions'. To determine a taxpayer's taxable income, the general rule is that the tax system operates on a synthetic, rather than on a schedular basis. In other words, 'gross income'¹⁴³ is a single, aggregate amount which includes income from all trades carried out. The taxpayer's allowable deductions are, likewise, a single amount comprising his aggregate deductions. The only exception to this principle is in respect of the deduction which the Act has expressly 'ring-fenced' such that they can be set off only against income from the trade to which they relate, and any loss in that trade cannot be set off against the taxpayer's other income from other trades.¹⁴⁴

If, therefore, in any year of assessment, a taxpayer's allowable deductions exceed his gross income, then for that year he has an assessed loss. There are two possible consequences for the income tax during this year of assessment: first, he has no taxable income and therefore he is not liable for income tax; secondly, the assessed loss of that year may be carried forward to the following year of assessment and be set off against the gross income of that year.¹⁴⁵

¹⁴³ Also defined under section 1 of the Act:

"'gross income', in relation to any year of period of assessment, means, in the case of any person, the total amount, in cash or otherwise, received by or accrued to or in favour of such person during such year of assessment from a source within or deemed to be within the Republic, excluding receipts or accruals of a capital nature, but including, without in any way limiting the scope of this definition, such amounts (whether of a capital nature or not) so received or accrued as are described hereunder, namely-..."

¹⁴⁴ Williams RC, *Income Tax in South Africa*, § 30, 300-301.

¹⁴⁵ *Ibid* at § 30, 301.

The expression 'balance of assessed loss' refers to the aggregation of the portions of any assessed loss incurred in the carrying on of trade exceeding the taxable income derived from the carrying on of trade and any other taxable income.¹⁴⁶

An important effect of section 20 (1) (a) is that a taxpayer¹⁴⁷ who in any year of assessment does not carry on a trade¹⁴⁸ is not allowed to carry forward to that year, any balance of assessed loss established in the immediate preceding year of assessment.¹⁴⁹ However it is not essential that a company carries on a trade during the whole of the year, but that any period of trading during the year is sufficient to achieve the requirement. Whether a taxpayer must actually earn income from the trade carried on, in order to be entitled to carry forward the previous year's assessed loss, is not clear, however in *ITC 664 (1948) 16 SATC 125* it was held, that it is necessary that the taxpayer derives income from the carrying on of a trade.¹⁵⁰ In a recent Appellate Division

¹⁴⁶ *CIR v Louis Zinn Organisation (Pty) Ltd* 1958 (4) SA 477 (A); for example if in year 1 there is an assessed loss from trading of R 55 000 and in year 2 a taxable income of R 35 000 the balance of assessed loss in year 1 is R 55 000 and in year 2 R 20 000. If in year 3 there is an assessed loss of R 65 000, the balance of assessed loss in that year is R 85 000.

¹⁴⁷ This decision has been overturned in relation to persons other than companies by section 20 (2A), it remains however valid for companies.

¹⁴⁸ Inland Revenue insists that a company actually carries on trading activities, and does not accept that the mere receipt of interests and dividends constitutes the carrying on of a trade. Nor does it accept that it will suffice if there is an intention to earn income from the carrying on of a trade. Silke on South African Income Tax, § 8.127, 8-339.

¹⁴⁹ *SA Bazaars (Pty) Ltd v CIR* 1952 (4) SA 505 (A); in *New Urban Properties Ltd v SIR* 1966 (1) SA 219 (A) this logic was taken one step further and it was held by Appellate Division that in such a situation there is no 'balance of assessed loss' to be carried forward into the following year.

¹⁵⁰ Silke on South African Income Tax, § 8.127, 8-338.

case¹⁵¹ the court held, that as a general rule profit was an essential element of the trade. The court did, however, accept that non profit activities could constitute the carrying on of a trade, if they were conducted on the grounds of commercial expediency or indirect facilitation of the trade. In this context Corbett JA concluded:

"Generally, unless the facts speak for themselves, this will call for an explanation from the taxpayer"

Therefore, it seems to be clear that as a general rule, 'trade' requires a profit motive. It is, however, evident that there may be other factors which override the profit requirement and that in such cases the taxpayer will have to give an explanation.¹⁵²

The assessed loss of a company is, paradoxically, a very valuable asset. If a company starts the current year tax year with an assessed loss of R 10 000 brought forward from a previous year, this means according to section 20 of the Act; that the company will incur no income tax liability on the first R 10 000 of what would otherwise have been 'taxable income' that it derives in the current year. The reason being that the loss carried forward will be set-off against the income of the current year. Therefore, with a corporate tax of 35%,¹⁵³ the company would save R 3 500 on income tax.

Where the taxpayer is a company, an assessed loss could easily be manipulated to gain a tax advantage. A wealthy company, for example, could buy shares in a company with an assessed loss. The former company could then divert some of its income into the latter company. The income which would

¹⁵¹ *De Beers Holdings (Pty) Ltd v CIR* 1986 (1) SA 8 (A), 47 SATC 229, 1986 Taxpayer 8.

¹⁵² Haxham and Haupt, Notes on South African Income Tax, 238.

¹⁵³ Current corporate tax is 35 c in respect of each Rand of taxable income; Meyerowitz on Income Tax, 16.

have borne tax in the wealthy company's hand will not attract income tax in the hands of the company with the assessed loss. The diverted income will only reduce the assessed loss of the company. Alternatively, the two companies could enter into an agreement to divert a profit-making opportunity to the company with the assessed loss and divide the resultant tax savings between them.¹⁵⁴

4.2 Section 20 (1) (a) (ii) of the Income Tax Act

The same scheme of gaining a tax advantage is the ratio behind most of the take-overs concerning companies usually already under provisional liquidation, has been used in the last years. As mentioned, the creditors of a company under provisional liquidation are very likely to accept an offer of reduced pay-out of their claims, because the pay-out would still be more than they would get under a liquidation, which would normally also take a lot of time and the high inflation (about 9% currently) would reduce their claims even more after liquidation.

The big problem, however, lies in section 20 (1) (a) (ii) of the Income Tax Act:

(ii) the balance of assessed loss shall be reduced by the amount or value of any benefit received by or accruing to a person resulting from a concession granted by or a compromise made with his creditors whereby his liability to them have been reduced or extinguished, provided such liabilities arose in the ordinary course of trade;

¹⁵⁴ Williams RC, *Income Tax in South Africa*, § 30, 301.

Such a benefit cannot be included in the taxpayer's gross income, but must be applied to reduce a balance of assessed loss. If the value of the benefit exceeds the assessed loss, the excess is not taxable.¹⁵⁵

This provision has in practice raised three major questions:

- must the compromise be made with *all* creditors?
- *which balance* of assessed loss must be reduced?
- what is meant by liabilities that arose in the ordinary course of trade?

The first problem was answered in *Blue Moon Investment (Pvt) Ltd v COT*¹⁵⁶, namely, that section 20 (1) (a) (ii) applies only when a compromise is made with the general body of creditors and not merely with one or a few of the creditors. It was argued that the legislature, by using the words 'made with his creditors', envisaged that before the provision could operate a concession should be granted or the compromise made with the whole body of creditors, and not just a few of them. Furthermore, if the legislature intended the provision to operate when the concession was granted or the compromise made with only some of the creditors, it would have used the words 'made with any of his

¹⁵⁵ Example: The assessed loss in year 1 is R 200 000, and during that year trade creditors whose claims amount to R 400 000 have agreed to accept R 0.80 in the rand in full settlement, the value of the benefit being R 80 000 (20 cents in the rand on R 400 000), the assessed loss must be reduced by R 80 000, so that the assessed loss to be carried forward to year 2 is R 120 000 (R 200 000 less R 80 000). If the creditors had compromised for R 0.375 in the rand, the value of the benefit would have been R 250 000 (R 0.625 in the rand on R 400 000), which would have meant that the assessed loss of R 200 000 would have been wholly extinguished and there would have been nothing to carry forward to year 2. The balance of the benefit not applied to reduce the assessed loss, that is, R 50 000, it is submitted, cannot be included in taxable income.

¹⁵⁶ *Blue Moon Investment (Pvt) Ltd v COT* 1966 (4) SA 205 RAD, 28 SATC 173, 1966 Taxpayer 230.

creditors.¹⁵⁷ This, however, conflicts with the view of the Inland Revenue, which accepts, in practice that section 20 (1) (a) (ii) applies, not only when a debtor makes an arrangement with all his creditors as a body, to release him wholly or partially from his debts, but also when a creditor, on his own initiative, releases a debtor from either the whole or a portion of a debt – for example, when a parent company releases its subsidiary company or when a debtor makes a compromise with only some of his creditors.¹⁵⁸

The provision of section 20 (1) (a) (ii) is designed to reduce the balance of assessed loss, which should be carried forward and not the amount that was brought forward from the preceding year. It was rejected by court¹⁵⁹, that it is the balance of assessed loss incurred by the taxpayer in a previous year that has been carried forward from the preceding year which has to be reduced to the extent of the compromise benefit enjoyed in the current year, and that the provision does not apply to the assessed loss incurred in the year in which the compromise arose.¹⁶⁰

As long as there is a link between the liability and the trading activities, the liability has arisen in the ordinary course of trade, whether it is of a capital or a revenue nature. Therefore a liability which arises in consequence of the

¹⁵⁷ Silke on South African Income Tax, § 8.129, 8-342.

¹⁵⁸ Ibid., § 8.129, 8-341; see Meyerowitz and Spiro on Income Tax, 862, which argue that the section refers to creditors and liabilities in the plural and while the Interpretation Act states that the plural imports the singular, it is always subject to the context.

¹⁵⁹ *CIR v Louis Zinn Organisation (Pty) Ltd* 1958 (4) SA 477 (a), 1958 Taxpayer 208.

¹⁶⁰ Example: The assessed loss of a company of R 200 000 at the end of year 1 and a trading income of R 240 000 for the year 2 and a compromise of R 80 000 in year 2, the taxable income for year 2 would be determined at R 40 000 (R 240 000 less R 200 000). The benefit does not reduce the assessed loss because the assessed loss and the compromise did not happen in the same year of assessment. If the assessed loss in year 1 were R 360 000 the balance of assessed carried forward to year 3 would be R 40 000 (R 360 000 less R 240 000 less R 80 000).

acquisition of a plant and machinery, is a liability which has risen in the ordinary course of trade.¹⁶¹

The section emphasises, that if an acquiror wants to take over a company and wishes to preserve the assessed loss, which the company might enjoy for tax purposes, value of any concession or compromise with the company's creditors should be kept to an absolute minimum. The assessed loss will be reduced to the extent of the compromise or concession, which will obviously reduce the appeal of the acquisition. A solution to this dilemma may be found by avoiding any compromise or concession and so avoiding the applicability of section 20 (1) (a) (ii).

One possible solution could be a buy-out of the creditor's claims by the acquiror. The creditors cede their claims to the acquiror in return for the agreed amount. The company receives no concession, no compromise is reached between the company and his creditors and the company's liabilities are not reduced or extinguished. Accordingly section 20 (1) (a) (ii) would have no application. The company has a new creditor who is substituted for its previous creditors.¹⁶²

If the matter was this simple, there would be no need for further discussion, however, it is more complex, because by taking over a company there might be an uncertainty of who the creditors are and what amount they owe to the company. If the books of the target company are not well prepared, the acquiror would not be prepared to risk a take over of the company. Therefore, as outlined in the preceding Chapters, an acquiror seeks the

¹⁶¹ Haxham and Haupt, Notes on South African Income Tax, 240.

¹⁶² Getz K and Jooste RJ 'Section 311 of the Companies Act: Preserving the Assessed Loss', 56.

protection of section 311 of the Companies Act to bind all creditors to the proposed arrangement.

The central problem is: Section 311 can only be used and therefore can only give protection to an acquiror, if there is some form of compromise, between the company and its creditors.¹⁶³ That is however when the balance of assessed loss has to be reduced according to section 20 (1) (a) (ii) of the Income Tax Act. To overcome these difficulties and to reduce the compromise to an absolute minimum, practitioners invented a scheme - the standard scheme¹⁶⁴ - which involves a nominal compromise (normally one cent in the rand) by the creditors and the cession of the balance of their claims to the third party. This has the effect that the scheme may be sanctioned by the Court under section 311 of the Companies Act and the assessed loss of the company is reduced only marginally.¹⁶⁵

Court however suddenly refused to sanction this type of scheme¹⁶⁶ and the development of the different schemes will be described in the next Chapter.

4.3 The different schemes

For the purpose of understanding the problem of tax of the assessed loss, what follows is a brief overview of each of the schemes concerned in terms of how they relate to the issue of taxation of assessed loss.

¹⁶³ See fn 2.

¹⁶⁴ See chapter 3.2.

¹⁶⁵ Haxham and Haupt, Notes on South African Income Tax, 241.

¹⁶⁶ *Ex parte Kaplan & Others NNO: in Re Robin Consolidated Industries Limited* 1987 (3) SA 413 (W), ('Robin Case').

4.3.1 The partial-cession scheme¹⁶⁷

The question of the assessed loss under this type of scheme is only an academic one because, like the 'standard scheme', it was also rejected by court. Nevertheless, the cession of 99% of the creditor's claims direct to the acquiror against payment of a stipulated amount, would not be considered as a compromise made with the company within the meaning of section 20 (1) (a) (ii) and would therefore preserve the assessed loss for the full amount of the 99%. The remaining 1% of the creditor's claims would be paid to the creditors by the company, which borrows the necessary amount from the acquiror. Although both amounts are distributed by the receiver to the creditors and the whole amount is (actually) paid by the acquiror, the remaining 1% is, in my view, a compromise between the company and its creditors (at least according to section 20 (1) (a) (ii) of the Income Tax Act) and would therefore reduce the assessed loss. *Berman J* held that it was no compromise under section 311 of the Companies Act and therefore refused to sanction the whole scheme.

4.3.2 The preference share scheme

The preference share scheme¹⁶⁸ is of the utmost importance concerning income tax because, first of all, it was accepted by court to be one between the company and its creditors according to section 311 of the Companies Act and, furthermore, it was not yet decided by the court whether this scheme could preserve the assessed loss pursuant to the provisions of section 20 (1) (a) (ii) of the Income Tax Act.

¹⁶⁷ See chapter 3.2.2.

¹⁶⁸ See chapter 3.3.

Before I focus on the tax question let me shortly bring back to our mind the salient features of the preference share scheme are the following: a third party agrees to pay a capital sum to the creditors in return for their agreeing to capitalize portion of their claims in return for renounceable preference shares. Prior to the allotment of the redeemable preference shares the creditors are to be deemed to have renounced their entitlement to the shares in favour of a person nominated by the company (the third party). The third party thereafter becomes the sole member of the company.¹⁶⁹

Turning now to the tax problem of preserving the assessed loss, the question has been raised whether there can be said to be any benefit received by or accrued to the company resulting from a concession made by or a compromise made with its creditors whereby its liabilities to them have been reduced or extinguished. Certainly, one effect of this scheme is to extinguish the company's liability concerned to its creditors. Therefore, a benefit does accrue to the company because, prior to the arrangement, the company owes certain debts to its creditors. After sanctioning of the scheme the debts fall away because they have been capitalized and therefore, in a legal sense, are no longer due. However, in my view, this does not result from a compromise made with its creditors. The creditors receive, in respect of their liabilities, part of the amount in cash and the balance by way of preference shares. This amount does not result from a compromise between the company and its creditors but results from the renunciation of their rights to the allotment of the redeemable preference shares.¹⁷⁰ Therefore, no compromise has been entered into.

Section 20 not only applies to a compromise, but also to a concession granted by the creditors. What arguments can be raised to bring this scheme

¹⁶⁹ Haxham and Haupt, Notes on South African Income Tax, 241.

¹⁷⁰ Finance Week 27/8 - 2/9 1987.

within the area of section 20 of the Income Tax Act? It is argued that the legal position of creditors is stronger than that of preference shareholders, because on the liquidation of a company creditors are ranked prior to preference shareholders. Thus there is a strong argument to the effect that at least a small concession is granted to the company. However, I do not see how it is possible for the Commissioner for Inland Revenue to determine a reasonable amount which should reduce the balance of assessed loss. What is the value of being ranked prior or later? A benefit has an amount or a value if it has money's worth or can be turned into money. To be an 'amount' something must have an ascertainable money value.¹⁷¹ Obviously, the same criterion applies in determining the 'value' of a benefit. A benefit has a money value to the extent that it compensates the recipient or saves it from expenditure or can be realised for money.¹⁷² More recently in *Commissioner for Inland Revenue v People's Stores (Walvis Bay) (Pty.) Ltd.*¹⁷³ Hefer JA said:

"It must be emphasised that income in a form other than money must, in order to qualify for inclusion in the 'gross income' be of such a nature that a value can be attached to it in money. As Wessel CJ said in *Delfos* case at page 251¹⁷⁴,

The tax is to be assessed in money on all receipts or accruals having a money value. If it is something which is not in money's worth or cannot be turned into money, it is not to be regarded as income.

On the other hand, the fact that the valuation may sometimes be a matter of considerable complexity does not detract from the principle that all income having a money value must be included. How the

¹⁷¹ *Commissioner for Inland Revenue v Butcher Bros (Pty.) Ltd.* 1945 AD 301 at pp 318-321.

¹⁷² *ITC 1613*, (1996) 59 SATC 187, at 195

¹⁷³ 1990 (2) SA 353 (A), 52 SATC 9

¹⁷⁴ 1933 AD 242, 6 SATC 92

valuation is to be done depends, of course, entirely on the nature of the income and the circumstances of the case."¹⁷⁵

In other provisions of the Act there are prescribed methods for determining amounts or values – see, for example, paras 5 (e) and (i) of 'gross income' in section 1. However, no such guidelines are given for the application of section 20 (1) (a) (ii).¹⁷⁶ The *onus* of proving that an ascertainable money value rests on the Commissioner and not on the taxpayer in terms of section 82 of the Income Tax Act.¹⁷⁷ If the Commissioner, therefore, cannot determine a money value, the assessed loss cannot be reduced because the taxpayer received no benefit.

The other question which has to be examined is the *quid pro quo* to which the creditors become entitled in settlement of their claims. The preference shares, which have to be issued at par value, are not necessarily worth that value. Although the restructuring of a company, which may follow a scheme of the nature described, may actually mean that the preference shares are worth their par value. In many cases it is unlikely that those preference shares could be redeemed immediately following the transaction at anything close to their par value¹⁷⁸. The amount which the creditors receive is therefore inadequate and that is why a concession has been granted.

The decision of the Australian High Court in *Grant v Federal Commissioner of Taxation*¹⁷⁹ has furnished us with some guidelines for

¹⁷⁵ See fn 174 at 21-2; compare also See also *Mooi v Secretary for Inland Revenue* 34 SATC 1, 1972 Taxpayer 69, 1972 (2) SA 675 (A) at 683 A-F; *Lace Proprietary Mines Ltd. v CIR* 9 SATC 349, 1938 AD 267 at 279-281.

¹⁷⁶ *ITC 1613*, (1996) 59 SATC 187, at 195.

¹⁷⁷ *CIR v Butcher Bros (Pty.) Ltd.* 1945 AD 301 at 319, 13 SATC 21

¹⁷⁸ Getz K and Jooste RJ 'Section 311 of the Companies Act: Preserving the Assessed Loss', 66.

¹⁷⁹ *Grant v Federal Commissioner of Taxation* (1976) 7 Australian Tax Report 1.

answering of our problem. In this case, the taxpayer paid \$ 97 000 for the allotment of 97 000 preference shares with a par value of 1 dollar each. The court valued these shares at an amount of \$ 39 770. The court held that the taxpayer's quid pro quo for the \$ 97 000 spent, namely the 97 000 shares, had to be valued with reference to the market value, which was \$ 39 770 notwithstanding the fact that in terms of company law it was not possible to pay less than \$ 97 000 for the allotment of 97 000 one dollar par value preference shares. The taxpayer was therefore held liable for gift duty. However this was not an unanimous judgment. The minority judge, Jacobs J, held that, as the lawful minimum had been paid for the preference shares, the allotment received was a full consideration for the money paid and therefore there was no liability for gift duty.

In an article in the journal 'the Taxpayer'¹⁸⁰, there is an analysis to the analogous question whether a concession or compromise has been granted or made where creditors receive par value preference shares for the face value of their claims. On one hand, if the shares to which the former creditors become entitled (notwithstanding that in the present context this entitlement is renounced in favour of a third party), have a market value of less than the amount of the claims, then a concession by the creditors would seem to have been granted. On the other hand a South African court may side with the approach of Jacobs J that, since the lawful minimum has been paid for par value preference shares, no concession or compromise can be said to be present. Nevertheless, the journal inclines more towards the majority view in *Grant v Federal Commissioner of Taxation*¹⁸¹ that the market value of the shares ought to prevail over the par value.

¹⁸⁰ The Taxpayer, Vol 38 (2) February 1989.

¹⁸¹ See fn 33.

There is a South Africa case which supports this view, although the circumstances in that case were different. The court¹⁸² held that the taxpayer had received 1 000 000 shares as consideration and that the shares had to be valued according to their market value. At page 280 Stratford CJ said:

"No cash consideration could be demanded from the purchaser who was entitled and obliged to deliver these shares in fulfillment of its obligation to pay for the assets bought. Thus the consideration must be valued and such valuation cannot be affected by the reference to £ 250 000 or to the nominal value of the shares. These two questions must be answered in favour of the respondent....

[281] The value of the shares on 29 November must, of course, be ascertained by enquiring what price could have been obtained for them, by adopting some reasonable method of sale on that date. To throw the whole 1 000 000 shares on the Johannesburg market on a given date would obviously be the worst possible way of gauging their value."

Nevertheless there are good arguments which can be advanced in favour of the preference share scheme rendering the provisions of section 20 (1) (a) (ii) wholly or partially inoperative:¹⁸³

(a) No benefit has in fact been received or accrued to the company, because the liability to pay back a debt of a certain amount has been replaced with the liability to redeem the preference shares at a value equal to the amount of the debt. Therefore, although the form of the liability has changed, the amount thereof is the same as before, and

¹⁸² In *Lace Proprietary Mines Ltd v Commissioner for Inland Revenue*, 1938 AD 267, 9 SATC 349.

¹⁸³ Getz K and Jooste RJ 'Section 311 of the Companies Act: Preserving the Assessed Loss', 67-69.

accordingly the company has not received a benefit from the scheme sufficient to reduce the assessed loss.

(b) According to the section 98 of the Companies Act, preference shares can be issued which may be redeemed either unconditionally or at the option of the company. According to subsection (1) (a) these shares can only be redeemed "out of profits of the company which would otherwise be available for dividends or out of the proceeds of a fresh issue of shares made for the purpose of the redemption." This is an exception to the general rule that a company cannot issue shares on terms that it shall or may redeem them at an agreed future date, since such redemption would amount to a purchase by the company of its own shares, which is illegal. Therefore it is arguable, as Getz and Jooste¹⁸⁴ point out, that in substance, if not in form, a redeemable preference share is analogous to an obligation to repay a debt in that a company has either an actual or a contingent obligation to repay to the holders of the shares the issue price thereof.

(c) Furthermore, the true market value of a creditor's claim as at the date of liquidation is generally significantly less than its face value. Assuming that the company, on sanction, has no creditors and that the redeemable preference shareholders are entitled, on winding up, to the repayment of the issue price of their shares in preference to other classes of shareholders, it is submitted that in most cases, if not all, the true market value of the redeemable preference shares as at the date of sanction is unlikely to be less than the true market value of the creditor's claim immediately prior to the compromise. Accordingly, the former creditors of the company, based on a

¹⁸⁴ Getz K and Jooste RJ, *supra*, 68.

calculation of the true value of their claims immediately prior to the compromise, have not accepted anything less in value, by their acceptance of the redeemable preference shares appropriately valued as to their true market value as at the date of sanction.¹⁸⁵

The most recent case on this tax issue was decided in favour of the taxpayer, because the CIR could not determine a reasonable money value for the benefit.

"I find it impossible, on what has been submitted to us, to quantify the benefit in monetary terms. The value of the benefit is not the whole face value or amount of the previously existing claims, having regard to the nature of redeemable preference share capital and other factors which require examination. In my opinion, without a prescribed formula or a deeming provision in the Income Tax Act, it is not possible to ascribe a monetary value to the benefit."¹⁸⁶

Therefore it seems that the preference share scheme is at the moment a recommendable scheme of arrangement in order to preserve the assessed loss.

¹⁸⁵ *Ibid.*, 69.

¹⁸⁶ *ITC 1613*, (1996) 59 SATC 187, at 196

4.4 The new development

4.4.1 The new Cape scheme

As shown in Chapter 3, the new Cape scheme was finally sanctioned by court¹⁸⁷ in 1990, being an arrangement between the company and its creditors under section 311 of the Companies Act.

What now needs to be examined is the question of whether, under this scheme, the assessed loss of the target company has to be reduced because of a concession granted or compromise made with its creditors. One of the salient features of this scheme is that the company pays the creditors the dividend with the capital sum borrowed from the proposer. However, the liability of the company remains unchanged because now the company owes the same amount (of the dividend) to the proposer. Furthermore, as mentioned, a part-payment of a debt does not constitute a compromise or arrangement as such.

The rest of the balance of the creditors claims is deemed to have been ceded to the proposer and the proposer is deemed to have purchased and acquired this balance. This means, that it is merely the person, who has the claims that has changed, but that the company's liability still remains intact. This is why the question of subordination and insolvency arose. The balance of claims is, as in other schemes, also subordinated, which is as I will show later¹⁸⁸ no reason for applying section 20 (1) (a) (ii) of the Income Tax Act. Thus, no benefit is granted or concession made to the company by its creditors

¹⁸⁷ *Ex parte De Villiers NO: in re MSL Publications (Pty) Ltd* 1990 (4) SA 59 (W) and also similar cases in Australia *re Mascot Home Furnishers (Pty) Ltd* (1970) V R 593 and *re Buildmat (Australia) Ltd* (1983) 1 ACLC 919.

¹⁸⁸ See chapter 4.5.

and the assessed loss can be fully used to set-off against the proposer's income.

4.4.2 The Debenture Scheme

The debenture scheme, also already successfully approved in the Cape Province¹⁸⁹, is one which is similar to the preference share scheme, but with the difference that the company issues debentures.

Again, a capital sum is lent to the company by the proposer, which is distributed via the receiver to the creditors as a dividend in respect of their claims. In order to receive the dividend, the creditors agree that their claims, reduced by the amount of the dividend, are converted into unsecured, subordinated debentures at the face value of the claims less the dividend. Furthermore, the creditors are deemed to have renounced their entitlement to the issue of the debentures in favour of the proposer. The rights of the creditors are limited to the right to receive the dividend, whereafter no creditor has any claim against the company. The debentures themselves are subject to a special debenture trust deed and are normally non-interest bearing and unsecured. This scheme clearly involves the company in terms of section 311 of the Companies Act, because the company has to create and issue the debentures, and has to pay the 'capital sum' to the creditors. The creditors - as in the preference share scheme - are parties of the arrangement because they have to agree to the conversion of their claims into debentures.

The debenture scheme is tax effective from the point of view of preserving any assessed loss of the company. It seems to be more effective than the preference share scheme, because there are no problems of valuating

¹⁸⁹ *Michael Meaker NO: in re Prime Brick (Pty) Ltd (in liquidation)* No 9022/93, unreported.

shares. Debentures can be issued at any amount, and therefore they can be issued at the exact amount of the creditors claims less the paid dividend. Therefore the form but not the amount of the liability changes, and consequently there is no concession granted or compromise made to the company by its creditors, which could reduce the assessed loss according to section 20 (1) (a) (ii) of the Income Tax Act. Furthermore, a creditor and a debenture holder have the same legal position in a liquidation so that even from this point of view no concession is granted by the creditors to the company.

4.5 Subordination and Insolvency

The problem of subordination agreements of creditors claims to solve the problem of insolvency of a company, was first raised *in ex parte Kaplan & Others NNO: in Re Robin Consolidated Industries Limited* by Coetzee DJP.¹⁹⁰ The main concern of the court was that in the 'standard scheme' the company's liabilities remained intact and "it merely substitutes one creditor for the previous creditors and it is as insolvent as when it was liquidated. When discharging the winding-up order, the court now sends back into the business world the same hopeless insolvent company to trade and incur debts as before."¹⁹¹ The court found that this is not illegal *per se*, but it has a great potential for harm to the public and future creditors. All the debts are consolidated in the hand of the acquiror of the company, which enables him to play a major role in any division of the assets in a future winding-up. The new creditor who has supplied goods, may find the great bulk of those goods being used to pay the main claim-owner.¹⁹²

¹⁹⁰ *Ex parte Kaplan & Others NNO: in Re Robin Consolidated Industries Limited* 1987 (3) SA 413 (W).

¹⁹¹ *Ibid.*, 426.

¹⁹² *Ibid.*, 426.

To overcome these concerns, the proposer of the scheme filed an affidavit with the court, proposing the subordination or back-ranking of the claims which are to be ceded to the offeror, or the conversion into new capital - preferable in the form of non-cumulative redeemable preference shares. The court's answer to this proposal was more than clear. Coetzee DJP preferred the conversion into new capital.¹⁹³

In the '*Multi-Bou*' case¹⁹⁴ the court did not express any view on this issue. In the '*Natal*' case¹⁹⁵ the issue was fully considered and the court disagreed with both Coetzee DJP's analysis of the problem and with his solution. The court, however, agreed that the company was insolvent in the sense that the liabilities exceed its assets. Consequently the court concluded that any company which has accumulated losses in excess of its share capital is insolvent – but there are undoubtedly, many companies in this position operating exceedingly successfully in the real business world. The real test for insolvency is whether the company can pay its debts. Many companies start business with a small share capital and carry on business only by means of their shareholders lending funds required for this purpose. All of this is well-known in the business world and persons who supply goods to companies are aware of this. If they are not satisfied with the company's creditworthiness, they should insist on cash payment. The courts do not make these decisions for

¹⁹³ *Ibid.*, 427;

"These are sound suggestions. The second one, namely the conversion of the acquired claims into capital, is preferable. Any terms of a separate deed in terms whereof these claims in the hands of Sassari are subordinated to those of future creditors will have to be very carefully devised to be effective. But even then, the same state of insolvency remains and, although this is better than nothing, it is not satisfactory. The conversion into capital is the real answer. 'Conversion' really means the creation of new share capital and the issue of shares to the offeror."

¹⁹⁴ *Ex parte Millman & Others NNO: in Re Multi-Bou (Pty) Ltd & Others* 1987 (4) SA 405 (C).

¹⁹⁵ *Ex parte Strydom NO: in Re Central Plumbing Works (Natal) (Pty) Ltd* 1988 (1) SA 616 (D).

them.¹⁹⁶ Therefore, the solvency of the company was not regarded as a matter of concern for the court.

There are, however, reported judgments¹⁹⁷ which reject completely the contention that a subordination agreement would have the effect of restoring an insolvent company to solvency or that it would provide any substantial safeguard for future creditors. Only in the Cape has a court held that a suitably worded agreement could restore the company to solvency.¹⁹⁸

In *ex parte De Villiers and Another NNO: in Re Carbon Developments (in liquidation)*¹⁹⁹ the Appellate Division finally concluded that the solvency of the company could be satisfied by a subordination agreement.

The important problem which remains unsolved, however, is the question whether the subordination of a creditor's claim against a company in favour of future creditors is a benefit to the company, resulting from a concession granted or compromise made whereby the liabilities have been reduced or extinguished according to section 20 (1) (a) (ii) of the Income Tax Act.

When claims are subordinated and the company has to pay them only when its assets exceed liabilities, which is obviously at an uncertain point of time, the company has obviously gained a benefit through the extension of time. Nevertheless, the liabilities have neither been reduced nor extinguished.

¹⁹⁶ *Ibid.*, 623.

¹⁹⁷ *Ex parte De Villiers NO: in re MSL Publications (Pty) Ltd* 1990 (4) SA 59 (W); *Ex parte Lebowa Development Corporation Ltd* 1989 (3) SA 71 (T).

¹⁹⁸ Although court still refused to sanction the agreement, *Cooper v A & G Fashion (Pty) Ltd; Ex parte Millman NO* 1991 (4) SA 204 (C).

¹⁹⁹ *Ex parte De Villiers and Another NNO: in Re Carbon Developments (in liquidation)* 1993 (1) SA 493 (A).

Therefore one requirement of section 20 (1) (a) (ii) of the Income Tax Act has not been fulfilled (assuming, of course, that market related interest rates are paid to the subordinated claims) and, therefore, section 20 (1) (a) (ii) is not applicable in this case and no reduction of the assessed loss will be made. Interest paid will certainly have to be subordinated as well.²⁰⁰

4.6 Section 103 (2) of the Income Tax Act

The problems around schemes of arrangements and offers of compromises under section 311 of the Companies Act, together with the assessed loss, face another uncertainty – whether the assessed loss can be used or not.

However, so far, this important tax issue which could, in practice, make a scheme unattractive again has not been discussed. Section 103 (2)²⁰¹ of the Income Tax Act, which was introduced to prevent a specific type of tax avoidance – the trafficking in assessed losses of companies – is a complicated

²⁰⁰ Getz K and Jooste RJ 'Section 311 of the Companies Act: Preserving the Assessed Loss', 71.

²⁰¹ Section 103 (2) of the Income Tax Act:

"Whenever the Commissioner is satisfied that any arrangement affecting any company or any change in the shareholding in any company or in the members' interests in any company which is a close corporation, as a direct or indirect result of which income has been received by or has accrued to that company during any year of assessment, has at any time before or after the commencement of the Income Tax Act, 1946, been entered into or effected by any person solely or mainly for the purpose of utilizing any assessed loss or any balance of assessed loss incurred by the company, in order to avoid liability on the part of that company or any other person for the payment of any tax, duty or levy on income, or to reduce the amount thereof, the set-off of any such assessed loss or balance of assessed loss against any such income shall be disallowed."

issue. However, it does not need to be mentioned as an important part of the scheme industry. What follows is a brief overview of some of the most important issues in regard to section 103 (2).

Section 103 (2) allows the Commissioner for Inland Revenue to disallow any set-off of assessed loss of a company against income, if the scheme, which was entered into, was entered into *solely or mainly* for the purpose of utilizing any assessed loss. Therefore where the main purpose of the taxpayer was to acquire a company's assets, trademarks or goodwill, or in other words, if there was a good business reason to acquire the company and the assessed loss was only a subsidiary consideration, section 103 (2) of the Income Tax Act is not applicable. However, it is always a matter of proof that the assessed loss was only a subsidiary consideration, and this onus lies with the taxpayer.

Section 103 (4), especially regulates that a scheme is *mainly or solely* entered into for the purpose of using the assessed loss when it is proved that a transaction results in the avoidance or postponement of liability for payment of any tax. As this presumption only arises when it is proved that the avoidance, postponement or reduction of tax would result, it is considered that the onus of proving the latter lies upon the Commissioner.²⁰²

In practice, therefore, when income has been diverted to a company with an assessed loss, and section 103 (2) is applied, the Commissioner of Inland Revenue will, on one hand, exclude the diverted income and show the assessed loss and, on the other hand, will include the diverted income in the income statement and income tax will have to be paid.

²⁰² Meyerowitz on Income Tax, 29.13.

However, so far there have been very few reported cases on section 103 (2) – six, to be exact, including the former equivalent of section 90 (1) (b) - which shows that this section is still rather toothless.²⁰³

However, section 103 (2), albeit not very efficient in the past, should always be kept in mind as an uncertain possibility where a company is acquired under a scheme of arrangement. A prosperous acquisition could easily turn into a disaster resulting in a double negative effect on the taxpayer.

4.7 Conclusion

I have tried to show how it should still be possible to use section 311 of the Companies Act to acquire a company and preserve the possible assessed loss when taking over a company. I have pointed to ways around a number of the difficulties raised in different judgments. It seems that the Appellate Division has opened up new possibility in *Ex parte De Villiers and Another NNO: in Re Carbon Developments (in liquidation)* 1993 (1) SA 493 (A) and *in Namex (edms) Bpk v Kommissaris van Binnelandse Inkomste* 1994 (2) SA 265 (A) to pave the way again for section 311 and the assessed loss, which seemed to be closed after the 'Robin' case. The invention of the new Cape scheme, which is a hybrid of the previous two schemes helped the scheme industry to stay alive.

Nevertheless, with a view especially to section 103 (2) of the Income Tax Act, any acquisition has to be prepared very carefully, to avoid mistakes which could probably result in the rejection of the tax benefit.

²⁰³ Silke on South African Income Tax, § 19.17, 19-39.

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