DISSERTATION

ON

RECENT DEVELOPMENTS IN SOUTH AFRICAN COMPANY LAW IN RESPECT OF OFFERS OF COMPROMISE AND SCHEMES OF ARRANGEMENT BETWEEN A COMPANY AND ITS CREDITORS AND/OR MEMBERS IN TERMS OF SECTION 311 OF THE COMPANIES ACT NO.61 OF 1973, AS AMENDED

by

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CHAPTER 1

INTRODUCTION

A company may wish to negotiate, or indeed be forced to negotiate, with its members and/or creditors with a view to modifying rights or claims in their common interest.[1] Such rights or claims against a company often vest in a large number of members or creditors with whom it would be impossible for a company to negotiate individually.

Section 311 of the Companies Act No. 61 of 1973, as amended ("the Act"), in providing for a compromise or arrangement between a company and its members and/or creditors (or a class of them), provides a statutory procedure, subject to supervision by the courts, whereby a company can negotiate with its members and/or creditors (or a class of them) collectively and bind such members or creditors to proposals agreed upon by a majority of such members or creditors. Section 311 makes provision for the reaching of binding agreement between a company and its members and/or creditors in a manner which modifies rights upon a majority vote subject to certain safeguards of the rights of dissenting minorities.[2]

Economic trends and pressures have played a key role in shaping and developing the utilisation of the provisions of Section 311 of the Act. Economic trends for some time in South Africa have been directed towards large business and financial concentration, resulting in an increasing number of acquisitions often by way of take-overs and mergers.[3] A variety of economic pressures have resulted in companies lacking sufficient capital for their business needs causing such companies (often when they are under provisional or final winding-up) to seek concessions from their creditors to enable them

to survive (though often under different controlling shareholders). Furthermore, controllers of companies have always sought to limit exposure to taxation, resulting in the ongoing search for the ability to beneficially utilise the assessed loss of a company for tax avoidance purposes. Take-overs, mergers, avoidance of final winding-up and the beneficial utilisation of assessed losses have materially contributed to the usage of Section 311 (and its predecessor Section 103 of the Companies Act of 1926).

The scheme of arrangement industry,[4] insofar as compromises or arrangements between a company and its creditors is concerned, was dealt a severe blow in 1987 in a judgment of the Witwatersrand Local Division in *Ex Parte Kaplan N.N.O. : In Re Robin Consolidated Industries*[5] when the standard practice in respect of compromises between a company and its creditors, which had prevailed in South Africa for some decades in countless applications routinely granted by the Courts, was held not to be a compromise or arrangement between a company and its creditors as contemplated by Section 311. The Cape Provincial Division shortly thereafter concurred but the Durban and Coastal Local Division disagreed.[6] Similarly in the case of schemes of arrangement between a company and its members courts have handed down judgments, or have expressed views *obiter*, which have made it difficult to always discern a consistent or binding set of *dicta* on certain important principles.[7] The aforegoing results in Section 311, an important section of our law given the import and intent thereof, being an interesting and material topic both for the academic and practising lawyer.

This dissertation will concentrate on recent developments in our law, both as regards members and creditors of a company, in respect of Section 311. As a necessary background to such developments (and hopefully thereby providing a clearer understanding thereof) certain material general principles applicable to Section 311 will also be discussed.[8] Bearing in mind the wealth of material existing in our law in respect of the title of this dissertation, and also due to constraints of space, this dissertation will of necessity largely be confined to South African Law. It must however be borne in mind that English Company Law and Australia Company Law contain sections which are very similar to Section 311.[9] Many important decisions of our law (and indeed Australian Law) on material principles applicable to Section 311 are derived from or supported by *dicta* of the English Courts. It follows that in certain appropriate instances brief reference will be made herein to English and Australian Law. Any detailed comparative study of the three legal systems is however a separate topic and beyond the scope of this

dissertation which, in essence, deals with current principles and trends relevant to schemes of arrangement or offers of compromise between a company and its members and/or creditors (or a class of them) in terms of Section 311 of the Act.

FOOTNOTES - CHAPTER 1

1. See the examples listed on pages 6 - 7 of Chapter 2.

2. See the discussion in Chapter 2.

3. Although, of course, a current topical issue is the question of "unbundling" which is already slowly starting to manifest itself in practice (including JSE companies), which process could in certain instances also benefit by the utilisation of the provisions of Section 311.

4. In *Ex Parte Kaplan NNO : In Re Robin Consolidated Industries* 1987 (3) SA 413 (W) at 422I Coetzee DJP characterised practitioners in this area of law as "the scheme of arrangement industry".

5. 1987 (3) SA 413 (W)

6. See the discussion in Chapter 3

7. See the discussion in Chapter 4

8. The dissertation is divided into three main chapters covering material general principles (Chapter 2), compromise or arrangements between a company and its creditors (Chapter 3) and arrangements between a company and its members (Chapter 4). Chapters 1 and 5 consist of the introduction and conclusion respectively.

9. See the discussion in Chapter 2

CHAPTER 2

GENERAL PRINCIPLES

Purpose of Section 311

Section 311 of the Act provides the machinery whereby a compromise or arrangement may be made between:

(a) a company and its creditors or any class of them; or

(b) a company and its members or any class of them; or

(c) a company and its creditors and members or any class of them.

The main advantage of Section 311 is that if the compromise or arrangement is agreed to by:

(a) a majority in number representing three-fourths in value of the creditors or class of creditors; or

(b) a majority representing three-fourths of the votes exercisable by the members or class of members,

(as the case may be) present and voting in either person or by proxy at the meetings called to consider the compromise or arrangement, such compromise or arrangement shall, if sanctioned by the Court, be binding on all the creditors or the class of creditors,

or on all the members or class of members (as the case may be).[1] It is interesting to point out with reference to the statutory majority required at a meeting of members in terms of Section 311(2) that, unlike its predecessor Section 103(2) of the 1926 Companies Act, agreement by a majority in number of members present at the meeting is not required. Henochsberg[2] considers such omission to have occurred in error. In English and Australian Company Law the equivalent sections of their Companies Acts (which sections are the same in all material respects as Section 311) provide for agreement by a majority in number of members representing 75% of the votes exercisable by members, present and voting, in person or by proxy.[3]

The reasons why a compromise or arrangement would be proposed between a company and its creditors and/or members are varied. Such reasons would *inter alia* include:

(a) the seeking of concessions from creditors arising out of financial pressures created by insufficiency of capital;

(b) avoiding winding up, or the discharge from winding up, thereby enabling the company to continue conducting business as a going concern;

(c) determination of dispute over rights and the enforcement of such rights;

(d) amalgamations or reconstructions;

(e) mergers and takeovers;

(f) raising of additional funds from existing shareholders or from an outside party;

(g) modifying the rights of creditors and shareholders *inter se*;

(h) the acquirer of the company being freed from the fear that any creditors of the company (including contingent creditors) could bring claims against the company in the future as a result of the binding effect of a sanctioned compromise or arrangement;

(i) preventing, in appropriate circumstances, a minority of creditors frustrating a beneficial proposal;

(j) the retention of the benefit of the assets, goodwill, trademarks, permits and the like of a company;

(k) retention and utilisation of assessed tax losses of a company.

The preceding paragraph represents examples of the more popular reasons for the proposing of a compromise or arrangement. Such examples require and result in the alteration of established rights. The alteration of such rights may be created contractually but as such rights are often spread amongst many creditors or members of the company, it would be practically impossible to negotiate with each such creditor or member separately. Consequently Section 311 provides the most popular and effective machinery for modifying rights without the need for unanimity. In essence Section 311 fulfils a practical need, namely the provision of machinery which overcomes the difficult, and at times impossible, task to negotiate individually with large classes of creditors or members of a company where the individual agreement of all of them is necessary to a proposal which is binding on them and the company. Section 311 has the effect of resulting in, by having strict regard to the procedure prescribed therein, the avoiding of the obtaining of the individual agreement of every creditor or member (or a class of creditors or members) to be bound by the compromise or arrangement and which would otherwise be necessary to give lawful effect to such compromise or arrangement. The purpose of Section 311 was aptly summarised by Coetzee, J (as he then was) in *Ex parte Lomati Landgoed Beherende (Edms) Bpk*; *Ex parte Lomati Landgoed (Edms) Bpk* as follows:

> *"The purpose of Section 311 of the Act can be concisely put as being an attempted solution of the problem attendant upon attaining an agreement in the case of a large number of widely distributed people who must be contacted with a view to negotiating the same agreement with each one. Section 311 is therefore particularly applicable where it is impossible or difficult to approach everybody individually with a view to submission of the offer."*[4]

Similarly, with reference to the purpose of Section 311, is the statement in *Australian Company Law* dealing with the equivalent section under the Australian Companies Code[5] where it is stated as follows:

> *"The section 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"* [6]

Meaning of compromise and arrangement

In *Ex Parte NBSA Centre Limited*[7] a description of "arrangement" in *Australian Company Law* was quoted with approval with the observation that the authors of the textbook had selected a description of 'arrangement' which accurately expresses its content and sense in the light of its historical purpose.[7] Such description reads as follows:

> *"The word "arrangement" is not restricted in its meaning by its association with the word "compromise". The former word has been given a liberal meaning and, generally speaking, unless the arrangement is ultra vires the company or seeks to deal with a matter for which a special procedure is laid down or to evade a restriction imposed by the Act, almost any arrangement otherwise legal which touches or concerns the rights and obligations of the company or its members or creditors may become to under this section: re: International Harvester Co of Australia (Pty) Limited (1955) VLR 669 (FC) per Louw ACJ at 672."* [8]

The same principles prevail in English Company Law.[9] The concept of an arrangement implies some element of "give and take", some compensating advantage to the members or creditors concerned. This compensating advantage must relate to some enforceable consideration for those concerned in the arrangement.[10]

A "compromise", on the other hand, is an agreement between a company and its creditors and/or members to settle a dispute over rights or to modify undisputed rights where a difficulty exists over their enforcement. Each party must give ground, but there must be a *quid pro quo*, not a gratuitous giving up of rights.[11]

Meaning of Class

The proposer of an arrangement or compromise must decide, in the light of what the arrangement or compromise is designed to achieve, which class of members and/or creditors of the company should be made parties to the proposed scheme. Members and creditors are separated into classes for the purposes of voting at the meetings of creditors and members on the basis of the similarity of their rights and not similarity of their interests although the Court may have regard when it decides whether it should, in the exercise of its discretion, sanction the arrangement or compromise to the fact that the interests of members or creditors of a class may be dissimilar.[12]

In the absence of a statutory definition of the concept of "class" our Courts have endorsed the approach of Bowen L J in *Sovereign Life Assurance Company v Dodd*[13] where it was held that:

> *"We must give such a meaning to the term "class" as will prevent the section being so worked as to produce confiscation and injustice, and that we must confine its meaning 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."*

The "common interest" approach must however not be permitted to conceal the basis of the classification which is the "similarity of rights". While members or creditors with similar rights should meet together to consider the acceptance of a compromise or arrangement, their interests may diverge. The presence of an interest which does not flow from the legal rights of a member or creditor may be relevant, at the time the Court is asked to sanction the compromise or arrangement, in considering whether the member or creditor concerned had acted *bona fide* with a view to the interests of their class, but it cannot form the basis of the classification for the holding of different meetings to consider the compromise or arrangement. If the determining factor for the classification is to be the "interest" of the member or creditor without sufficient regard to their rights, it could lead to a greater number of meetings than is necessary to arrive at their intention and wishes.[14]

In essence:

(a) the class to which a member belongs must primarily be determined by the rights and obligations arising out of the conditions of issue of each class of shares;

(b) the class to which the creditor belongs must primarily be determined by the nature of its claim (e.g. preferent, secured or concurrent).

Procedure in terms of Section 311

The procedure in terms of Section 311 comprises the following main elements:

(a) the application to Court to summon meetings;

(b) the convening and holding of the meetings;

(c) the application to Court to sanction the compromise or arrangement;

(d) registration of the sanction order in terms of Section 311(6)(a) of the Act.

Whilst a detailed discussion of the aforegoing is beyond the scope of this dissertation, it is necessary to make brief reference to the basic principles thereof. Very similar procedures are followed in England and Australia.[15]

At the stage of the application for leave to convene meetings the Court is primarily concerned with the probable response to the scheme of the members or creditors. If the Court, on consideration of the information at its disposal, is of the view that there is a reasonable probability that the requisite statutory majority of creditors or members of the company may accept the scheme, it will generally order a meeting of creditors to be convened. In addition, the Court is also concerned that the scheme, on the face of it, appears to be made in good faith, honesty, its terms are unambiguous, understandable and that sufficient information has been gathered and can be furnished to the creditors or members to enable them to assess the relative merit of the scheme and the alternatives thereto.[16]

The meetings will be held and conducted in accordance with the directions of the Court. As the requisite statutory majorities referred to in Section 311(2) need only be attained by members or creditors present and voting either in person or by proxy at the meetings, it follows that shareholder or creditor apathy, in the context of not bothering to attend meetings in order to protect or enforce their rights, operates in favour of a proposer of the arrangement or compromise.

Notwithstanding the fact that the requisite statutory majorities may have approved the compromise or arrangement in terms of Section 311(2) the Court still has a discretion as to whether or not to sanction a compromise or arrangement. The onus is on the applicant seeking sanction to satisfy the Court that sanction ought to be granted. The Court must be satisfied that the statutory provisions (including Section 312 of the Act) have been complied with, the classes of creditors or members were fairly represented by those who attended, the statutory majorities approving the compromise or arrangement were acting bona fide in the interests of the relevant class, the compromise or arrangement is such that a businessman would reasonably approve, it is fair and reasonable as regards the different classes of creditors or members and that it is not contrary to the requirements of commercial morality generally and the public interest.[17] The Court will also take cognisance of the report of the Master of the Supreme Court in terms of Section 311(4).[18] It is emphasised that the Court has a complete discretion. The cases indicate that the tests propounded in our case law should be regarded as guides to, not fetters on, the exercise by a Court of its discretion. But it is clear that the Court does not sit merely to rubber stamp the scheme even if it has been passed by the requisite majority.[19] A sanctioned compromise or arrangement is in essence a contract between the company on the one hand and the creditors or members on the other hand.[20]

Although a formality, registration of the sanction order in terms of Section 311(6)(a) of the Act is of importance in that in terms of Section 311(6)(a) an order of Court sanctioning a compromise or arrangement shall have no effect until a certified copy thereof has been lodged with the Registrar of Companies under cover of the prescribed form and registered by him. In terms of Section 311(6)(b) a copy of such order of Court shall be annexed to every copy of the memorandum of the company issued after the date of the order (failure to do so being a criminal offence in terms of Section 311(7)).

Section 311(3)

Section 311(3) provides that no compromise or arrangement shall affect the liability of any person who is a surety for the company. It follows that an arrangement or compromise need not expressly reserve the rights of any creditors against sureties for debts of the company as such rights are unaffected, in terms of Section 311(3), by such compromise or arrangement.[21]

In *Ex parte Vosey Bond Property Investments Limited*[22] Leon J held that Section 311(3) does not expressly or by necessary implication prevent parties from contractually altering the position which the statute would otherwise bring about.[23] On that ground Leon J held that the Court had the power to sanction an arrangement for the cancellation of a guarantee in favour of debenture holders, the majority of whom had voted in favour of the acceptance of the arrangement, with the result that the minority who had voted against it was nevertheless bound by the cancellation of the guarantee, presumably by virtue of Section 311(2). In *Incorporated General Insurances Limited v Cement Distributors (South Africa) (Pty) Limited* ("IGI") the Appellate Division however commented that it had grave doubts about the validity of such view.[24] The Appellate Division pointed out, *obiter*, that it had difficulty with the proposition that a Court could hold that a creditor who has voted against the acceptance of a scheme of arrangement is bound to abide by a clause in it providing for the termination of his right to proceed against a surety, for, *ex hypothesi*, he has in fact not contracted out of the protection afforded to him in terms of Section 311(3).[25]

In the *IGI* case, in terms of a scheme of arrangement sanctioned by the Witwatersrand Local Division, creditors were deemed to have ceded to the offeror their claims against the company together with their right, title and interest in and to any security held therefor.[26] The respondent had successfully claimed in the court *a quo* payment of an amount in terms of a suretyship agreement whereby the appellant had bound itself to the respondent as surety and co-principal debtor for the due payment of all amounts due and payable by the company which was the subject matter of the scheme to the respondent. In confirming the decision of the court *a quo*, the Appellate Division held that the very existence of the provision contained in Section 311(3) militated against the notion that a deed of suretyship was included within the ambit of security for the purposes of the scheme as drafted. If it was so included, it would mean that creditors who held deeds of

suretyship would forfeit the protection they enjoyed under Section 311(3) by relinquishing their rights to look to their sureties for payment of the company's debt without receiving any compensation or advantage in return for so doing, and it was, inherently, highly unlikely that the draftsman of the scheme or any party interested in or connected with it, could have envisaged or intended such a result.[27]

Peremptory obligations imposed by statute for the conservation of public monies including income tax

On a few occasions certain practitioners in the scheme of arrangement industry considered the question whether amounts owing in terms of a statute, ordinance or regulation to government bodies, local authorities or the Commissioner for Inland Revenue (hereinafter collectively referred to as "statutory bodies") were capable of being compromised in terms of an offer of compromise or scheme of arrangement. As time went by any possible doubts faded from consideration having regard to the fact that over a lengthy period no Court had refused to sanction a scheme of arrangement which involved compromising the claims of statutory bodies. Furthermore, the statutory bodies themselves appeared to regard a sanctioned scheme where their claims were the subject of a compromise as being binding upon them. This apparent ability to successfully compromise the claims of statutory bodies however came to an end in the judgments of *Mercian Investments (Pty) Limited v Johannesburg City Council*[28] ("Mercian Investments") and *Namex (Pty) Limited v Commissioner for Inland Revenue*[29] ("Namex").

In the *Mercian Investments* case the applicant, whose winding up order had been discharged together with the sanction of an offer of compromise in terms of Section 311, had sold certain property belonging to it situated within the municipality of the respondent. The applicant discovered on attempting to effect transfer of such property to a purchaser that the respondent refused to issue certain clearance certificates on the ground that there remained an unpaid balance by applicant in respect of respondent's claims relating to the pre-liquidation period in respect of the property to be sold. The applicant company sought an order declaring that such claims (which claims were revenues due to the Respondent in terms of Section 48 of the Local Government Ordinance 17 of 1939) to have been compromised by the said offer of compromise duly sanctioned by the Court.

The Court held that the revenue of a local authority was in the nature of trust money and the local authority, as a statutory body, was obliged to recover it and apply it in accordance with its statutory powers and duties. A local authority could not renounce a peremptory statutory obligation imposed by the legislator for the conservation of public monies.[30]

The Court, in arriving at its decision, was also obliged to consider what was the effect of the sanction of a compromise or arrangement by a Court. The Court confirmed that a sanctioned compromise or arrangement was in effect a contract between the company on the one hand and the creditors and/or members on the other hand. The Court pointed out that the effect of sanction had been considered in several cases and the import of their dicta was succinctly stated by Gubbay JA in *Parker v W.G.B. Kinsey & Co. (PVT) Ltd* as follows:

> *"To my mind, it is of fundamental importance to have regard to the effect of the sanctioning of a compromise or arrangement, subject, of course, to registration of the order, pursuant to Section 167 (3) of the Act. I comprehend it to be this: the sanction is not an order of Court ad factum praestandum, a contravention of which is punishable by contempt of Court. It merely gives to the compromise or arrangement contractual force as between those bound by it, deriving such force, not from the actual consent, but by operation of law. The rights and obligations of the parties bound are determined by the terms of the compromise or arrangement, express or implied. They are not to be sought outside the confines sanctioned by the Court. Questions relating to validity and interpretation follow normal contractual principles, for the act of sanction does not convert the compromise or arrangement into an order of Court. The Court has no greater power over it than in any other sort of contract. It cannot judicially condone a default in performance, nor can it relieve a party bound by it from the consequences of its operation."*[31]

The Court accordingly concluded that the sanction by a Court of a scheme was not intended by the legislature to serve as a statutory mechanism to clad the respondent with a capacity to contract in defiance of its relevant right and in violation of its duty to collect revenues due to it. The scheme as sanctioned in this case was to the extent of the rights and obligations of respondent to collect revenues due to it illegal in its effect and incapable of binding the respondent by its terms. It was *ultra vires* the respondent to have submitted to the scheme as established.[32] The Court cited with approval a statement by *Pennington*[33] to the effect that notwithstanding the wide powers conferred

upon a Court with regard to schemes of arrangement, the Court could only sanction a scheme which would be valid without the Court's sanction if every creditor or member concerned agreed to it. In other words, the only power which the Court has is to make the scheme binding on dissenting creditors or members, it has no power to sanction something which the parties could not do by agreement. This latter point should always be borne in mind by proposers of schemes of arrangement especially with the current tendency of our Courts to examine more critically the legal efficacy of schemes placed before it.

In *Namex* the Court again emphasised that whilst the term "arrangement" in Section 311 has been given a wide meaning by our Courts, a Court will not sanction any proposed scheme of arrangement which is contrary to the general law or *in fraudem legis*. The Court, after examining many reported judgments dealing with Section 311 and its predecessor Section 103 of the Companies Act No. 46 of 1926, confirmed that our Courts have treated Section 311 (and Section 103) as empowering them to bind resisting and supine creditors only where the proposed scheme is one to which the parties could, in law, have bound themselves by agreement. Section 311 does not empower the Court to sanction a transaction which the parties cannot themselves undertake. The legislature did not intend Section 311 to be used to enable a company to do anything *ultra vires*. Similarly, it was not intended to vest the Court with the necessary authority to enable - and still less to compel - a creditor to do what he is not otherwise permitted to do.[34]

The Court duly held that a claim of the Commissioner for Inland Revenue could not be the subject matter of a compromise in terms of a scheme of arrangement or offer of compromise. The fact that in the past the Commissioner for Inland Revenue had participated in numerous schemes sanctioned in terms of Section 311 (which schemes had involved remitting taxes and the cession of the Commissioner's claims for income tax to the proposer) did not create any binding precedent in the view of the Court. The Court cited case law to the effect that our common law in many instances treated the State as it did a minor. In the Netherlands the rule was adopted and extended to the fiscus as the custodian of the public treasury. Thus, waivers, errors and even negligence in claiming taxes are not regarded as a bar to the Commissioner for Inland Revenue when he later seeks to carry out his duty to collect taxes. The Court pointed out that it is a long and firmly established principle of our law that public officials entrusted with the duty of collecting taxes cannot forego the taxes due to the State or any part of them. The

Commissioner for Inland Revenue is required by the Income Tax Act to administer its provisions and to collect taxes. Its rights and duties under the Income Tax Act cannot be transferred to another. Indeed the Court pointed out that it could not conceive of a scheme which could bind the Commissioner for Inland Revenue to forego his rights or abandon his duties.[35] Even where a scheme provided for payment of a claim for income tax in full it could not prevent the Commissioner for Inland Revenue from thereafter coming back for more, if circumstances as contemplated in the Income Tax Act justified - or indeed compelled - him so to do. The judge aptly summed it up as follows:

> *"Unlike Oliver Twist, defendant is not only entitled, but he is duty bound to say 'I want some more' and defendant will get it - even if Mr Bumble himself has to go hungry!"* [36]

The Securities Regulation Code on Takeovers and Mergers ("the Code") and the Rules of the Securities Regulation Panel ("the Rules")

Where a scheme of arrangement is designed to effect a merger or takeover, the Code and the Rules may have a role to play. The Code recognises that takeovers and mergers may be effected by means of a scheme of arrangement. A scheme of arrangement is defined in the Code as meaning a compromise or arrangement between a company and its members or any class of them in terms of Sections 311 to 313 of the Act.

The Code emanates from the Securities Regulation Panel ("the Panel") which was established under the provisions of Section 440B of the Act. In terms of Section 440C of the Act the Panel is empowered and required to make rules on and regulate all transactions and schemes which constitute 'affected transactions".[37] A material reason why the Code has come into existence is in an endeavour to ensure fair and equal treatment for all holders of shares in takeovers and mergers and to provide a framework within which such transactions are to be conducted. The Code and Rules came into effect on 1 February 1991 and is based to a large extent on the City Code on takeovers and mergers issued by the London Panel (which has generally proved successful in ensuring fair and equal treatment of all holders of relevant securities in a takeover or merger transaction). The Code enjoys the force of law and an affected transaction must comply with the Code.[38]

The Code applies in all cases where the offeree company is a public company (whether or not listed on the Johannesburg Stock Exchange). The Code also applies where the offeree company is a private company where the shareholders' interest valued at the offer price, and the shareholders' loan capital, exceed R5-million and there are more than 10 beneficial shareholders, provided that the executive director of the Panel may exempt any particular transaction affecting a private company if satisfied that there can be no prejudice to minority shareholders.

In terms of the Code all holders of the same class of shares of an offeree company shall be treated similarly by an offeror and where an offer is made for more than one class of shares, separate offers shall be made to each class. "Offer" is defined in the Code as including an offer in respect of an affected transaction, howsoever effected. In terms of Rule 29 of the Rules:

(a) where an offer is implemented by a scheme of arrangement then, for the purposes of the Rules, the company in respect of which the scheme is proposed, shall be deemed to be the offeree company and the persons who will be the holders of relevant shares of the company after the scheme of arrangement has been sanctioned shall be deemed to be the offeror;

(b) save insofar as the Panel may otherwise permit, or unless the Supreme Court has ordered otherwise, the provisions of the Rules relating to disclosure and, where possible, timing and periods of notice shall apply *mutatis mutandis* to any offer implemented by a scheme of arrangement.

Section 424(1)

An important question arising in the context of compromises and arrangements is whether a person who has ceased to be a creditor of a company pursuant to a sanctioned compromise or arrangement still has the *locus standi* to institute an action in terms of Section 424(1) of the Act[39] for an order rendering personally liable all persons who knowingly had participated in any fraudulent or reckless conduct of the business of the company? Such question is important as it may feature as one of the considerations by the Court whether to exercise its discretion to sanction the compromise or

arrangement.[40] Generally, in terms of an arrangement or compromise creditors will not receive anything near payment in full of their claims. Although an arrangement or compromise would be more beneficial than the dividend payable on a winding-up it is still likely to result in the creditors writing off a substantial portion of their claims. If creditors, however, were able in the context of a particular matter to institute successfully an action in terms of Section 424(1) they could possibly recover payment in full of their claims as opposed to the dividend payable if the scheme was sanctioned. If by virtue of such sanction, creditors would however lose their locus standi to sue in terms of section 424(1) it would in such circumstances be of some importance for the Court to consider such loss of locus standi (and the consequent potential monetary loss to creditors) in the proper exercise of its judicial discretion when considering whether to sanction an arrangement or compromise (or possibly even whether it is even advisable to grant leave to convene meetings to consider the compromise or arrangement).[41]

Two issues arise for consideration viz:

(a) whether the right conferred upon creditors by Section 424(1) is *ipso iure* extinguished upon the sanctioning and implementation of a compromise or arrangement; and, if not

(b) whether a person bringing an action after a compromise or arrangement has been sanctioned and implemented, is a creditor within the meaning of the phrase 'creditor of the company' in Section 424(1) of the Act.

The matter was raised by Stegmann J in a judgment handed down on 7 December 1987, but only reported in 1990, in the case of *Ex Parte De Villiers N.O. in re: MSL Publications (Pty) Ltd (in liquidation)* ("MSL").[42] The facts of the case were that in terms of an arrangement creditors would receive a nominal dividend in respect of their claims and the unpaid balance of their claims would then be ceded to the proposer. Pursuant to such payment and cession, creditors would have no further claims against the company. Stegmann J was of the view that the aforementioned features of the arrangement would effectively disentitle such creditors from pursuing any action in terms of Section 424. In *Ex Parte Lebowa Development Corporation Limited*[43] ("Lebowa"), *Singer N.O v M.J. Greeff Electrical Contractors (Pty) Ltd*[44] ("Singer") and *Ex Parte De Villiers & Another N.N.O. in re: Carbon Developments (Pty) Ltd (in liquidation)*[45] ("Carbon Developments") Stegmann

J repeated the views which he expressed in the MSL case. In essence, the views of Stegmann J are that upon sanction of an arrangement providing for the cession of creditors claims to the proposer of the arrangement any right to sue in terms of Section 424 passes from cedent (the creditor) to cessionary (the proposer). Accordingly, the creditor will cease to have any locus standi to institute any claim in terms of Section 424(1). Similarly, if the arrangement extinguishes the debts and liabilities of the company, Section 424(1) cannot function after the extinction of such debts and liabilities upon sanction of the arrangement because for Section 424(1) to be operable the company must have debts or other liabilities.[46]

In, however, the case of *Pressma Services (Pty) Ltd v Schuttler & Another*[47] ("Pressma"), the Cape Provincial Division took a different view to that expressed by Stegmann J in his various judgments aforesaid. In the Pressma case the terms of the compromise were that creditors rights to obtain payment of their claims were limited to such rights as were provided for in the offer; creditors ceased to have any further claims against the company or the offeror and such creditors claims were deemed to have been ceded to the offeror.[48] The applicant, a creditor of the company prior to its liquidation, had instituted proceedings against the Respondents, the directors of the company prior to its liquidation, in terms of section 424(1). The argument was raised by the respondents that the applicant did not have the right to proceed in terms of Section 424(1) as it had ceased to be a creditor of the company upon the offer of compromise being sanctioned and implemented. The applicant was accordingly no longer a 'creditor of the company' within the meaning of the phrase in Section 424(1) and accordingly had no *locus standi* to institute any proceedings under Section 424(1). The Court held that it was unthinkable that the legislature could have intended that the purpose of Section 424(1) should be frustrated and the remedy provided by it could be lost because of the sanctioning and implementation of a compromise in terms of Section 311. There was nothing, the Court held, in either Section 311 or in Section 424 which could justify the conclusion that the right conferred upon a creditor by Section 424(1) *ipso iure* ceased to exist upon the sanction and implementation of a compromise. Furthermore, the words 'creditor of the company' had, in the view of the Court, in order to give effect to a material objective of Section 424(1) (i.e. to provide creditors with a meaningful remedy against the abuse at which the section was directed), to be construed so as to include a person in respect of whom there had been an existing indebtedness at the time when the compromise was sanctioned.[49]

In the *Carbon Developments* case, Stegmann J analysed the Pressma judgment and concluded that he was in disagreement with it, stating as follows:

> *"The entire argument in the judgment is ..... conducted on too narrow a footing. It seems to me that it overlooks a fundamental and decisive factor. There is no reason to doubt that, in making provision in Section 311 for a compromise between a company and its creditors, the legislature intended to leave creditors free to agree to deal with their rights as they saw fit, i.e. to agree to compromise their rights, to alienate them, or to extinguish them, as they chose. There is nothing in Section 424(1) or its context, which abridges a creditor's freedom to agree in terms of Section 311 to compromise any rights he may derive from Section 424(1) or to alienate such rights, or to extinguish them. The conclusion reached by Van Schalkwyk A.J. in Pressma Services appears to accept that the legislature, when providing the rights created by Section 424(1) in the circumstances defined therein, intended to create a species of incorporeal property which was to be different from virtually all other incorporeal property in that the holder thereof was to have no power to agree to cede it, or to compromise it, or to extinguish it ..... The consequences thereof is said to be that creditors are placed in the remarkably advantageous position of being free to compromise, alienate or extinguish their claims against a company in terms of Section 311, secure in the knowledge that nothing they may agree to in terms of such compromise can affect their inalienable and indestructible rights guaranteed by the legislature in all circumstances in terms of Section 424 ..... No doubt the legislature has power to devise and enact such an anomalous scheme of things. However, I am respectfully unable to accept that the legislature has in fact done so in terms of Section 424(1). Certainly it has not done so in express terms and I remain unpersuaded by the argument that it is done so by implication ..... For Section 424(1) to be operable at all, the company must have 'debts or other liabilities'. If the company has no 'debts or other liabilities', then an essential requirement is missing and Section 424(1) cannot provide a remedy. In a case which all the creditors are all agreed in terms of Section 311 to a compromise which specifically provides for the extinction of all the company's debts and liabilities, it seem to me to be quite obvious that Section 424(1) cannot possibly function after the extinction of such debts and liabilities by the agreement of the creditors and the sanction of the Court ..... Furthermore, in a case in which the creditors have all agreed in terms of Section 311 to a compromise which provides, not for the extinction or novation of their claims, but for the cession thereof to the proposer of the compromise - as in the Pressma Services case - it seems to me that (at least in the absence of an agreement to the contrary) any ancillary right to approach the Court in terms of Section 424(1) ..... must necessarily pass to the cessionary as a right ancillary to the ceded claim."*[50]

In the *Carbon Developments* case Stegmann J also referred to the interesting question of whether effect will be given to any agreement between a cedent and a cessionary in terms of which the cedent purports to retain ancillary rights to approach a court for an order in terms of Section 424(1), whilst at the same time parting with the claim which gave him *locus standi* to do so. Stegmann, in commenting on this issue, expressed the opinion *obiter* that in his view this seemed somewhat doubtful but that he did not propose to pursue the issue further as it was not a question which arose for decision in the *Carbon Developments* case.[51]

The *Carbon Development* case was the subject of an appeal to the Appellate Division.[52] Regretfully, in the light of the *ratio* of the case, the Appellate Division raised, but did not find it necessary to deal with the question whether a duly sanctioned compromise or arrangement, which had the effect of extinguishing the debts of a company, could preclude a declaration being made by the Court under Section 424(1). It is however relevant to point out that it was the submission of both counsel for the appellants and the *amici curiae* that such a compromise did not preclude a declaration being made by the Court under Section 424(1). It was argued that reference to 'debts' in Section 424(1) is to debts which were incurred by the company at the time of the alleged wrongful conduct and not necessarily to debts which were still owing by the company at the time of the application under 424(1). In referring to the argument of counsel Goldstone J A simply commented as follows:

> *"In the view I take in this matter, it is not necessary to decide this interesting and difficult question."* [53]

It is a pity that the Appellate Division was not able to consider, even *obiter*, this issue bearing in mind its importance as one of the factors in the exercise by a Court of its discretion to sanction a compromise or arrangement. From a commercial perspective, an action in terms of Section 424 may be both lengthy and costly. Creditors may prefer the certainty of a dividend in terms of an arrangement rather than to pursue a course of action under Section 424. Any deductibility for income tax purposes of the unpaid or extinguished portion of their claims would also no doubt be an issue for consideration by creditors. It is submitted that until there is certainty on the issue in all divisions of the Supreme Court, and indeed for sound reasons in any event, a liquidator should be obliged in the statement which he submits to creditors in terms of Section 312 of the Act,

to point out to creditors in some detail whether in his view the company was trading in insolvent circumstances giving all relevant facts and figures to creditors in this regard. The effect of current judgments on the rights of creditors in terms of section 424 should also be drawn to the attention of creditors. Creditors will then be in a position, when they consider the arrangement, to be able to take into account the commercial wisdom of accepting a dividend against the possibility of pursuing a Section 424 action assuming, of course, the said judgments of Stegmann J is correct. This will enable the Court, when it considers whether to sanction an arrangement, to be satisfied that based on adequate disclosure and information, creditors voting in respect of the arrangement made any decision to approve the arrangement in respect of this issue intelligently, honestly and in good faith. Obviously in appropriate cases a duty may arise for a court to look past the commercial implications for creditors of an arrangement and pay heed to the wider ramifications of public policy as Stegmann J has done in his aforementioned judgments. However, unless there are materially overriding considerations of public policy, it is submitted that the Court should, in considering an issue of this nature, adopt the view that in monetary or commercial matters it is the creditors, and not the public, who would lose the ability to obtain a higher dividend in terms of an arrangement than upon a winding up and who, in addition, would also have to bear the cost of any action in terms of Section 424. The Courts need to strike a balance between considerations of public policy and the argument that it should not dictate to creditors (especially where it is shown that they have considered the arrangement based on all relevant information) what is in their own interest.[54] It must also furthermore be borne in mind, from the wider point of public policy, that an arrangement under Section 311 would not preclude any criminal proceedings.[55] The views of Berman J as to the advantages and benefits of an arrangement or compromise should also not be lost sight of by the Court when considering the exercise of its discretion upon sanction, viz:

> *"And indeed, far more often than not, nothing but good came of this practice, for creditors invariably received a greater dividend upon the implementation of the scheme than they would otherwise have been paid, the third party obtained control over the company with its assessed loss and frequently some of or even all its stock and equipment, and the company was discharged from liquidation. And this apparently advantageous and seemingly unobjectional practice might well have continued to the satisfaction and for the benefit of all concerned, had not the Transvaal Court been alerted to what is ultimately held to be the fatal defect in that practice, and to which, in the Robin judgment, it summarily put an end in that province."* [56]

Section 312

Where a meeting of creditors or members is summoned under Section 311 for the purpose of agreeing to a compromise or arrangement, it is important that such creditors or members must be sufficiently informed about the effect and implications of the compromise or arrangement. In terms of Section 312 of the Act, where any meeting of creditors or members is summoned under Section 311, there shall, with every notice summoning the meeting, be sent a statement explaining the effect of the compromise or arrangement. Such statement shall record all relevant information material to the value of any shares or debentures concerning the arrangement and shall further record any material interest of the directors of the company (whether as directors or as members or as creditors of the company or otherwise) and the effect thereon of the compromise or arrangement insofar as it is different from the effect on the like interests of other persons. The contents of the statement in terms of Section 312 will be determined basically by the nature of the proposed compromise or arrangement and all the circumstances of the case in issue. Such statement should be fair and as far as possible give all the information reasonably necessary to enable the recipients to determine how to vote. A copy of such statement must be placed before the Court when sanction is sought in order that the Court may be satisfied that it was adequate, in particular that creditors or members were sufficiently informed about the effect and the implications of the compromise or arrangement. The Court's power to sanction a compromise depends on compliance, or substantial compliance, with Section 312. At the very least, non-compliance in a material respect will usually deter the Court from exercising its discretion in favour of sanction.[57]

Section 313

The adoption of the provisions of Section 313 may in certain circumstances facilitate a compromise or arrangement in terms of section 311. If an application is made to the Court under Section 311 for the sanctioning of a compromise or arrangement, and it is shown to the Court that such compromise or arrangement has been proposed for the purpose of or in connection with a scheme for the reconstruction of any company or the amalgamation of two or more companies and under the scheme the whole or any part of

the undertaking or the property of any company concerned in the scheme is to be transferred to another company, the Court may make provision for any or all of the issues referred to in Section 313(1)(a) - (f)[58] for the purposes of facilitating advantageously the giving of effect to such compromise or arrangement. Section 313(2) states that where an order under Section 313(1) provides for the transfer of property or liabilities, that property shall be virtue of the order vest in, subject to transfer in due form, and those liabilities shall become the liabilities of, the transferee company.

FOOTNOTES - CHAPTER 2

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1. Sections 311(1) and (2) of the Act. Section 311(1) reads as follows:

> *"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 summonsed in such manner as the Court may deem fit."*

Section 311(2) reads as follows:

> *"If the compromise or arrangement is agreed to by*
>
> *(a) a majority in number representing three-fourths in value of the creditors or class of creditors; or*
>
> *(b) a majority representing three-fourths of the votes exercisable by the members or class of members,*
>
> *(as the case may be) present and voting either in person or by proxy at the meeting, such compromise or arrangement shall, if sanctioned by the Court, be binding on all the creditors or the class of creditors, or on the members or class of members (as the case may be) and also on the company or on the liquidator if the company is being wound up or on the judicial manager if the company is subject to a judicial management order."*

2. Henochsberg on the Companies Act (Meskin ed) 4th edition page 509

3. Section 425 (2) of the Companies Act 1985 (England) and Section 315(4) of the Companies Code (Australia)

4. 1985 (2) SA 517 (W) at 520

5. Section 315 of the Companies Code

6. Paterson and Ednie, 2 ed, Vol II at 2374 as quoted with approval in Ex Parte NBSA Centre Limited 1987 (2) SA 783 (W) at 787G

7. NBSA Centre supra (note 6) at 787 I

8. Paterson and Ednie supra (note 6) at 2375

9. See, inter alia, Farrar : Company Law, 3rd Edition (1991) at 619 - 620 and the cases cited therein.

10. See, for example, Ex Parte Cyrildene Heights (Pty) Limited 1966 (1) SA 507 (W) at 308 - 309, Ex Parte Federale Nywerhede Bpk 1975 (1) SA 826 (W) at 834 and Re NFU Development Trust Limited (1973) 1 ALL ER 135 at 140. An "arrangement" also includes a reorganisation of the share capital of a company in the manner contemplated by 311(8) of the Act.

11. See, for example, Ex Parte Cyrildene Heights (Pty) Limited, supra (note 10) at 308 and Re NFU Development Trust supra (note 10) at 140. Ordinarily an offer of compromise or scheme of arrangement occurs between a company and its creditors and a scheme of arrangement occurs between a company and its members.

12. See, for example, Ensor v South Pine Properties (Pty) Limited 1978 (2) SA 755 (N) at 763, Borgelt v Millman N.O. and Another 1983 (1) SA 757 (C) at 763 and Ex Parte Garlick Limited 1990 (4) SA 324 (C) at 331 - 333

13. [1892] 2 QB 573 (CA) at 583 quoted with approval in Borgelt v Millman N.O. supra (note 13), at 763.

14. See, for example, Ensor v South Pine Properties (Pty) Limited, Borgelt v Millman N.O. and Ex Parte Garlick Limited supra (note 12). See also CCH Australian Company Law and Practice at 33,324 - 33,332 and 33,601 - 33,603 where it is confirmed that the Australian Courts apply the same principles as our law in respect of the "meaning of class".

15. See Section 425 of the Companies Act 1985 and Section 315 of the Companies Code.

16. See Henochsberg op cit at pages 504 - 507 and the cases cited therein and Ex Parte De Villiers and Another N.N.O.: In Re Carbon Developments (Pty) Limited (in liquidation) 1993 (1) SA 493 AD at 507H - 508G

17. See Henochsberg op cit at pages 510 - 511 and the cases cited therein. See further the discussion in this Chapter 2 under the sub-heading *"Section 424(1)"* and the discussion in Chapter 3 under the sub-heading *"Subordination"*.

18. Section 311(4) reads as follows:

> *"If the compromise or arrangement is in respect of a company being wound up and provides for the discharge of the winding-up order or for the dissolution of the company without winding-up, the liquidator of the company shall lodge with the Master a report in terms of Section 400(2) and a report as to whether or not any director or officer or past director or officer of the company is or appears to be personally liable for damages or compensation to the company or for any debts or liabilities of the company under any provision of this Act, and the Master shall report thereon to the Court."*

19. See Henochsberg op cit at pages 510 - 511 and the cases cited therein. See also CCH Australian Company Law and Practice at 33,351 - 33,354 and Gower :

Principles of Modern Company Law, 5th edition (1992) at 696 - 697 and the cases cited therein. In the *Carbon Developments* case supra (note 16) the Appellate Division in dealing with the issues of leave to convene meetings and sanction stated at 507 H - 508 G as follows:

> *"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, 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.'
> >
> > *Per Trengove J in Ex parte Bruyns NO: In re Mammoth Construction & Drilling Co (Pty) Ltd (under Provisional Liquidation) 1973 (3) SA 721 (T) at 722B-C.*
>
> *While that is the primary question, the Court is also concerned that the offer, on the face of it, appears to be made in good faith and honestly, and that its terms are unambiguous and understandable.*
>
> *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. He said the following in In re Alabama, New Orleans, Texas and Pacific Junction Railway Company [1891] 1 Ch 213 at 247:*
>
> > '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 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 the 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.'
>
> *I would respectfully adopt that formulation. It is clearly the proper approach at the sanction stage. Although compliance with the statutory conditions will not be relevant at the stage of convening meetings, the other considerations referred to by Fry LJ are no less appropriate. They strike a balance between the duty of the Court to be satisfied that the offer appears to be fair and honest and the recognition that it should not dictate to men of business what is in their own interests.*
>
> *It would be inappropriate to attempt to formulate a more precise rule in a matter of discretion and in a context where the variety of facts and circumstances is endless.*

The Court considering such an application should also 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. Indeed s312(1) of the Act requires that, where meetings are summoned under s311, every creditor or member must be sent a statement containing the information set out in subparagraph (a) thereof. A draft of that statement need not be placed before the Court at the stage of an application for leave to convene meetings. At the sanction stage it must clearly be before the Court in order that it may satisfy itself that the provisions of s312(1) have been observed."

20. See inter alia Ex Parte Ensor: In Re Cape Natal Litho (Pty) Limited 1978 (3) SA 908 (D) at 911 where Didcott J stated as follows:

> *"Although this compromise gets its force from the Court's imprimatur, this does not mean that its intrinsic character is any the less contractual. After sanctioning it and thus bringing it into operation, the Court has no greater control over it than any other sort of contract."*

See further Ex Parte Kaplan NNO: In Re Robin Consolidated Industries 1987 (3) SA 413 (W) at 419 C where Coetzee DJP styled the central characteristic of an arrangement as *"plainly contractual, albeit compulsory in respect of the minority"*. At 419I Coetzee DJP confirmed that such contractual nature does not cease to be such merely because third persons (e.g. the proposer or the receiver) are required to make finance available or perform certain duties (administrative or otherwise). See further Henochsberg op cit 515 and the cases cited therein.

21. See Incorporated General Insurances Limited v Cement Distributors (South Africa) (Pty) Limited 1990 (1) SA 132 AD at 136 H - I. The position is the same in England and Australia as is confirmed, for example, in CCH Australian Company Law and Practice at 33,621.

22. 1978 (2) SA 134 (D)

23. ibid at 138 A-B

24. supra (note 21) at 136 H

25. ibid at 136 J - 137 A

26. this judgment of the WLD being prior to Ex Parte Kaplan & Others N.N.O in re Robin Consolidated Industries Limited supra (note 20)

27. ibid at 137 - 138

28. 1990 (1) SA 560 (WLD)

29. 1992 (2) SA 761 (C). This case is on appeal to the Appellate Division.

30. supra (note 28) at 566

31. 1988 (1) SA 42 (25) at 47 E - H

32. supra (note 28) at 573 B - G

33. ibid at 573 I - J

34. Namex supra (note 29) at 770 - 771

35. ibid at 772 - 774

36. ibid at 775 B

37. An "affected transaction" is defined in the Code as meaning:

> *"Any transaction (including a transaction which forms part of a series of transactions) or scheme, whatever form it may take, which:*
>
> *(a) taking into account any securities held before such transaction or scheme, has or will have the effect of:*
>
> *(i) vesting control of any company (excluding a close corporation) in any person, or two or more persons acting in concert, in whom control did not vest prior to such transaction or scheme; or*
>
> *(ii) any person, or two or more persons acting in concert, acquiring or becoming the sole holder or holders of all the securities, or all the securities of a particular class, of any company (excluding a close corporation); or*
>
> *(b) involves the acquisition by any person, or two or more persons acting in concert, in whom control of any company (excluding a close corporation) vests on or after the date of commencement of Section 1(c) of the Companies Second Amendment Act 1990, of further securities of that company in excess of the limits prescribed in the rules".*

38. Section 440L of the Act.

39. Section 424(1) reads as follows:

> *"When it appears, whether it be in a winding-up, judicial management or otherwise, that any business of the company was or is being carried on recklessly or with intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose, the Court may, on the application of the Master, the liquidator, the judicial manager, any creditor or member or contributory of the company, declare that any person who was knowingly a party to the carrying on of the business in the manner aforesaid, shall be personally responsible, without any limitation of liability, for all or any of the debts or other liabilities of the company as the Court may direct."*

40. See Henochsberg op cit at page 511 and the cases cited therein.

41. See, for example, Ex Parte De Villiers NO: In Re MSL Publications (Pty) Limited (in liquidation) 1990 (4) SA 59 (W)

42. 1990 (4) SA 59 (W)

43. 1989 (3) SA 71 (T)

44. 1990 (1) SA 530 (W)

45. 1992 (2) SA 95 (W) (which case was heard on appeal by the Appellate Division - see note 16 supra)

46. ibid at 107 - 108

47. 1990 (2) SA 411 (C)

48. this judgment being prior to the Robin case supra (note 20).

49. supra (note 47) at 416-418

50. supra (note 45) at 106H - 108C

51. ibid at 108D

52. Ex Parte De Villiers and Another NNO: In Re Carbon Developments (Pty) Limited (in liquidation) supra (note 16)

53. ibid at 501.

54. See further the judgment of Street J in Re Vardin International (1971 - 1973) CLC 40 - 024 as cited in CCH Australian Company Law and Practice at 33,371 where the judge put the dilemma as follows:

> *"what then should the attitude of the Court to be to the proposal that, in lieu of the salutary and investigatory processes of a winding up, the creditors should be invited to accept a compromise of 11 cents in the dollar - a compromise procurable by the company fed into the tax loss sale traffic current in this community? It is a familiar question. Vindication of commercial morality on the one hand. Recovery for the unfortunate creditors of something from the wreck on the other hand."*

55. See, for example, Du Preez v Garber in re Die Boerebank Bpk 1963 (1) SA 806 (W) at 814, 825 - 826 and Ensor N.O. v South Pine Property and Another 1978 (2) SA 755 (N) at 760

56. Ex Parte Millman and Others N.N.O. in re Multi Bou (Pty) Limited and Others 1987 (4) SA 405 (C) at 409H - J

57. See for example the South Pine case supra (note 55) at 760.

58. Section 313(1)(a) - (f) makes provisions for all or any of the following matters:

(a) the transfer to the transferee company of the whole or any part of the undertaking and of the property or liabilities of any transferor company;

(b) the allotment or appropriation by the transferee company of any shares, debentures or other like interests in that company which under the compromise or arrangement are to be allotted or appropriated by that company to or for any person;

(c) the continuation by or against the transferee company of any legal proceedings pending by or against the transferor company;

(d) the dissolution, without winding up, of any transferor company;

(e) the provision to be made for any persons who, within such time and in such manner as the court may direct, dissent from the compromise or arrangement;

(f) such incidental, consequential and supplemental matters as are necessary to secure that the reconstruction or amalgamation shall be fully and effectively carried out.

CHAPTER 3

COMPROMISE OR ARRANGEMENT AS BETWEEN A COMPANY AND ITS CREDITORS

Introduction

It was fairly common practice in the early 1960's in the Cape Provincial Division for arrangements or compromises brought under Section 103 of the Companies Act of 1926 (the precursor of Section 311) to provide that a third party offered to acquire by cession the claims of creditors for a consideration which would entitle secured and preferent creditors to receive no less than they would on a winding-up of the company and concurrent creditors a dividend in excess of what they would achieve on a winding-up.[1] A halt was however called to this practice when it was pointed out at the hearing of one such application some 30 years ago that the scheme did not constitute a compromise between the company and its creditors, as it did not entail any adjustment of rights as between them as debtor and creditors, which is the distinctive feature of a compromise.[2] The lack of such element of compromise in the scheme was cured, or so it was believed, and for some 25 years accepted as cured, by inserting therein a provision whereby a reduction of the claim of each creditor by 1 cent in the rand (or some similarly small fraction) was deemed to have taken place. This concept had, it was thought, the effect of adjusting the rights of the company and its creditors as between themselves, and accordingly served to introduce the element of compromise into the scheme.[3] The same principles were also utilised in the other provinces of South Africa with regard to compromises or arrangements between a company and its creditors.[4] As time went by such compromises became more sophisticated with ancillary provisions designed for its implementation (and usually advantageous to the proposer) being grafted on resulting in

lengthy and complex documentation. The process whereby the claims were to be reduced by 1 cent in the rand (or one rand per claim), generally however remained a feature of every compromise, although with the passing of time its intended purpose and significance sometimes became lost. This type of scheme - hereinafter called "the Standard Scheme"[5] - was approved over the years in ever increasing numbers by the Courts throughout South Africa. In essence positive benefits were derived from the Standard Scheme[6] in that creditors invariably received a greater dividend than they would otherwise have been paid, the proposer of the scheme obtained control over the company, often with an assessed loss for income tax purposes and the company was discharged from liquidation to continue trading as a going concern. This practice however came to an end when the Witwatersrand Local Division in a full bench decision in *Ex parte Kaplan N.N.O. : in re: Robin Consolidated Industries Limited*[7] ("Robin") identified a fatal defect in the Standard Scheme and accordingly put an end to the Standard Scheme in its area of jurisdiction. Subsequently, the Cape Provincial Division in a full bench decision in *Ex parte Millman & Others N.N.O.: In Re Multi-bou (Pty) Ltd*[8] ("Multi-Bou") concurred with the *Robin* judgment and consequently also put an end to the Standard Scheme within its area of jurisdiction. In the Durban and Coastal Local Division, however, a full bench in the case of *Ex parte Strydom N.O. : in re: Central Plumbing Works (Natal) (Pty) Limited, Ex Parte Spendiff N.O. in re Candida Footwear Manufacturing (Pty) Limited*; *Ex Parte Spendiff N.O. in re Jerseyside (Pty) Limited*[9] ("the Natal Case"), upheld the validity of the Standard Scheme. The *ratio* in Robin and Multi-bou on the one hand and the *ratio* in the Natal case on the other hand have not as yet been the subject matter of any judgment of the Appellate Division and consequently no uniform approach exists amongst the various divisions of the Supreme Court with regard not only to the validity or otherwise of the Standard Scheme but also in respect of certain other kinds of schemes which have subsequently developed in an endeavour to overcome the problems arising out of the rejection of the Standard Scheme in the Cape and the Transvaal. The Robin, Multi-Bou and Natal cases represented a significant turning point in the field of compromises and arrangements. It is therefore unfortunate, given the uncertainty that prevails in such a key and beneficial area of our law, that in the six years which have lapsed since the Robin case, the Appellate Division has not as yet had the opportunity to consider any case which would finally determine this aspect of our law in respect of compromises or arrangements between a company and its creditors. Such uncertainty has however given rise to a certain amount of ingenuity in the scheme

of arrangement industry outside of Natal in order to overcome the problems arising out of the Robin and Multi-bou cases.

The Standard Scheme

The Standard Scheme essentially involved the following:

(a) Creditors agreeing to reduce their claims against the company by a nominal amount (usually 1 cent in the rand or one rand per claim); and

(b) The creditors' claims, after the aforementioned reduction, being deemed to be ceded to the acquirer of the company in consideration for a specified amount (i.e. the consideration paid in terms of the compromise or arrangement).

The reason for structuring the Standard Scheme in the above manner (besides the advantageous income tax implications which will be discussed in more detail below) was that if the Court was approached in terms of Section 311 with a scheme which simply involved a purchase (cession) of the claim of a creditor by the proposer of the scheme, this would be rejected by the Court on the basis that the jurisdictional requirements of Section 311 were not satisfied in that the scheme did not involve an arrangement or compromise between the company and its creditors. By including in the scheme the 'compromise' of 1 cent in the rand as between the company and each of its creditors, the belief was for many years, until the Robin case, that the jurisdictional requirements (i.e. a genuine compromise or arrangement between the company and its creditors) of Section 311 was satisfied.

A detailed definition of the Standard Scheme is contained in *Namex (Pty) Limited v Commissioner of Inland Revenue*[10] where Selikowitz J described it as follows:

> *"The 'Standard Scheme' is essentially one in which the offerer 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. The last provision was developed in an effort to establish that the scheme was, in fact, one between the company and its creditors - as is required by Section 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 of the company 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 loan account to draw income from the company with tangible tax benefits." [11]

The Robin Case

The material reasons why the Court (Coetzee DJP) in the *Robin* case rejected the Standard Scheme may be summarised as follows:

(a) The Court stressed that it is trite that the Court has no power to order a meeting to consider an arrangement which is not one between the company and its creditors or members. This did not mean that a third party could not be involved in the arrangement. However once under a proper construction of the contract the third person is the true party to the arrangement to the exclusion of one of the others, it can no longer be said to be an arrangement between the latter two parties as the role of such third party destroys the privity between the company and the creditors or members which is a vital pre-requisite to the operation of Section 311. Applying this analysis to the standard scheme the Court held that when stripped of a large number of ancillary provisions required to put it into operation, it was no more than an acquisition by the offeror of the creditors claims and as such was a compromise between the offeror and the creditors and not one between the company and the creditors.[12]

(b) In rejecting the view that the reduction of creditors claims by one cent in the Rand turned the whole scheme into a valid arrangement between the company and its creditors, the Court distinguished two parts of every compromise or arrangement - firstly, its basic content, that is the substance thereof which can stand alone and be the subject of an order under Section 311; and secondly its administrative element, being the conditions devised for the effective

implementation of the scheme. Such conditions were ancillary to the basic content and standing alone were meaningless. The court held that the totality of the basic content of the standard scheme was a reduction of creditors claims by one cent in the rand and the further provision that the reduced claims be ceded to a third person 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 part of the scheme that the myriad of ancillary conditions are included in the standard scheme. These, the Court held, are divisible from the reduction part, being an arrangement between the creditors and a stranger (the offeror) instead of the company. The court was accordingly constrained to disregard the cession aspect of the scheme thus leaving the reduction aspect the only content of the arrangement. To paraphrase Coetzee DJP this was of 'no interest to any person and accordingly the reduction scheme became exposed as a useless device which could not accomplish anything'.[13]

The Multi-Bou Case

In the Multi-Bou case, which followed shortly after the judgment in the Robin case, the Cape Provincial Division was faced with a scheme clearly designed to counter the defect in the Standard Scheme rejected in the Robin case. Prior to considering this proposed scheme the Court (Berman J) analysed the Standard Scheme. The Court, as in the *Robin* case, held that the material content of the Standard Scheme is the cession of the claims by the creditors to the proposer in a manner which did not require the participation or consent of the company and as such is not an arrangement between the company and its creditors. In arriving at such conclusion, the Court held as follows:

> *"The scope and purpose of the section is strictly limited to considering an arrangement between the company and its creditors, and not to an arrangement between its creditors or between its creditors and a third party. Thus, whilst an arrangement may be come to which is not only beneficial to the company but also to the advantage of both the creditor and proposer of the arrangement, that is to the satisfaction of all parties concerned, nevertheless unless it is one between the company and its creditors, with or without the inclusion and participation of a third party (and there is nothing, in my view, to inhibit the introduction of a third party into an arrangement and such introduction of a third party in no way renders the arrangement*

any less one between the company and its creditors), the application to have it referred to meetings of creditors cannot be entertained by the Court.

Now if one submits the standard scheme in its simplest form, viz without the provision for a reduction of all claims of creditors of a company by 1 cent in the rand, to scrutiny, it is readily apparent that it is nothing more than an arrangement between a third party and the creditors whereby the former acquires, by cession as against payment, the latter's claims, an arrangement which does not require the participation or consent of the company. Nor does the agreement of the creditors to reduce their claims against the company by 1 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. Nor for that matter does the reduction of claims by 1 cent in the rand constitute a compromise between the company and its creditors, for a compromise presupposes a dispute; see Sneath v Valley Gold Ltd [1893] 1 Ch 477; Ex parte Cyrildene Heights (Pty) Ltd (supra at 308G-H), and there is nothing in dispute between them - each creditor moreover will receive the same amount as a dividend out of the moneys paid by the third party whether the scheme provides for a 1 cent reduction in the rand or not." [14]

The essential feature of the proposed scheme in Multi-bou was that the offeror would acquire by way of cession 99% of each creditor's claim against payment of a stipulated amount. The company would then borrow on loan account from the offeror a further amount to be paid to its creditors for the remaining 1% of their claims. Both amounts would be paid to a receiver who would be responsible for making a distribution to the creditors on sanction of the scheme. It was argued by Counsel for the applicant that this proposed arrangement was distinguishable from the Standard Scheme in that the company would play an essential role being a party to a tripartite transaction between itself, the creditors, and the offeror. The company, as debtor, would have to agree to the partial cession of 99% of each of the creditor's claims for the cession to be valid in law. A further distinguishing feature of the scheme, as argued by Counsel for the applicant, was that certain of the assets of the company would be transferred to the receiver for the benefit of creditors, which assets would otherwise be and remain the property of the company, and this was said (by applicant's counsel) to require the consent of the company and the creditors and would accordingly create an arrangement between them.

The Court pointed out that the coming into operation of the scheme, including the cession of the claims of the creditors and the payment to them for the purposes of

extinguishing the remaining 1% of their unceded claims, is dependent upon the eventual sanction of the scheme by the Court and the registration of a certified copy of the sanction order by the Registrar of Companies in terms of Section 311(6)(a). The Court was of the view that the scheme is and must be regarded, if not as a single transaction, then as a number of separate transactions inter-dependent on each other and concluded simultaneously, and not as a progression of transactions taking place in a particular order, chronological or otherwise. Until registration of the order of court sanctioning the scheme had been effected, none of the steps contemplated in the scheme has any final or binding force, for until then the sanction order has no effect.[15] Dealing with the argument that the proposed scheme was distinguishable from the Standard Scheme in that it is a scheme where the company plays an essential role and as such does constitute an arrangement between the company and its creditors as part of a tripartite transaction (it being argued by Counsel that this was the position because the consent of the company, as debtor, is a vital pre-requisite to the cession to the offeror of 99% of each creditor's claim as this was in each instance a partial cession of a claim and therefore one which required the agreement of the debtor to afford it legal force and validity), the Court held that on a proper analysis of the scheme what appeared and purported to be a partial cession was nothing of the kind. The cession of 99% of the creditors claims could not be regarded, in the view of the Court, as an isolated arrangement or transaction apart and distinct from the other provisions of the scheme, which must be considered as a single transaction as and when 99% of the claims are ceded to the offeror against payment and the remaining 1% is extinguished by payment out of an amount also provided by the offeror for this purpose. Consequently no action for payment in respect of the said 1% can be brought against the company as the creditor has contractually bound himself, upon sanction, to look to the receiver for payment for whatever is due to him in respect of the 1% of his claim out of the funds provided by the offeror. Accordingly, the Court held, not only is there no possibility of more than a single action being maintained in respect of any creditor's claim but, more to the point, what is ceded to the offeror is the entire balance of the claim of such creditor and not a part of it, and the consent of the company is accordingly not required to render the cession legally effective and enforceable, for where part of a claim has been paid or satisfied, the remainder or balance can be ceded without reference to the debtor and without its consent.[16]

With regard to the remaining distinguishing feature argued by Counsel for the applicant (i.e. the transfer of certain assets to the receiver for the benefit of creditors, which assets would otherwise be and remain the property of the company, and which would accordingly require the consent of the company and thus create an arrangement between the company and the creditors) the Court held that such feature amounted to nothing other than an arrangement between the offeror and the company. The creditors, paid out by the receiver, have no claims against the company and therefore no interest in its assets. Whatever is paid or done takes place only after sanction and nothing is finally achieved until sanction. The Court was of the view that it is illusory to talk of arrangements being made and carried out at some preliminary stage, where in reality everything done only becomes effective and legally binding upon registration of the sanction order by the Registrar of Companies.[17]

The Court accordingly concluded that since the consent of the company to the cession of the unpaid portion of the claims of the creditors was not required, the scheme was not an arrangement in terms of Section 311 between the company and its creditors but only one between the offeror and the creditors.[18]

Furthermore, the Court held that there was yet another ground upon which the scheme should be rejected, namely that although on the face of it the scheme was based upon a partial cession, it was in reality nothing but the Standard Scheme in another form; it was a sham, a disguised or simulated transaction, structured to give the appearance and impression of an arrangement between the company and its creditors when in substance it was an arrangement between the offeror and the creditors.[19]

The Natal Case

In the Natal case (which was the subject matter of three applications referred for consideration to a full bench of the Durban and Coastal Local Division) the Court (Friedman J) was of the view that the Standard Scheme fulfilled the jurisdictional requirements of Section 311 by virtue of the fact that the deemed cession of creditors claims to the offeror in terms of the Standard Scheme was an arrangement between the company and its creditors. The Court held that because a 'deemed' as opposed to an 'actual' cession was present in the Standard Scheme, the company was required to

recognise a state of affairs which did not in fact exist. This required the participation of the company, the effect whereof was that the deemed cession of the claims of creditors was an arrangement between the company and its creditors for the purposes of Section 311. The Court distinguished the *Multi-Bou* case on the basis that no deemed cession was present in that case. The Court pointed out that the judgment in the *Robin* case had emphasised the final effect of the arrangement, namely the acquisition of the creditors claims by the offeror, but it overlooked the means by which that effect was achieved, namely a deemed cession. Friedman J summarised the matter as follows:

> *"In our view, therefore, there is no difficulty in conceptualising within the framework of a scheme of arrangement a 'deemed cession', that a cession shall be regarded as having taken place even although in truth and in fact it has not. Such a concept, to have any effect, however, requires the active participation of the debtor, i.e. the company. In the first place, what is required to bring about this situation is agreement on the part of the company to regard a third party as its creditor in place of its actual creditor, as if the actual creditor had ceded its claim to the third party. This concept can only be given any legal effect by the actions of the company in recognising a state of affairs as existing, which does not in fact exist. The contract is not one which, as Coetzee DJP says, exists purely between cedent and cessionary. Where there has in fact been a cession, the company is obliged to recognise the cessionary as its new creditor; where the cession is 'deemed', there is obviously no obligation on the company to recognise a state of affairs which does not, in fact, exist. It would seem to follow that the Court could not, in any event, make an order affecting the company without the company being a party thereto. The arrangement, therefore, whereby the company will recognise the offeror as its new creditor in place of its old, seems to us to be not only notionally and linguistically, but also in its basic content, an arrangement between it and its creditors."* [20]

The Court also advanced two further reasons why it was of the view that the Standard Scheme was an arrangement between the company and its creditors, viz:

(a) The offeror may not be in a position to acquire by means of cession the claims of all creditors. He may, for example, be unaware of the existence of all the creditors and even those of whom he is aware may be unwilling to cede their claims to him. It is only by the company making an arrangement with its creditors that the desired result can be achieved.

(b) Those creditors who are prepared to cede their claims to the offeror may, and often are, prepared to do so only upon the basis that all creditors of the same class will receive a similar dividend. This is something which the offeror may not be able to achieve for fairly self-evident reasons. The proposal therefore involves the company arranging with its creditors that they will all be treated on the same basis and this aspect of the arrangement is between the company and its creditors.[21]

In support of its decision in respect of a deemed cession the Court illustrated, in somewhat of a different manner, its argument as follows:

> *"It is usually a condition of the Standard Scheme that the offeror acquires all the shares of the company. This refers to an actual acquisition of the shares and is therefore an arrangement which must be concluded between the offeror and the company's shareholders or members. It is a transaction in which the company may play no part. On the other hand, it may be proposed in a scheme of arrangement that upon sanction of the scheme, all the shares in the company shall be deemed to have been transferred to the offeror. The achievement of this result requires the participation of the company. The company is required to enter into an arrangement with its members whereby it will regard the offeror as its new and only member, even if the existing members do not go through all the formalities attendant upon the actual transfer of the shares and even if they do not actually transfer their shares to the offeror. Such an arrangement will, so it seems to us, be one between the company and its members for the purposes of Section 311 (See re: Savoy Hotel Limited [1981] 3 All ER 646 at 653-654 D)."* [22]

In conclusion the Court pointed out that:

> *"When all is said and done, the Standard Scheme, reduced to its simplest form, amounts to no more nor less than this. The offeror makes the following proposals to the company: 'I am prepared to make a sum of money available to you to distribute equally amongst all your creditors. You must arrange with them that if they accept this money, you will then regard me as your only creditor as if all your present creditors had validly ceded their claims to me. If you arrange this, I will release you from liquidation and permit you to continue to trade'. In our view, the arrangement which the company then seeks to make pursuant to such a proposal is properly said to be one between the company and its creditors. What Coetzee DJP appears to have done in the Robin case is to look merely at the final effect or result of the scheme, namely the acquisition by the offeror of creditors claims, and has not looked at the scheme itself by means of which*

that has been achieved. In this, we believe, with the greatest respect to him, he has erred." [23]

Income Tax Considerations

In the *Robin* judgment, Coetzee DJP stated that he found it difficult to understand the reluctance of parties to proceed with a compromise on the very simple basis of the company itself compromising with its creditors with the very same funds provided by the offeror which would then become converted into capital.[24] With respect to Coetzee DJP this comment appears to illustrate that the learned judge had failed to take into consideration the effect of Section 20(1)(a)(ii) of the Income Tax Act on the structuring of a compromise or arrangement with a view to retaining the benefit of the assessed loss of the company. Arrangements or compromises between a company and its creditors frequently involve a company which is in financial difficulty or in the course of being wound up. One of the effects of a sanctioned scheme in such latter event is the simultaneous discharge of the winding-up order of the company[25] and accordingly the ability thereafter of such company to continue to trade as a going concern. A significant motivation in acquiring a company which is in financial difficulty or in the course of being wound up is the fact that such a company usually has an assessed loss which can be of obvious benefit to the acquirer from an income tax point of view if the company can again be placed on a profitable footing. It follows that if the retention of the assessed loss of a company is a consideration then the draftsman of such compromise or arrangement must structure such compromise or arrangement that he complies both with the jurisdictional requirements of Section 311 and the principles necessary to avoid a reduction of the assessed loss in terms of Section 20(1)(a)(ii). Some consideration of the income tax implications of Section 20(1)(a)(ii) in respect of a compromise or arrangement between a company and its creditors is accordingly of importance.

Before dealing with Section 20(1)(a)(ii) it is relevant to point out that Section 103(2) of the Income Tax Act must also be borne in mind when considering the preservation of an assessed loss in a compromise or arrangement. Whilst a detailed analysis of Section 103(2) is beyond the scope of this paper, it is relevant to point out that in terms of Section 103(2) whenever the Commissioner of Inland Revenue is satisfied that any agreement affecting any company or any change between the shareholders in the

company, 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 being entered into or effected by any person solely or mainly for the purpose of utilising 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. A fairly common example of the type of activity which Section 103(2) is designed to avoid is where there has been a diversion of income to the company or where the company, after a change of shareholding, earned income from activities which it had not undertaken before. It must however be emphasised that even where there is an avoidance of liability for tax, Section 103(2) will be inoperative unless the avoidance of tax was the sole or main purpose of the agreement or change in shareholding. In other words, if there was some sound business or commercial reason for the transaction (eg. to obtain the benefit of the company's assets, goodwill, trademarks, tradenames, permits or the like) the fact that the assessed loss was also taken into account, but was merely a subsidiary consideration, will not result in Section 103(2) becoming applicable. The onus of showing that tax avoidance was not the sole or main purpose lies on the taxpayer.[26]

It is important for any proposed acquirer of a company in terms of Section 311 to bear in mind that if in any year of assessment a company did not carry on a trade it is, firstly, not permitted to carry forward to that year any assessed loss established in the immediately preceding year of assessment and secondly, the company loses forever its right to carry forward such an assessed loss. It is however not essential that a company carries on a trade during the entire year of assessment. Any period of trading during such year will suffice. The reason for the requirement of some period of trading is that Section 20(1)(a) of the Income Tax Act envisages a continuity in setting off an assessed loss in every year succeeding the year in which it was originally incurred, so that in each succeeding year a balance can be ascertained which can be carried forward from year to year until it is exhausted. The mere fact that a company keeps itself alive during the year of assessment, but without trading, is not enough to entitle it to carry forward an assessed loss into the next year. It would appear that the carrying forward of an assessed loss is not precluded where there has been no income derived from the carrying on of a

trade provided that the taxpayer has in fact carried on a trade during the year of assessment with the intention to earn an income.[27]

Section 20(1)(a) of the Income Tax Act provides that in calculating the taxable income derived by any person from carrying on any trade, an assessed loss brought forward may be set off against such income. A limitation on the set-off of an assessed loss against income in terms of Section 20(1)(a) is however provided in Section 20(1)(a)(ii). Section 20(1)(a)(ii) reads as follows:

> *"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 liabilities to them have been reduced or extinguished, provided such liabilities arose in the ordinary course of trade."*

It will be apparent from Section 20(1)(a)(ii) that if an acquirer of the company wishes to preserve any assessed loss which the company may enjoy for tax purposes, the amount or value of any concession by or compromise with the company's creditors must be kept to an absolute minimum. The company's assessed loss will be reduced to the extent of the amount of any concession by or compromise with its creditors. Consequently an intended acquirer of a company which enjoys an assessed loss for tax purposes would be desirous, firstly, of effecting a compromise or arrangement between the company and its creditors by the usage of the advantageous Section 311 procedure and, secondly, he would wish to minimise the amount or benefit of any such compromise in order to preserve as much as possible of the assessed loss of the company, regard being had to the provisions of Section 20(1)(a)(ii).

For many years the Standard Scheme provided the ideal method for preserving the assessed loss of a company. From an income tax point of view (assuming of course the provisions of Section 103(2) were not applicable) the compromised element with the creditors of the company (usually 1 cent in the rand or one rand per claim) in terms of the Standard Scheme resulted in an insignificant reduction in the assessed loss of the company in terms of Section 20(1)(a)(ii).

It follows that the *Robin* and *Multi-bou* cases delivered a blow to the scheme of arrangement industry (save in Natal) not only from the point of view of the usage of

Section 311, but also in respect of the termination (save in *Natal*) of a proven and tested method of avoiding any material reduction in any assessed loss of a company in terms of the provisions of Section 20(1)(a)(ii).

Fortunately, the scheme of arrangement industry has managed however to show some resilience following Robin and Multi-Bou, both with regard to the advantageous utilisation of Section 311 and the proposing of schemes which are capable of preventing a substantial reduction in any assessed loss of a company in terms of Section 20(1)(a)(ii), as is illustrated hereunder.

The Boltstone Case

The next saga in the battle to preserve the assessed loss of a company was the proposing of a scheme of arrangement between a company and its creditors which generally became known as the "preference share scheme". This type of scheme was first approved in a number of unreported judgments in the Transvaal and thereafter in the Cape.[28] The first reported judgment on the preference share scheme was the Orange Free State decision of *Sackstein N.O. v Boltstone (Free State) (Pty) Ltd (in liquidation)*[29] ("Boltstone"). The essence of the preference share scheme is that the claims of the creditors, as reduced by the dividend payable to them in terms of the scheme, is converted into preference share capital. The creditors are then deemed to have renounced their entitlement to the issue and allotment of such preference shares in favour of a person (usually the proposer) nominated by the company. The rights of all creditors under such scheme, with regard to payment of their claims, are then confined to the right to claim payment of the dividends receivable by them under the scheme. The dividend received by creditors is derived from funds which are either loaned to the company (usually by the proposer of the arrangement) or from the issue and allotment of shares in the company (usually to the proposer of the compromise or arrangement).

The Court held in Boltstone that the preference share scheme was indeed one between the company and its creditors. The creditors were directly involved in that they had to agree to the conversion of their claims into capital and to renounce their entitlement to the issue of redeemable preference shares in exchange for the receipt of a dividend. The company was also directly involved in that it passes a resolution consenting to the

transfer of the issued share capital of the company to the proposer (or its nominee); passes a resolution to capitalise the claims of the creditors on the basis of creating preference shares; allotting and issuing them to the parties entitled thereto and paying the capital sum in terms of the scheme to the creditors.

Although not apparent from the reported judgment, a perusal of the scheme of arrangement in the Boltstone case clearly shows that the preference shares in Boltstone were of a redeemable nature. Most, if not all, of the preferent share schemes utilise the method of redeemable preference shares but the terms and conditions thereof tend to vary. Certain schemes provide an actual redemption date, whilst other schemes provide that the redemption date is to be determined at the discretion of the directors of the company. The value of the redemption is equivalent to the issue price of the shares. Certain schemes provide for a dividend (usually non-cumulative) to be declared at the discretion of the directors. Most schemes entitled the preference shareholder to priority for repayment of capital in the event of the company being wound up.

Whilst the preference share scheme clearly satisfies the jurisdictional requirements of Section 311, of material importance is whether it is able to preserve the company's assessed loss pursuant to the provisions of Section 20(1)(a)(ii) of the Income Tax Act. This issue is yet to be decided by our courts.

Analysis of Retention of Assessed Loss by Utilisation of Preference Share Scheme

Proponents of the preference share scheme argue that such scheme is tax effective in that Section 20(1)(a)(ii) of the Income Tax Act does not apply in that a liability to repay a debt of a certain amount has been replaced with a liability to redeem preference shares at a value equal to the amount of the debt. Consequently although the form of the liability has changed the amount thereof is the same as before.

The first article to be published on the tax effectiveness of the preference share scheme appeared in *Finance Week* (August 27 - September 2 1987) by Gavin Urquhart. Urquhart analysed the tax implications of the scheme and concluded that "caution is indicated". Urquhart pointed out that:

(a) There can be no doubt that one effect of the scheme is to reduce or extinguish the liabilities of the company concerned to its creditors. The question is whether however this results from a concession granted by or a compromise made with these creditors;

(b) Creditors would receive in respect of their liabilities a dividend in cash and the balance by way of preference shares. Although creditors would effectively only receive such dividend, this results from the renunciation of their rights to the preference shares in favour of the offeror and not as a result of having entered into a compromise with the company;

(c) Section 20(1)(a)(ii) does not only apply to compromises but also to concessions granted by creditors. There must be a strong argument that the creditors are granting a concession to the company. Urquhart argued that material factors which point in this direction are:

(i) The legal position of creditors is stronger than that of preference shareholders in that creditors rank prior to preference shareholders on the liquidation of the company. By accepting preference shares in place of the liabilities, the creditors may therefore be said to have granted a concession to the company as contemplated in Section 20(1)(a)(ii);

(ii) Although the preference shares will be issued at a par value, this does not necessarily mean that they are in fact worth that value. Although the restructuring of the company which may follow the scheme may actually mean that the preference shares are worth their full value, this is certainly not automatic. In many cases it is unlikely that such preference shares could be redeemed immediately following the transaction at anything close to their par value. If the value of the preference shares is therefore less than their par value, there must be a strong argument that the creditors have granted a concession to the company.

The matter was then considered in the 1987 *Income Tax Reporter*.[30] The author of the article, Professor R J Jooste, appeared hopeful that the preference share scheme would indeed overcome Section 20(1)(a)(ii). The *Income Tax Reporter* stated as follows in this regard:

> *"For Section 20(1)(a)(ii) to apply a benefit must be received by or accrued to the company. It is true that the legal position of creditors is stronger than that of preference shareholders but it does not appear to follow from the fact that a benefit has been derived by the company. It has been correctly pointed out that, although the preference shares will be issued at a par value, they will not necessarily be worth that value. It has accordingly been suggested that if the value of the preference shares is less than their par value that the creditors have granted a concession to the company. Does it follow, however, that a benefit has accrued to or been received by the company? Has the form of the liability not simply changed leaving the amount thereof the same as before? Has the liability to repay a debt of a certain amount not simply been replaced with the liability to redeem the preference shares with a par value equal to the amount of the debt? If a benefit has, in fact, accrued to or been received by the company two mitigating factors should, however, be borne in mind. Firstly, an amount of value will have to be arrived at in respect of the benefit. If there is in fact a benefit, it will be extremely difficult if not impossible to quantify. Secondly, even if there is a benefit and it can be quantified, it may not be of major magnitude relative to the assessed loss and accordingly the reduction of the assessed loss in terms of Section 20(1)(a)(ii) may not be significant enough to cause concern."*[31]

Professor R J Jooste writing in the 1989 *Income Tax Reporter*[32] again considered the matter following the Boltstone case. On reading such volume of the *Income Tax Reporter* it initially appears that the journal alters its apparently previous positive view on the preference share scheme. However on closer examination it is apparent from the article (see footnote 11 on page 10 thereof) that Professor Jooste had incorrectly assumed that the nature of the shares in the Boltstone case were preference shares as opposed to redeemable preference shares (as mentioned the Boltstone case does not make it clear that the shares were in fact redeemable preference shares but a perusal of the actual scheme and the resolutions passed pursuant thereto clearly reflect that redeemable preference shares were issued). It follows that the 1989 *Income Tax Reporter* must be seen as commenting on the tax position if preference shares as opposed to redeemable preference shares is issued. Insofar as any scheme involving preference shares is concerned the 1989 *Income Tax Reporter* favoured the view that the company would

indeed derive a clearly defined benefit.[33] With respect, as regards preference shares (as indeed would also be the position if the claims of creditors were capitalised by way of ordinary shares) this is correct. There are material differences between a preference share and a creditor's claim. A creditor's claim must be paid on due date whether or not profits exist. A preference shareholder, on the other hand, is only entitled to be paid a dividend out of profits and a return of capital is only possible in limited circumstances. These differences support the view that the company is deriving a clearly defined benefit (the face value of the reduced claims) which will reduce the company's balance of assessed loss.

The most detailed analysis of the tax implications of the preference share scheme appears in the February 1989 *Taxpayer*.[34] The material arguments of *The Taxpayer* on this issue may be summarised as follows:

(a) For the purposes of analysis *The Taxpayer* breaks down the requirements of Section 20(1)(a)(ii), all of which must be present before an assessed loss is diminished or extinguished, as follows:

(i) the amount or value of any benefit received by or accruing to the company;

(ii) resulting from a concession granted by or a compromise made with its creditors;

(iii) whereby its liabilities to them have been reduced or extinguished.

(b) As far as requirement (i) is concerned, *The Taxpayer* submits that a benefit does accrue to the company. *The Taxpayer* states in this regard that:

> *"Prior to sanction of the arrangement by the Court the company owes certain debts, due and payable by it, to its creditors. After sanction, there are no debts due and payable by the company. The debts have been capitalised, it is true, and in an accounting sense the entity might still owe its shareholders the amount which has been capitalised, but in a legal sense the amount capitalised is no longer due and payable."* [35]

(c) As far as requirement (ii) is concerned, *The Taxpayer* argues that this is more difficult to adjudicate. It points out that Section 20(1)(a)(ii) envisages a situation in which the creditors have agreed to accept something less than they were originally entitled to insist upon. The question is whether, by converting their claims into share capital, the creditors have granted a concession to or made a compromise with the company. *The Taxpayer* submits that a persuasive approach is to examine the *quid pro quo* to which the creditors become entitled in settlement of their claims; if it is adequate then there is no concession or compromise; if it is inadequate then a concession must have been granted or a compromise made. *The Taxpayer* refers to an Australian decision, *Grant v Federal Commissioner of Taxation* 7 ATR 1 as reported in 1982 Taxpayer 224 *et seq* ("Grant"), as highly instructive in this regard. In this case the taxpayer paid $97000 for the allotment of 97 000 preference shares with a par value of $1 each, but the Court valued these preference shares at $39 770. The majority of 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 their market value of $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 $1 par value preference shares. The taxpayer was accordingly held liable for gift duty on the difference between the amount paid and the market value of the shares allotted. However, in a minority judgment, 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 there was no liability for gift duty. *The Taxpayer* considers the question whether a compromise or concession has been granted or made where creditors receive par value preference shares for the face value of their claims to be directly analogous. On the 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 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 adopt the approach of Jacobs J that since the lawful minimum has been paid for par value preference shares no concession or compromise can (objectively) be said to be present. *The Taxpayer* refrains from speculating which approach is likely to be followed in South Africa although the journal states that it inclines towards the majority view in the Grant case that the market value of the shares ought to prevail over the

par value. They state that there is local authority for such an approach, albeit in different circumstances viz in *Lace Proprietary Mines Limited v Commissioner for Inland Revenue* 1938 AD 267 the Court held that the taxpayer received 1 000 000 shares as consideration and that the shares had to be valued according to their market value. *The Taxpayer* however indicates that it is unwilling to be dogmatic on the question of the existence of a concession granted by creditors under the preference share scheme although their inclination is towards the view that if the market value of the shares is less than the amount of the claims a concession has been granted. The fact that the creditors proceed to renounce their entitlement to the allotment of the shares in return for a lesser amount seems, to *The Taxpayer*, to corroborate the view that a compromise or concession has taken place.[36]

(d) As far as requirement (iii) above is concerned, *The Taxpayer* points out that there can be no doubt that the company's liabilities to its former creditors have been extinguished. On sanction of the arrangement the company no longer has any creditors.[37]

The Taxpayer therefore concludes that if its analysis of the provisions of Section 20(1)(a)(ii) is correct, the company may well lose a substantial portion of its assessed loss by adopting the preference share scheme, rendering the scheme ineffective from a tax point of view.[38]

It is submitted that the following arguments can be advanced in favour of the preference share scheme possibly rendering the provision of Section 20(1)(a)(ii) wholly or partially inoperative, viz:

(a) No benefit has in fact been received by or accrued to the company in that although the form of the liability has changed (i.e. the creditor's claims into redeemable preference shares) the amount thereof (i.e. the liability to redeem at the issue price which price is equal to the unpaid value of the creditor's claims) and the obligation to repay same has remained as before.

(b) It is a general rule that a company cannot issue shares on terms that it shall or may redeem them at an agreed future date as such redemption would amount to

a purchase by the company of its own shares, which is illegal. There is one exception to this general rule, namely the Act makes provision for the issue of preference shares which may be redeemed either unconditionally or at the option of the company. Such preference shares can only be redeemed out of the proceeds of a fresh issue of shares or out of profits which would otherwise be available for dividend. From a financial point of view redeemable preference shares may in the circumstances perhaps be regarded as a hybrid form of shares and debentures containing features of both, although in law they are clearly treated as shares. It is accordingly arguable 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 (if the shares are redeemable on or before a fixed date) or a contingent (if the shares are redeemable at the option of the company) obligation to repay to the holders of the shares the issue price thereof. It is also interesting to note that the Financial Mail in its definition of debt:equity ratio includes as part of the meaning of "debt" redeemable preference shares and excludes redeemable preference share in its definition of total shareholders funds.[39]

(c) The obligation to redeem, provided the shares are redeemable on a fixed date (i.e. an actual obligation as opposed to a contingent obligation), is enforceable to the extent that it is submitted the failure to redeem can result in the adoption by the shareholder of the ultimate sanction against a company, namely winding-up. The ultimate sanction of a creditor is likewise to wind-up the company in the case of a failure to pay any debt which is due and payable.

(d) If the line of reasoning in the minority judgment (to the effect that if the lawful minimum has been paid for the allotment or issue of the shares no concession or compromise can objectively be said to be present) in Grant's case is followed by a South African Court (see also in this regard Section 92 of the Act - "shares not to be allotted or issued unless fully paid-up").

(e) In monetary terms the true (market) value of a creditor's claim as at date of liquidation is generally significantly less than its face value. Assuming (as is usually the case) the company on sanction has no creditors and 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 in such circumstances that in most, if not all, instances the true (market) value of the redeemable preference shares as at date of sanction is unlikely to be less than the true (market) value of the creditor's claims immediately prior to the compromise (or date of winding-up). Accordingly the former creditors of the company, based on a 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 values as at date of sanction.

One possible consideration, if possible, is to so structure the scheme that with effect from the date of sanction the company acquires substantial new assets in consideration for the issue of shares to the seller thereof (i.e. "a reverse take over"). In such event the argument as to the true value of the preference shares is likely to be significantly or entirely negated.

In conclusion, the preference share scheme is one way or another, certainly not without difficulty from a tax point of view and should, until the issue is settled, be approached with some caution.[40] If such a scheme is to be adopted then it is suggested that in an endeavour to enhance the arguments in its favour, the following terms and conditions relating to the issue of such shares should be adopted:

(a) Redeemable preference shares, as opposed to preference shares, should always be issued.

(b) The amount or value of the redemption must be equal to the issued price of the shares.

(c) The obligation to redeem such shares should preferably be an actual, and not a contingent, obligation on the company.

(d) The holders of the redeemable preference shares should have a right to the repayment of capital in preference to other shareholders in the event of the winding-up of the company.

(e) Provision should be made for a fixed dividend alternatively a variable rate dividend to be declared at the discretion of the directors of the company.

(f) The company should not have the right to issue any shares, whether redeemable or not, ranking in priority to or pari passu with the redeemable preference shares issued in terms of the scheme.

Subordination

A standard provision in schemes of arrangement or offers of compromise involving companies in provisional or final liquidation is a condition that in the event of sanction of the scheme the company be discharged from liquidation in terms of Section 354(1) of the Act simultaneously with the sanction of the scheme. For many years the courts routinely granted an order of this nature once it had decided to sanction the scheme. However, in the *Robin* case, the Counsel invited by the Court to act as *amicus curiae* argued that although the Standard Scheme represented a compromise as far as creditors were concerned, it was not one as far as the company was concerned. The result of the Standard Scheme was that the company's liabilities remained intact. It merely substituted one creditor (the offeror and pursuant to the scheme the controller of the company) for the previous creditors by virtue of the cession of the claims and consequently was as insolvent as when it was wound-up. Consequently when discharging the winding-up order, the Court sent back into the business world the same hopelessly insolvent company to trade and incur debts as before. Per se this was not illegal, but a greater potential for harm and prejudice to the public than before lurked in this state of affairs. It was argued that this arose from the fact that all the debts of the company were now consolidated in the hands of the controller of the company. Because this enabled such person to play a dominant role in any division of the assets in the event of any future winding-up, a new creditor who supplied goods to such company may find the bulk of these goods being used to pay the indebtedness of this large "creditor/controller" which has now arrived on the scene. The Court associated itself with the argument of

Counsel. It furthermore pointed out that if after trading perfectly *bona fide* and obtaining large amounts of good on credit, the company subsequently realised that it could not carry on, the controller, *qua* creditor, would end up with a concurrent dividend comprising a substantial portion of the assets of the company. The Court stated that:

> *"In the hands of disreputable persons who become new controllers this kind of scheme concentrates awesome powers for harm. The public interest, which is clearly a proper consideration in the exercise of the Court's discretion, probably demands that, because such results are foreseeably possible, this kind of scheme, even if otherwise legal, should not be countenanced."* [41]

The Counsel who acted as *amicus curiae* in the *Robin* case had pointed out during a prior meeting with the applicants that he intended to argue this issue and consequently a supplementary affidavit was filed by applicant during the course of the hearing of the *Robin* case in which it was tendered that the ceded claims be the subject of a subordination and/or are converted into new capital (preferably in the form of non-cumulative redeemable preference shares) to the extent that may be required to render the company solvent. Coetzee DJP regarded the aforegoing as sound suggestions. Coetzee DJP indicated a preference for the second suggestion, namely the conversion of acquired claims into capital stating *obiter* as follows:

> *"Any terms of a separate deed in terms whereof these claims ..... 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 as satisfactory. The conversion to 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 sanctioning of the scheme. The Court will examine such a separate contract to determine whether it is a real capitalisation."* [42]

In the *Multi-Bou* and *Natal* cases the issue of subordination also arose. In the light of the *ratio* in *Multi-Bou* case it was not necessary for the Court to consider the matter, but it did comment as follows:

> *"In the Robin judgment a preference was expressed for the conversion of the ceded claims into new capital as a means of avoiding the dangers inherent in permitting an insolvent company to carry on business; Counsel in this Court indicated a preference for the subordination of the ceded claims in the event that it issue an order as sought in the application. In the light of the conclusion which I have reached, it is undesirable for this Court to decide how this problem is best solved, it being of academic interest only in this case."* [43]

The issue was more fully considered in the *Natal* case. The Court disagreed with the *Robin* case, both in respect of the suggested problem (i.e. the discharge of the insolvent company to trade and incur debts as before) and with the proposed solution (i.e. capitalisation). The Court state as follows:

(a) Whilst it was true that the company which the Court 'sends back into business' is insolvent in the sense that its liabilities (all of which are owing to its new controller) exceeds its assets, any company which has accumulated losses in excess of its share capital is insolvent in this sense. The Court expressed the view that there were undoubtedly very many companies operating exceedingly successfully in the real business world in this position. From a commercial point of view, and the Court pointed out that in its view it was recognised in many ways in the Act, the true test of the solvency of a company is not whether the liabilities of such company exceeds its assets, but whether it is able to pay its debts. The Court pointed out that there are, for example, very many companies that commence business with a negligible share capital and can purchase the assets necessary to carry on its business only by means of its shareholders lending or advancing to it the funds required for this purpose. The Court emphasised that all of this is well known in the commercial world and persons who supply goods to companies have regard to the realities of the situation in considering whether or not to grant credit to the company. If such suppliers are not satisfied with the company's creditworthiness they may insist upon being paid cash or refuse to supply it. That is their prerogative. The Court felt that it is not for the Court to make such decisions for them. The Court also felt that it was difficult to see why such future or potential creditors should enjoy any greater protection in cases where companies are released from liquidation following upon the sanction of a scheme of arrangement. [44]

(b) There was also another protection to creditors against companies trading in insolvent circumstances. In practice auditors of companies in such circumstances will require the shareholder/creditor to subordinate his claims against the company to those of other creditors, failing which the auditor will be obliged to report the continued trading of the company as a material irregularity in terms of Section 20(5) of the Public Accountants and Auditors Act No. 80 of 1991.[45]

(c) That to insist upon the conversion of shareholders claims in the share capital, as suggested in the *Robin* case, would be an exercise in futility. Assuming the Court were to insist that the shareholders loan accounts be capitalised as a condition precedent either to the sanction of the scheme or to the release of the company from liquidation, this would have no practical effect. Immediately upon the release of the company from liquidation, the pre-sanction situation could be restored with the company reducing its share capital back to what it was and thereby recreating as it were the shareholders loan accounts. As at this stage the company will not have any liabilities, the reduction can be accomplished in terms of Section 83 of the Act simply by means of special resolution.[46]

In the *Lebowa*, *MSL Publications* and *Carbon Developments* cases,[47] Stegmann J, in each of his judgments in such cases, clearly rejected the argument that a subordination agreement would have the effect of restoring an insolvent company to solvency or that it would provide any material safeguard for future creditors. Stegmann J was of the view that the Court could not, on the grounds of public policy including a recognition of the need to maintain a measure of commercial morality, knowingly expose future creditors to a company which would remain insolvent if an arrangement or compromise was sanctioned and pursuant thereto any winding-up order was discharged, thereby enabling such company to continue to trade in insolvent circumstances.[48]

In *Cooper v A & G Fashions (Pty) Limited : Ex Parte Millman & Another*,[49] ("A & G Fashions") the Cape Provincial Division however held that a suitably worded subordination agreement could restore a company to solvency where the effect of the subordination provision is that as long as the company's balance sheet shows that its liabilities exceed its assets, the subordinated debt remains a contingent liability. A contingent debt is valued according to the prospect of its becoming enforceable. In

evaluating a company's financial position, one would not assess the debt at its face value.[50]

The Court further held as follows:

(a) If the Court was satisfied that in a scheme the company was solvent immediately after its sanction, and would probably not be made insolvent by the burden of pre-sanction liabilities, it would more readily sanction a compromise than if it feared that pre-sanction liabilities might be re-imposed upon the company and render it insolvent once more.[51]

(b) The Court might even, in the exercise of the discretion conferred upon it by the Act, sanction a scheme when the company's liabilities exceed its assets, provided that there appears to be sufficient working capital satisfactorily to conduct the business upon which it proposed to embark.[52]

The Court acknowledged that a subordination as opposed to a capitalisation would safeguard the assessed loss which the company had incurred in previous years. The Court regarded it as "perfectly understandable"[53] that the company would endeavour to retain its assessed loss. Similarly in the *Natal* case the Court acknowledged, without any disapproval, that the Standard Scheme was evolved as a means whereby an offeror could assume control of a company in a manner by which that company's assessed loss could be preserved and thereafter utilised in the hands of the offeror for tax avoidance purposes.[54]

Although any detailed analysis is beyond the scope of this paper, it will be appreciated that the effect of Stegmann's judgments in respect of the issue of subordination affected a number of commercial issues, including the long-standing practice of auditors believing that it was not necessary for them to record as a material irregularity in terms of Section 20(5) of the Public Accountants and Auditors Act No. 80 of 1991 that a company was trading in insolvent circumstances if a subordination agreement was in existence.[55] From the perspective of Section 311 the subordination issue is of material importance because, as will be seen below, the efficacy of a subordination agreement forms the basis of three kinds of tax-effective schemes in the Cape subsequent to the *Robin* and *Multi-bou* cases. It was therefore fortunate that the *Carbon Developments* case was the subject matter of

an appeal to the Appellate Division.[56] The unanimous judgment of the Appellate Division was delivered by Goldstone, JA. The Appellate Division held as follows:

(a) The essence of a subordination agreement, generally speaking, is that the enforceability of a debt, by agreement with the creditors to whom it is owed, is made dependent upon the solvency of the debtor and the prior payment of its debts to other creditors. Save possibly in exceptional cases, the terms of the subordination agreement will have the following legal effect: the debt comes into existence or continues to exist, as the case may be, but its enforceability is made subject to the fulfilment of a condition, the condition usually being that the debt may be enforced by the creditor only if and when the value of the debtor's assets exceed his liabilities, excluding the subordinated debt. In the event of the insolvency of the debtor, sequestration would normally mean that the condition upon which the enforceability of the debt depends will have become incapable of fulfilment. The legal result of this would be that the debt dies a natural death and that the erstwhile creditor would, in consequence, have no claim which could be proved in insolvency.[57]

(b) The fact that the liabilities of the company exceed its assets does not necessarily mean that the incurring of further debts would constitute fraudulent or reckless conduct. In this context, the existence and terms of a subordination agreement would be material and relevant in deciding whether the persons conducting such business incurred the debts with the reasonable expectation of their being paid in the normal course. The fact that a major creditor subordinated its claims and to that extent created a moratorium for the benefit of other creditors, is obviously relevant in determining the subjective state of mind of the debtor or those conducting the business.[58]

(c) Where a debt has been subordinated there is no interference with the statutory ranking of claims on insolvency: the creditor has no claim unless other creditors receive payment in full. The liquidator would be obliged to have regard to a subordination agreement which was valid and in force as at the date of liquidation.[59]

(d) A significant number of companies traded in South Africa with a negligible share capital and maintained the viability to conduct business by means of its shareholders lending or advancing to it the funds required for this purpose. These shareholders loans will in many instances be subordinated to the extent necessary to ensure that the subordinated debt does not exceed the assets of the company. As Goldstone J A pointed out, if the view taken by Stegmann J was correct, it would follow that for decades in South Africa the officers of a vast number of private companies (unbeknown to them) and notwithstanding the generally accepted practice in the commercial world, have acted unlawfully and dishonestly.[60]

The acceptance of the principle of subordination materially assists to keep the way open for the continuation of arrangements or compromises involving the beneficial utilisation of tax loss companies as will be seen hereunder. The principle of subordination does not of its own accord result in any reduction of an assessed loss in terms of Section 20(1)(a)(ii).[61] Although subordination may result in a concession being granted to a company by its creditors it does not result in the reduction or extinguishing of the liability (indeed provision may be made for interest to be paid provided such payments are also subordinated).[62] As mentioned above, Section 20(1)(a)(ii) can only apply if all the requirements of Section 20(1)(a)(ii) are satisfied including the reduction or extinguishing of the liabilities of the company arising out of the compromise between the company and its creditors.[63]

The Excluded Creditor Scheme

It is apparent that any scheme which was designed to overcome the issues raised in the *Robin* and *Multi-Bou* cases would of necessity have to preserve a reasonable proportion of the assessed loss of a company.

Subsequent to the *Robin* and *Multi-bou* cases, potential proposers of compromises or arrangements in the area of jurisdiction of the Cape Provincial Division were in the fortunate position that the Cape Provincial Division supported the principle that the 'solvency' of the company on the discharge of the winding-up order could be satisfied by subordination as opposed to capitalisation. The principle of subordination was first

accepted in certain unreported cases in the Cape Provincial Division[64] and thereafter the subject matter of the *A & G Fashions* case.[65] The aforegoing enabled the development in the Cape (subsequent to *Robin* and *Multi-bou*) of a scheme which is aptly styled "the excluded creditor scheme". It was this type of scheme which was the subject matter of the scheme of arrangement in the *A & G Fashions* case.

The excluded creditor scheme is favourably adopted where a small number of creditors have in terms of value the greatest percentage of claims against the company. In essence the excluded creditor scheme involves the company compromising with its creditors ("the scheme creditors") for a monetary consideration, acquired from money lent to the company usually by the proposer of the scheme[66] ("the capital sum"), save that the claims of certain creditors ("the excluded creditors") are excluded from the ambit of the scheme. The claims of the scheme creditors against the company are compromised and fully discharged in return for payment of a monetary dividend (derived from the capital sum and in addition, on occasions, from the sale proceeds of certain assets of the company) but the claims of the excluded creditors, who are usually few in number, are dealt with independently of the scheme by way of a separate agreement of cession between the creditor and the proposer of the scheme and to which the company is not a party. The claims of the excluded creditors are ceded to the proposer as against payment of a monetary dividend which is usually the same as that paid by the company to the scheme creditors. As the face value of the ceded claims of the excluded creditors usually form a material amount in value of the total claims of all the creditors against the company, the value of claims forming the compromise with the scheme creditors (who usually constitute a majority in number but a small amount in value) is relatively small. Consequently it is only by the relatively small amount of the value of the compromise with scheme creditors that the assessed loss is reduced in terms of section 20(1)(a)(ii). No set off against the assessed loss takes place in respect of the cession of the claims of the excluded creditors to the proposer, such transaction falling outside the ambit of the scheme.

The excluded creditor scheme, besides constituting a scheme between the company and the scheme creditors within the meaning of Section 311, satisfies the principle that an insolvent company should not be discharged from liquidation by virtue of the fact that the ceded claims of the excluded creditors together, with the capital sum, are subordinated. Such subordination must be binding and effective, such result generally

being achieved by following the principles referred to in the *A & G Fashions* case.[67] It follows that the end result of the excluded creditors scheme is the full discharge of the claims of scheme creditors against the company and the vesting in the proposer (besides control of the company) of the ceded claims of the excluded creditors, subject to the subordination. The proposer upon sanction and the simultaneous discharge of the company from winding-up thus has control of a company free of outside creditors coupled with a relatively small reduction in any assessed loss of the company.

The Development of a New Cape Scheme

The Excluded Creditor Scheme has a number of inhibiting features which in a number of instances renders it difficult, time-consuming and costly to implement, viz:

(a) it is necessary to negotiate individually with each of the excluded creditors in order to persuade such creditors to cede their claims directly to the proposer of the scheme (and accordingly outside the ambit of the scheme). This is sometimes time-consuming and difficult;

(b) excluded creditors sometimes realise from the perspective of the proposer retaining the benefit of the assessed loss, that it is essential for the proposer to obtain cession of their claims outside of the scheme and consequently sometimes demand a higher dividend than that paid to the scheme creditors. Indeed in practice unless the excluded creditors have some vested interest in seeing the scheme succeed (eg. likely ongoing business with the company once it was discharged from winding-up or a business relationship with the proposer of the scheme which makes it of commercial importance to support the proposer) it may prove difficult to persuade excluded creditors to cede their claims outside of the scheme for the same consideration payable to the scheme creditors;

(c) scheme creditors believing (on occasions erroneously), or indeed being aware, that the excluded creditors may be receiving a higher dividend for the cession of their claims exhibit reluctance to support the scheme in view of the perceived (or actual) different treatment of the excluded creditors;[68]

(d) excluded creditors on certain occasions insist on ceding and being paid for their claims irrespective whether or not the scheme is sanctioned. This is an unacceptable risk to a proposer who would insist on such cession and payment being conditional upon sanction;

(e) not every company which was the target of a scheme satisfied the basic premise necessary for tax purposes pursuant to Section 20(1)(a)(ii) (and indeed, ease of negotiation) that the excluded creditors should constitute few in number but a significant majority in value.

Consequently endeavours were made to propose an alternative acceptable scheme in terms of Section 311 which would also retain the assessed loss (or a significant amount thereof). Such endeavours resulted in the consideration by the Cape Provincial Division[69] (in an unreported judgment) of a scheme of arrangement in terms whereof the proposer provided the company (by way of a loan) with a monetary amount ("the capital sum") to enable the company to make a dividend payment to its creditors subject to the conditions that should the scheme be sanctioned then:

(a) the rights of creditors to receive payment of their claims shall be limited to the right to obtain payment of the dividend in terms of the provisions of the scheme;

(b) no creditor shall thereafter have any claim against the company (and the proposer and the receiver) for any further payment or consideration in respect of any claim;

(c) the outstanding balance of the claims of the creditors of the company shall be deemed to have been ceded to the proposer who shall be deemed to have purchased and acquired all such claims;[70]

(d) the capital sum and the ceded claims acquired by the proposer shall be subordinated (as per the subordination provisions approved in *Cooper v A & G Fashions*).

The Cape Provincial Division duly granted leave to convene meetings of creditors and thereafter (after approval by the statutory majority of creditors at the scheme meetings)

duly sanctioned the scheme. The successful argument of Counsel[71] in favour of this new scheme ("the New Cape Scheme") may be summarised as follows:

(a) The objective of the New Cape Scheme is that the capital sum provided by the proposer (by way of a loan) to the company is utilised by the company to enable it to compromise the claims of creditors for a monetary consideration, such claims upon sanctions being deemed to have been ceded to the proposer. The liabilities of the company on sanction (namely, its liability to the proposer for the capital sum advanced and the ceded claims) are subordinated so that the company will, in the practical sense, be solvent and in a position to continue trading as a going concern.

(b) The Standard Scheme considered in the *Robin*, *Multi Bou* and *Natal* cases comprised in essence a transaction between the proposer and creditors of the company in terms whereof the proposer acquired the claims of the creditors by way of a cession or deemed cession against payment of an amount generally slightly higher than the creditors would have received in a winding-up. Such standard scheme normally contained a provision deeming the claims of the creditors to have been reduced by an insignificant amount in supposed satisfaction of the requirement of a "compromise". The New Cape Scheme differs in essential respects from the Standard Scheme and does not rely on the variation of the Standard Scheme which was encountered in the *Multi Bou* case.

(c) In the Excluded Creditor Scheme the proposer undertook to advance money to the company. Such money was then used (by a receiver) to pay (on behalf of the company) the Scheme Creditors a portion of their claims, the balance of such claims being extinguished. No cession of the claims of Scheme Creditors was involved. The aforegoing clearly constituted a compromise between the company and the Scheme Creditors.

(d) There is ample authority that where the company itself acquires funds which are utilised to effect a compromise with its creditors, such scheme constitutes an arrangement between the company and its creditors within the meaning of Section 311.[72] The New Cape Scheme similarly involves a payment by the company (via the receiver) to its creditors of money acquired by the company by

way of a loan from the proposer. Creditors after payment of their dividend in terms of the scheme have no further claims against the company (and the proposer or the receiver) for payment in respect of the balance of their claims. The distinguishing feature of the New Cape Scheme is that the proposer is deemed to have purchased and acquired all such balance of the claims of the creditors, which are deemed to have been ceded to him. The manner in which the cession features in the New Cape Scheme is however not open to the objection raised in the *Robin* and *Multi Bou* cases for the following reasons:

(i) in the Standard Scheme considered in the *Robin* and *Multi Bou* cases, the proposer simply acquired the claims of creditors by offering to pay them a certain dividend. The payment was effected (via the Receiver) by the proposer to the creditors. It was simply a purchase price paid by the proposer for the acquisition of the claims in which the company as debtor played no part;

(ii) in the New Cape Scheme, by contrast, it is the company (via the Receiver) which pays a dividend to its creditors. Such payment does not constitute the purchase price paid by the proposer in acquiring the claims. The payment actually reduces the amount owing by the Company to the its creditors;

(iii) while the company is plainly involved in the payment 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 (which is more than they would receive on winding-up) are required to accept the deemed cession of the balance of their claims to the proposer. This deemed cession is not a separate transaction from the payment. In order to receive payment, the creditors have to agree to the cession. The company, by undertaking to pay its creditors a portion of their claims and by recognising the proposer as its new creditor, becomes a party to the arrangement.[73]

The New Cape Scheme has since been the subject matter of a few successful unreported applications in the Cape Provincial Division.[74] Scheme of arrangement practitioners now await with interest whether the New Cape Scheme will in effect become 'the new standard scheme' once it has had the opportunity of being the subject of further judicial consideration and hopefully a considered reported judgment. The New Cape Scheme does of course depend to some extent on the principles regarding a deemed cession approved in the Natal case.[75] The company does however play a more direct role than in the Standard Scheme in that it undertakes and provides (via a receiver) the payment to creditors in consideration for the compromise of their claims. It is further submitted with regard to the New Cape Scheme that:

(a) its substance (i.e. its basic content as described and interpreted in the *Robin* and *Multi-Bou* cases) can be the subject matter of an order in terms of Section 311 in that it is an arrangement or compromise between the company and its creditors.

(b) the consent and participation of the company is required for the material elements thereof. The company is not merely used as conduit. The company has a material interest in the scheme and plays an important role in relation to the mechanics thereof. Enforceable rights and obligations flow from the totality of the scheme as between the company and its creditors.

(c) provided the parties to a scheme are the company on the one hand and the creditors or members on the other hand, our courts have constantly accepted that this does not exclude the possibility that a third party can also be part of the scheme, provided it is not to the exclusion of one of the company or its creditors or members (as the case may be).[76]

(d) the scheme of arrangement in the *MSL* case,[77] which in certain material respects is similar to the New Cape Scheme, was held by Stegmann J to be an arrangement between the company and its creditors in that it was clear that the insolvent company was to participate substantially in the proposed arrangement and that the arrangement was between the company and its creditors. An essential feature of the arrangement in the *MSL* case was the cession (it is not clear from the judgment whether the arrangement was an 'actual cession' or 'deemed cession') to the proposer of the unpaid balance of the creditors claims.

In essence, the scheme in the *MSL* case was the provision by the proposer of the amount to be utilised by the company to effect payment to creditors ("the capital sum") by way of the allotment and issue by the company of new shares to the proposer (as opposed to a loan to the company in terms of the New Cape Scheme); the utilisation of the capital sum (together with certain proceeds of the assets of the insolvent company) to effect part payment of the debts of the company and, most importantly, the unpaid balances of such debts were deemed to be ceded, alternatively ceded, by the creditors to the proposer.[78]

(e) two schemes of arrangement adopting similar principles were approved by the Australian Courts In Re Mascot Home Furnishers (Pty) Limited and Re Buildmat (Australia) Limited.[78]

The New Cape Scheme appears to be the most popular format of schemes of arrangement currently proposed in the Cape Provincial Division between a company and its creditors in terms of Section 311. As is apparent from the legal principles discussed in this Chapter 3, the New Cape Scheme:

(a) satisfies the jurisdictional requirements of Section 311 in that it constitutes an arrangement between the company and its creditors;

(b) is tax effective from the point of view of preserving any assessed loss of a company (Section 20(1)(a)(ii) subject, of course, to Section 103(2) of the Income Tax Act);

(c) the subordination of the ceded claims and the capital sum resolves the issue of the reluctance of Courts to discharge an insolvent company from winding-up (simultaneously with sanction of an arrangement or compromise).

The Debenture Scheme

Another type of scheme which, subsequent to the *Robin* judgment, has been the subject matter of successful unreported cases involving schemes of arrangement in terms of Section 311 in the Transvaal and the Cape[79] is a scheme which adopts similar legal

principles to the Preference Share Scheme, but in lieu of redeemable preference shares involves the creation and issue of debentures ("the Debenture Scheme"). The Debenture Scheme contains the following salient features:

(a) the funds necessary to enable the company to enter into the scheme of arrangement with its creditors is lent to the company by the proposer ("the capital sum");

(b) the capital sum is distributed to creditors (via the receiver) as a dividend in respect of their claims;

(c) in consideration for the rights of creditors to receive from the company (via the receiver) such dividend on their claims;

(i) the claims of all the creditors against the company, reduced by their dividends in terms of the scheme of arrangement, are converted to unsecured subordinated debentures ("the debentures") at the face value of such claims less the said dividends payable to creditors;

(ii) creditors are deemed to have renounced their rights to the debentures in favour of the proposer;

(iii) the rights of all creditors are confined to the right to claim payment of the said dividend, whereafter no creditor shall have any claim against the company;

(d) the debentures are subject to terms and conditions contained in a debenture trust deed. The salient features recorded in such debenture trust deed are that:

(i) the debentures shall be unsecured and non-interest bearing;

(ii) the debentures shall not be redeemable, partially or in full, save upon the issue of a certificate by the auditors of the company that the assets of the company, fairly valued, exceed its liabilities, and only to the extent of such excess;

(iii) in the event of a winding up of the company, the rights of debenture holders shall rank after other creditors but before shareholders of the company;

(iv) the conditions attaching to the debentures may not be varied, added to, or subtracted from, amended or cancelled.

The company is directly involved in the Debenture Scheme in that it *inter alia* creates and issues the debentures, recognises the renunciation thereof, issues the debenture to the party entitled thereto, pays the capital sum in terms of the scheme to the creditors and passes all the necessary resolutions to give effect to the aforegoing. The creditors are also directly involved in the scheme in that they have to agree *inter alia* to the conversion of their claims into debentures and to renounce their entitlement to the issue of such debentures in exchange for the receipt of a dividend. The nature of the debentures are, as is apparent from the Debenture Scheme, in the form of unsecured subordinated debentures.

As is apparent from the legal principles discussed in this Chapter 3, the Debenture Scheme:

(a) satisfies the jurisdictional requirements of Section 311 in that it constitutes an arrangement between the company and its creditors;

(b) is tax effective on the point of view of preserving any assessed loss of a company (Section 20(1)(a)(ii)), subject, of course, to Section 103 (2) of the Income Tax Act);

(c) the subordination of the debentures (and, if necessary, the capital sum) resolves the issue of the reluctance of courts to discharge an insolvent company from winding up (simultaneously with the sanction of a compromise or arrangement).

It follows that the New Cape Scheme and the Debenture Scheme both achieve the same result. However, the New Cape Scheme does have the advantage of less documentation and a consequent saving in time and cost *inter alia* in that it does not involve the creation and issue of debentures, the drafting of a debenture trust deed, the issue of debenture

certificates, the maintenance of a register of debenture holders and the passing of all the necessary resolutions of and incidental to the creation, issue and allotment of the debentures and the debenture trust deed.

FOOTNOTES - CHAPTER 3

1. See, inter alia, Ex Parte Millman & Others N.N.O. in re: Multi-Bou (Pty) Ltd & Others 1987(4) SA 405 (C) at 408

2. Ibid at 409

3. Ibid at 409

4. See Ex Parte Kaplan & Others N.N.O. in re Robin Consolidated Industries Limited 1987 (3) SA 413 (W) at 423-424 and Ex Parte Strydom N.O.: In Re Central Plumbing Works (Natal)(Pty) Limited, Ex Parte Spendiff N.O.: In Re Candida Footwear Manufacturing (Pty) Ltd; Ex parte Spendiff N.O.: In Re Jerseyside (Pty) Ltd 1988 (1) SA 616 (D) at 618 - 619

5. As it was christened by Berman J in Multi-Bou supra (note 1) at 408B.

6. Characterised by Berman J in Multi-Bou supra (note 1) at 409J as an *"apparently advantageous and seemingly unobjectionable practice."*

7. Robin case supra (note 4)

8. Multi-bou case supra (note 1)

9. Ex Parte Strydom supra (note 4)

10. 1992(2) SA 761 (C)

11. Ibid at 767I - 768B

12. Robin case supra (note 4) at 419 - 420

13. Ibid at 423 - 426

14. Multi-Bou supra (note 1) at 411C - I

15. Ibid at 413

16. Ibid at 413 - 414

17. Ibid at 414

18. Ibid at 414 - 415

19. Ibid at 415 - 416

20. Ex Parte Strydom supra (note 4) at 621 G - 622 A

21. Ibid at 622 B - D

22. Ibid at 612 E - G

23. Ibid at 622 H - 623 A

24. Robin case supra (note 4) at 427 I

25. Section 354(1) of the Act

26. Section 103(4) of the Income Tax Act

27. See Meyerowitz and Spiro, The Taxpayer's Permanent Volume on Income Tax in South Africa, paragraph 856 at 390 and the cases cited therein.

28. See, for example, David John Rennie N.O. In Re: National Machinery Suppliers (Pty) Limited Case No. 87/12733 (WLD)

29. 1988 (4) SA 556 (0)

30. (1987) 26 Income Tax Reporter 323

31. Ibid at 331

32. (1989) 28 Income Tax Reporter 7

33. Ibid at 10

34. The Taxpayer, Volume 38, No. 2, February 1989.

35. Ibid at 29

36. Ibid at 29 - 30

37. Ibid at 30

38. Ibid at 30

39. See, for example, the definition contained in edition dated 14 April 1989.

40. In an article in Finance Week (February 23 - March 1, 1989) Professor Dennis Davis after summarising the various competing arguments for and against the preference share scheme concluded that this type of scheme should be carefully considered before being held out as tax-safe.

41. Robin case supra (note 4) at 427 A - B

42. Ibid at 427 F - H

43. Multi-Bou case supra (Note 1) at 417 G

44. Ex Parte Strydom supra (Note 4) at 623

45. Ibid at 623

46. Ibid at 623 - 624

47. See Chapter 2 supra (notes 42, 43 and 45)

48. In, for example, the Lebowa case supra (Chapter 2 note 43) at 116D, Stegmann J described the practice of allowing companies to trade in insolvent circumstances as a "social evil". In Australia, the courts are also reluctant on grounds of public policy to stay or discharge a winding-up order where the company might thereby be enabled to continue to trade in insolvent circumstances - see, for example, *Re Buildmat (Australia) Ltd* 1983 (1) ACLC 919 at 922 - 923 and *Collins & Anor v G. Collins & Sons Pty Ltd* (1984) 2 ACLC 595 at 597 - 598. Regarding the issue of subordination, in *Collins & Anor v G. Collins & Sons Pty Ltd* (supra) when the matter first came before the Court it was proposed, on behalf of the applicants, that they would advance to the company the monetary consideration which was the subject matter of the scheme of arrangement in order to pay the claims of all unsecured creditors (other than the applicants) and to pay the costs of the winding up. It was proposed that this should be done pursuant to a deed entered into between the applicants and the company in terms whereof the applicants undertook, in substance, that the debt owing to themselves by the company, together with the amount advanced to the company, would not be repayable within a period of 12 months, and that such debt would be subordinated to all other debts of the company. Furthermore, the applicants would not call for or otherwise require repayment, in whole or in part, of such debt excepting insofar as the same could be paid out of the nett income of the company in each financial year after deducting all expenses and costs and making full provision for all liabilities contingent or otherwise of the company. In addition, such subordinated debt would be free of interest. The court, relying on in *Re Dennistone Real Estate Pty Ltd* and *Re Data Homes Pty Ltd*, which cases are cited at pages 597 - 598 of the judgment, indicated to the applicants that it would not be prepared to agree to the subordination. The issues which concerned the court in this regard was how would the subordinated claim rank in the statutory administration in the event of the company being subsequently wound up; by whom and how would the subordination be enforceable; what would happen if the applicants disregarded the subordination and, in any event, the company would remain insolvent (see page 597 and the citation by the court, with approval, of the judgment of Street J in *Re Data Homes Pty Ltd* (1971) 1 N.S.W.L.R. 338). In the light of the adverse views expressed by the court, the application was adjourned and the applicants then put forward a proposal that in lieu of the subordination the relevant debt would be converted into redeemable preference shares which conversion ensured the absorption of the whole of the debts owing to the applicants so that, upon the termination of the winding up, the company would no longer have any creditors. The court expressed its approval with this procedure. In the case of *Re Cascade Pools (Australia) Pty Ltd* (1985) (3) ACLC 552 an application for an order under Section 315 of the Companies Code was sought. The scheme of arrangement proposed that three of the creditors of the company would remain as creditors of the company but it was proposed in order to overcome the insolvency of the company as a result of such debts remaining, that such creditors would enter into an agreement in terms whereof the respective claims against the company would be deferred *inter alia* for as long as the company was unable to pay its debts as they fell due out of its own money or if there was a deficiency in assets over liabilities or in shareholding funds or if the

company was placed in receivership or liquidation. The court rejected the proposed deferment *inter alia* holding that it was not at all clear that if such undertakings were given, there would be an effective means of enforcement thereof. In addition, the terms of the obligation, involving as it would the question whether at some point in time the company was unable to pay its debts as they fell due out of its own monies, or whether the making of a particular payment would lead to such a consequence, lacked the degree of precision which should characterise an undertaking to the court (at 554). In essence the Australian Court did not accept the particular subordination as a sufficient counter to the requirements of the public interest. It is perhaps therefore possible than an Australian Court may in the future reconsider the matter if a subordination agreement can be so structured that its efficacy is beyond doubt. It is interesting to note that Counsel in the *Cascade Pools* case submitted that there was little difference between the said deferment of the claims and what Counsel termed "the ordinary kind of moratorium scheme to which the Court is accustomed to give approval" in order to try and avoid a winding-up of a company. The response of the Court was however that there were a number of significant differences, of which it mentioned two, between the deferment proposals and the moratorium scheme. In the moratorium scheme the court indicated that it would generally need to be satisfied that during the period of the moratorium there is a reasonable prospect that the company would be able to trade out of its difficulties and, furthermore, the moratorium was not open-ended but for a fixed period. In conclusion the court stated that it appeared to it that the best possible available means of avoiding its objection to the proposed scheme, whilst preserving the essential features of the proposals, was by converting such debt into redeemable preference share capital instead of deferring them in the manner proposed.

49. 1991 (4) SA 204 (C)

50. Ibid at 207

51. Ibid at 207

52. Ibid at 208

53. Ibid at 213 H

54. Ex parte Strydom supra (note 4) at 618 J-H. In addition to the fact that the proposer of an arrangement should not be compelled by a Court to change the existing debt structure of the company (which would be the situation if a capitalisation of the debt as opposed to a subordination of the debt took place) in such a way as to deprive the proposer of the existing tax advantages flowing from any assessed loss of the company, there are further reasons why subordination, rather than a conversion to capital, is favoured in the case of compromises or arrangements between a company and its creditors viz: (i) the proposer of an arrangement should be entitled to elect from his own business point of view whether he wishes to subordinate or capitalise the claims which he acquires against the company arising by virtue of the arrangement. The court should only intervene if his choice of method results in the scheme being contrary to public policy or manifestly unbusinesslike. If both methods ensure the 'effective solvency' of the company then the court should not force a proposer to adopt one method in preference to another if the capital sum advanced by the proposer is to

enable the company to effect a compromise with its creditors. The funds are not retained by the company or utilised in the conduct of its business. It is accordingly somewhat misleading that such funds could constitute capital in the accepted and meaningful sense of the word; (ii) if a capitalisation takes place and in due course (as indeed is intended by any proposer of an arrangement) the financial position of the company improves as a result of successful trading, the proposer would only be able to obtain repayment of the capital sum, and the former claims which were capitalised, by way of a reduction of capital. This would be an unnecessary expense; and (iii) in the normal course of events (and this is assumed by persons dealing with a company) share capital constitutes funds from the shareholders to the company for use in its business. The capitalisation of claims acquired in terms of an arrangement would be artificial and in a sense a misrepresentation of what is normally assumed to constitute share capital. The capital sum is used to pay an equivalent liability on the part of the company to its various creditors. The claims acquired in terms of the scheme would, wholly or partially, not be represented by assets. Any resultant capitalisation, as opposed to a subordination, would mean that the majority of the share capital arising out of the conversion would not be represented by assets and would accordingly have to be regarded as lost in the sense contemplated in terms of Section 344(e) of the Act. This would expose the company to immediate winding up under Section 344(e). Indeed, this undesirable consequence and effect of an artificial capitalisation was pointed out by Stegmann J in the *MSL* and *Singer* cases supra (Chapter 2 notes 42 and 44).

55. See *inter alia* the *Carbon Development* case, supra (Chapter 2 note 45) at 112 - 119

56. Ex Parte De Villiers & Another NNO In Re Carbon Developments (Pty) Limited (in liquidation) 1993 (1) SA 497 AD

57. Ibid at 504 - 505

58. Ibid at 505

59. Ibid at 505

60. Ibid at 503

61. See 1987 Income Tax Reporter supra (note 30) at 324

62. See, for example, A & G Fashions case supra (note 49) at 213 E. A properly constituted subordination agreement should always provide that if interest should at any time accrue on the subordinated debt, the payment of such interest is also subordinated.

63. See February 1989 Taxpayer supra (note 34) at 29

64. See, for example, Millman N.O. and Another: In Re Lans Clothing Distributors (Pty) Limited Case No. 3245/88, Millman N.O. and Another: In Re De Wet Bros (Pty) Limited Case No. 8796/88, Stein N.O.: In Re Knobbs Material Centre (Pty) Limited Case No. 1847/89, Millman and Gore N.N.O: In Re The Point Sporting Clubs Limited Case No. 11432/90 and L V W Bester N.O.: In Re Dandev (Pty) Limited Case No. 6098/91

65. A & G Fashions supra (note 49)

66. There is ample authority that where the company itself acquires funds which are utilised to effect a compromise with its creditors such scheme constitutes a compromise or arrangement between the company and its creditors within the meaning of Section 311 - see, for example, Investments (Pty) Limited v Crown Furniture Manufacturers (Pty) Limited 1963 (2) SA 271 (W); Friedman v Bond Clothing Manufacturers (Pty) Limited 1965 (1) SA 673 (T); Ex Parte Cyrildene Heights (Pty) Limited 1966 (1) SA 307 (W); Ex Parte Lebowa Development Corporation Limited supra (Chapter 2 note 43) and A & G Fashions supra (note 49).

67. A subordination agreement, drafted in accordance with the judgment in A & G Fashions supra (note 49), would read as follows:

> *"(a) The proposer agrees and undertakes that:*
>
> *(i) the capital sum lent and advanced by it to the company ("the Loan") and the claims of all the creditors of the company deemed to be ceded to the proposer in terms of the provisions of the scheme of arrangement ("the Acquired Claims") will be subordinated to the extent that the liability of the company exceed its assets as fairly valued; and*
>
> *(ii) for as long as the Loan and the Acquired Claims remain subordinated, it will not prove a claim for the recovery thereof against the company in the event of the company subsequently being wound up or placed under judicial management until all creditors of the company whose claims arose after the date of sanction of the scheme ("the Sanction Date") shall have been paid in full; and*
>
> *(iii) the subordination of the Loan and the Acquired Claims shall ipso facto cease to be of any further force and effect upon the auditors of the company certifying that the assets of the company fairly valued exceed its total liabilities (including subordinated liabilities); and*
>
> *(iv) in the event of any portion of the Loan and the Acquired Claims attracting interest, such interest is hereby subordinated on the same terms and conditions set out in the said subparagraphs (i) - (iii) (inclusive); and*
>
> *(v) the provisions of the said subparagraphs (i) to (iv) (inclusive) shall be binding on the proposer's successors-in-title and assigns as fully and effectually as if they had signed this agreement in the first instance; and*

(vi) *it will not dispose of the subordinated claims, or any part thereof, to any person whomsoever unless the latter lodges with the auditors of the company an undertaking to be bound, mutatis mutandis, by the said undertakings given by the proposer herein and no such disposal of the said claims shall be valid or enforceable until such time as the said undertaking has been lodged*

(b) *if the scheme is agreed to by the requisite majority of the classes of creditors in terms of Section 311(2) of the Act, the proposer shall after the meetings and prior to the date of sanction of the scheme procure the passing of a special resolution amending the Articles of Association of the company by the insertion of a new article recording:*

(i) *the provisions of the said paragraph (a) hereof ("the Subordination");*

(ii) *that for as long as the Subordination remains in force and effect:*

(aa) *the auditors of the company shall be obliged in the annual financial statements of the company to note the terms and conditions of the Subordination;*

(bb) *the articles recording the Subordination shall not be repealed, modified or amended in any manner whatsoever unless the auditors of the company have lodged a certificate with the Registrar of Companies certifying that the assets of the company as fairly valued exceed its liabilities."*

68. It is pointed out that it has not been the practice of the Courts (see, for example, the cases cited in note 64 supra) in such schemes to request or insist upon disclosure of the provisions of the transactions between the proposer and the excluded creditors.

69. R J Walters NO & Others : In Re Lansdowne Textile Industries (Pty) Limited Case 12972/91

70. As is apparent from the discussion in this Chapter 3 it is obviously the attitude of a Court to this aspect of the scheme which is of crucial importance (both in respect of the jurisdictional requirements of 311(1) and Section 20(1)(a)(ii) of the Income Tax Act.)

71. Advocates P Hodes SC and R Goodman (as appears from the heads of argument filed by Counsel in the unreported judgments referred to in note 69 supra).

72. See cases cited in note 66 supra

73. See Ex Parte Strydom supra (note 4) at 621 - 622

74. See, for example, R J Walters NO and Others: In Re Lansdowne Textile Industries (Pty) Limited Case No. 12972/91; Ralph Millman NO: In Re The Debonair Group Limited Case No. 13986/92, Ralph Millman and Lawrence Ivan Stein NNO: In Re The Belmor Group (Pty) Limited Case No. 5411/93 and Solomon Gutman NO: In Re S Smith & Co (Cape) (Pty) Limited Case No. 9949/93.

75. Ex Parte Strydom supra (note 4) at 621 - 622

76. See, for example, Robin supra (note 4) at 419 - 420

77. MSL case supra (Chapter 2 note 42) at 75

78. In CCH : Australian Company Law and Practice (at 33, 354), reference is made, in illustrating a method in which a person could take advantage in Australia of an insolvent company for tax loss purposes by means of a scheme of arrangement, to the arrangement approved in *Re Mascot Home Furnishers (Pty) Limited* (1970) V.R. 593 by Gillard J. Such arrangement adopts similar principles to that inherent in the New Cape Scheme as appears from Gillard J's description of such tax loss schemes as follows:

> *"The essential feature of such schemes has been that pecuniary consideration has been paid by a third party to a trustee for the company concerned, its members and its creditors, and after such payment the third party became the assignee from the creditors of their debts and the transferee of the shares from the members. From the proceeds of such payments the trustee, although the company debts were not extinguished, was enabled to pay a dividend, or to increase the dividend payable by the company to the existing creditors in respect of their debts."*

Similarly, in *Re Buildmat (Australia) Ltd* (1983) 1 ACLC 919 the Supreme Court of New South Wales had no difficulty that a proposed arrangement was within the ambit of the Australian equivalent (Section 315 of the Companies Code) of our Section 311 where such arrangement provided that an associate company of the applicant would provide sufficient funds to the applicant in order to enable the applicant *inter alia* to pay 5% of the claim of each participating creditor. Each participating creditor was required, upon payment of the 5% of their claims, to assign the balance of their claims against the Company to the said associate company of the applicant.

79. See, for example, Michael Meaker N.O. : Prime Brick (Pty) Limited (In Liquidation), Case No.9022/93 (CPD).

CHAPTER 4

SCHEME OF ARRANGEMENT AS BETWEEN A COMPANY AND ITS MEMBERS

Introduction

In recent years (especially where the prior co-operation of the board of directors of the offeree company can be obtained) take-overs and mergers have often been the subject matter of the scheme of arrangement procedure provided by Section 311 as opposed to other procedures under the Companies Act whereby mergers and take-overs can be effected.[1] As is apparent from the discussion in Chapter 2, a take-over by way of a scheme of arrangement will often be the most advantageous procedure for an offeror more particularly having regard to the voting procedures required for approval of a scheme in terms of Section 311(2).[2]

Where the offeror intends to acquire all the issued shares, or all the issued shares of a particular class, in a company a take-over is generally implemented in terms of Section 311 by casting it in the form of a reorganisation of the authorised and issued share capital (or sometimes just the issued share capital) of the offeree company, whereby the offeror is in effect substituted for its existing members. The reorganisation is effected by a scheme of arrangement between the offeree company and those of its members whose shares are to be affected by the scheme. The offeror is as a result the new holder of all the issued shares (or the shares of that class) in the offeree company.

The use of the Section 311 procedure for the purposes of a take-over must be analysed against the background of different approaches by our courts from time in respect of

issues such as whether the reorganisation or reduction of share capital against an enforceable consideration or an offer to take over or 'expropriate' shares for a cash consideration, falls from a jurisdictional point of view, within the concept of an arrangement between the company and its members in terms of Section 311. The analysis hereunder of the leading cases on these issues indicates that the approach of our courts has not always been consistent. Another key issue which has been the subject matter of consideration by our courts is whether the scheme of arrangement procedure in terms of Section 311 may be used to effect a take-over, in particular where the nature of the scheme is such that other sections of the Act legislate for such procedure.[3] Likewise, the analysis hereunder of the leading cases on this issue reveals at times an inconsistent approach by our courts.

Ex Parte Federale Nywerhede Bpk

In *Ex parte Federal Nywerhede Bpk*[4] ("Federale") a scheme of arrangement was proposed *inter alia* in terms whereof a company ("Company A") which held the majority of the ordinary shares of another company ("Company B"), was to become the sole ordinary shareholder of Company B by means of a cancellation of the ordinary shares in Company B of the minority shareholders (the capital of Company B to be reduced accordingly), such minorities, as the consideration for acceptance of the scheme, receiving shares in Company A.

Two issues arose for consideration by the Court, viz:

(a) whether the proposed scheme could be considered to be an arrangement within the meaning of Section 311;

(b) whether the proposed arrangement was a take-over offer as defined in Section 314 (1) of the Act and as such could not be the subject matter of a scheme of arrangement in terms of Section 311 since the legislature in Sections 314 - 321 of the Act[5] had devised the broad framework for the making of a take-over offer.

The Court (Coetzee J, as he then was) held as follows:

(a) The subject matter of the scheme could be considered to be an arrangement between Company B and its minority shareholders within the meaning of Section 311. When the cancellation of the shares of the minority shareholders in Company B was effected by a special resolution of a subsequent meeting of members and an application to court following thereon, an obligation rested on Company B towards such minority shareholders to ensure that the counter value, namely the shares in Company A, were allotted to them. Such shares formed the compensating advantage, coupled with enforceable rights in respect thereof, concepts essential to an arrangement between the meaning of Section 311.[6]

(b) The proposed arrangement was not a take-over offer as defined in Section 314(1) of the Act as it was not an offer for the acquisition of shares. Only the cancellation of shares would take place. Company B's holding company, Company A, would issue shares in consideration for the cancellation of certain shares and not for the acquisition thereof;[7]

Notwithstanding the finding that the proposed arrangement was not a take-over as defined in Section 314 (1) of the Act, the Court pointed out, *obiter*, that the scheme of arrangement procedure was available for the presentation of a take-over offer notwithstanding the fact that the legislature had in terms of Sections 314 - 321 devised the broad framework for the making of a take-over offer, provided, of course, that it was indeed an arrangement between the company and its members within the meaning of Section 311.[8]

Ex Parte Satbel: In Re Meyer v Satbel

Ex Parte Satbel: In Re Meyer v Satbel[9] ("Satbel No.1") represented a significant inroad into the usage of Section 311 to effect a take-over. A material term of the proposed scheme was that the shares of existing shareholders of the company would be taken over by the offeror solely by way of a cash consideration. The Court (Coetzee J, as he then was) held that in order to satisfy the requirements of Section 311 (1), the scheme, which would need to be scrutinised as a whole, should at least constitute a re-arrangement of shareholders rights before it would qualify as an arrangement in terms of Section 311. A scheme whereby shareholders rights disappear completely against payment of a

monetary consideration amounts not to a re-arrangement but to an expropriation and could consequently not be allowed in terms of Section 311. In the view of the Court as the essential meaning of the word 'arrangement' was that of a survival in a different form, and not disappearance, a scheme whereby shareholders rights disappear completely, in return for a monetary consideration, could not be sanctioned because this would amount to an expropriation and not a re-arrangement.[10]

Ex Parte Natal Coal Exploration Co. Ltd

In *Ex Parte Natal Coal Exploration Co. Ltd*[11] ("Natal Coal") the substance of the scheme was that minority shareholders of the company (who were the subject matter of the scheme) were offered a purely monetary compensation in return for the compulsory acquisition of their shares. The Court (Stegmann J), in coming to the same conclusion as the court in the *Satbel No.1* case, held that an arrangement contemplated by Section 311 must truly arrange or re-arrange the rights of the offeree. A scheme that seeks to subvert all of such rights and to replace them with a mere cash payment and nothing remotely resembling the rights in question is not an arrangement contemplated by Section 311. A scheme in which the compensating advantage that is offered in return for the expropriation of shares is merely a right to a fixed or determinable sum of money does not qualify as an arrangement contemplated by Section 311.[12]

Ex Parte Suiderland Development Corporation / Ex Parte Kaap-Kunene Beleggings Bpk

Ex Parte Suiderland Development Corporation, Ex Parte Kaap-Kunene Beleggings Bpk[13] ("Suiderland") involved two schemes of arrangement in respect of two associate companies, Kaap-Kunene Investments Limited and Suiderland Development Corporation Limited. The significance of the Suiderland judgment is that the Cape Provincial Division differed in this decision from the judgments of the Witwatersrand Local Division in *Satbel No.1* and *Natal Coal.*

The schemes *inter alia* also provided for a reduction of capital and, further, the purpose of such schemes was the take-over by the majority shareholders of the shares of the

minority shareholders. The Court had no difficulty in allowing the Section 311 procedure to be used as opposed to the then take-over provisions and the reduction of capital provisions of the Act. In dealing with such issues the Court commented as follows:

> *"Formerly in England and Australia Courts were reluctant to authorise under their equivalent of our Section 311, schemes capable of being implemented under other provisions of their Companies Acts. In Re National Bank Ltd [1966] 1 All ER 106 (Ch), a scheme to obtain control of a company was authorised despite the fact that other provisions explicitly dealt with this manoeuvre. In Re Robert Stephen Holdings Ltd [1968] All ER 195 (Ch) and Re Trix Ltd; Re Ewart Holdings Ltd [1970] 3 All ER 397 (Ch), the 'scheme' procedure was advocated as preferable to the statutorily prescribed alternative, as affording greater protection for minorities. See too RE Savoy Hotel Ltd [1981] 3 All ER 646 (Ch) at 650 H and Joubert Law of South Africa, Volume 4 para 356 as also the authorities listed in its copious footnotes. Section 311 is, in other words, not regarded as merely a residual provision, but has come into its own."* [14]

The schemes proposed in the Suiderland case provided as material terms thereof that the shares of the minority shareholders were to be cancelled in consideration for the payment to such minorities of 130c per share in cash. The Court held that such schemes were 'arrangements' within the meaning of Section 311 and that the compensating advantage for the purposes of Section 311 could indeed be the payment of money to the shareholder whose shares were to be 'expropriated'. It was pointed out by the Court that it was confiscation of shares (in the sense where shareholders were to lose all their rights and receive nothing in return) that would not contain the elements of 'give and take' requisite to enable meetings to be authorised in terms of Section 311 for the consideration of an arrangement. The Court emphasised that it saw no reason why the 'compensatory advantage' should have to take the form of a retention of rights as members of the company.[15]

Ex Parte NBSA Centre Limited

In *Ex Parte NBSA Centre Limited*[16] ("NBSA") a scheme was proposed in terms whereof a management company was to acquire the entire issued share capital in various property owning companies, one of which was the applicant company, in the course of the

formation of a property fund in terms of the Unit Trusts Act. An arrangement in terms of Section 311 between the company and its members was accordingly proposed, such arrangement between the company and its members involving a reorganisation of the capital structure of the company and the disposal of the resulting shares to the property fund for cash. No reduction of capital however was involved. The cash consideration for each ordinary share held by scheme members could be used, all or in part, at the option of such scheme members to invest in units in the property fund. It was held by the Court that the scheme was the economic equivalent of a scheme whereby members in one company became members in another company which now became the holding company in the event of the sanction of the arrangement. Consequently the Court held that the totality of the arrangement in this case was one between the company and its members and therefore fell within the ambit of Section 311.

The importance of the NBSA case is however materially due to the fact that the three judges involved (Coetzee DJP, Goldstone J (as he then was) and Gordon AJ) took the opportunity to reconsider, albeit obiter, the different approaches adopted in the *Satbel No. 1* and *Natal Coal* cases on the one hand and the Suiderland case on the other hand. Three separate judgments were written. A lengthy judgment by Coetzee DJP followed by a judgment by Goldstone J and a short judgment by Gordon AJ.

Coetzee DJP, in the course of his judgment commented on the issue whether an offer to take over shares for a cash consideration could be the subject matter of an arrangement in terms of Section 311. Coetzee DJP stated that upon reflection it was wrong to rely on the perception that a mere cancellation or acquisition of shares for a monetary consideration could not fall within the ambit of Section 311. Coetzee DJP indicated that this was a perception which rested too heavily on nuance and feel. For this reason he was prepared to hold that he was wrong in that formulation insofar as that aspect of the matter formed the basis of that part of his decision in the *Satbel No.1* case.[17] It accordingly followed, as Coetzee DJP pointed out, to the extent that this formulation was followed and developed by Stegmann J as the *ratio decidiendi* in the *Natal Coal* case, this was equally wrong.[18] Goldstone J in his separate judgment also analysed this situation and likewise came to the conclusion that a cash payment for shares did not remove the matter from the ambit of Section 311. Goldstone J further indicated that he agreed with the views expressed by the Court in the *Suiderland* case to the effect that it was confiscation and not expropriation which did not contain the element of 'give and take'

necessary to bring an arrangement within the ambit of Section 311. The compensatory advantage need not take the form of a retention of rights as a member of the company. Expropriation for fair compensation is a case of 'give and take.'[19] In his judgment Gordon AJ indicated that it was unnecessary for him to decide obiter whether an offer for cash only could constitute an arrangement in terms of Section 311 of the Act.[20]

Another important issue raised *obiter* in the NBSA judgment was the usage of the Section 311 procedure where a scheme of arrangement involved a reduction of capital. Coetzee DJP indicated his disagreement with the said statement in the Suiderland case that the Section 311 procedure is an alternative to other statutorily prescribed procedures. Coetzee DJP was of the view that permitting a Section 311 arrangement, as was done in the Suiderland case, in respect of the cancellation of shares was clearly wrong. Coetzee DJP was of the view that once any scheme involved a reduction of capital such reduction could not be effected by way of a Section 311 procedure it being necessary to follow the applicable reduction of capital provisions of the Act. Coetzee DJP did however indicate that it was possible that a reduction of capital could be done in conjunction with a Section 311 procedure. In arriving at such views, Coetzee DJP reasoned as follows:[21]

(a) A scheme which is tantamount to a compulsory purchase by a company of its shares with the inevitable effect of a reduction of capital is illegal if done using the Section 311 scheme of arrangement procedure. Proceedings for the reduction of capital will have to be put into effect. Only the scheme, or part of it, which necessitates the invocation of Section 311 is an arrangement, provided further that it is not illegal or *ultra vires* the company;

(b) *A fortiori* any scheme, or part of it, in respect of which an exclusive procedure for its attainment is prescribed in the Act is not an arrangement in terms of Section 311. Such scheme can only be achieved by employing the prescribed machinery in terms of the Act. Where such a scheme is one which involves a reduction of capital then the applicable procedures under the Act must be followed;

(c) if one part of a scheme involves a reduction of capital and the other part is an arrangement that necessitates the invocation of Section 311, the reduction of capital part does not thereby become an arrangement or part of the arrangement

in terms of Section 311. Such reduction must be accomplished by the usage of the reduction of capital procedure. Even if the reduction is embodied in the scheme document which the Court sanctions as an arrangement, it does not thereby become an arrangement in terms of Section 311. The reduction is a collateral matter which can only be dealt with as a condition precedent to the coming into force of the arrangement in terms of Section 311 and the particular procedural requirements of the Act in respect of a reduction of capital must be complied with;

(d) the Court has no jurisdiction to allow any substantive matter which is not an arrangement to be dealt with as an arrangement under Section 311. It does not have the discretion to sanction such a scheme or to order scheme meetings. Only an arrangement between the company and its members or creditors or a class thereof can be an arrangement in terms of Section 311. In every case it will have to be determined on a consideration of all the relevant aspects of the scheme and the surrounding facts whether it is such an arrangement between the company and its members or creditors;

Coetzee DJP accordingly concluded that the application in the *Natal Coal* case was correctly refused although the *ratio decidiendi* was defective. It should have been refused for the reason that the cancellation of the shares against payment by the company was a reduction of capital which must be achieved solely by application of the reduction procedure of the Act. The purported arrangement was for that reason not an arrangement within Section 311.[22]

In dealing with the reduction of capital issue, Goldstone J in his judgment stated that as this issue was not relevant to the scheme of arrangement before the Court he preferred to say nothing about it. Gordon AJ concurred with the said views of Coetzee DJP.

It is respectfully submitted that whilst it is wrong to state that it is incorrect to regard a mere reduction of capital as an arrangement within the ambit of Section 311 where it is unrelated to the creation or destruction of other relationships between the company and its members, the approach of the Court in the Suiderland case is to be preferred, namely that where the totality of the scheme is within the ambit of Section 311 then, notwithstanding the fact that a portion of such scheme may have as a result the reduction

of capital, it is permissible to follow Section 311 since the reduction of capital is only one of the steps in the totality of procedures that is adopted for the purpose of such scheme. Support for this view, as was stated in the Suiderland case, is found in England and Australia.[23] Section 311 also provides better protection for the interests of minorities.[24] It is indeed a pity that Goldstone J in the NBSA case refused to express an opinion on the applicability of Section 311 where an arrangement incorporated as part thereof a reduction of capital. It is accordingly suggested for the sake of certainty that proposers of arrangements incorporating a reduction of capital (save perhaps in the Cape having regard to the judgment in the Suiderland case) resolve this issue by dealing with the reduction of capital portion of the scheme in terms of the reduction of capital provisions of the Act and the balance of the scheme in terms of Section 311.[25]

Ex Parte Satbel (Pty) Ltd (Meyer N.O. Intervening)

In *Ex Parte Satbel (Pty) Ltd (Meyer N.O. Intervening)*[26] application was made in terms of Section 311 for the sanctioning of a scheme of arrangement whereby the applicant company, Satbel (Pty) Ltd ("Satbel"), would become a wholly owned subsidiary of its majority shareholder, Satbel Investment Holdings (Pty) Ltd ("Holdings"). The sanction was opposed by certain minority shareholders. The scheme provided *inter alia* that:

(a) Kersaf Investments Limited ("Kersaf"), which owned 50% of the shares in Holdings, would allot to scheme members Kersaf shares against payment to Kersaf by Holdings of R10.50 per share out of the relevant portion of the scheme consideration;

(b) Holdings would pay Kersaf that portion of the scheme consideration required for the allotment of shares to scheme members and pay the balance of the scheme consideration directly to scheme members;

(c) the said undertakings by both Kersaf and Holdings were enforceable at the instance of Satbel;

(d) a new category of shares, 'B' ordinary shares, would be created by way of a capitalisation from Satbel's non-distributable reserves. These shares would be

allocated and credited as fully paid up to Satbel's existing shareholders in a fixed ratio;

(e) scheme members would then be deemed to have:

(i) disposed of their scheme shares to Holdings;

(ii) renounced in favour of Holdings their right to the allotment of the new 'B' ordinary shares attributable to the scheme shares. Such 'B' ordinary shares would then be deemed to have been allotted directly to Holdings;

(f) in consideration of such deemed disposal and deemed renunciation, scheme members would receive the scheme consideration.

In opposing the scheme, Counsel for the minority shareholders raised two objections:

(a) that the proposed scheme was *in fraudem legis* in that the scheme provisions had been designed, firstly, to disguise the fact that the arrangement was one between members only (and not one between Satbel and its members as required by Section 311) by creating an unnecessary and non-existent obligation on the part of Satbel and, secondly, by creating an unnecessary and ineffective modification to Satbel's capital structure with regard to the creation of the new "B" ordinary shares (the submission being that the new 'B' ordinary shares would disappear once the scheme had been effected) for the express purpose of simulating the scheme as one between Satbel and its members;[27]

(b) that the scheme amounted to a take-over within the meaning of Section 314 and accordingly the take-over procedure which was then in force in terms of Section 314 - 321 of the Act should have been utilised and that it had been incompetent for Satbel to have proceeded by way of Section 311.[28]

The Court (Gordon AJ) in sanctioning the scheme held as follows:

(a) as to the first objection, good and sufficient reasons had been advanced for the proposed scheme, adequately supported by the documentation filed. It was clear

from the documentation that the scheme whereby Satbel was to become a wholly owned subsidiary of Holdings resulted from a series of elaborately structured agreements entered into between a number of parties. Furthermore, the minority shareholders had laid no foundation for the far reaching submissions that the scheme was *in fraudem legis*;[29]

(b) as to the second objection, the facts of the case did not comply in all respects with the requirements of Section 314 of the Act in that Section 314 required an offer by the offeror company made directly to the shareholders bypassing the offeree company, whereas in the instant case, Holdings had made no offer and there could accordingly be no contract whereby Satbel's shareholders could contractually bind Holdings to the scheme.[30]

Significantly, the Court then went on to state, obiter, that in any event, even if the requirements of Section 314 had been met, there would be no bar to proceeding in terms of Section 311 if the requirements of the latter section could be met.[31] The Court based its view on the judgment of Trollip J (as he then was) in *Du Preez and Another v Garber In Re Die Boerebank Bpk*[32] when the judge, referring to the wide character to be imported into the meaning of arrangement under Section 311, held that the only limitations in respect of an arrangement is that it cannot authorise something contrary to general law or be wholly *ultra vires* the company and that if capital is to be reduced the formalities must also be complied with.

Ex parte Mielie-Kip Limited

A scheme of arrangement was proposed in *Ex parte Mielie-Kip (Pty) Limited*[33] in terms whereof Kanhym Limited ("Kanhym") would acquire all the shares of the minority shareholders in *Mielie-Kip (Pty) Ltd* ("Mielie-Kip") in return for which such minorities would receive 88c per share. Payment would be supervised and administered by Mielie-Kip, the issuer of the shares, and for this purpose it was agreed between Mielie-Kip, Kanhym and Kanhym Investments (the controlling shareholders in Kanhym) that provided the scheme became binding:

(a) Kanhym Investments would provide the funds from which minorities would be paid;

(b) the minorities would be obliged to hand their share certificates to Mielie-Kip's transfer secretaries;

(c) Mielie-Kip would mail a cheque in payment within 7 days of a member so delivering the shares;

(d) Mielie-Kip would register transfer of the shares in the name of Kanhym.

At the hearing of the matter, Counsel for Mielie-Kip, with respect correctly, did not argue that a purchase of shares or an attempt to create such contract is in itself an arrangement between the company and its members. The case put forward by Counsel for Mielie-Kip was that the scheme of arrangement was correctly proposed in terms of Section 311 in that such scheme was between Mielie-Kip and its members because of the aforementioned obligations imposed on Mielie-Kip in terms of the scheme.

It is apparent that the scheme in essence involved a purchase of shares between a purchaser (Kanhym) and sellers (the minority shareholders). The aforementioned obligations imposed upon Mielie-Kip related to the practical implementation and execution of the proposal namely a sale and purchase of shares. It is accordingly not surprising that the Court came to the conclusion that the proposed scheme was not an arrangement as contemplated by Section 311. The Court (Flemming DJP) held that:

(a) The objective of Section 311 is to overcome absence of unanimous consent to a beneficial scheme when such scheme was an arrangement of rights on one side or the other. The underlying idea of an arrangement is a binding adjustment or altered basis which somehow had a bearing on what had previously existed. It could only relate to a transaction which directly affected the proprietary rights of shareholders in their shares. It is not any arrangement between a company and any other person but something affecting the relationship between the company and its members. An essential ingredient of the idea of an arrangement in this context was that there be newly created understanding about the

company-member relationship qua member.[34] Flemming DJP described the aforegoing in the following manner:

> *"The underlying idea of an arrangement is concededly merely some binding adjustment or altered basis which somehow has a bearing upon what hitherto exists. The question is: what is so adjusted or affected? The statute guides the answer. It is not any arrangement between a company and any other person but (leaving aside arrangements with creditors qua creditors and affecting their rights as creditors) something affecting the relationship between the company and its members. That relationship is normally governed as to its existence and its content by statute law, common law, and the deed of incorporation. Possible subject matters for an arrangement between a company and its members are therefore eg. the continued existence or not of issued or issuable shares; consolidation or splitting of shares; the rights of redemption, to dividends, in regard to voting, etc attaching to the shares. I accept that when assessing a proposed scheme from an overall point of view, it may come within Section 311 even if it is not a 're-arrangement' of rights in the sense that it does not merely alter - but - permit - to - survive, but arranges, eg, for termination of the relationship with or without substitution of a new relationship between the member and the company. I, however, see no way of getting away from the need for a newly created understanding about the company-member relationship qua member."*[35]

(b) A purchase of shares is not an arrangement between the company and its members but between a purchaser and seller. It was unacceptable to the Court that adding obligations in regard to the mere execution of the proposal, which in itself is not an arrangement as contemplated by Section 311, causes the whole to become such an arrangement. On analysis the scheme in *Mielie-kip* involves the applicant in no more than such obligations. In contrast to the indefinite duration associated with an arrangement which impacts on rights or duties as a member, the obligations added to the *Mielie-kip* scheme operate only for the short time needed to pass on the purchase price and for registration of the transfers.[36]

(c) It was the 'totality' of the proposed arrangement which a court would consider as to whether it fell within the ambit of Section 311 from a jurisdictional point of view. The overall scheme must be considered and the question then asked whether it creates enough of an arrangement between the company and its members to fall within Section 311, even if one or more part of the arrangement in isolation would not by itself have made the grade.[37]

It is interesting to quote Flemming DJP's remarks in dealing with the question as to why an agreement for the purchase of shares should not be an arrangement in terms of Section 311. The learned judge stated as follows:

> *"There is no reason why an offer from A to obtain the shares of B against remuneration (which would result in the sale but with "expropriation" coming in from the point of view that it may become binding even if B refuses the offer, other shareholders being in a position by the requisite majority to veto his refusal) would be an arrangement between the company and the seller. It in no way affects the existence, scope or content of the relationship between the company and the member. What flows from being the relevant holder of specific shares is unchanged. In that respect, already, the arrangement is not with the company or between the company and its member. A sale, compulsory sale, expropriation and the like furthermore only change the riders and not the qualities of the reins which link the rider with the horse. The company is relative to the nature of the transaction an unnecessary party if the reins are merely handed over. Unnecessary 'joining' in the transaction in terms of the words used or the form of the contract should not influence the substance: a purchase of shares with complete consent or with majority consent is not an arrangement between the company and its members, but between offeror and offerees."* [38]

Flemming DJP also saw fit to pose the question why Section 311 would have been intended by the legislator to cater for a party who is about to attempt a take-over bid when Section 314 of the Act (now repealed) catered for such need. The judge however then went on to indicate that other than the aforesaid comment, he preferred to remain uninvolved in what was not necessary for him to decide for the purposes of the Mielie-Kip case. However the judge did state further that the absence of comment by him on this issue did not imply his rejection of the view that Section 314 (at least since the commencement of the Companies Act of 1973) should either as a question of law or as a question of exercise of the Court's discretion be the mechanism for take-over bids to the exclusion of Section 311.[39] It follows that once again a Court had raised, albeit *obiter*, questions that indicated an intention to hold views which could differ from *dicta* in prior cases dealing with such issues. Flemming DJP acknowledged this issue in respect of schemes of arrangement when he stated in concluding his judgment:

> *"The field has become one where it is hardly possible to make a statement which is not different from a dictum in one or more decisions."* [40]

Ex parte Garlick

In *Ex parte Garlick Limited*,[41] the applicant, Garlick Limited ("Garlick") had been granted leave to convene a meeting of its shareholders to consider a scheme of arrangement proposed by Jano Retail Holdings (Pty) Ltd ("Jano") in terms of Section 311. Jano proposed to acquire, by way of the scheme of arrangement, all the issued ordinary shares of Garlick which were not owned by it or its wholly owned subsidiaries and their nominees. In terms of the scheme shareholders would receive a cash consideration in respect of each existing Garlick ordinary share. Further details of the scheme appear from the undermentioned analysis of the case.

The share capital of Garlick consisted of ordinary and preference shares, which shares were listed on the JSE. Jano was the beneficial holder of 100 ordinary shares in Garlick but held no preference shares. Furthermore, at all relevant times, 60.1% of the ordinary issued shares in Garlick were held by a company called Garlick Consolidated Limited ("Garcon"). Garcon was a subsidiary, but not a wholly owned subsidiary, of Jano. At a general meeting of Garcon shareholders held prior to the application to court for leave to convene meetings of Garlick, it was *inter alia* resolved that Garcon could vote in favour of the acceptance of the scheme which Jano proposed to submit to the ordinary shareholders of Garlick.

At the scheme meeting the voting, including that of Garcon, resulted in the number of votes being cast for the scheme representing 90.1% of the total issued share capital of the company. Even if Garcon had not voted[42], the result of the voting would have been that the votes cast in favour of the scheme represented 84.5% of the votes exercisable by the scheme members present at the meeting. Application for leave to sanction the scheme was accordingly duly made.

A minority shareholder (Mr Meer) opposed the sanction of the scheme. In view of its interest in the matter, Jano was granted leave to intervene in the application for sanction.

Counsel for Mr Meer *inter alia* argued that the scheme was not an arrangement between the Applicant and its members as required in terms of Section 311. Counsel further

argued that in any event the Court had a discretion to sanction the scheme and that in the alternative it should exercise its discretion not to sanction in that the object of the scheme was the acquisition by one member of all the shares of the other members, which object was not, in Counsel's view, directly attainable under Section 311 ("the discretionary argument"). The Court however duly sanctioned the scheme of arrangement.

In understanding how the Court arrived at the conclusion that the scheme was an arrangement contemplated in terms of Section 311, it is necessary to set out the scheme in detail. Moreover, such detail reflects that the scheme was not merely between a purchaser (Jano) and sellers (the shareholders). Furthermore the scheme in the Garlick case provides a useful guideline as to how to successfully structure a take-over of a company in a manner acceptable to a court (alternatively to the Cape Provincial Division) by the usage of the more advantageous Section 311 procedures.

The scheme of arrangement provided that Garlick would:

(a) sub-divide and redesignate 30 000 unissued shares of R1.00 each into 3 000 000 "B" ordinary shares of 1c each ranking upon their issue *pari passu* (rateably in accordance with their number and not their nominal value) with the existing ordinary shares of Garlick save that, in compliance with the Act, on a poll each holder of such shares would be entitled to that proportion of the total votes in the company which the aggregate amount of the nominal value of the shares held by him bears to the aggregate amount of the nominal value of all the shares issued by Garlick entitled to vote at such meeting; and

(b) convert two unissued ordinary shares of R1.00 each to two "A" redeemable cumulative preference shares of R1.00 each carrying the rights set forth in the scheme documentation;

Special resolution 5 of the scheme documentation provided for the inclusion of a new article in Garlick's Articles of Association dealing with the rights attaching to the "A" redeemable cumulative preference shares and a further special resolution providing for the inclusion of a new article setting out the rights attaching to the "B" redeemable preference shares. The scheme then went on to provide that as at the operative date of

the scheme:

(a) Jano or its nominee would subscribe for one "A" redeemable cumulative preference share of R1.00 at par plus a premium of R30 000.00;

(b) the said 3 000 000 "B" ordinary shares would be allocated to the holders of ordinary shares in Garlick's capital registered as such at the close of business on the record date of the scheme in the ratio of one "B" ordinary share for each ordinary share held, credited as fully paid up at par by way of a capitalisation of R30 000.00 of the amount outstanding to the credit of Garlick's share premium account after Jano had subscribed for the said "A" redeemable preference shares of R1.00;

(c) Jano or its nominee would subscribe for 2 999 900 "B" redeemable preference shares of R1.00 each at par plus a premium of 565c per share;

(d) Garlick would redeem each of the 2 999 900 "B" redeemable preference shares of R1.00 each at par plus a premium of 565c per share in terms of Section 98 of the Companies Act out of the proceeds of the new issue to Jano referred to above;

(e) each holder of a scheme share would be deemed to have renounced in favour of Jano or its nominee its right to receive the allocation of the "B" ordinary shares attributable to scheme shares; and those "B" ordinary shares, upon the scheme becoming operative and upon written application by Jano or its nominee, would be issued directly to Jano or its nominee;

(f) in consideration for the deemed renunciation of the right to the allocation of the "B" ordinary shares attributable to each scheme share, each holder of a scheme share would receive a cash consideration for each scheme share held on the record date of the scheme.

In essence scheme members would accordingly receive for each scheme share a cash consideration for the said redemption and a further cash consideration for the said renunciation.

Amongst the conditions precedent to which the scheme was subject was one to the effect that a general meeting of the members of Garlick would have passed the special and ordinary resolutions required to carry the scheme into effect. The consideration payable to scheme members was secured by means of a bank guarantee.

Although the final effect of the scheme was the acquisition of shares of members for a cash consideration which was the position in the *Mielie-Kip* case the scheme of arrangement in the Garlick case differed materially from the scheme of arrangement in the *Mielie-Kip* case in that the manner in which the scheme was proposed and structured clearly reflected that the company was very much an involved party to the scheme. The Court held in this regard as follows:

> *"These provisions show that the company is very much a party to the scheme. The scheme which involves a reconstruction of the Applicant's capital, without which it cannot be carried into effect, is not merely one between Jano and applicant's shareholders. I am accordingly satisfied that the scheme qualifies as an arrangement as contemplated by the section."* [43]

It follows that while it is true that the object of the scheme was the acquisition by Jano of all the issued ordinary shares in the Applicant, once regard was had to the actual terms of the scheme, the court was satisfied that the arrangement proposed was not simply one between Jano and the shareholders of Garlick but between Garlick and its shareholders with Jano being a permissible party thereto. The Court was satisfied that both in form and in substance the scheme of arrangement required the company to play an active and essential role in proposing and implementing of the scheme.

After satisfying itself that the scheme complied with Section 311, the Court then dealt with the discretionary argument advanced by Counsel for Meer. The Court duly held as follows:

> *"It was argued on behalf of Meer that the object of the scheme was the acquisition by Jano of all the shares of the other members of the Applicant and that this was not directly attainable under Section 311 of the Act. The Court should therefore, so it was argued, exercise its discretion against sanctioning the scheme.*
>
> *It is correct that Jano proposes to acquire all the issued shares of the Applicant; indeed that is stated in terms of the scheme documents. The manner in which Jano seeks to achieve this is by means of the*

scheme, the salient features of which have been set out above. What Section 311 (1) of the Act speaks of is an 'arrangement' which is proposed between a company and its members. The word 'arrangement' is, as was said in the Multi Bou case supra at 410 G - H, conceptually something of the widest character, limited only by what is contrary to general law or ultra vires the company.

The object of the scheme in the present case is not one which falls within either of the limitations referred to in the Multi Bou case. The avowed object of the scheme does not remove it from the ambit of an "arrangement" as contemplated by Section 311 and there is accordingly no justification for refusing to sanction it merely because it aims at securing control of the Applicant by Jano."[44]

It follows that the Court supported the view that Section 311 (as opposed to the now repealed Section 314 which was in force when the Court heard the matter) could be used as a mechanism for a take-over bid provided the scheme of arrangement was between the company and its members As mentioned in Chapter 2, the Securities Regulation Code on Take-overs and Mergers promulgated on 18 January 1991 recognises that take-overs can be the subject matter of a scheme of arrangement in terms of Section 311 provided that any applicable provisions of the Securities Regulation Code are followed. The Court also had no difficulty with the consideration received by members for their shares being a cash consideration. Unfortunately, the *Garlick* scheme did not involve a reduction of capital as it would certainly have been beneficial to future proposers of scheme of arrangements between a company and its members had the Court handed down a considered judgment on this issue.[45]

FOOTNOTES - CHAPTER 4

1. For example the reduction of capital procedure under Sections 83 to 90 of the Act and the redemption of redeemable preference shares under Section 98 of the Act.

2. The voting required in terms of Section 311(2) is a majority representing three-fourths of the votes exercisable by the members or class of members, as the case may be, present and voting either in person or by proxy at the meetings. Other issues which would be considered by an offeror in deciding which procedure should be adopted in terms of the Act for a merger or take-over would be *inter alia* tax and stamp duty considerations, the wishes of the non-controlling interest to be acquired and the attitude of the directors and shareholders of the offeree company.

3. For example, if a scheme involves a reduction of capital whether the procedures in terms of Section 83 - 90 of the Act must be followed to the exclusion of Section 311 or whether Section 311 may be used exclusively or in conjunction with such reduction of capital procedure in the Act.

4. 1975 (1) SA 826 (W)

5. Prior to the establishment of the Securities Regulation Panel and the promulgation of the company law amendments which flowed therefrom in R29 Government Gazette 12962 of 18 January 1991, the now repealed Sections 314 - 321 of the Act contained the framework for the making of a take-over offer. The current Section 440K (being an amendment effected to the Act in terms of the said Government Gazette of 18 January 1991) closely follows the repealed Section 321 of the Act.

6. Federale Nywerhede supra (note 4) at 834

7. Ibid at 833

8. Ibid at 832 - 833

9. 1984 (4) SA 349 (W)

10. Ibid at 359 - 360

11. 1985 (4) SA 279 (W)

12. Ibid at 283 - 284

13. 1986 (2) SA 442 (C)

14. Ibid 444 H - J. The protection which the use of Section 311 can give minority shareholders, when compared with the degree of protection which such minority would enjoy if the reduction of capital procedure was used, is (assuming that the minority shareholders are the subject matter of the scheme and consequently vote as a class) at least four-fold: firstly, the minority has the procedural advantage of a separate meeting at which to consult together and to try to persuade each other to vote for or against the proposal; secondly, the minority must receive the benefit of the information required in terms of Section 312; thirdly, the proposal cannot succeed without the support of the holders of three-fourths of the minority shares as are present or represented at the meeting; and, fourthly, the minority has the discretion of the Court at the stage of the application for sanction (See, for example *Re: Robert Stephen Holdings Ltd* [1968] 1 All ER 195 (Ch) and *Natal Coal Exploration Co Ltd* supra (note 11) at 282 - 283).

15. Ibid at 445

16. 1987 (2) SA 783 (W)

17. Ibid at 792

18. Ibid at 792

19. Ibid at 809 - 810

20. Ibid at 813

21. Ibid at 801 - 802. It is pointed out that with regard to this aspect of his judgment Coetzee DJP uses the term 'arrangement' as strictly an arrangement within Section 311 and 'scheme' in a wide sense to denote a general or overall plan of reconstruction of rights attaching to shares in one or more companies (see 801F).

22. Ibid at 802

23. Ex parte Suiderland supra (note 13) at 444 H - J. See also Gower op cit at page 694 and the cases cited therein.

24. See note 14 supra.

25. See, for example, *NBSA* case supra (note 16) at 801 H - J; Cilliers and Benade, Corporate Law, footnote 5 at 464; Ex parte Mielie-Kip Ltd 1991 (3) SA 449 at 454H and the unreported CPD case of Ex Parte Tollgate Holdings Ltd (Case 269/92) where part of the scheme involved a reduction of capital and accordingly application was made to court in terms of the applicable reduction of capital provisions of the Act and Section 311.

26. 1987 (3) SA 440 (W)

27. ibid at 443

28. ibid at 445

29. ibid at 445. See also Ex Parte Millman and Others NNO: In Re Multi-Bou (Pty) Limited 1987 (4) SA 405, more fully discussed in Chapter 3 hereof, where the Court held, at 415 - 417, that the scheme proposed was a disguised or simulated transaction - disguised inasmuch as the parties did not as between themselves really intend it to have the legal effect which its terms conveyed to the world at large.

30. ibid at 446

31. ibid at 446

32. 1963 (1) SA 806 (W)

33. 1991 (3) SA 449 (W)

34. Ibid at 453

35. Ibid at 453

36. Ibid at 455.

37. Ibid at 452 and 455

38. Ibid at 453 G - 454 H

39. Ibid at 454

40. Ibid at 456A

41. 1990 (4) SA 324 (C)

42. It is interesting to point out that in terms of the Securities Regulation Code on Take-Overs and Mergers (which was not in force at the time of the Garlick case) Garcon could at the instance of the Securities Regulation Panel have been excluded from voting.

43. Garlick case supra (note 41) at 331 G

44. Ibid at 340 H - 314 B

45. See further the discussion on the issue of reduction of capital in this Chapter 4.

CHAPTER 5

CONCLUSION

Whilst issues such as the varying practices of different divisions of the Supreme Court, the conflicting dicta, albeit in many instances *obiter*, of certain judges, the ability to retain assessed losses and judgments of the nature of *Mercian Investments* and *Namex* do constitute, to some extent, inhibiting factors in the usage of Section 311, the scheme of arrangement industry does not appear to have lost sight of the fact that established legal principles coupled with its own ingenuity have enabled it to overcome many of the obstacles placed in its path by certain Courts (indeed in some cases corectly having regard to the jurisdictional requirements of Section 311, the need of the Courts to strike a balance between the wishes and interests of the majority and the dissenting minority and the requirements of public policy). As reflected in this dissertation the door remains open to propose compromises or arrangements between a company and its members and/or creditors which are capable of sanction in a manner beneficial to the varying interests of the parties thereto. Section 311 has and will continue to play an important and beneficial role in areas such as take-overs, mergers, utilisation of assessed losses, and the restoration of companies in financial difficulty as going concerns.

The Courts generally regard compromises or arrangements in terms of Section 311 as beneficial[1] and have, in significant instances, shown a willingness to take cognisance of generally accepted practices in the commercial world.[2] The variety of facts and circumstances applicable to schemes are endless and the Courts have found it inappropriate to attempt to formulate precise rules in matters where they are entitled and obliged to exercise their discretion.[3] Sight must also not be lost of the flexibility

inherent in the widely accepted meaning of arrangement, in essence that almost any arrangement, not contrary to general law or *ultra vires* the company, which touches upon or concerns the rights and obligations of the company and its members and/or creditors may be the subject matter of Section 311.[4] As is stated by Coetzee DJP in the *NBSA* case:

> *"Section 311 (and indeed company law in general), should in its interpretation not be dealt with, as a person may for instance in dealing with the Criminal Procedure Act, by rushing for dictionaries or applying simple rules that are merely "our guides and not our masters".*[5]

Such an approach, in Coetzee DJP's view, could turn such a branch of law into something entirely superficial.[6] Coetzee DJP is of the view that Section 311 (as with company law in general) should be interpreted and dealt with in its historic context, in its economic context and, above all, in the context of the inner logic of the Companies Act and company law.[7]

Whilst it is hoped that the remaining conflicting *dicta* of our Courts will be resolved in the near future (and some caution, as indicated, is required with certain arrangements or compromises until such resolution) as a general trend the recent developments in our law have kept open, and indeed at times clarified, the path for scheme of arrangement practitioners to continue utilising the beneficial Section 311 procedures for a wide range of commercial transactions.

FOOTNOTES - CHAPTER 5

1. See, for example, Ex Parte Millman and Others NNO: In Re Multi-Bou (Pty) Ltd and Others 1987 (4) SA 405 (C) at 409J

2. See, for example, Ex Parte De Villiers and Another NNO: In Re Carbon Developments (Pty) Limited (in liquidation) 1993 (1) SA 493 (A) at 503G

3. ibid at 508 E

4. See further Chapter 2 under the heading *"Meaning of Compromise and Arrangement"*

5. Ex Parte NBSA Centre Limited 1987 (2) SA 783 (W) 785I - 786A

6. ibid at 786B

7. ibid at 786E

8. See, for example, Carbon Developments supra (note 2)