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**THE PROHIBITION AGAINST THE PROVISION OF FINANCIAL ASSISTANCE BY A COMPANY TO THE PURCHASERS OF ITS SHARES AS AN ASPECT OF THE CONCEPT OF THE MAINTENANCE OF CAPITAL**

QUALIFICATION FOR WHICH REGISTERED: MASTER OF PHILOSOPHY

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Research dissertation presented for the approval of Senate in fulfillment of part of the requirements for the Master of Philosophy courses and a minor dissertation. The other part of the requirement for this qualification was the completion of a programme of courses.

I hereby declare that I have read and understood the regulations governing the submission of Master of Philosophy dissertations, including those relating to length and plagiarism, as contained in the rules of this University, and that this dissertation conforms to those regulations.

Signed by candidate

SIGNED: H BRUK

Date: 08.06.2007

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# **THE PROHIBITION AGAINST THE PROVISION OF FINANCIAL ASSISTANCE BY A COMPANY TO THE PURCHASERS OF ITS SHARES AS AN ASPECT OF THE CONCEPT OF THE MAINTENANCE OF CAPITAL**

## **I. THE OBJECTS OF THE DISSERTATION**

The objects of the dissertation are:

1. To examine the relationship between the concept of the prohibition of financial assistance by a company to the purchasers of its shares and the “maintenance of capital rule” and to consider the historical aspects relating to the above.
2. To review the law relating to the “provision of financial assistance”.

Aspects considered below include the following:

- a. Historical aspects of the development of British Company Law.
- b. The maintenance of capital rule.
- c. Circumstances where it may be deduced that the rules relating to the maintenance of capital were breached.
- d. The prohibition of a company purchasing its own shares.
- e. The law relating to the issue of shares at a discount and the paying of commission on their issue.
- f. Redeemable preference shares.
- g. Comments on the shortcomings of the “maintenance of capital” concept.
- h. The prohibition against a company providing financial assistance for the acquisition of its shares.
- i. An analysis of the subsections of Section 38 including a consideration of the judgment in *Gardner v Margo* (2006) SCA(RSA).
- j. The concept of the “impoverishment test”.
- k. Whether the granting of financial assistance will render the whole transaction as being void.
- l. The declaration of dividends as a consideration in relation to the prohibition against the granting of financial assistance.
- m. Is the financial standing of the purchaser relevant in relation to the provisions of Section 38 (1).
- n. Whether the fact that a share purchaser takes over a debt of the company will be relevant to the law relating to the prohibition of financial assistance.
- o. The application of the principle ‘*in pari delicto potior est conditio possidentis*’ to transactions prohibited in terms of Section 38.
- p. Onus of proving the infringement of Section 38.
- q. Offences in terms of Section 38 (3).
- r. Section 40 of the Close Corporation’s Act 69 of 1984.
- s. Amendment of section 38 of the Companies Act.
- t. Review of relevant provisions of the new Companies Bill of 2007
- u. Australian Company Law.
- v. New Zealand Company Law.
- w. English Company Law.

## **II. INTRODUCTION**

The laws of a land are basically not enacted arbitrarily in a vacuum, but are determined by the ebb and flow of political economic and social developments nationally and globally. The last three decades have brought dramatic changes which have been mirrored in laws passed and in the interpretations of statutory laws. Who could have forecast the fall of communism and the fragmenting of the Russian colossus and who would have forecast the demise of apartheid in South Africa? In addition the last few years have seen economic crimes of a magnitude seldom perpetrated before.

In South Africa the emphasis of many laws has moved from the preservation of apartheid to the promotion of Black Economic Empowerment and the enshrinement of constitutional rights for all.

In the United States of America, the Enron, Worldcom and other similar massive plundering of the assets of companies together with the fraudulent stock exchange manipulations and the failure of the companies' auditors to adequately perform their professional duties have resulted in the passing of the Sarbanes-Oxley Act of 2002. This act incorporates stringent new accounting and public-disclosure rules in an attempt to curb the abuses that had cost shareholders billions of dollars. However, as Justice Ralph H Zulman stated in his talk given at Corporate Governance Conference on 25.06.2005 –

“But one form of excess may be replacing another. The wave of corporate scandals has now turned into a rising tide of red tape.”

In the book on British Company Law by L.G.B. Gower entitled *The Principles of Modern Company Law – 2<sup>nd</sup> edition* dated 1957, reference is made on pages 56 and 57 to the crises facing companies as a consequence of the then impending nationalization proposals of the Labour Party and their implications for the company law.

South Africa as a developing country had not only to meet the challenges of ensuring better corporate governance but also had to make the laws more “user-friendly” to attract investments.

These considerations will be referred to below.

## **III. HISTORICAL ASPECTS OF THE DEVELOPMENT OF BRITISH COMPANY LAW**

As was the case with other dominions of the British Commonwealth, South African Company Law was based upon the British Law. It is necessary to briefly examine the historical development of company law in order to appreciate the emphasis on the “maintenance of capital concept” with its related prohibition in respect of the provision of financial assistance by a company to enable its shares to be acquired. The reason for the above is that the development of company law reflects the changing political, economic and social circumstances within a country.

Gower<sup>1</sup> makes the following statement:

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<sup>1</sup> Supra p21

“This book is concerned with modern company law, but there are some branches of modern English Law which cannot be properly understood without reference to their historical background, and company law is certainly one of them; indeed of all branches of the law it is perhaps the one least readily understood except in relation to its historical development”.

Initially trading on joint account as compared with trading on one’s own account was undertaken in a form of partnership. As trade, especially foreign trade developed the partnership format was replaced by joint stock companies.

The East India Company which was chartered by the Crown in 1600 was the first to develop into a joint stock company where stock was subscribed for a number of years.

Gower<sup>2</sup> writes that the advantage of “limited liability” conferred by incorporation was not initially appreciated. The number of foreign trading companies declined during the latter years of the seventeenth century. However, the number of domestic companies increased. Share dealing became common and stock broking became an accepted occupation. However, no attempt was made to control the operations of companies. During the first two decades of the eighteenth century there was what Gower<sup>3</sup> referred to as “an almost frantic boom in company flotations”. Companies were formed often without the company promoters expending funds to obtain charters or moribund companies were acquired. Investors rushed to invest in companies with strange objects e.g. the object of making square cannon balls.

The above promoters were, however, not without humane feelings in that the prospectus specifically provided that the new type of cannon ball was to be used only against Turks and not against Christians.

A company which proposed to lend money on land in Ireland and to operate a banking partnership acquired the charter of the Sword Blade Company which had been formed to manufacture hollow sword blades – Gower<sup>4</sup>. The above company acted as bankers for the South Sea Company which had schemed to acquire the entire British National Debt of approximately £31,000 000. In June 1720 the shares were dealing at over 1 000%. By the end of the year the shares stood at 125%.

The bursting of the “South Sea Bubble” led to the collapse of many other companies. Investigations disclosed fraud and corruption in the affairs of the South Sea Company. There is indeed nothing new under the sun. Illogical greed does beget illogical greed as speculators have so often found out to their cost in various stock market crashes. Unfortunately solid investors are also often misled by the machinations of so-called solid and respectable directors.

The reaction of the British government was to act in a stringent manner – not unlike the American Congress passing of the Sarbonnes-Oxley Act referred to above. However, the Bubble Act was far more extreme. The following is a quote from Pennington’s Company Law – 5<sup>th</sup> edition on page 8:

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<sup>2</sup> Supra p25

<sup>3</sup> Supra p25

<sup>4</sup> Supra p27

“The state of the market in the short term and the Bubble Act in the long term made it impossible for companies to raise further capital by invitations to the public and for the next one hundred years capital was obtained wholly by the private solicitations of affluent persons, except in the case of the few companies incorporated by Special Acts of Parliament from 1760 onwards”.

The circumstances of the wild speculations and the attendant losses were to remain in the English psyche. As a consequence of the restrictions imposed on incorporated companies, there was a growth of the use of unincorporated companies which were in effect only partnerships. When the unincorporated companies became the object of ‘market manipulations’ the State considered it necessary to bring the law more into accord with the prevailing financial climate.

The 1844 Act which followed upon another slump introduced three main principles which constituted the basis of company law. These included differentiations between private partnerships and joint stock companies, incorporation of companies by registration as compared with a special act or charter and full publicity of the company’s activities. Limited liability of the members was attained in the Act of 1855. The Limited Liability Act was replaced by the Joint Stock Companies Act which as Gower<sup>5</sup> observed was passed in the “heyday of laissez-faire”.

Gower<sup>6</sup> continues as follows:

“It allowed incorporation with limited liability to be obtained with a freedom amounting almost to license; all that was necessary was for seven or more persons to register a memorandum of association. Virtually all the safeguards prescribed by the 1855 Act were deleted; there was no minimum nominal or paid up capital or share value, only the provision for winding up on the loss of three-fourths of the capital was retained”.

He continued:

“In effect the legislature had adopted Lord Bramwell’s recommendation and accepted the view that those who dealt with companies had only themselves to blame if they burnt their fingers”.

The mystic word “limited” was intended to act as a red flag warning the public of the dangers which they ran if they had dealings with the new invention.” The extracts from Gower’s book<sup>7</sup> shed light on various aspects of company law which impacted upon the concept of the maintenance of capital.

On the one hand there was an appreciation more than 140 years ago that the public must be mature enough to correctly deal with companies and the dangers inherent in such dealings. Obviously the operations of companies must be linked to penalties for dishonest or grossly incompetent directors and other officers of the company. On the other hand as it was considered by Gower<sup>8</sup> and others that there was merit in a company law which provided for a more controlled environment even if the controls were excessive, unnecessary or even misdirected.

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<sup>5</sup> Supra p48

<sup>6</sup> Supra p48

<sup>7</sup> Supra p48

<sup>8</sup> Supra p52

There were many amendments to the law, partially to meet the dynamic developments and partly to close the “stable door” after some gross dishonesty on the part of directors or other officers of companies. Within the concept of the limited liabilities of companies there was a feeling that there was a sort of bargain between companies and the public.

On the one hand there was the granting of limited liability with all the mischief that could ensue therefrom including potential harm to creditors and minority shareholders. On the other hand there was a need to ensure that companies’ capital funds were properly maintained so as to ensure that the assets of a company were not unfairly dissipated.

The prohibition against the granting of financial assistance by a company to purchasers of its shares was a concept akin to the maintenance of capital concept. The effects of the incorporation of a company and the consequent separation of the assets of the company from its shareholders were considered, inter-alia, in *Oakes vs Turquand and Harding*<sup>9</sup>, *Salomon v Salomon and Company Ltd*<sup>10</sup> and the interesting case of *Dadoo Ltd. v Krugersdorp Municipal Council*.<sup>11</sup> There is an impression in the latter case that the court looked for an opportunity to overcome the discriminatory legislation preventing Asiatics from owning immovable property in the Transvaal. The relevant law did not impose any restrictions on companies with Asiatic shareholders from owning immovable property in Transvaal. The court could have “lifted the corporate veil” and held that the company was a subterfuge for overcoming the land ownership laws of the province.

The Australian High Court in *Ascot Investments (Pty) Ltd. v Harper*<sup>12</sup> held that even if a company was not formed for the purpose of avoiding a legal obligation, it may lift the corporate veil if the company was a mere puppet of its controller.

South Africa enacted the Companies Act of 1926 which was largely based on the English Companies (Consolidation) Act of 1908. This Act was replaced by the South African Companies Act of 1973. There were major amendments in 1999 as well as in 2006. The bill incorporating the 2006 amendments has been signed by the President but the date for the amendments coming into effect has not yet been determined. However, a bill known as the 2007 Companies Bill referred to below is anticipated to become law at the end of 2008.

#### **IV. THE MAINTENANCE OF CAPITAL RULE**

As referred to above, there was a fear prevailing in the English “financial psyche” that the public or more specifically the creditors and minority shareholders had to be protected from the machinations of the directors and other officers. One of the aspects upon which emphasis was placed was the “maintenance of capital” and its related concept “the prohibition of companies granting financial assistance” to purchasers of the companies’ shares. The courts developed the “maintenance of capital” rule. The rule was basically that the assets introduced into a company as its issued share capital was represented by its “capital fund”. This was also referred to as the “guarantee fund”.

The following is a representation where the assets introduced as capital was R1 000:

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<sup>9</sup> (1867) L.R. 2 H L 325

<sup>10</sup> (1897) A.C.22

<sup>11</sup> (1920) A.D.530

<sup>12</sup> (1981) 148 C L R 337

## Balance Sheet of a (Pty) Ltd. as at 31.01.01

Issued Share Capital	R1 000
Capital Fund consisting of Cash at Bank	<u>R1 000</u>

The assets representing the capital fund could only be returned to shareholders subsequent to the reducing of the share capital in terms of the statutory law.

Before the 1999 amendment of the Companies Act reductions of capital were governed by Sections 83 to 90 of the Act. These sections provided for the reductions of the capital to be approved when the following circumstances were present:

1. The company had the appropriate authority in its articles.
2. The consent of creditors was obtained.
3. The appropriate special resolution was approved by the members.
4. The reduction was approved by the court.

Section 84 provided that subject to the above the company could cancel any paid up capital which was lost or pay off any paid up share capital in excess of the requirements of the company.

Prior to the prohibition against the issuing of partly paid up shares there was a distinction between the fully paid issued shares and partly paid shares. The latter referred to that portion of the issued shares in respect of which the shareholders had paid calls made upon them by the company but had not paid the full amount of the par value at which the shares were issued. With regard to the balance of the net assets in excess of the capital fund, the company had no legal restrictions preventing it from distributing those assets.

Blackman *et al*<sup>13</sup> state the following with regard to the repealed Sections 83 to 90:

“Strictly speaking, these rules did not form part of the capital maintenance rule itself, for that rule merely insisted that capital funds be returned only under a formal reduction of share capital. But they did serve to justify the rule: if the legislature had gone to such lengths to protect creditors in the case of a capital reduction, it could hardly have intended that the company should be able to return capital funds to its members by other means”.

The term capital includes the following:

- the money or value subscribed in terms of the memorandum of association.
- any share premiums.
- the capital redemption reserve fund.
- capitalized reserves.
- money borrowed to pay dividends.

The decision in Trevor v Whitworth<sup>14</sup> became the bedrock upon which the maintenance of capital concept was based. The need for a company to maintain its capital fund became the “golden rule” for courts in England and Commonwealth countries for a hundred years.

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<sup>13</sup> Supra

<sup>14</sup> (1887) 12 App. Cas. 409

The above case was decided in terms of the 1867 Companies Act which unlike the 1862 Act did permit the reduction of the capital of the company when undertaken in terms of the Act. There was a need for approval of creditors and shareholders and the approval of the court. The terms were not unlike those contained in Sections 83 to 90 of the South African Company Law before its amendment in 1999.

The following are extracts from the judgment:

“Lord Watson:.... One of the main objects contemplated by the legislature, in restricting the power of limited companies to reduce the amount of their capital as set forth in the memorandum, is to protect the interests of the outside public who may become their creditors. In my opinion the effect of these statutory restrictions is to prohibit every transaction between a company and a shareholder, by means of which the money already paid to the company in respect of his shares is returned to him, unless the court has sanctioned the transaction. Paid-up capital may be diminished or lost in the course of the company’s trading; that is a result which no legislation can prevent; but persons who deal with, and give credit to a limited company, naturally rely upon the fact that the company is trading with a certain amount of capital already paid, as well as upon the responsibility of its members for the capital remaining at call; and they are entitled to assume that no part of the capital which has been paid into the coffers of the company has been subsequently paid out except in the legitimate course of its business”.

Lord Herchell in delivering his judgment concurred with Lord Watson stating:

“What is the meaning of the distinction thus drawn between a company without limit on the liability of its members and a company where liability is limited, but, in the latter case, to assure to those dealing with the company that the whole of the subscribed capital, unless diminished by expenditure upon the objects defined by the memorandum, shall remain available for the discharge of its liabilities? The capital may, no doubt, be diminished by expenditure upon and reasonably incidental to all the objects specified. A part of it may be lost in carrying on the business operations authorized. Of this, all persons trusting the company are aware and take the risk. But I think they have a right to rely, and were intended by the legislature to have the right to rely, on the capital remaining undiminished by any expenditure outside these limits, or by the return of any part of it to the shareholders ... Nothing can be stronger than (the) carefully-worded provisions (in the Companies Act 1867 governing the reduction of share capital) to show how inconsistent with the very constitution of a joint-stock company, with limited liability, the right to reduce its capital was considered to be.”

The judgment contained the seeds for future criticism of the “capital maintenance concept” viz. that it was acceptable for a company to trade legitimately even though it had lost a large part of its “capital fund” but it could not return any portion of the capital funds without the reduction of its share capital in terms of the provisions of the Act. Criticism of the above concept will be referred to in greater detail below. However, it is pertinent to repeat Lord Bramwell’s admonition that persons who deal with companies had only themselves to blame if they burnt their fingers. A great amount of ingenuity was used to overcome the “maintenance of capital concept” and it was necessary for the courts to conclude from the evidence presented whether in substance and effect a payment was a return of capital.

Blackman *et al*<sup>15</sup> refer to different cases where payments were reflected in such a manner so as to disguise the fact that a payment is a return of capital. Examples of such include the following:

- Halts Garage<sup>16</sup> – return of capital in the form of excessive directors' remuneration.
- Aveling Barford Ltd. v Perion Ltd<sup>17</sup> - return of capital by the sale of an asset for an amount below its market value. Hoffman J emphasized in this case that it did not depend exclusively upon what the shareholders call a transaction but rather on its substance.
- Redweaver Investments Ltd. v Lawrence Field Ltd<sup>18</sup> where it was held that “any agreement which in substance provides for the company to return share capital is illegal and cannot be enforced (void) unless some specific statutory authority for the return could be found.”
- Barclays Bank plc v British and Commonwealth Holdings plc<sup>19</sup> – the company had no capacity to return its capital to its members otherwise than in accordance with the provisions of the Act, and hence returns of capital contrary to the Act were ultra vires: It was held that a company had no power to rescind a contract for the acquisition of the shares and to return the application moneys as moneys borrowed or as this would involve an illegal reduction of capital: Merchant Credit Private Ltd. v Industrial & Commercial Realty Co Ltd.<sup>20</sup>

## **V. CIRCUMSTANCES WHERE IT MAY BE DEDUCED THAT THE RULES RELATING TO THE MAINTENANCE OF CAPITAL WERE BREACHED**

### **Payments of Dividends out of Capital**

The capital fund could not be reduced by the payment of dividends out of capital. This would prevent the creditor's guarantee fund from being whittled away by payments to shareholders expressly made as a return of capital. There was no statutory authority for the above in earlier English Companies Acts even-though the Companies Clauses Act of 1845 prohibited the declaration of dividends out of capital without the consent of creditors. In Flitcrofts Case<sup>21</sup> re Exchange Banking Company Jessel M R stated:

“The creditor has no debtor but that impalpable thing the corporation, which has no property except the assets of the business. The creditor, therefore, I may say, gives credit to the company on the faith of the implied representation that the capital shall be applied only for the purposes of the business and he has therefore a right to say that the corporation shall keep it's capital and not return it to shareholders.”

It has been difficult to determine whether dividends have been paid out of capital.

The following are examples of cases in which the correctness of dividends declared was questioned:

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<sup>15</sup> Supra on p 5-106

<sup>16</sup> 3 A11 ER 1016

<sup>17</sup>( 1989) BCLC 626

<sup>18</sup> (1991) ACSR 438-443 SC(NSW)

<sup>19</sup> (1996) 1 BCLC 115 CCHD and CA

<sup>20</sup> (1983) 7 ACLR 711 (PC)

<sup>21</sup> (1882) 21Ch.D 519 C.A.

***Stringer's case (in re Mercantile Trading Company)***<sup>22</sup>.

Selwyn L J said:

“If it is made to appear that for the purposes of fraud, or for any other improper motive, a company has declared and paid a wholly delusive and improper dividend, and has thereby in effect taken away from its creditors a portion of the capital which was available for the debts of those creditors, I entertain no doubt that the court would have full jurisdiction, and would exercise it by ordering the repayment of the money so improperly paid. But in the present case we have to consider whether this dividend was, in truth, a dividend declared under such circumstances ...”

If we were to lay down as a rule that there must be actually cash in hand, or at the bankers of the company, to the full amount of the dividend declared, we should be laying down a rule which, in my judgment, would be inconsistent with what I understand and believe to be the custom of all companies of this description, and also inconsistent with mercantile usage, and we should be laying down a rule which would open the door to and encourage a very great amount of litigation, because there are very few dividends indeed which would not be open to more or less question if such a rule as that were laid down. I think that in the absence of any fraudulent intent as against the shareholders, or as against the creditors or the public, the court ought not to be astute in searching out minute errors in calculation, in an account honestly made out and openly declared ...”

***Lee v Neuchatel Asphalt Company.***<sup>23</sup>

Lindley L J said:

“There is nothing at all in the Acts about how dividends are to be paid, nor how profits are to be reckoned; in that it is left, and very judiciously and properly left, to the commercial world. It is not a subject for an Act of Parliament to say how accounts are to be kept; what is to be put into a capital account, what into an income account is left to men of business.”

***Bolton v Natal Land and Colonization Company.***<sup>24</sup>

In this case the court held that dividends could be declared out of current profits despite the fact that on a correct valuation of the assets in the balance sheet there would be no profits to distribute.

***Verner v General and Commercial Investment Trust.***<sup>25</sup>

The decisions in *Lee v Neuchatel Asphalt Company*<sup>26</sup> and in *Bolton v Natal Land and Colonization Company* were approved.<sup>27</sup>

Lindley L J stated:

“There is no law which prevents a company from sinking its capital in the purchase or production of a money-making property or undertaking, and in dividing the money annually yielded by it, without preserving the capital sunk so as to be able to reproduce it intact either before or after the winding-up of the company.”

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<sup>22</sup> (1869) 4 Ch. App. 475

<sup>23</sup> (1889) 41 CHD 1

<sup>24</sup> (1892) 2 Ch. 124

<sup>25</sup> (1894) 2 Ch. 239

<sup>26</sup> *Supra*

<sup>27</sup> *Supra*

***Bond v Barrow Haematite Steel Company.***<sup>28</sup>

Farwell J said:

“It is, however, necessary to bear in mind that the two propositions – (1) that dividends must not be paid out of capital, and (2) that dividends may only be paid out of profits – are not identical, but diverse. The first is the requirement of the statutes, and cannot be dispensed with; the latter is in Table A or the articles of the particular company, and is one of the regulations of this company which has to be construed. A company which has a balance to the credit of its profit and loss account is not bound at once to apply that sum in making good an estimated deficiency in value of its capital assets. It may carry it to a suspense account.”

***Ammonia Soda Company v Chamberlain.***<sup>29</sup>

Swinfen Eady L J said:

“The Companies Act does not impose any obligation upon a limited company, nor does the law require, that it shall not distribute as dividends the clear net profit of its trading unless its paid-up capital is intact or until it has made good all losses incurred in previous years..”

***Lubbock v British Bank of South America.***<sup>30</sup>

A banking company with a paid-up capital of £500 000 sold part of its undertaking for £875 000. After providing for all its liabilities, it was left with a surplus of £205 000. The Court held that the £205 000 could be treated as profit available for dividend.

Chitty J said:

“The capital of the bank is intact, and the account shows it, and after providing for the capital, there remains a surplus which rightly goes to the profit and loss account. All that the company is required to do, by force of the Companies Act, is to keep its capital intact, and not to pay dividends out of its own capital; in other words, to keep that capital for its creditors, and any others who may be concerned therein ...”

The above cases were extracted from “Company Law Through the Cases” by H R Hahlo – Second Edition.

**The law relating to the distribution of dividends**

The above was summarized by Gower<sup>31</sup> as follows:

“Dividends cannot be paid if this would result in the company’s being unable to pay its debts as they fall due. All the following rules are subject to the aforesaid condition pertaining to solvency.

1. Losses of fixed assets need not be made good before treating a revenue profit as available for dividend, i.e. it is not legally essential to make any provision for depreciation.
2. Losses of circulating assets in the current accounting period must be made good. This is accepted in all the cases but seems to be true only if “circulating assets” is defined very narrowly so as to embrace only the stock-in-trade in the narrowest sense. So far as other current assets are concerned it is neither accounting practice,

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<sup>28</sup> (1902) 1 Ch. 353

<sup>29</sup> (1918) 1 Ch. 266

<sup>30</sup> (1892) 2 Ch. 198

<sup>31</sup> Supra p109-111

nor, it is thought, legally necessary, to debit a fall in value of fixed assets to the income statement.

3. A realized profit on the sale of fixed assets, and, perhaps, an unrealized increase in the value of fixed assets on a bona fide revaluation may be treated as a profit available for dividend, at any rate if there is an overall surplus of fixed and circulating assets over liabilities. Whether it is then necessary to revalue all fixed assets is not clear, but accountants take the view that it is.
4. Losses, even revenue losses on circulating assets, made in previous accounting periods need not be made good; a dividend can be paid provided there is a profit on the current year's trading. In other words, each accounting period is treated in isolation."

The above legal principles prevailed in South Africa until the 1999 amendments to Section 90.

### **The prohibition of a company purchasing its own shares**

As referred to above an attempt by a company to purchase its own shares led to the decision in *Trevor v Whitworth*.<sup>32</sup> The Court held that despite the authority granted in its memorandum and articles the above would prejudice creditors and potential creditors. The prohibition was removed in South Africa in the Companies Act. The amended Section 85 contains the procedure whereby a company can purchase its own shares.

Section 39(1) of the South African Act provided that subject to limited exceptions a company could not own shares in its holding company and any transfer, allotment or issue of a company's shares to a subsidiary would be void.

The only exceptions were:

1. Where the shares were held in a nominee capacity. The rules relating to a subsidiary would relate to its nominee.
2. The shares were acquired before 1 January 1974.
3. The shares allotted related to capitalization shares issued to subsidiaries which held the shares as above.

Section 89, as amended in 1999, enables a subsidiary to hold a maximum of 10% of the aggregate of the issued shares of its holding company. However, restrictions were imposed on the voting rights of shares held by subsidiaries.

The shares held by a subsidiary will in terms of Section 39 only have voting rights in the following circumstances:

- Where the shares are acquired in a subsidiary of the holding company which is also a subsidiary of the acquiring company.
- Where a company is acting in a representative capacity and the holding company or its subsidiary are not beneficially involved.

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<sup>32</sup> Supra

## **The law relating to the issue of shares at a discount and the paying of commission on their issue**

Section 80 permits a company to pay a commission to any person in consideration of his subscribing for shares in the company or for procuring others to do so. The Section provides the conditions under which payments could be made. The Section in providing for a payment to the subscribers of the shares is in effect providing permission for payments out of capital.

Section 81 authorises a company to issue shares at a discount where shares of that class had previously been issued. The conditions under which the shares can be issued include the issue being sanctioned by the Court.

In the case *Ooregum Gold Mining Company of India, Ltd. v Roper*<sup>33</sup> the court held that shares could not be issued at a discount. The case was decided in terms of the English Companies Act of 1862.

## **Redeemable preference shares**

Section 98 of the Act authorizes a company to issue redeemable preference shares. This section was in existence prior to the Act's amendment in 1999. The shares may be redeemed subject to the provisions of the section without the need for authorization by the court. However, should the shares be redeemed from the profits of the company otherwise available and not from the proceeds of a new issue then the profits as aforesaid must be transferred to a reserve fund to be called the "capital redemption reserve fund." The provisions of the Act which refer to the reduction of capital apply to the capital redemption reserve fund. However, in terms of Section 98(c) no such shares shall be redeemed unless and until the premium payable on redemption has been provided for out of the profits of the company or from the share premium account.

## **VI. COMMENTS ON THE SHORTCOMINGS OF THE "MAINTENANCE OF CAPITAL" CONCEPT**

The following are basic weaknesses in the concept:

### **1. There is no minimum share capital required when a company is incorporated.**

The following is an extract from *Gower*<sup>34</sup>:

"Subject, however, to these limitations, the law does ensure that the company initially receives assets at least equivalent to the nominal amount of the paid up capital. To this extent the insistence on shares with a fixed nominal value serves a useful purpose. But what prevents this from being any real safeguard is the refusal of the law to prescribe any minimum to what the nominal value may be. If a company can be formed, and one has been, with a capital of 1/2d., divided into two 1/4d. shares, it is clear that it is no protection to creditors to know that the company once received a halfpenny or the equivalent."

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<sup>33</sup> (1892) A.C. 125

<sup>34</sup> *Supra* – p101

2. **The company may lose all or part of the share capital as a consequence of trading losses and in terms of *Trevor v Whitworth*<sup>35</sup> and other cases that followed the aforesaid judgment, this would not contravene the capital maintenance concept.**

It is unreasonable to believe that a creditor would find it acceptable to lose money when his debt is not paid by a company which has lost its capital due to trading losses whereas he would be unhappy where his debt was not paid where reductions in the capital fund had been caused as a consequence of the company having to reduce the capital contrary to statutory requirements.

3. **Where the paid up capital consists of shares which were issued in exchange for assets there could be an extreme difficulty in confirming the correctness of the valuation as there are no statutory provision for ensuring the correctness of valuations.**

The following are examples of cases where the courts were faced with problems relating to valuations.

***Salomon v Salomon and Company Ltd.*<sup>36</sup>**

Lord Macnaghten said the following in regard to the value at which the assets of a sole trader were sold to the company:

“The price fixed by the contract was duly paid. The price on paper was extravagant. It amounted to over £39 000 – a sum which represented the sanguine expectations of a fond owner rather than anything that can be called a businesslike or reasonable estimate of value.”

***Belmont Finance Corporation v Williams Furniture Ltd.*<sup>37</sup>**

In this case a company, Maximum was sold for £500 000. On the company subsequently going into liquidation, the receiver obtained a fair value of £60 069. At the trial the judge accepted the correctness of the valuation of £500 000. The Court of Appeal considered that £500 000 was excessive and considered the lower valuation to be more reasonable.

4. **The courts have been faced with the need to determine whether a distribution has been from net profits or from capital.**

The rules extracted from the English Court cases (and accepted in South Africa) appear to be illogical in view of the concept of maintaining the capital of the company. It is difficult to comprehend that while it was not permissible to reduce the capital of a company other than in terms of the statute, it was possible to lose essentially the whole of the capital fund of a company and still be able to declare dividends from the current profits.

The above is compounded by the fact that the courts have ruled that not only can a company declare dividends as above but would be permitted to do so without making good trading losses sustained in previous years.

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<sup>35</sup> Supra

<sup>36</sup> 1897 AC22

<sup>37</sup> 1980 1 All ER 393 CA

An extreme example of the ridiculousness of the above was Stringer's case.<sup>38</sup> A company had traded with the Confederate States of America during the American Civil War. As a consequence of the Federal victory the stock of cotton in The Confederate States and the debt due by these states had become valueless. In addition a number of vessels had been lost.

The Court held as follows:-

"The company was fully justified in putting a value on the ships and on the Confederate debt; and inasmuch as it is clear that, having regard to the extremely hazardous nature of the operations in which the ships were engaged, no insurance of them could be effected, the valuation of the ships became a matter of mere estimate; and inasmuch as with respect to the value of the obligation on the part of the Confederate Government, there could be no fixed principle on which it could be valued – for it depended upon the views which different persons might take."

- 5. The obligation of directors to act in a bona fides manner with regard to all their duties vis-a-vis their companies may obviate the need to use the "maintenance of capital" concept in order to successfully institute actions against errant directors.**

There are fiduciary relationships between directors and their companies. The directors must avoid conflicts of interests and exercise reasonable care and diligence in the performance of their obligations and duties.

The legal codes of all countries provide for criminal and civil sanctions for breaches by directors (e.g. Sections 424 and 425 of The South African Act).

The following is an extract from the English case of Belmont Finance Corporation v Williams Furniture Ltd. and Others<sup>39</sup> which sets out the fiduciary relationship of directors vis-a-vis the company and parties who may have been benefited from the director's inappropriate behaviour:

"A limited company is of course not a trustee of its own funds: it is their beneficial owner; but in consequence of the fiduciary character of their duties the directors of a limited company are treated as if they were trustees of those funds of the company which are in their hands or under their control, and if they misapply them they commit a breach of trust (re Lands Allotment Co (1894) 1 Ch 616 at 631, 638 (1891-94) All ER Rep 1032 at 1034, 1038), per Lindley and Kay LJJ). So, if the directors of a company in breach of their fiduciary duties misapply the funds of their company so that they come into the hands of some stranger to the trust who receives them with knowledge (actual or constructive) of the breach, he cannot conscientiously retain those funds against the company unless he has some better equity. He becomes a constructive trustee for the company of the misapplied funds."

In Jacobson and another v Liquidator of M Bulkin & Co Ltd<sup>40</sup> the Court found that the company had sustained losses as a consequence of the directors entering into

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<sup>38</sup> Supra

<sup>39</sup> Supra

<sup>40</sup> (1976) (3) S.A. 781 (T)

transactions which had impoverished the company when providing financial assistance prohibited in terms of the Companies Act. The remedy was by way of action for damages against the defaulting directors. In this case the Court held as follows:

“Bulkin got what he bargained for and the company got what it bargained for. What could the plaintiff have claimed from Bulkin in an action against him only, based on unjustified enrichment? Bulkin and the company are in *pari delicto*. Although the Courts will in certain circumstances order restoration of property or compel restitution in an appropriate manner where such a course is necessary to prevent injustice or to satisfy the requirements of public policy, the Court has no discretion to grant relief where the purpose of the action is not restoration but the enforcement of an illegal obligation.”

## **VII. THE PROHIBITION AGAINST A COMPANY PROVIDING FINANCIAL ASSISTANCE FOR THE ACQUISITION OF ITS SHARES**

As referred to above, the prohibition against a company providing financial assistance for the purchase of its shares was a related concept to “the maintenance of capital”. The reason for the prohibition was to prevent the “mischief” which could result from persons with insufficient funds gaining control of the company and using the assets of the company to pay for the shares with the consequent or potential impoverishment of the company. This could have the effect of causing losses to minority shareholders and creditors by reducing the capital fund of the company.

The prohibition was incorporated into the 1926 South African Companies Act as Section 86(bis) (Section 38 of the 1973 Act). The origin of the prohibition – as stated above - is to be found in the ruling in *Trevor v Whitworth*.<sup>41</sup>

Since 1872 English law permitted the reduction of a company’s capital where the reduction had been approved by the Courts.

The 1999 amendment of the South African Act provided for a new Section 90. This section permits the reduction of the company’s capital without the need for an application to court.

A new Section 85 enacted in the 1999 amendment contains protections against inappropriate actions by directors prejudicing shareholders or creditors. It was the attempt for a company to purchase its own shares which was the basis of *Trevor v Whitworth*.<sup>42</sup> Basically the capital maintenance concept would in the past have resulted in delays in reducing the capital, and would involve considerable legal costs and while being a nuisance would not have created undue problems for the dishonest.

The prohibition against a company providing financial assistance for the purchase of its shares has arguably been the most troublesome section in the Act. The problems caused by the section were recognized in the 2006 amendment of Section 38.

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<sup>41</sup> *Supra*

<sup>42</sup> *Supra*

## **The comments below relate to the law before the 2006 amendment.**

J S Mc Lennan in an article entitled “Financial Assistance to Acquire Shares: The Trouble Continues (1)” concludes with a quote from Dr Leonard Sealy with regard to Section 54 of the English Companies Act which corresponds to Section 38 of the South African Act.

“No reform of the companies’ legislation has anything of the ‘urgency and importance’ that can be claimed for the amendment of s 54. The existing law has long been a scandal; as the Jenkins Committee declared in 1962: “Section 54 ... has proved to be an occasional embarrassment to the honest without being a serious inconvenience to the unscrupulous.”

In another article “Financial Assistance to Acquire Shares – The Trouble Continues (3)” SA Merc LJ (2001) J S Mc Lennon concludes as follows:-

“The real problem is, of course, the badly-drafted and misconceived s 38. One can only hope that one day the Standing Advisory Committee will do something about it.”

Blackman, Jooste and Everingham in *Commentary on the Companies Act*<sup>43</sup> make the following statement:

“It is unfortunate that in 1999, when the legislation made its unsystematic efforts to eliminate the capital maintenance principle it did not undertake a radical reform of Section 38. With the tests of liquidity and solvency largely replacing the capital maintenance principle there is no longer the need to preserve Section 38 in its present form. Perhaps consideration should have been given to permitting a company to give financial assistance subject to adequate safeguards for creditors and minority shareholders.”

F H I Cassim in his article in the *South African Law Journal* (entitled: “*The Reform of Company Law and the Capital Maintenance Concept*”<sup>44</sup>) also criticized the section.

The following are extracts from the above article:

“According to s38 – described as a legal practitioner’s nightmare – it is unlawful for a company to finance a purchase of its own shares. The section is couched in such wide terms that it is difficult to know for certain whether a particular transaction offends s38 – and yet, the consequences of a contravention are severe in that they result in a criminal offence, the nullity of the transaction and an action for damages against the responsible directors for breach of fiduciary duty in entering into an illegal transaction on behalf of the company (Jacobson v Liquidators of M Bulkin and Co Ltd.<sup>45</sup>; Belmont Finance Corporation v Williams Furniture Ltd.<sup>46</sup>)

The wide wording of the section has resulted in many an innocuous transaction being struck down – even transactions that may benefit a company. The section is best summed-up in the words of Gower, who long ago stated that the section ‘became notorious as unintelligible and liable to penalize innocent transactions while failing to deter guilty ones’. (L C B Gower *Principles of Modern Company Law* 5 ed (1992) at 227).”

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<sup>43</sup> Supra 4-58

<sup>44</sup> p290-293

<sup>45</sup> Supra

<sup>46</sup> Supra

Section 38 could be perceived as being a section that could be used as the justification for a court application to have a contract declared void when a party thereto no longer desired to be bound by the contract. Financial assistance which is afforded “in the ordinary course of sound business” is however, not prohibited by the section.

Section 38 as contained in the Companies Act before the 2006 amendment reads as follows:

**38. No financial assistance to purchase shares of company or holding company.**

1. No company shall give, whether directly or indirectly, and whether by means of a loan, guarantee, the provision of security or otherwise, any financial assistance for the purpose of or in connection with a purchase or subscription made or to be made by any person of or for any shares of the company, or where the company is a subsidiary company, of its holding company.
2. The provisions of subsection (1) shall not be construed as prohibiting –
  - (a) the lending of money in the ordinary course of its business by a company whose main business is the lending of money; or
  - (b) the provision by a company, in accordance with any scheme for the time being in force, of money for the subscription for or purchase of shares of the company or its holding company by trustees to be held by or for the benefit of employees of the company, including any director holding a salaried employment or office in the company; or
  - (c) the making by a company of loans to persons, other than directors, bona fide in the employment of the company with a view to enabling those persons to purchase or subscribe for shares of the company or its holding company to be held by themselves as owners; or
  - (d) the provision of financial assistance for the acquisition of shares in a company by the company or its subsidiary in accordance with the provisions of Section 85 for the acquisition of such shares.
3.
  - (a) Any company which contravenes the provisions of this section, and every director or officer of such company, shall be guilty of an offence.
  - (b) For the purpose of this subsection ‘director’, in relation to a company, includes any person who at the time of the alleged contravention was a director of the company.
  - (c) It shall be a defence in any proceedings under this section against any director or officer of a company if it is proved that the accused was not a party to the contravention.

In *Lipschitz NO v UDC Bank*<sup>47</sup> Miller J stated the following:

“The prohibition against the giving of financial assistance is couched in very wide terms. It relates to “any” financial assistance, whether given “directly or indirectly” and it relates, moreover, to such assistance not only when it is given for the purpose of the purchase of or subscription for any shares in the company, but also if it is given in connection with such purchase or subscription. The words “in connection with” serve to extend (albeit not considerably, as I shall later show) the field marked out by the words “for the purpose of”.

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<sup>47</sup> (1979) (1) SA789A p799

Before examining Section 38 with reference to both decided cases and commentaries on the section by legal experts, the writer wishes to reflect on one issue which does not appear to have received sufficient attention with regard to the law prevailing prior to the 2006 amendment.

When a company is formed its first transaction would be the allotment of shares to the initial shareholders. The opening journal entry would be as follows:-

Shareholders Loan Account – debit -	R100
Issued Share Capital – credit -	R100

(being the allotment of 100 ordinary shares of R1 each to the shareholders)

It is apparent that the transaction would have been void in terms of Section 38(1) and in terms of Section 38(3)(a) the company and every director would have been guilty of an offence. The above would have been the legal position as the section specifically prohibits financial assistance for subscriptions for shares and the journal entry referred to above involves a loan for the acquisition of shares in the company.

The 2006 amendment enables the shareholders to approve the transaction.

## VIII. AN ANALYSIS OF THE SUBSECTIONS OF SECTION 38

Section 38 can basically be divided into three parts:

- Subsection 38(1) sets out the nature of the actions which are prohibited;
- Subsection 38(2) details loans and financial assistance by companies which are not prohibited;
- Subsection 38(3) refers to the parties who would be guilty of offences should Subsection 38(1) be contravened.

### **Subsection 38(1)**

The courts have on occasion had to consider every word in 38(1) and in order to fully understand the contents of the subsection it will be necessary to do the same.

#### ***“No company”***

All companies, whether public or private fall within the ambit of the Act. Consequently other juristic persons such as close corporations are not affected. In addition the proportion of shares involved is irrelevant – *Karoo Auctions (Pty) Ltd. v Hersman*<sup>48</sup>.

#### ***“Shall give directly or indirectly”***

The term “directly” is not confined to the manner in which the assistance is given but to the assistance itself. It is irrelevant that the money was intended for investment and that the rate of interest was favourable or that there would be no problems relating to the repayment of the loan.

The writer of the article, s38 – Financial Assistance: An Analysis of Case Summary Company Law Journal F5 2/1977, writes as follows:

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<sup>48</sup> (1951) (2) SA 33E

“If, therefore, a transaction of the company, falling short of a loan or security specifically tied to the share price, directly assisted the conclusion of the share transaction, there would, on this view be a direct contravention of the prohibition and no further enquiry would be necessary.”

However, the writer states that the interpretation of the word “indirectly” being extended to include virtually any financial transaction entered into simultaneously with the disposal of the shares would constitute a breach is not correct. The reason for this being that the section is of a penal nature and must be interpreted restrictively. A recent decision in *Gardner v Margo* introduced a new element in distinguishing between the “ultimate intention” and “direct purpose”. This case and related cases are considered below.

#### **A consideration of the judgment in *Gardner V Margo* (2006) SCA 36 (RSA)**

This case concerned the interpretation of a contract (‘the mandate’) entered into between the first appellant, Tony Ricky Gardner (‘Gardner’), and the second appellant, OTR Mining Ltd. (‘OTR’), on the one hand, and Mr Jan Abraham Joubert (‘Joubert’), on the other. In terms of the mandate, Joubert instructed Gardner to sell a large number of Joubert’s shares in OTR and so the company gave a guarantee to Joubert in respect of such shares. Joubert subsequently ceded to the respondent, Roger Hugh Margo (‘Margo’), “all his rights, title and interest in and to all claims, including the claim for rectification, which he had against Gardner and OTR” in terms of the mandate. Margo, as cessionary, sued Gardner and OTR in the Johannesburg High Court for payment of the unpaid proceeds of shares in OTR which Gardner sold. One of the arguments presented by the appellant was the issue whether the guarantee granted by OTR constituted a breach of provisions of Section 38(1). BJ van Heerden JA delivered the judgment. The rest of the judges concurred with the aforesaid. In view of the approach adopted by the court it is necessary to consider the judgment in detail.

Van Heerden JA stated the following:

“No company shall give, whether directly or indirectly, and whether by means of a loan, guarantee, the provision of security or otherwise, any financial assistance for the purpose of or in connection with a purchase or subscription made or to be made by any person of or for any shares of the company.....”

In *Lewis v Oneanate (Pty) Ltd*. Nicholas AJA stated at 818(c) that -

“The object of a provision such as s 38(1) is the protection of the creditors of a company, who have a right to look to its paid-up capital as the funds out of which their debts are to be discharged ..... The purpose of the Legislature was to avoid that fund being employed or depleted or exposed to possible risk in consequence of transactions concluded for the purpose of or in connection with the purchase of its shares”.

Although the prohibition against the giving of financial assistance is couched in very wide and general terms –

“There has ..... been a tendency, in the light of the extremely wide terms of the prohibition considered in conjunction with the circumstance that contravention of the section constitutes a criminal offence, to give close attention to the underlying purpose of the prohibition and the real mischief at which it was aimed ... and, with that in mind, to adopt

what JC Beuthin has described in (1973) 90 SALJ at 213 as “a much narrower approach to the section” (*Lipschitz NO v UDC Bank Ltd*<sup>49</sup> (1979)).

In *Lipschitz NO v UDC Bank Ltd.* the court appears to have accepted the distinction drawn by Schreiner JA in *Gradwell (Pty) Ltd. v Rostra Printers Ltd*<sup>50</sup> between the ‘ultimate goal’ of the transaction in question and its ‘direct object, and to accept that it is only the direct object of the transaction that is relevant. If the direct object is not the provision of financial assistance by the company for the purpose of or in connection with a purchase of its shares, then it is irrelevant that the ultimate goal of the transaction was to enable a person to purchase such shares. Moreover, financial assistance within the meaning of s 38(1) is given only when the direct object of the transaction is to assist another financially – the s 38 prohibition is not contravened when the direct object of the transaction is merely to give another that to which he or she is already entitled.

As was submitted by Margo’s counsel, the guarantee given by OTR to Joubert was not intended to provide financial assistance to anyone in respect of the purchase of OTR shares. The direct object of the guarantee was to provide Joubert with some security for that to which he was entitled in terms of the mandate, i.e. part of the proceeds of the shares to be sold on his behalf by Gardner. In my view, the guarantee does not fall foul of s 38(1) of the Companies Act and counsel for the appellants (once again, wisely) did not press this point at all.

The interpretation placed on Section 38(1) by the court (and the appellants’ counsel) does not appear to conform with the section and the accepted interpretation thereof on a consideration of the judgments referred to in the case viz *Gradwell (Pty) Ltd. v Rostra Printers Ltd. and Another*,<sup>51</sup> *Lipschitz NO v UDC Bank Ltd*,<sup>52</sup> *Lewis v Oneanate (Pty) Ltd. and Another*.<sup>53</sup>

***Gradwell (Pty) Ltd. (Gradwell) v Rostra printers Ltd and another (Rostra)***

This case related to a claim by the appellant for commission in respect of the sale of the shares in and the loan due by a company known as Printing House Ltd. The respondents repudiated the claim on the grounds that the commission related to a contract that was invalid because it infringed Section 86 (bis) 2 of Act 46 of 1926 (which corresponds to Section 38(1) of the present Companies Act.)

The Balance Sheet of Printing House Ltd. at the time of the offer reflected the following:

Share Capital	£20 000	Land at cost	£66 178
Loan Rostra	£40 258		
Bond Building Society	£10 255		

However, the purchase price for the shares and loan account was £42 500 less the bond of £10 255. In order to accommodate the transaction it was decided to increase the mortgage bond and to use the proceeds to reduce the loan account of Rostra.

As the indebtedness to the building society had increased and the value of the loan had decreased the required purchased consideration was reduced due to a cheaper article having

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<sup>49</sup> (1979) (1) SA789A at 797H to 798A at 799E to F

<sup>50</sup> (1959) (4) SA 419

<sup>51</sup> Supra

<sup>52</sup> Supra

<sup>53</sup> (1992) 4 (SA) 811A

been purchased. It was clear that Crowden Products Ltd. (Crowden) the proposed buyer would have been unable or unwilling to purchase the shares and loan account at its original price of £40 258. As the purchase consideration was less than the balance on the loan account it was apparent that the shares were worthless.

As referred to above, Crowden contended that the obtaining of the increased bond infringed the prohibition against the granting of financial assistance. The court, however, held that the above transaction resulted in the acquisition of a smaller and therefore cheaper article and not because financial assistance was provided to assist in the purchase of the larger more expensive one.

Schreiner JA stated the following (p425):

“I do not think, however, that in this case it matters whether the words ‘or otherwise’ are given a restricted meaning or not. Loan, guarantee and the provision of security are certainly ways in which a company could provide financial assistance in the purchase of its shares. It could lend money to the purchaser or guarantee or secure his borrowings from someone else. But the method employed can hardly determine what is the giving of financial assistance within the meaning of the sub-section. Loan, guarantee and the provision of security may, I apprehend, be used also for other purposes than the giving of financial assistance. It would consequently not advance the reasoning to enquire whether the method used was similar to loan, guarantee or the provision of security instead of asking directly whether the giving of financial assistance covers the payment of a debt that is due and payable. In the present case the company was itself to borrow the money and its property was to be used to secure the loan. Thereby it would incur a liability but it would receive a corresponding amount of money. The question whether it was to give financial assistance would depend not on how it obtained the money – by loan, secured or not, by realizing assets or otherwise – but on what it was to do with the money when available. We were pressed by counsel for Crowden with the importance of the purpose of the whole transaction. The purpose of Crowden and Rostra was inevitably that of the company, the actions of which were entirely controllable by Rostra. The purpose must be taken to have been to help Crowden to buy and Rostra to sell the company’s shares. But this does not carry Crowden to success. Unless what was to be done would amount to giving of financial assistance within the meaning of the sub-section the purpose and the connection would not be important.”

The part of the judgment in the above case that influenced the court in *Gardner v Margo*<sup>54</sup> was the following:

“I do not agree with the contention advanced on Crowden’s behalf that the partial discharge of the loan indebtedness was merely incidental to the transaction in any relevant sense. It is true that it was not the ultimate goal of the transaction. But it was the direct object of the parties to pay off part of the loan account so as to leave a smaller account to be purchased. The way the ultimate object was to be achieved was by carrying out a step, the partial discharge of the indebtedness, which, though it was more convenient to Crowden and possibly also to Rostra, was not the giving of financial assistance” (page 427).

The court’s approach in *Gradwell (Pty) Ltd. v Rostra Printers Ltd. and Another*<sup>55</sup> was to differentiate between the purchase of a cheaper article (where the loan account had been reduced) and the more expensive article (before the loan account had been reduced). The

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<sup>54</sup> (2006) SCA36 (RSA)

<sup>55</sup> *Supra*

arrangement whereby the loan was reduced (and the bond increased) was the direct object of the parties as otherwise the transaction could not be completed. The ultimate object was to enable the purchaser to buy the shares and loan account of Printing House Ltd. However, the prohibition of providing direct assistance referred to in section 38(1) refers specifically to financial assistance for the purchase of the company's shares and not to any other type of assistance.

Based on the judgment of the above case it is not possible to appreciate the rationale for the judgment in *Gardner v Margo*.<sup>56</sup> Further cases will be considered below in order to ascertain whether they could provide clarification for the decision.

***Lewis v Oneanate (Pty) Ltd. and another***<sup>57</sup>

This case related to the repudiation of an offer by Lewis to purchase the shares and loan account of Bergriviershoek (Pty) Ltd. (Bergriviershoek) from Oneanate.

The purchaser wished to purchase the entire property known as Dewdale Farm situated in the Franschhoek Valley.

Each of Oneanate and Bergsrievierhoek owned approximately 50% of Dewdale Farm. The offer of Lewis contained the following clause:

3. The transaction will be structured in the most efficient manner possible (and as presently advised) the farm property owned by Oneanate (Pty) Ltd. will be transferred to Bergriviershoek (Pty) Ltd. This will include the commercial and farming operations. I will thereafter acquire the shares and loan claims in the last mentioned company thereby giving me total ownership and control of the venture" (page 818).

The purchase price of the shares and loan account of Bergriviershoek would be R10,500 000 payable as follows:

R7,000 000 in cash and the balance of R3,500 000 would be secured by a mortgage bond for that sum to be passed by Bergriviershoek in favour of Oneanate.

Lewis claimed that the passing of the mortgage bond would constitute a contravention of Section 38(1) of the Companies Act. It was held that Oneanate gave financial assistance but not Bergriviershoek, the company whose shares and loan account were acquired.

As was the case in *Gradwell (Pty) Ltd. v Rostra Printers Ltd*<sup>58</sup> there were in effect two transactions undertaken to accomplish the ultimate goal. In this case the ultimate goal was the sale of the whole of the Dewdale Farm and the direct object of the sale of part of the Dewdale Farm was to achieve the sale of the whole. However, Section 38(1) refers to the granting directly or indirectly ..... any financial assistance.

The preliminary transaction as referred to above did not constitute a transaction prohibited in terms of Section 38(1). This case should not have been considered as a precedent for the reasoning of the court in the case of *Gardner v Margo*.<sup>59</sup>

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<sup>56</sup> Supra

<sup>57</sup> Supra

<sup>58</sup> Supra

<sup>59</sup> Supra

***Lipschitz NO v UDC Bank Ltd***<sup>60</sup>

Lipschitz instituted the action as the liquidator of various companies. This case was referred to in *Gardner v Margo* as a precedent for the judgment in that case. The facts of this case are basically as follows:

The case involved an appeal against the decision of the Witwatersrand Local Division that certain claims lodged by the respondent against three companies be rejected in terms of Section 86(bis) (now Section 38(1) of the current Companies Act). The three property owning companies referred to in the judgment Oreon, Ferndale and Kruben had borrowed funds from UDC Bank. Another company referred to as Prosun controlled by Mr Baker offered to purchase the shares and loan account due by Kruben. The purchase price was to be paid partially in cash and the balance would be paid a year later. The offer was accepted. Subsequently Prosun acquired the shares and loan accounts of Oreon. Ubco also controlled by Baker then took over the rights and obligations of Prosun under two agreements and was substituted for Prosun as the purchaser of the shares in and loan accounts against Oreon and Kruben.

Baker's purpose was that Ubco as soon as it obtained full control of the stands owned respectively by Oreon and Kruben by virtue of its acquisition of Prosun's rights, would consolidate those stands together with stand 876 which it already owned and controlled, into a single stand for development. It was in those circumstances and with that purpose that Ubco approached the UDC Bank for a loan.

UDC Bank (UDC) advanced a loan which would cover the balance of the purchase price owing by Ubco to Prosun in respect of the shares and loan accounts against Oreon. The judgment referred to the above as the "first transaction".

The following acts were performed in respect of the above:

- (i) Ubco signed an acknowledgement of debt in favour of UDC in respect of the agreed price of the Oreon shares.
- (ii) Oreon passed a resolution acknowledging that it was indebted to the bank in respect of the loan account and undertook to pass a mortgage bond over certain fixed property as security for the debt.
- (iii) Ubco ceded to UDC its rights to the loan accounts against Oreon.
- (iv) Oreon furnished UDC with a special power of attorney to pass the bond referred to above.
- (v) Ubco granted an option to UDC to subscribe at par for one quarter of the issued share capital of Oreon, or to require payment by Ubco, in lieu of its right to acquire such shares of R25 000.

UDC thereupon duly advanced the sum of R132 500 to Ubco on loan and it was not disputed that, when so doing, UDC knew that the purpose of the agreement was to enable Ubco to acquire the shares in and loan accounts against Oreon. Subsequently there was what was referred to as a second transaction. Ubco borrowed an amount from UDC to enable it to discharge its obligations to Prosun in respect of the purchase of the shares in and loan account against Kruben.

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<sup>60</sup> Supra

The following are the pertinent components of the second transaction:

- (i) Ubco consented to transfer to UDC, for so long as Baker and Ubco remained indebted to UDC, the entire issued share capital of Ubco.
- (ii) Ubco signed an acknowledgement of debt in favour of UDC.
- (iii) Ubco, Oreon, Kruben and Baker signed a deed in terms of which they jointly and severally bound themselves as sureties and co-principal debtors to UDC.
- (iv) Each of Kruben and Oreon gave to UDC a special power of attorney to enable “surety mortgage bonds” to be passed over their immovable property.

The contemplated surety mortgage bond by Oreon in favour of UDC was duly executed. This bond served to secure the obligations of Ubco to UDC in respect of the purchase by Ubco of the loan accounts against Oreon and the purchase of the shares in Kruben (see pages 795 to 797).

It was contended by the counsel for the liquidator that both transactions would fall foul of Section 86bis(2) even if only the second transaction contravened the section. Miller JA referred to the following extract from the statement of Schreiner JA in *Gradwell (Pty) Ltd. v Rostra Printers Ltd.*<sup>61</sup> :

“that the partial discharge by the company on the loan account debt would not be ‘merely incidental’ to the transaction and that, although ‘the ultimate goal’ of the transaction was the purchase of the shares ‘it was the direct object .... To pay off part of the loan account.’ (page 426D-E). ‘The ultimate goal’ of the transactions was the purchase of shares in the company (see also 425F-G) there was another and more direct and not merely incidental object which was to reduce the company’s debt in respect of the loan account”.

Miller JA, continuing with his consideration of the above case, stated as follows:

“It is true that it was also pointed out that the “purpose and connection” of a payment would not be important unless it amounted to giving of financial assistance (at 425G), but it would appear from the judgment as a whole that the conclusion that financial assistance in breach of the section was not to be given derived in part from an examination of the direct purpose of the payment to be made by the company. The ultimate finding was that the section had not been contravened because (i) the payment, although it would facilitate the purchase of the company’s shares, which was the ultimate object, would be made with the direct (and legitimate) object of discharging an existing debt which was due and payable; (ii) such payment would not alter to its detriment the financial position of the company; (iii) therefore, in the particular circumstances of the case, the paying off of the existing debt could not be brought “within the notion of giving financial assistance”. And it must constantly be borne in mind that the court found that the passing of the bond by the company would not constitute the giving of security for the purpose of the purchase of the shares but would be the means whereby money was to be raised to pay off the existing and due debt of the company.

As I have mentioned, it is not necessary for present purposes to comment on the correctness or otherwise of the ultimate decision on the facts of *Gradwell’s*<sup>62</sup> case. Nor is it necessary to decide whether, where the purpose of the company in giving financial assistance is in

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<sup>61</sup> Supra p779-780

<sup>62</sup> Supra

issue, the court must be satisfied, before finding that the section has been contravened, that it was the company's sole purpose to facilitate by such assistance the purchase of shares in the company."

The court held that the first transaction was not in contravention of the prohibition.

Miller JA stated the following (page 806):

"There would surely be no room for a finding that, because A knew of B's ultimate intention regarding the purchase of shares in the company, the financial assistance given by A, although not given for the purpose of the purchase of shares but for a different purpose, was nevertheless given in connection with the purchase of shares and was therefore in contravention of the section."

The second transaction was found to be in contravention of Section 86(bis).

With regard to the contention in the judgment in *Gardner v Margo*<sup>63</sup> it would appear that the references to "ultimate intention" and "direct purpose" related to the fact that there were interrelated transactions. The term "ultimate intention" would appear to refer to the ultimate acquisition of an asset which was not necessarily related to the purpose of the provision of prohibited financial assistance. The term "direct purpose" refers to the actual financial assistance given directly (or indirectly) given by the company to a purchaser of its shares (or its holding company's shares). It is this assistance which is prohibited in terms of Section 38(1). It is consequently difficult to agree with the judgment in *Gardner v Margo*. Section 15 3(1) of the English Companies Act and the judgment in *Brady v Brady*<sup>64</sup> are relevant. (refer to p60)

### **Whether by means of a loan, guarantee, the provision of security or otherwise**

A contentious issue raised both by *Blackman et al*<sup>65</sup> and in the article in *The South African Company Law Journal*<sup>66</sup> referred to above is whether the words "or otherwise" must be interpreted according to the "*ejustum generis* rule" which in the context of Section 38 would mean that words which form a category (such as loan "guarantee" security) would be restricted to the same category.

It was held by the aforesaid writers that the "*ejustum generis* rule" does not pertain and the word "otherwise" can have a meaning outside a category comprising loan, guarantee or security and may take any other form. The section is very broad as to the method of assistance which is covered in that it covers loans, guarantees, the provisions of security and as referred to above a broad term of "otherwise". The assistance must be financial to fall within the ambit of Section 38. It will not be relevant if the assistance is in the nature of moral support or the provision of documentation or expertise.

In terms of the judgment in *Gray v Thesing Vastgoed BV*<sup>67</sup> facilitating a transaction e.g. by acting as a conduit for the transmission of funds will not constitute financial assistance.

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<sup>63</sup> Supra

<sup>64</sup> (1988) BCLC 20 (CA); (1989) AC 755

<sup>65</sup> Supra p4-58

<sup>66</sup> Supra

<sup>67</sup> (1987) (1) SA 744A

***Karnovsky v Hyams***.<sup>68</sup>

This case refers to a transaction relating to the disposal of shares of a company which involved the company providing security of its assets for the share-seller's claims. One of the provisions was that a mortgage bond could be passed to secure the loan. The sellers would have a secured loan as compared to the loan which had been unsecured. It was contended that the sellers had received financial assistance from the company in respect of the loan.

The court, however, held that as the company had also received a benefit in that the loan which was due on call was replaced with a loan which was payable at a future date there was no prohibited financial assistance. The court held further that even had the company repaid the loan at the date of the sale there would have been no prohibited financial assistance. The court also found that the company had not been impoverished.

***Goss v E C Goss & Co (Pty) Ltd***<sup>69</sup>

In this case the sole shareholder sold 75% of her holding for R12 000. Payment was to be effected as follows:-

An immediate payment of R800 purporting to be the full purchase price of the shares. Weekly payments of R200 for 56 weeks (R11 200). In return for receiving the amount of R200 per week the seller had to attend the company's offices for three mornings a week.

The sale was conditional upon the seller entering into a service agreement with the company. The court held that the two contracts were not severable and that the service agreement was entered into as a subterfuge in order to overcome the provisions of Section 86bis and as such unenforceable.

***The London Ranch (in liquidation) v Hyreb Estate***<sup>70</sup>

This case related to an agreement providing that various sites were to be set aside for the seller. Two further sites were to set aside for a church and a synagogue. It was later contended that the conditions amounted to a breach of Section 86bis(2).

The court held that the above conditions did not constitute a breach of the section. The rationale was that the applicant required no financial assistance to complete the deal and that the above conditions were merely prerequisites retained by the sellers as part of the consideration for the sale. The judgment is justifiable if the sites were to be alienated by the company at a fair price. However, if the prices were not reasonable then it could reasonably be considered that the transaction was subject to the prohibition

***Lewis v Oneante (Pty) Ltd***<sup>71</sup>

In this case a share purchaser acquired the entire issued capital of the company. Payment was to be partly in cash and partly to be paid over a period. In order to secure the payment of the balance, the company passed a bond over property which was to be transferred to the company. The bond would be passed at the same time as the property was transferred. The court held that unless the value of the property transferred was less than the bond there

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<sup>68</sup> (1961) (2) SA 368W

<sup>69</sup> (1970) (1) SA 602D

<sup>70</sup> (1963) (2) SA 570E

<sup>71</sup> (1992) (4) SA 811A

would be no provision of financial assistance as the bond would not secure any of the property held by the company immediately prior to the passing of the bond.

Blackman *et al* (on p4-59) refer to the following statement made by Hoffman J in *Charterhouse Investment Trust Ltd. v Tempest Diesel Ltd*<sup>72</sup>

“There is no definition of giving financial assistance in the (English) section although some examples are given. The words have no technical meaning and their frame of reference is in my judgment the language of ordinary commerce. One must examine the commercial realities of the transaction and decide whether it can be properly described as giving financial assistance by the company, bearing in mind that the section is a penal one and should not be strained to cover transactions which are not fairly within it.”

An interesting decision referred to by Blackman *et al* (on p4-59) was *Chaston v SWP Group*<sup>73</sup>. In this case it was held that where a subsidiary company paid for a due diligence test relating to the acquisition of the holding company’s shares the payment would constitute ‘financial assistance’.

Nicholas JA in *Lewis v Oneanate (Pty) Ltd* stated the following:

“In *Lipschitz NO v UDC Bank Ltd.* this court had under consideration the provisions of s 86bis(2) of the Companies Act 46 of 1926. From the judgment of Miller JA, with whom the other members of the court concurred, the following propositions may be extracted –

The prohibition against the giving of financial assistance is couched in very wide terms. It relates to ‘any’ financial assistance, whether given ‘directly or indirectly’ and it relates to such assistance not only when it is given for the purpose of the purchase of or subscription for any shares in the company, but also when it is given ‘in connection with’ such purchase or subscription (at 797D-E).

The prohibition contains two main elements – the giving of financial assistance and the purpose for which it is given. Although the two elements are linked to form a single prohibition, they are vitally different in concept (at 799E).

There is no comprehensive definition of ‘financial assistance’ in the section or elsewhere in the Act. From time to time various tests have been formulated by the courts as a guide to a proper answer to the question whether what a company has done in a given case constitutes the giving of ‘financial assistance’ within the meaning of the section (at 798B-C).

One such test is the so-called ‘impoverishment test’, which asks the question, has the company become poorer as a result of what it did for the purpose of or in connection with the purchase of its shares? (at 798C-E).

The application of the impoverishment test is not always appropriate. In some cases the test may be a helpful guide and may often yield a clear and decisive answer to the problem. In other cases it may be not only unhelpful but irrelevant (at 801D-E).

The section provides in terms that the giving of a guarantee or the provision of security constitutes the giving of financial assistance. In such cases, if the giving of the guarantee or the providing of the security is shown to be for the purpose of or in connection with the

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<sup>72</sup> (1986) (1) BCLC 10

<sup>73</sup> (2003) (1) BCLC 675 (CA)

purchase of the company's shares, the section would be contravened, whether or not such guarantee or security actually renders or is likely to render the company poorer (at 800-801).

Although the section does not in its terms prohibit the conclusion of a contract for the sale of shares in which there is provision for the giving of financial assistance, if a contract provides for future financial assistance which if actually given would be in contravention of the section, it is invalid and unenforceable (at 802B-803C)".

### **Any financial assistance**

Blackman *et al* (4-58) define "assistance" to involve something in the nature of aid or help. The assistance cannot however, exist in a vacuum but must be given to somebody. Reference is made to the case of *Sterileair (Pty) Ltd v Papallo*.<sup>74</sup>

The writers confirm that the assistance must be of a financial nature. The following are examples of assistance that would not be prohibited in terms of Section 38.

1. Providing documents.
2. Answering requests for information.
3. Entering into bona fides service agreements.
4. Facilitating the conclusion of a transaction (e.g. by serving as a vehicle for the transmission of money to a party to a transaction) - Blackman *et al*.<sup>75</sup>

The prohibition is not confined to financial assistance given to the purchaser, but applies to any person provided it is for the purpose of or in connection with the purchase of the shares. (*Jacobson and Another v Liquidator of M Bulkin & Co Ltd*).<sup>76</sup>

### **For the purpose of or in connection with**

The judgment in *Lipschitz N O v UDC Bank Ltd*<sup>77</sup> contains the following:

"The prohibition in the section comprises two main elements; one is the giving of financial assistance, the other is the purpose for which it is given (or in "connection with" provision). The two elements are linked to form a single prohibition, but although so linked they are different in concept."

The writer, reviewing the above judgment in *The South African Company Law Journal* 1979 (pages F10 - F11), states the following with regard to the phrase 'in connection with'.

"We consider, with respect, that in this regard the judgment provides a most welcome clarification of a troublesome phrase. Many practitioners and some academics have tended to give the words "in connection with" a very wide meaning sufficient to impugn transactions merely because they are contemporaneous with, or agreed upon within the same series of negotiations as, sales of shares in a contracting company. The judgment in the following passage, indicates a much more restricted interpretation which is particularly relevant in a common situation, namely, one where the company whose shares are

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<sup>74</sup> (1998) 29 ACSR 461

<sup>75</sup> Supra p4-58

<sup>76</sup> (1976) (3) SA 781 (T) 787-788

<sup>77</sup> Supra p799

involved, is required to give undertakings, not in regard to the share sale, but in respect of the sale of the loan account associated therewith.”

“If given their literal meaning, the words “in connection with” may have a very wide connotation but it is probably seldom that they are used in legislation in their wide, literal sense. An act only remotely associated with an event may be said, literally, to have been an act in connection with such event, but unless the subject matter of the legislation and the context of the particular provision clearly indicate otherwise, it would not ordinarily be accepted that even the most remote connection was intended to be visited with sanctions or penal consequences.”

The following is a further extract from the judgment in *Lipschitz NO v UDC Bank*<sup>78</sup>:

“The prohibition in s 86 bis (2) is clearly aimed against the giving of financial assistance by a company if it is given for the purpose of the purchase of its shares. The ‘in connection with’ provision is an alternative to ‘for the purpose of’ and in the context of the section its connotation cannot be otherwise than profoundly affected by the concept to which it is an alternative. The words ‘in connection with’ appear to have been inserted in order to cover a situation where, although the actual purpose of the company in giving financial assistance might not have been established, its conduct nevertheless stood in such close relationship to the purchase of its shares that, substantially if not precisely, its conduct was similar to that of a company which have the forbidden assistance with the purpose described in the section. In short, the alternative was inserted merely to close possible loopholes; it was not intended by such insertion to create a different type of offence, or a lesser offence, or to prohibit conduct which was not substantially similar to the conduct prohibited by the main provision characterized by the words ‘for the purpose of’. Obviously it is not possible to define the exact extent of the enlargement of the scope of the prohibition by the addition of the words in question; the fact of each case will determine whether the established ‘connection’ with the purchase of shares constitutes conduct which the Legislature was concerned to prohibit.

Where the purpose of the company in performing the act complained of is established and that purpose is for something other than the purchase of the company’s shares there would in general (though there may be exceptions) be little or no room for a finding that, for purposes of s 86 bis(2), the act was nevertheless performed in connection with the purchase of the shares. For example, company A, for its own business purposes, guarantees B’s overdraft at a bank so as to enable B to carry on his business of manufacturing certain equipment which the company necessarily requires for its business and which equipment it purchases from B. Company A knows full well at the time of giving the guarantee that B, who has confidence in its stability and management, intends to invest in shares in company A the surplus profits he will make as a result of being able to continue his manufacturing business by reason of the overdraft facilities made available to him by virtue of A’s guarantee. B in fact thereafter uses such profits for the purchase of shares in A. The guarantee given by A clearly amounts to the giving of financial assistance to B, but not at all for the purpose of the purchase of the company’s shares; its purpose, clearly established, was to enable B to continue producing the equipment required by A for its business. In such a case there would surely be no room for a finding that, because A knew of B’s ultimate intention regarding the purchase of shares in the company, the financial assistance given by A, although not given for the purpose of the purchase of shares but for a different purpose, was nevertheless given in connection with the purchase of shares and was therefore in contravention of the section”.

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<sup>78</sup> Supra p804-808

The term 'in connection with' is therefore an extension of the term 'for the purpose of' and applies where although the giving financial assistance by a company, might not have been established, its conduct nevertheless stood in such close relationship to the purchase of its shares that, substantially if not precisely, its conduct was similar to that of a company which gave the forbidden assistance with the purpose described in the section. In short, the alternative was inserted merely to close possible loopholes; it was not intended by such insertion to create a different type of offence, or a lesser offence, or to prohibit conduct which was not substantially similar to the conduct prohibited by the main provision characterized by the words 'for the purpose of'. Obviously, it is not possible to define the exact extent of the enlargement of the scope of the prohibition by the addition of the words in question; the facts of each case will determine whether the established 'connection' with the purchase of shares constitutes conduct which the legislature was concerned to prohibit.

The terms for the 'purpose of' or 'in connection with' were considered in various other cases including the following:

*S v Hepker*.<sup>79</sup>

In this case, the company purchased assets from the purchaser of the shares to provide the funds to enable the shares in the company to be purchased. The following is an extract from the judgment:

“National Gelatine bought the shares in Silverton Investments, not because it needed or wanted them, but solely and exclusively to create an indebtedness to Hepker and Chiddy by means of which its profits, and other money which it borrowed, could be paid to Hepker and Chiddy, so that Hepker and Chiddy could pay the former shareholders. If that is not financial assistance, albeit indirectly, for the clear purpose of paying for its own shares, then I would like to know what it is. Clearly it is at least financial assistance 'in connection with' the purchase of the shares. This phrase certainly has a wider connotation than 'for the purpose of'.”

*Gradwell (Pty) Ltd. v Rostra Printers Ltd.*<sup>80</sup>

This case also involved the purchase of assets in similar circumstances to the above. It related to a transaction where the shares and loan account of the seller were purchased at a reduced amount as a consequence of a bond that was taken out to repay part of the seller's loan. The company therefore owed on a mortgage bond which had previously not been in existence.

The following is an extract from the judgment:

“Having money available the company could part with it in various ways that would enable the recipient to purchase the company's shares with the money. It could for instance buy an asset, not required for the purposes of its business, in order to provide the seller of the asset with money with which to buy the shares. It was contended on behalf of Crowden that this would be giving financial assistance. If the purchase of the asset were effected at a price known to be inflated, this would no doubt be the giving of financial assistance. It would indeed be equivalent to a gift and would clearly involve a reduction of the company's capital. It was one of the illustrations given by Lord Greene in *re V G M Holdings Ltd.*, 1942 ch. 235 at page 240. It is, I think, significant that the Master of the

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<sup>79</sup> (1973) (1) SA 472 (W)

<sup>80</sup> *Supra*

Rolls did not mention the case of the purchase of an asset at a fair price with the object of enabling the seller of the asset to buy the shares.”

The VGM Holdings Ltd<sup>81</sup> case referred to above was decided on the issue as to whether the provision of financial assistance contained in Section 54 of English Companies Act of 1929 extended to subscriptions for shares.

In this case the learned judge referred to the practice then prevalent as follows:-

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

The above cases were considered by the writer in The South African Company Law Journal 1977 page F13. The writer considered the possibility that Gradwell (Pty) Ltd v Rostra Printers Ltd and Another<sup>82</sup> case together with the VGM Holdings Ltd.<sup>83</sup> case were authorities for a view that Section 38 would not apply if the sale was a reasonable one at a fair price. However, he also noted the contrary view expressed by Heimstra J in Hepker's case.<sup>84</sup>

“... a fair price is not the only qualification to such a purchase by the company. If it is not a purchase which the company might in any event reasonably have made in the ordinary course of business and to advance its business, then such a purchase is nothing but indirect financial assistance to the seller.”

***Belmont Finance Corporation v Williams Furniture Ltd. & Others.***<sup>85</sup>

In this case it was held that even if a fair price was paid the prohibition against financial assistance could be applicable. The following is an extract from the judgment:-

“A breach of s 54 of the 1948 Act occurred if a company, without regard to its own commercial interests, bought something from a third party with the sole purpose of putting the third party in funds to acquire shares in the company, notwithstanding that the price paid was a fair price. Thus, even-though the agreement for the purchase of the share capital of Maximum by Belmont was a satisfactory commercial transaction for both Williams and City and for G and its associates, it nevertheless contravened s 54 even if the 500 000 pounds paid by Belmont for Maximum had been a fair price, because it was not a commercial transaction in its own right but merely part of a scheme to enable G and his

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<sup>81</sup> (1942) CH 235; (1942) (1) All ER 244 (CA)

<sup>82</sup> Supra

<sup>83</sup> Supra

<sup>84</sup> Supra

<sup>85</sup> Supra

associates to acquire Belmont at no cash cost to themselves, was not a transaction in the ordinary course of Belmont's business, and did not enable Belmont to acquire anything which it genuinely needed for its own purposes."

In *Gradwell (Pty) Ltd v Rostra Printers Ltd and Another*<sup>86</sup> it was held that it was acceptable for the company to increase its bond debt and reduce the loan in the normal course of business as the debt was due and payable. While appreciating the legislative and judicial fears concerning the need to protect the weak (the creditors and minority shareholders) from the wiles of the strong (the directors and majority shareholders) the need for the directors and other officers to act bona fides in the interest of the company should provide sufficient protection to the creditors and minority shareholding. The issue should be the harm that the 'strong' could cause and not a legal technicality relating to a transaction which may have caused no harm to either party. As will be referred to below the Close Corporation Act does not include an equivalent section to Section 38. Also the 2006 amendment to Section 38 removes the harshness of the section. The amendment is in line with the changes in the approach of other countries to the prohibition with regard to the granting of financial assistance.

### **A purchase or subscription made by any person for any shares of the company**

Initially the act only referred to the purchase of shares. However, the Law was amended after the English decision in *VGM Holdings Ltd*<sup>87</sup> where it had been held that the prohibition did not refer to shares acquired by subscription.

*J Blackman et al*<sup>88</sup> considered the situation where the financial assistance is in respect of other transactions.

"Where the financial transaction relates to the cancellation of a share sale the transaction is not contravened."

### ***Pires v American Fruit Market (Pty) Ltd.***<sup>89</sup>

The writer expressed uncertainty as to whether an exchange of shares constitutes a "subscription". However, reference was made to the case of *Gold Fields Ltd. v Harmony Gold Mining Co Ltd*<sup>90</sup> where it was held by the Supreme Court of Appeal in relation to an offer of shares requiring a prospectus that the term "subscription" includes an exchange of shares.

*Blackman et al*<sup>91</sup> refer to the case of *Johnson v Johnson*<sup>92</sup> where subsequent to a dispute between two shareholders of a company the minority shareholders' shares were converted into redeemable preference shares which were subsequently redeemed. In addition the company paid the outgoing shareholder a considerable amount as a restraint of trade. It was held that there was no contravention of the equivalent of Section 38 as there had been no purchase or subscription.

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<sup>86</sup> Supra

<sup>87</sup> Supra

<sup>88</sup> Supra p4-65

<sup>89</sup> (1952) (2) SA 337 T

<sup>90</sup> (2005) (2) SA 506 SCA

<sup>91</sup> Supra 4-65

<sup>92</sup> (1983) (2) SA 324 (W)

The following is an extract from the case:

“Section 86 bis (2) does not prohibit the giving by company C of financial assistance for the purpose of or in connection with the purchase by B of the existing shareholders’ loan accounts against C. Even if the agreement relating to the passing of the bond had amounted to or involved a contravention of s86 bis (2) that would not have had the effect of invalidating the loan agreement. The giving by company C or the promise by company C to give invalid security to A in respect of the existing shareholders’ loan accounts, which are to be ceded to A, does not invalidate either those loan accounts themselves or the loan agreement between A and B. There cannot be valid security for an invalid principal debt; but the converse proposition is not true: the validity of a principal obligation is not affected by the fact that the accessory obligation in respect of the giving of security is invalid. See *South Western Mineral Water Co Ltd. v Ashmore* (1967) 2 All ER at 958D and *Spink (Bournemouth) Ltd v Spink* (1036) Chapter 544.

## IX. THE PURCHASE OF LOAN ACCOUNTS

The provisions of Section 38(1) are only relevant to the purchase of shares of a company and not to the acquisition of amounts due by a company. This is so even where the purchase of the loan accounts facilitates the purchase of the shares. Refer to *Blackman et al*<sup>93</sup> where reference is also made to *Lipschitz v UDC Bank Ltd.*<sup>94</sup>

Cases referred to in the above judgment include the following:

- *Gradwell (Pty) Ltd. v Rostra Printers Ltd and Another.*<sup>95</sup>
- *Evrard v Ross.*<sup>96</sup>

In the above cases the companies borrowed money on bonds to pay off loan accounts.

### *Karnovsky and others v Hyams.*<sup>97</sup>

In this case the loan was not sold but the company passed a bond to secure the loan when the shareholder sold his shares.

### *Lombard Agencies (Pty) Ltd. v Amalgamated Construction Co (Pty) Ltd*<sup>98</sup>.

In this case it was a condition of the sale of shares that a bond should be passed to secure the purchase price when the shares were sold. The question as to whether it was significant that the loans were initially due and payable but subsequently ‘time to pay’ was granted was considered but found to be irrelevant. It will often be necessary to distinguish and separate the portion of an amount paid between that applicable to the shares and that which relates to the loan account or where the company is a subsidiary company, the shares of the holding company and relevant loan account.

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<sup>93</sup> Supra 4-65

<sup>94</sup> Supra

<sup>95</sup> Supra

<sup>96</sup> (1977) (2) SA 311 D

<sup>97</sup> Supra

<sup>98</sup> (1976) (3) SA 86 D

Section 38 only relates to the purchase of shares in the company or its holding company. It does not relate to financial assistance granted in respect of the purchase of shares in other companies.

## **X. THE CONCEPT OF THE 'IMPOVERISHMENT TEST'**

It is strange that neither the English Companies Acts nor the company law of the Commonwealth states e.g. South Africa whose laws followed the English Law actually embodied the concept of the "impoverishment test" in their statutory law. This is especially so since it was the fear of minority shareholders and creditors being harmed as a consequence of the "capital fund" of the company not being maintained due to the granting of "financial assistance" for the purchase or subscription of its own shares that caused the enactment of Section 38 or its equivalent sections in other jurisdictions. The impoverishment test has, however, been considered in various cases in South African and other courts.

As H S Cilliers et al in their Corporate Law – Second Edition on paragraph 20-22 state:

"Neither the section nor the act provides a definition of the word "financial assistance".

(See also the judgment of Hoffman J in Charterhouse Investment Trust v Tempest Diesel.)<sup>99</sup>

The above writers stated that the 'impoverishment test' is one of the tests used in determining whether the company has granted financial assistance. In other words the issue is whether the company has become poorer as a consequence of the assistance.

The 'impoverishment test' was approved in Gradwell (Pty) Ltd. v Rostra Printers Ltd. and another<sup>100</sup> as a factor for determining the presence of financial assistance.

Miller JA in Lipschitz NO v UDC Bank Ltd.<sup>101</sup> considered the application of the 'impoverishment test' and referred to the above case.

The learned judge observed that it was not necessary to express an opinion on the correctness of the judgment in the Gradwell (Pty) Ltd v Rostra Printers Ltd but pointed out that the case was not an authority for the general proposition confirming the 'impoverishment test' as appeared to have been substantially accepted in some of the cases.

In respect of the above Miller J A referred to the following from the judgment in Evrard v Ross:

"Despite the criticisms which have been made of the 'impoverishment' test, the weight of authority would seem to favour the view that this will usually determine whether there has been a contravention of the section. The language of the section is very wide indeed but the cases show that the courts have been extremely reluctant to stigmatize 'innocent' transactions. If due weight is given to the word 'financial' in the section I do not think that

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<sup>99</sup> Supra

<sup>100</sup> (1959) (4) SA 419 A 425

<sup>101</sup> Supra

it would be correct to hold that the company's pecuniary resources have been employed where its true financial position has remained unchanged."

As referred to above the case of *Lipschitz v UDC Bank Ltd*<sup>102</sup> was reviewed in *The South African Company Law Journal* 1979 on pages F1 to F18.

The following appeared on page F6:

"The judgment goes on to give an exposition of the true role of the impoverishment test in the application of the section in a passage which we quote in full as follows:  
'Section 86 bis (2) (now Section 38) expressly and unequivocally includes within the meaning of 'financial assistance' acts not necessarily nor even probably involving impoverishment of the company or the employment at all of its 'pecuniary resources'. The giving by a company of a guarantee or the provision by it of security does not per se involve the actual or even probable disbursement or employment of the company's funds (*C F Jacobson v Liquidators Est M Bulkin & Co Ltd*. 1976 (3) SA 781 (T) on page 788 H to 789 A; 94 SALJ at p 268), yet if such guarantee or security was provided by the company and if it were to be established that it was provided for the purpose of or in connection with the purchase of the company's shares, the section would be shown to have been contravened whether or not such guarantee or security actually rendered or was likely to render the company poorer, for the section expressly provides that the giving of a guarantee or the provision of security constitutes financial assistance.' "

Miller J A concludes as follows with regard to the impoverishment test:

"I have no doubt that in certain cases, depending largely upon the form which the alleged financial assistance is said to have taken, the impoverishment test might be a very helpful guide and might often yield a clear and decisive answer to the question whether financial assistance was given by the company. (Cf per Lord Denning, M R in *Wallersteiner v Moir* (1974) 3 All ER 217 at p238 (H). But in other cases, of which I have given examples, the inquiry envisaged by the impoverishment test might be not only unhelpful but entirely irrelevant ..."

Nicholas AJA in *Lewis v Oneanate (Pty) Ltd and Another*<sup>103</sup> referred to the *Lipschitz NO v UDC Bank Ltd*.<sup>104</sup>

The learned judge accepted that inter alia one of the relevant propositions that could be derived from the above case in deciding whether financial assistance was present was the 'impoverishment test'.

In an article entitled "More About Financial Assistance" which appeared in the *South African Law Journal* 477 – 482 R C Beauthin writes that the 'impoverishment test' may provide considerable assistance when investigating alleged contraventions of Section 38 of the Companies Act especially when applied in a broad common-sense manner as was the case in *S v Hepker*.<sup>105</sup>

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<sup>102</sup> Supra

<sup>103</sup> Supra p816-817

<sup>104</sup> Supra

<sup>105</sup> Supra

In conclusion it is apparent that the 'impoverishment test' is not a conclusive test but rather one of the issues that may determine whether prohibited financial assistance was granted by a company to the purchasers of its shares.

## **XI. WHETHER THE GRANTING OF FINANCIAL ASSISTANCE WILL RENDER THE WHOLE TRANSACTION AS BEING VOID**

Unlike the position in Australia and New Zealand the granting of 'prohibited financial assistance' has consistently been held by the courts to be void.

In *Karoo Auctions (Pty) Ltd. v Hersman*<sup>106</sup> a contract relating to commission in respect of the sale the shares and loan account of a property company was held not to have been enforceable as the sale involved financial assistance for the sale of the shares.

In *Albert v Papenfus*<sup>107</sup> a debit was raised by the seller of the shares against the company in respect of 'personal goodwill'. The raising of the goodwill was purported to have arisen during the seller's management of the hotel belonging to the company. The court held that the goodwill belonged to the company and that neither a bond raised to secure the indebtedness nor the surety which related thereto were enforceable.

In *Lipschitz v UDC Bank Ltd*<sup>108</sup> Miller J A stated the following:

"But it would be strangely purposeless to prohibit the performance of an act yet to leave untouched an agreement for the performance of such act. It might be (I express no opinion on the point) that an agreement of that kind, not carried out, would not constitute the criminal offence created by the section, but it is to me unacceptable, in the context of the legislation now in issue, that a contract for the performance of an act which is not only prohibited but which would constitute a criminal offence if it were performed, could be an enforceable contract. All the indications are that the legislature intended that such a contract should be invalid and unenforceable, the prohibition is couched in negative terms and there is no realistic method (the penalty for contravention is a comparatively modest fine) by which the mischief at which it is aimed could effectively be avoided otherwise than by treating the contract as void and unenforceable."

The learned judge referred to the English case of *Victor Battery Co Ltd. v Curry's Ltd.*<sup>109</sup> where it was in effect held that: an agreement for the giving of financial assistance within the meaning of the section was not void although the actual giving of such assistance would be hit by the section. However, Miller JA stated that the judgment has fallen into disfavour in England as well as in South Africa, Australia and New Zealand.

### ***Selangor United Rubber Estates v Cradock***<sup>110</sup>

The judgment in this English case confirms that their Section 54 (the equivalent of Section 38) does not merely create an offence but it also invalidates the transaction.

### ***Saambou Nasionale Bouvereniging v Ligatex (Pty) Ltd***<sup>111</sup>

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<sup>106</sup> (1951) (2) SA 33 E

<sup>107</sup> (1964) (2) SA 713 E

<sup>108</sup> Supra

<sup>109</sup> (1946) (1) All ER 519 (Ch)

<sup>110</sup> Supra

<sup>111</sup> (1976) (1) SA 868 E

This case related to circumstances where a person unconnected with the company provided the funds which were used in breach of Section 38. The court held that the agreement between the purchaser and the seller and the agreement between the company and Saambou were severable. Saambou was not a party to a transaction as it did not know the purpose for which the money was borrowed. The loan agreement was consequently enforceable.

## **XII. THE DECLARATION OF DIVIDENDS AS A CONSIDERATION IN RELATION TO THE PROHIBITION AGAINST THE GRANTING OF FINANCIAL ASSISTANCE**

This issue is extensively covered in an article "Section 38 Financial Assistance By Dividend Declaration"<sup>112</sup>.

The writer of the article emphasized the fact that it is the fundamental right of shareholders to receive dividends which are legally permissible. This right may be exercised by the shareholders or by ensuring that the directors pass the necessary resolution at any time to suit themselves (the shareholders). The company does nothing of its own volition in regard to the dividend; it merely responds to the legal demand on it that it shall declare and pay the dividend. Consequently the writer is of the opinion that no legally permissible dividend can ever constitute a breach of Section 38 as the company is not giving financial assistance but merely discharging a legal obligation just as the company in *Gradwell (Pty) Ltd v Rostra Printers Ltd and Another*<sup>113</sup> discharged its legal obligation relating to the payment of debts.

The above would apply even where the declaration is an unusual one in that it is something more than a simple distribution of current profits.

Reference is made to the judgment in *Novick and Another v Comair Holdings Ltd and Others*.<sup>114</sup>

The issue in this case related to a clause in the agreement when the purchasers bought the shares and loan accounts due by Comair subsidiaries. The clause provided for the declaration of a dividend of R650 000 on or before the effective date. The dividend was to be credited to the vendor's loan account. Colman J while accepting that the declaration of such a large dividend would have been abnormal could not find anything in the agreement which constituted the provision of financial assistance for the purchase of the shares in the company.

The learned judge referred to the New Zealand case of *Re Wellington Publishing Company Ltd*<sup>115</sup>

This case dealt with the issue of the prohibition relating to the granting of financial assistance in terms of a section in the New Zealand Company Law which is equivalent to the South African Section 38. In this case unlike the circumstances in *Novick and Another v Comair Holdings Ltd and Another*<sup>116</sup> the vast majority of the company's reserves were

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<sup>112</sup> The South African company law Journal 1979 F18-F20

<sup>113</sup> Supra

<sup>114</sup> (1979) (2) SA 116 W

<sup>115</sup> (1973) (1) NZLR 133

<sup>116</sup> Supra

distributed. There were no minority shareholders who had not accepted the offer and the existing creditors were adequately covered. The court did not consider that the potential prejudice to future creditors was of any relevance.

With regard specifically to the declaration of a dividend, the judgment considered that it could not be said that the payment of a dividend was within the concept of financial assistance in its normal meaning; that payment of a dividend was part of the normal function of a company, a return on investment, much the same as the earning of profits by an individual trader.

Another interesting New Zealand case is *Coleman v Meyers*.<sup>117</sup> In this case the purchaser of the shares of the company used the proceeds of a dividend declared to repay the short-term loans granted to him by the company. The dividend declaration was not considered to be a breach of the section relating to financial assistance. However, the managing director was held to have been guilty of a breach of his fiduciary duty and ordered to pay damages.

Cilliers et al on page 323 refer to the Jenkins Report 1962 which dealt with Section 54 (equivalent to Section 38 of the South African Companies Act).

An example of an unobjectionable transaction was the following:-

“A borrows the money to buy control of company B and then causes company B to pay a dividend, which company B can properly do, and uses the dividend to repay the loan.”

### **XIII. IS THE FINANCIAL STANDING OF THE PURCHASER RELEVANT IN RELATION TO THE PROVISIONS OF SECTION 38 (1)?**

The report of the British Company Law Committee (The Jenkins Committee) CMND 1749 of 1962 stated that the “mischief” which Section 54, (the equivalent section to the South African Section 38) was aimed at was the potential abuses which could result from persons gaining control of a company and using its funds to pay for their shares in circumstances where they had insufficient funds to pay for their shares. In *Jacobson and Another v Liquidator of M Bulkin & Co Ltd*<sup>118</sup> Le Grange J stated as follows:

“But if I have understood Mr Kirk-Cohen’s argument he did not seek to apply the ‘impoverishment test’ as I have applied it. Mr Kirk-Cohen, it appears to me, applied the so-called test in a manner which makes the operation of the prohibition dependent upon the financial position of the borrower of the money at the time when the loan is made or at the time when repayment of the loan is desired. If his submission is correct then a company which lends money to a person to enable him to purchase shares in that company does not contravene the section if the debtor is a millionaire or if he furnishes ample security for the loan but does so if the borrower is a man of straw. The proposition that the legality of the loan depends on the eventual ability of the debtor to repay the loan does not merit consideration.”

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<sup>117</sup> (1977) 2 NZLR 225 CA (NZ)

<sup>118</sup> *Supra*

While accepting that the above extract is a correct interpretation of South African Company Law does lead one to question the basic premise of the section viz that the company must be spared from the 'mischief' that could result from men of straw taking over control of the company.

***Wallersteiner v Moir***<sup>119</sup>

This English case related to a group of entities controlled by Dr Wallersteiner. As a consequence of a transaction the company ended up with a claim of 340 000 pounds against a Nassau company with no assets. The transaction involved the passing of cheques "round the house". The court held that Section 54 was applicable. The judgment confirms that such passing of cheques will not regularize the transaction nor hide the actual intention of the parties involved.

**XIV. WHETHER THE FACT THAT A SHARE PURCHASER TAKES OVER A DEBT OF THE COMPANY IS CONSIDERED TO BE THE PROVISION OF PROHIBITED FINANCIAL ASSISTANCE**

The issue arises as to what the position would be where the transaction involves the purchaser assuming liability for a debt due by the share seller. There could be a problem with regard to the application of Section 38 if the ability of the share purchaser to repay the loan is questionable.

**XV. THE APPLICATION OF THE PRINCIPLE, 'IN PARI DELICTO POTIOR EST CONDITIO POSSIDENTIS' TO TRANSACTIONS PROHIBITED IN TERMS OF SECTION 38**

The above maxim is translated to mean that where parties are in equal guilt the position of the one in possession (the defendant) is the stronger.

Wille & Millin, Mercantile Law of South Africa<sup>120</sup> state the following:

"The effect of this rule is that where money has been paid or property delivered pursuant to an illegal agreement the loss lies where it falls, and the machinery of the courts cannot be invoked to restore a party to the position which would have existed had there been no performance."

The consequence of the application of Section 38 could result in the situation where a party to a transaction has parted with funds as a consequence of an agreement freely entered into between two parties. The one party may subsequently have regrets and successfully apply to court for the agreement to be declared as being void in terms of Section 38. He may have funds in his possession which were paid to him by the other party.

In *Evrard v Ross*<sup>121</sup> shares and loan accounts were purchased for R15 910. After R10 000 was paid the purchaser repudiated the agreement with regard to the unpaid balance of R5 910. However, the purchaser did not claim a refund of the R10 000 already paid presumably as a consequence of the "in pari" maxim.

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<sup>119</sup> (1974) (3) All ER 217

<sup>120</sup> 17<sup>th</sup> Edition (1975) p32

<sup>121</sup> *Supra*

## **XVI. ONUS OF PROVING THE INFRINGEMENT OF SECTION 38**

The onus of proving the financial assistance is upon the person asserting such a case. In this respect Henochsberg (p75) refers to *Augusto v Soceida de Angolana De Comercio International Limitada (Sacildo)*.<sup>122</sup>

## **XVII. EXCEPTIONS TO PROHIBITIONS (SECTION 38(2))**

### **Section 38(2)(a):**

This subsection refers to loans made in the ordinary course of the business by a company whose main business is the lending of money. Henochsberg<sup>123</sup> considers that for the exemption to apply the loan must be on the same terms as if the borrower was going to use the loans for any other purpose. However, reference is made to *Steen v Law*<sup>124</sup> where the court held that the provisions referring to a loan being in the ordinary course of the company's business relates to where the lending of money is part of the company's main business.

### **Section 38(2)(b)**

The subsection refers to the provision of money granted by trustees of a trust formed for the benefit of employees (including directors) for the subscription or purchase of shares in the company or in its holding company.

### **Section 38(2)(c)**

This subsection provides for loans to bona fides employees to enable them to subscribe for or to purchase shares in the company. Unlike subsection 38(2)(b) the exemption does not apply to directors of the company. Sections 38 2(a)(b) and (c) provide exceptions in respect of loans but not to guarantees provided. *Blackman et al*<sup>125</sup> consider that it is anomalous that a person who is a director of a holding company and an employee of its subsidiary company but not a director, may borrow from the subsidiary, but not from the holding company to buy shares in the holding company.

### **Section 38 (2)(d)**

This section was introduced in the 1999 amendment to the Act to accommodate the provisions of the new Section 85. This section authorizes a company to acquire its own shares.

Section 38(2)(d) reads as follows:

“The provision of financial assistance for the acquisition of shares in a company by the company or its subsidiary in accordance with the provisions of Section 85 for the acquisition of such shares.”

**PA Delpont** in an article entitled “Company Groups and Acquisition of Shares” published in 2001<sup>126</sup> criticized the wording of the subsection. He considered the subsection to be “virtually useless”. The writer was of the opinion that the exclusion contained in the subsection should only have pertained to subsection 85(4) and not the whole of Section 85.

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<sup>122</sup> (1998) (4) SA 127 (NM) 1999 (2) 788 (NM)

<sup>123</sup> *Supra* p78

<sup>124</sup> (1964) AC 287 (PC)

<sup>125</sup> *Supra* 4-67

<sup>126</sup> 13 SA Mercantile Law Journal

Section 85(4)(a) reads as follows:

A company shall not make any payment in whatever form to acquire any shares issued by the company if there are reasonable grounds for believing that-

- a) the company is, or would after the payment be, unable to pay its debts as they become due in the ordinary course of business; or
- b) the consolidated assets of the company fairly valued would after the payment be less than the consolidated liabilities of the company.

Subsection 85(4)(a) imposes a 'liquidity test' – can the company pay its debts in the ordinary course of business?

Subsection 85(4)(b) imposes a 'solvency test' – will the assets be in excess of the liabilities?

**PA Delport** writes as follows:

“What this exclusion thus in effect now provides, is that a company may give financial assistance, if shares are acquired in terms of Section 85. The person who acquires the shares is the company, so the exclusion applies to financial assistance given to the company by the company. This is in law clearly impossible.”

The exclusion of the holding company/subsidiary situation was then considered. Delport considered two options:

1. Where the company provides financial assistance for/to the subsidiary to enable it to purchase shares in the holding company. The 1999 Companies Act in terms of Section 39 and 89 authorise a subsidiary company to hold a maximum of 10% of the issued share capital of the holding company. The problem that Delport found with the above was that it excluded third parties and this exclusion would be contrary to the philosophy of the amended act.
2. The second consideration is where the subsidiary provides its holding company with financial assistance for the acquisition of the holding company's shares by the holding company. The writer emphasizes that loans by a subsidiary to its holding company are permissible inter alia in terms of Section 37 provided there is compliance with the requisite provisions of the Act.

**Kathleen van der Linde** took P A Delport to task in an article entitled “Financial Assistance for the Acquisition of Shares in Accordance with Section 85 of the Companies Act”. In a reply to Delport which appeared in 2001<sup>127</sup>, she emphasized that section 38(2)(d) must be interpreted against the background of the prohibition contained in section 38(1).

Section 38(1) prohibits both the company and its subsidiaries from providing 'financial assistance'.

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<sup>127</sup> 13 SA Mercantile Law Journal on p437

Subsection 38(2)(d) was introduced in recognition of the possibility of a company purchasing shares in its own company or a subsidiary purchasing shares in its holding company. The above purchases were now possible as a consequence of the amendment of Section 85 referred to above.

Van der Linde states that subsection 38(2)(d) does not mention the parties to whom the assistance may be given. However, in terms of Section 38(1) a subsidiary may not give assistance for the purchase of shares in its holding company. Consequently if there would be no subsection 38(2)(d), it would not be possible for the subsidiary to provide assistance to the holding company for the purchase of shares in terms of Section 85.

Van der Linde then considered the situation where a company has subsidiaries other than the acquiring subsidiary. She wrote that while it is not possible for the acquiring subsidiary to render assistance to itself, it is possible for the other subsidiaries to provide the acquiring subsidiary with financial assistance.

### **Cassim's interpretation**

Associate Professor F H I Cassim also considered Section 38(2)(d) in an article entitled "Unraveling the obscurities of Section 38(2)(d) of the Companies Act"<sup>128</sup>.

The writer emphasized his opinion that he considered Section 38(2)(d) to have been "ineptly drafted" as well as not being easy to construe. This difficulty is compounded by a lack of proper punctuation. (p494).

Cassim continues as follows on the same page:

"The result is that its intent and its effect are as blurred as its true meaning. It is unsurprising therefore to find that leading textbook writers and some academic commentators are either undecided or sharply divided over its meaning and effect. For instance, Blackman et al are content to state in a terse paragraph that the meaning of s 38(2)(d) is not obvious and that 'it is unclear how a company can give itself financial assistance to purchase its own shares or the shares of its holding company'. They go on to state that perhaps it was intended that s 38(2)(d) should refer, not to s 85, but to s 89 (M S Blackman, R D Jooste & G K Everingham Commentary on the Companies Act (2002) vol 1 para 4-66). Henochsberg simply ignores the first part of s 38(2)(d) and attempts to explain the effect of the rest of the subsection in a brief passage (P M Meskin & B Galgut Henochsberg on the Companies Act 5 ed (1994) vol 1 78(1)-79). Delpont sweeps aside s 38(2)(d) by boldly declaring that 'due to these uncertainties, the exclusion contained in s 38(2)(b) [sic] is therefore virtually useless' (P A Delpont 'Company groups and the acquisition of shares' (2001) 13 SA merc LJ 121 at 125-6). This view is rejected by Kathleen van der Linde 'Financial assistance for the acquisition of shares in accordance with s 85 of the Companies Act – a reply to Delpont (2001) 13 SA Merc LJ 437."

Blackman *et al* <sup>129</sup>write as follows:

"Section 38(2)(d)4 of the Act provides that s 38 ..... shall not be construed as prohibiting ... the provision of financial assistance for the acquisition of shares in a company by the company or its subsidiary in accordance with the provisions of s 85 for the acquisition of

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<sup>128</sup> (2005) SA Law Journal 493

<sup>129</sup> Supra 4-67

such shares.” This provision appears to be aimed at exempting three situations from the prohibition in s 38(1) (for explanation purposes the company whose shares are being acquired will be referred to as company X):

- Company X’s subsidiary assists company X in acquiring shares in company X;
- Company X assists in the acquisition of company X’s shares by company X’s subsidiary;
- A subsidiary of company X assists another subsidiary of company X in acquiring shares in company X;

Unfortunately the provision only succeeds in exempting the financial assistance given in the first situation. The second and third situations are not covered because an acquisition of shares by a subsidiary in its holding company is not possible in terms of s 85 of the Act but only in terms of s 89. The fact that s 89 provides that subsidiary companies may *mutatis mutandis* in accordance with ss 85, 86, 87 and 88, acquire shares in their holding company, does not, it is submitted, enable one, as has been suggested, to construe s 39(2)(d) as referring to an acquisition by a subsidiary of shares in its holding company in terms of s 89. Section 89 is the enabling provision, not s 85, and the fact that s 89 refers to s 85 in the way that it does, is no justification for such a construction. An amendment to s 39(2)(d) making reference to s 89 is essential if the provision is to achieve its apparent purpose of covering all three of the situations referred to above.”

As referred to above:

- Section 85 authorizes a company to acquire its own shares.
- Section 86 refers to the liability of directors and shareholders in certain circumstances relating to the acquisition of shares in terms of Section 85.
- Section 87 refers to the procedure of acquisition of its shares by a company.
- Section 88 refers to the enforceability of contracts for acquisition by a company of its shares.
- Section 89 authorizes subsidiary companies in certain circumstances to acquire up to a maximum of 10% in its holding company.
- Section 90 refers to payments to shareholders by a company.

Cassim<sup>130</sup> comments as follows in relation to the opinions expressed by Delpont and Van Der Linde and Blackman *et al.*

“It is implicit in this provision that a company is permitted to give ‘financial assistance’ to itself to enable it to acquire its own shares – and it is this part of s 38(2)(d) that has aroused the most controversy. For instance, it has been said, with reference to this part of s 38(2)(d), that ‘[t]he person who acquires the shares is the company, so the exclusion applies to financial assistance given to the company by the company. This is in law clearly impossible. (Delpont *op cit* 126). (See also Blackman *op cit* para 4-66; and Van der Linde *op cit* 440, stating that it is ‘obviously’ not possible for the company to give assistance to itself and no exception is called for.)

It is submitted with respect that, contrary to what some academic commentators have stated, there is indeed a compelling reason for the first part of s 38(2)(d). Precisely because the words ‘financial assistance’ in s 38(1) are not defined and because the section is couched in such wide terms, it may strictly be possible for a company to give ‘financial assistance’ to itself for the purchase by it of its own shares. To take one simple but

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<sup>130</sup> *Supra* 496-497

common example: a company wishes to repurchase its own shares in terms of s 85, but it presently does not have the cash resources to pay for the share repurchase. It consequently borrows money from a bank or other financier and in addition gives security for the loan by mortgaging its assets. On any interpretation of s 38(1), the giving of such security constitutes 'financial assistance' by the company for the acquisition by it of its own shares. This may at first strike one as quite odd if not absurd, but it is a distinct possibility since the company or its directors could have reasonable grounds for believing that the company is solvent and is able to pay its debts as they become due in the ordinary course of business, thereby satisfying the requirements of s 85(4)(a) and (b). Yet the company may presently lack the cash resources to pay for the share repurchase. When the company borrows money to effect the share repurchase and gives security for the loan, had it not been for the first part of s 38(2)(d), there would have been a real and grave risk of a contravention of s 38(1) which would result not only in a criminal offence but also, on the ground of illegality, in the nullity of the transaction (*Lipschitz NO v UDO Bank Ltd.* 1979(1) SA 789 (A) at 802 E-F and 803 A-B, unless the illegal part is severable: *Goss v E C Goss & Co (Pty) Ltd.* 1970 (1) SA 602(D)). Far worse, the directors of the company could be held liable to the company for damages for a breach of their fiduciary duty in entering into an illegal transaction on behalf of the company (*Jacobson v Liquidator of M Bulkin and Co Ltd.* 1976 (3) SA 781 (T) at 791A; *Belmont Finance Corporation v Williams Furniture Ltd.* (No 2) [1980] ALL ER 393 (CA)).

Cassim on page 497 submits that as section 38 stands it does not only prohibit the provision of financial assistance for the purchase of the company's shares by someone else but it also refers to situations where funds are borrowed by a company to effect a buy back of its shares in terms of Section 85.

Cassim elaborates his contention by emphasizing that in terms of the Interpretation Act of 1957 the term "person" includes both natural and legal persons. Consequently Cassim rejects the view of Delpert that it is "clearly impossible for a company to give financial assistance to itself. Reference is made on page 497 to the judgment of Arden LJ in *Chaston v SWP Group plc*<sup>131</sup> where the possibility of a company giving financial assistance to itself was conceded and acknowledged even though the possibility was left undecided and the learned judge remarked that it was an unusual case.

Cassim on pages 497 and 498 continues as follows:

"As stated above, s 38(1) is a penal provision with severe consequences applying to a contravention of the section. No legal practitioner would want to risk a contravention of the section. It was therefore, essential for the legislature to ensure that s 38(1) would not be contravened should the company give any 'financial assistance' to itself for the purposes of a share buy-back."

As a consequence of the group nature relating to corporate structures Cassim (on p498) expresses the view that it is correct for the provisions of Section 38(2)(d) should include transactions by subsidiaries. Cassim concludes as follows (on pages 500 and 501):-

"The net result of the second part of s 38(2)(d) is that it facilitates, subject to vital safeguards, the injection of capital into a subsidiary by its holding company to enable the subsidiary to acquire the shares of its holding company without any fear that this would constitute indirect financial assistance contrary to s 38(1). To this extent, the second part of s 38(2)(d), like the first part of it, is largely 'an avoidance of doubt' provision. There was

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<sup>131</sup> (2003) BCLC 675 (CA) par47

no intention on the part of the legislature to modify substantially the basic prohibition in s 38(1) against a company giving financial assistance for the purchase of, or subscription for the shares of a company. For this reform one will have to wait for the comprehensive reform of company law.”

Blackman *et al*<sup>132</sup>, however, consider that Cassim’s interpretation of Section 38(2)(d) presents a number of difficulties. The difficulties referred to are the following:-

“First if the legislature intended to make the exemption conditional on certain safeguards being satisfied why did it not simply list the safeguards rather than making a bland reference to s 85 which contains all sorts of provisions which clearly have no application to the situation in question?”

In a footnote the writer’s question whether the protections for creditors and minority shareholders contained in Section 85 are applicable to the situation where a company assists itself by acquiring its own shares. The opinion is expressed that such safeguards are necessary as it would be possible for a company to give itself financial assistance before the buy-back with the consequence that the Section 85 solvency and liquidity criteria and the passing of a special resolution does not take place at the time of the giving financial assistance.

There could consequently not be the required protection for creditors and minority shareholders at that time should the financial position of the company deteriorate as a consequence of the buy-back.

“Secondly, this interpretation provides no exemption from the s 38(1) prohibition where a subsidiary assists its holding company in acquiring its own (i.e. the holding company’s) shares or where a subsidiary assists a fellow subsidiary in acquiring shares in the holding company.

Thirdly, it appears from the quote above that Cassim is saying that s 38(1) does not prohibit a holding company from assisting its subsidiary in acquiring shares in the holding company (see the italicized words). Surely such a situation is undoubtedly covered by s 38(1)? It is true that this can be seen as the holding company indirectly assisting itself in the purchase of its own shares but the holding company and subsidiary are two separate legal personae and the prohibition in s 38(1), is, in this regard, plain.”

## **XVIII. OFFENCES IN TERMS OF SECTION 38(3)**

### **Section 38(3)(A)**

This section provides that the company and every director or officer of the company shall be guilty of an offence should the provisions of Section 38 be contravened.

### **Section 38(3)(B)**

This section provides that for the purpose of the subsection ‘director’ in relation to a company includes any person who at the time of the alleged contravention was a director of the company. Whereas in Section 38(3)(a) reference is made to any director or officer of the company, Section 38(3)(b) only refers to a ‘director’ who at the time of the alleged

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<sup>132</sup> Supra 4-68-1 and 4-68-2

contravention was a director of the company and not to an officer of a company (other than a director) at the time of the contravention?

### **Section 38(3)(C)**

This section provides that it shall be a defence in any proceedings against any director or officer of a company if it is proved that the accused was not a party to the contravention. The penalty for a company is a fine.

Section 441(1)(e) provides for a fine or up to two years imprisonment or both in respect of a director, officer or former director who commits an offence.

## **XIX. SECTION 40 OF THE CLOSE CORPORATION'S ACT 69 OF 1984**

This section reads as follows:

A corporation may give financial assistance (whether directly or indirectly and whether by means of a loan, guarantee, the provision of security or otherwise) for the purpose of, or in connection with, any acquisition of a member's interest in that corporation by any person, only –

- (a) with the previously obtained written consent of every member of the corporation for the specific assistance;
- (b) if, after such assistance is given, the corporation's assets, fairly valued, exceed all its liabilities;
- (c) if the corporation is able to pay its debts as they become due in the ordinary course of its business; and
- (d) if such assistance will in the particular circumstances not in fact render the corporation unable to pay its debts as they become due in the ordinary course of its business

This section is very similar to the new Section 38(2)(A) of the Companies Act in respect of the need for approval from members, the tests of solvency and liquidity of the entity. The close corporation must be in a position to pay its debts as they become due in the ordinary course of business and for its assets to exceed its liabilities at the time of the transaction. It is possible for the parties to a transaction to overcome the restrictions of Section 38 by the conversion of a company into a close corporation before concluding the relevant contract.

## **XX. AMENDMENT OF SECTION 38 OF THE COMPANIES ACT**

As has been referred to above Section 38 as constituted before the enactment of the Corporate Laws Amendment Bill was an anachronism in that it still clung to the 'maintenance of capital' concept. The section was out of step with the 1999 amendments to the Act which inter alia permitted a company subject to protections for creditors and minority shareholders to purchase its own shares (Section 85) and to make distributions out of capital (Section 90)).

As referred to above the Close Corporations Act has as far back as 1984 permitted close corporations (subject to legislative protections) to provide financial assistance in respect of the acquisition of members interests. The ridiculous situation prevailed that the Companies Act prohibited a company with one shareholder from providing financial assistance to a prospective purchaser of its shares even-though the only asset was of a

minor value despite there being a most willing seller and a most willing buyer. On the other hand there was no problem (if all the legalities were adhered to) for a close corporation to provide financial assistance for the purchase of the members interest even though the close corporation owned an asset of a considerable value. The need to update the Companies Act had been recognized.

The following are extracts from a foreword to Draft 6 of “A Framework for Company Law – Guidelines for Corporate Reform, December 2003, delivered by Alex Erwin, Minister of Trade and Industry”.

“The decision of the DTI to review and modernize corporate law in this country was based on the need to bring our law in line with international trends and accommodate the changing environment for business both in South Africa and globally.”

He continued as follows:

“The time has arrived for South Africa to ensure that there is a framework of company law, which is up-to-date competitive and designed for a modern corporation that is not only a domestic force, but also an international competitor. The framework to be created must facilitate and encourage enterprise and must promote transparency and fair dealing, while providing effective remedies for transgressions”.

The following are extracts from a Nedlac Report on Corporate Law Reform:-

- 3.1 That corporate law reform is necessary and overdue.
- 3.1.1 Corporate law needs to ensure compatibility and harmonization with the best practice jurisdictions internationally

The amended Section 38 is in keeping with the above.

The following is the amendment:

“Section 38 of the Companies Act, 1973, is hereby amended by the insertion after subsection (2) of the following subsections:-

“(2A) Subsection (1) does not prohibit a company from giving financial assistance for the purchase of or subscription for shares of that company or its holding company, if

- (a) the company’s board is satisfied that –
    - (i) subsequent to the transaction, the consolidated assets of the company fairly valued will be more than its consolidated liabilities; and
    - (ii) subsequent to providing the assistance, and for the duration of the transaction, the company will be able to pay its debts as they become due in the ordinary course of business; and
  - (b) the terms upon which the assistance is to be given is sanctioned by a special resolution of its members.
- (2B) For the purposes of paragraph (2A)(a), the directors must consider any contingent liabilities which may arise to the company, including any contingent liability which may result from giving the assistance.”

The effect of this amendment is to change Section 38 from a “stumbling block” in the path of the sale of shares into an additional weapon which could be used in actions against directors or other officers who have acted contrary to the interests of the company.

Delpont in his article<sup>133</sup> referred to the fact that Section 38 prior to its amendment contained elements of both capital maintenance and the regulation of abuse of control. The effect of the amendment is to preserve the maintenance of capital concept while regulating against the abuse of control.

The proposed enactment of subsections 38(2) and 38(2)(B) must have been most gratifying to Professor F H I Cassim who had recommended similar amendments to the act in his article, The Reform of Company Law and the Capital Maintenance Concept which appeared in the South African Law Journal.

The Business Day dated 13 May 2006 reported upon the proposed amendment under two headings viz:

“Law to aid Firm’s BEE Ambitions” on page 1 and  
“Move to Help Companies Fund Worker Share Plans” on page 2.

However, while undoubtedly assisting the above the amendment of Section 38 will most certainly remove a considerable hindrance in the disposal of shares in companies in circumstances where the provision of ‘financial assistance’ would be necessary for the consummation of the transactions.

The amendment of Section 38 does not alter the position that where the financial assistance is prohibited the transaction as a whole is void as was the case with the Karoo Auctions (Pty) Ltd. v Hersman<sup>134</sup> and other cases referred to above.

## **XXI. A REVIEW OF THE PROVISIONS OF THE NEW COMPANIES LAW CONTAINED IN THE COMPANIES BILL 2007 AS RELATED TO THE PROHIBITION AGAINST THE PROVISION OF FINANCIAL ASSISTANCE BY A COMPANY TO THE PURCHASERS OF ITS SHARES**

### **Introduction**

In many respects the proposed law breaks away from the present companies’ law known as The Companies Act of 1973 as amended (the present act). The objectives of the Bill have been summarized by the South African Institute of Chartered Accountants as follows:

### **Objective of the Bill**

In terms of the Explanatory Memorandum to the Bill, the Bill has a five-point statement of economic growth objectives, namely:

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<sup>133</sup> Supra

<sup>134</sup> Supra

1. Encouraging entrepreneurship and enterprise development by simplifying the procedures for forming companies and reducing costs associated with the formalities of forming and maintaining a company.
2. Promoting innovation and investment in South African markets and companies by providing for flexibility in the design and organization of companies and a predictable and effective regulatory environment.
3. Promoting the efficiency of companies and their management.
4. Encouraging transparency and high standards of corporate governance.
5. Making company law compatible and harmonious with best practice jurisdictions internationally.

The provisions of the Companies Bill of 2007 that relate to the granting of financial assistance by a company for the purchase of its shares are contained in Section 4 and 40. As is the case with the present act as amended in 1999 there are no requirements with regard to the “maintenance of capital”.

In Sections 85 to 90 of the present Act there are provisions that subsequent to distributions by companies or the purchase by companies of their shares the “solvency and liquidity” requirements must be satisfied.

#### Section 4 of the Companies Bill of 2007

This section defines “solvency and liquidity”.

#### 4. Solvency and liquidity test

- (1) For any purpose of this Act, a company satisfies the solvency and liquidity test at a particular time if, considering all reasonably foreseeable financial circumstances of the company at that time –
  - (a) the company’s total assets equal or exceed its total liabilities; and
  - (b) it appears that the company will be able to pay its debts as they became due in the course of business for a period of –
    - (i) 12 months after the date on which the test is considered; or
    - (ii) in the case of a distribution contemplated in section 48, 12 months following that distribution.
- (2) For the purposes contemplated in subsection (1) –
  - (a) the board or any other person applying the solvency and liquidity test to a company may consider –
    - (i) only financial information that satisfies financial reporting standards; and
    - (ii) any fair valuation of the company’s assets and liabilities, or other valuation that is reasonable in the circumstances, subject to paragraph (b); and
  - (b) unless the Memorandum of Incorporation of the company provides otherwise, a person applying the test in respect of a distribution contemplated in section 48 is not to regard as a liability any amount that would be required, if the company were to be liquidated at the

time of the distribution, to satisfy the preferential rights upon liquidation of shareholders whose preferential rights are superior to those receiving the distribution.

This section clearly spells out what must be considered when applying the test. In keeping with the modern approach there is an introduction of a spirit of reasonableness into the proposed company law. The bill provides in Section 2(a)(1) that when applying the solvency and liquidity test to a company only the financial information that satisfies financial reporting standards would be applicable to the valuation of the company's assets and liabilities.

An interesting provision is contained in Section 2(b) where it is provided that subject to a provision in the Memorandum of Association the rights of preferential shareholders must be ignored when applying the solvency and liquidity test.

#### **Section 40 – The financial assistance for the purchase of shares**

- (1) A company must not give direct or indirect financial assistance to a person for the purpose of, or in connection with, the purchase of a share or option issued or to be issued by the company or a related or inter-related company-
  - (a) if the company's Memorandum of Incorporation expressly prohibits giving such financial assistance, as contemplated in subsection (2)(b);  
or
  - (b) in any other circumstances, unless all of the applicable following conditions are satisfied;
    - (i) Irrespective of the status or category of company concerned, the board must be satisfied that –
      - (aa) immediately after giving the financial assistance, the company would be in compliance with the solvency and liquidity test, and
      - (bb) the terms under which the assistance is proposed to be given are fair and reasonable to the company.
    - (ii) Any condition or restrictions respecting the granting of such assistance set out in the company's Memorandum of Incorporation, as contemplated in subsection (2)(c), must be satisfied.
    - (iii) The financial assistance must be -
      - (aa) pursuant to an employee share scheme that satisfies the requirements of section 62; or
      - (bb) pursuant to a special resolution of the shareholders, adopted within the previous 5 years, which approved such assistance either for the specific recipient, or generally for a category of potential recipients, and the specific recipient falls within that category; or

- (cc) in the case of a closely held company, pursuant to a specific authorization set out in the company's Memorandum of Incorporation.
- (2) A company's Memorandum of Incorporation may –
    - (a) specifically authorize any financial assistance contemplated in subsection (1);
    - (b) prohibit any financial assistance contemplated in subsection (1); or
    - (c) impose additional conditions or requirements respecting the granting of any such assistance.
  
  - (3) A resolution by the board of a company to provide financial assistance contemplated in subsection (1), or an agreement with respect to the provision of any such assistance, is void to the extent that the provision of that assistance would be inconsistent with –
    - (a) this section; or
    - (b) a prohibition, condition or requirement contemplated in subsection (2).
  
  - (4) Any director of a company who voted in favour of a resolution, or approved an agreement, that is void to any extent as contemplated in subsection (3) –
    - (a) is liable to compensate the company or any shareholder for any loss, damages or costs that the company or shareholder may have sustained or incurred in relation to the transaction, if proceedings to recover any such loss, damages or costs are commenced within two years after the issuance of the shares, securities or other rights; and
    - (b) may be held as responsible as the company, in terms of this Act, for the contravention.

**Comment**

Section 40 sets out the circumstances under which a company may give direct or indirect financial assistance to a person for the purpose of, or in connection with, the purchase of a share or option issued or to be issued by a company or a related or inter-related company. The section refers to shares which have been issued ie a sale by the holder of shares and the issue of new shares by the company.

The section treats options similarly to shares.

The section is not dissimilar to the provisions of Section 38(1) of the 1973 Companies Act as amended.

As terms such as “financial assistance”, “directly”, “indirectly”, “purpose”, “in connection with” etc. are not defined it will be necessary to refer to case law to determine whether the words used are relevant in determining whether prohibited financial assistance was provided by a company.

In contrast to Section 38 of the present act the members of a company may in terms of Sections 40(1)(a) and 40(2) elect to have a Memorandum of Incorporation which will or will not expressly authorize the company to provide financial assistance.

However, in terms of Section 40(1)(b) even if the Memorandum of Incorporation authorizes the granting of financial assistance all of the circumstances referred to in the section must be present.

The emphasis is on the board of directors being satisfied that the granting of the financial assistance will comply with the provisions of Section 4 relating to the solvency and liquidity test and that the proposed assistance is fair and reasonable. The directors must consequently have no doubt that the granting of the financial assistance will not result in unreasonable prejudice to the company.

The proposed Section 40 emphasizes that the shareholders of a company may determine the company's policy with regard to the granting of financial assistance. In this respect the following sections would be relevant – Section 40(1)(a), Section 40(1)(ii), Section 40(1)(iii)(bb), Section 40(1)(iii)(cc) and Section 40(2).

In respect of the above there is a similarity to Section 38(2A) of the 1973 Companies Act as amended in 2006.

Section 40(3) expressly provides that a resolution by the board of a company or any transaction which is inconsistent with the provisions of the section or prohibited in terms of the Memorandum of Association will be void.

The question arises whether the transactions will be void as far as it relates to the company or would it also relate to other persons who were parties to a transaction e.g. in *Karoo Auctions (Pty) Ltd. vs Hersman*<sup>135</sup> the contract relating to commission due to an agent in an affected transaction was held to be void.

In *Saambou Nasionale Bouvereniging vs Ligatex (Pty) Ltd.*<sup>136</sup> the court held that as the building society was not a party to a transaction as it did not know the purpose for which the money was borrowed the loan transaction was not void.

It would appear as if Section 40(3) would not affect the validity of transactions between third parties of the nature referred to above.

Section 40(4) provides that a director who voted in favour of a resolution or approved an agreement, that is void to any extent as contemplated in subsection 40(3) is liable to compensate the company for any loss, damage, costs etc sustained. The proceedings to recover the loss must be sustained within a two year period.

Section 91 sets out the standards of director's conduct which includes a duty to exercise the care, skill diligence expected of a reasonably diligent person and to have the requisite knowledge and skill.

Section 91(6) expressly provides that the provisions of Section 91 are in addition and not in substitution for any duties under the common law.

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<sup>135</sup> (1951) 2 SA 33E

<sup>136</sup> (1976)(1) SA 868E

Section 93 contains a blanket provision providing for the liability of directors to the company for any losses suffered as a consequence of their gross negligence, willful misconduct or breach of trust.

In all other respects a director, who has acted honestly and reasonably will not be liable to the company.

### **Offences and Penalties**

While the Companies Bill of 2007 provides for the decriminalization of the Company Law Chapter 9 does provide in Section 214 for criminal sanctions should any person be guilty of reckless conduct and non-compliance.

Specifically Section 215(1) refers to actions which may constitute criminal actions.

However, despite the presence of penalties there is no provision such as contained in Section 38(3)(c) of the 1973 Companies Act.

In this respect reference is made to S V Hepker (1973)(1) SA 472 (W).

## **XXII. AUSTRALIAN LAW**

The details of the Australian Law were extracted from understanding Company Law by Phillip Lipton and Abe Herzberg – 8<sup>th</sup> Edition – mainly pages 180 to 183.

The aim of the Company Law Review Act of 1998 was to facilitate business and investments by improving the efficiency of corporate regulation, reducing complexity and reducing regulatory burdens and compliance costs on business. Its enactment resulted in streamlining various areas of the Companies Law.

These include:

- the simplification of the registration of companies;
- the distinguishing of the auditing requirements of large and small proprietary (private) companies;
- small companies are exempted from the need to appoint auditors;
- the decriminalizing of the Act;
- the only criminal sanctions relate to dishonesty by the directors and other officers of the company;
- The law relating to financial assistance was also amended.

The South African Companies Bill of 2007 contains provisions similar to the above.

Prior to the Company Law Review Act, the law subject to a number of exceptions prohibited the granting of financial assistance in respect of the acquisition of its shares. Included in the exception was shareholders' approval. The law was considered as being excessively complex and covered many normal transactions which had no potential to harm the interests of a company's shareholders or creditors. In this there is a parallel with the opinions of various legal writers in South Africa, England etc. As we have seen the South African Corporate Laws Amendment Act OF 2006 provides for the amendment of the company law to permit the granting of financial assistance in certain circumstances. Similar circumstances are contained in the provisions of Sections 260A to 260C of the Australian Act.

In terms of Section 260A, a company may only grant financial assistance to acquire shares in the company or its holding company in the following circumstances:

- **Section 260A(1)(a)**  
Where the giving of the assistance does not materially prejudice the interests of the company, its shareholders or the company's ability to pay its creditors; or
- **Section 260B**  
Where the assistance is approved by the shareholders;
- **Section 260E**  
Where the assistance is exempted in terms of the section;
- **Section 260(A)(2)**  
Financial assistance may be given before or after the acquisition of shares and may take the form of paying a dividend. As is the case in terms of the South African Companies Act, Australian Law does not define "financial assistance". However, the following are examples of "financial assistance":
  - The company lending a person money to be used to acquire shares in the company;
  - The company guaranteeing a person's loan where the proceeds of the loan are used to acquire shares in the company;
  - The company providing its own assets as security for a person's loan where the proceeds of the loan are used to acquire shares in the company;

On page 181 of *Understanding Company Law* by Phillip Lipton and Abe Herzberg 8<sup>th</sup> Edition reference is made to the following cases relating to the provision of financial assistance.

***Hunter's Products Group Ltd. v Kindley Products (Pty) Ltd***<sup>137</sup>

In this case part of the purchase price for shares in a company was funded by the company's bank account.

***Independent Steels (Pty) Ltd. v Ryan***<sup>138</sup>

In this case the vendor shareholders were to be paid from the gross turnover of a subsidiary company.

***Darvall v North Sydney Brick & Tile Co Ltd***<sup>139</sup>

In this case the court came to a decision based on the director's duties without considering the financial assistance aspect.

In order to ensure that the shareholder's approval is properly authorized Section 260A(1)(b) provides for the approval to be given by special resolution passed at a general meeting or by a resolution passed by all the shareholders at a general meeting. This provision is similar to subsection 38(2B)(b) of the proposed amendment of the South

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<sup>137</sup> (1996) 14 ACLC 86

<sup>138</sup> (1989) 7 ACLC 804

<sup>139</sup> (1987) 12 ACLR 537

African Act. The notice convening the meeting must set out all known material information.

Exempted financial assistance transactions are contained in Section 260C of the Act and include financial assistance given in the ordinary course of commercial dealing consisting of:

- Section 260C(1)(a) – acquiring or creating a lien on partly paid shares.
- Section 260(1)(b) – where a person pays the company for its shares in installments.
- Section 260C(2) – financial assistance given in the normal course of the company’s business and on ordinary commercial terms.
- Section 260C(3) – where the financial assistance is in the form of a guarantee or other security given by a subsidiary of a borrowing corporation in the ordinary course of commercial dealing.
- Section 260C(4) – where assistance is given under an employees share scheme that has been approved by the general meeting of the company or if it is a subsidiary company by the approval of the general meeting of the holding company.
- Section 260C(5a) – a reduction of share capital.
- Section 260C(5b) – a permitted share buy back.
- Section 260C(5c) – assistance given under a court order.
- Section 260C(5d) – a discharge on ordinary commercial terms of a liability incurred by the company in relation to a transaction entered into on ordinary commercial terms.

The provisions of Section 260 are similar to the amended Section 38 of the South African Act.

The Australian Law, however, only provides for civil offences in respect of which a director or other officer could be sued for damages caused by their malpractice in relation to the company or shareholders.

The South African Law provides for a fine for the company and a fine and prison for errant directors (Section 441).

In terms of Section 260D a contravention of Section 260A does not affect the validity of the transaction. This provision is different from the South African Law. In terms of South African case law where a transaction is prohibited in terms of Section 38, the whole contract is void and unenforceable. The Australian Law is similar to the South African Law in that it is relatively simple and does not contain a surfeit of provisions to control the “granting of financial assistance”.

### **XXIII. NEW ZEALAND COMPANY LAW**

The New Zealand Companies Act of 1993 provides for financial assistance to be given for the purpose of, or in connection with the acquisition of shares of the company.

The above law, unlike the South African and Australian Laws is subject to extensive conditions. The relevant Sections are Sections 76 – 81.

## **Section 76**

The New Zealand Act incorporates a dichotomy of orientations. On the one hand it authorized the provision of financial assistance by a company for the purchase of its shares while on the other hand it is heavy on preventing abuses. It is similar in many respects to the South African Act in providing the circumstances where financial assistance which includes loans, guarantees and the provision of security may be given. Section 76(1)(a) authorizes the granting of financial assistance for the purchase of shares or shares to be issued (subscriptions) by a company or its holding company, whether directly or indirectly in the following circumstances:-

All shareholders must have consented in writing to the giving of the assistance. This provision does not correspond with the South African Law where only a special resolution is required. For a special resolution to be passed in South Africa 75% of the members must have approved the resolution at a general meeting in respect of which 21 days notice had been given.

In terms of Section 76(2) prior to the shareholders consent the board of directors must have previously resolved as follows:

- The company should provide the assistance;
- Giving the assistance is in the best interest of the company; and
- The terms under which the assistance is given are fair and reasonable to the company;

Even if Section 38(2A) of the South African Act does not spell out the terms under which financial assistance is given in the same detail as the New Zealand Act the terms are similar as the board of directors would have to consider whether the assistance should be given before approaching the shareholders.

As in South Africa the notice of the meeting of shareholders must set out in full the grounds for the directors reasons for the provision of financial assistance.

In terms of Section 76(5) a company may not give financial assistance if subsequent to the approval of the assistance by the board and before the assistance is given, the board ceases to be satisfied that the giving of the assistance or the terms under which the assistance is given is in the best interest of the company.

Even-though the above is not specifically referred to in the South African Act the South African Law specifically provides for penalties for directors and other officers acting contrary to the interest of the company.

These include Sections 424 and 425 of the Act.

## **Section 77**

Section 77, as is the case with Section 38(2A) of the South African Act, provides that no financial assistance may be given unless the board of directors is satisfied that the company will immediately after the providing of the assistance satisfy the solvency test which means that the assets excluding any assistance given in terms of the section exceeds the liabilities of any sort including contingent liabilities.

As is the case with the terms of Section 76(5), Section 77(3) provides that should the board cease to be satisfied at any time after the passing of the resolution by the board that the solvency test will not be satisfied then the financial assistance will be deemed not to have been authorized. Consequently the company will be prohibited from providing the assistance. There is no equivalent provision in Section 38 of the South African Act but by implication that the directors of a South African company will be held liable if they act against the interest of the company in not taking into account subsequent events.

## Section 78

Section 78(1) considers damages which may be suffered by the shareholders of a company as opposed to the company itself as a consequence of the giving of the assistance.

The section provides as follows:

Special financial assistance ... (1) Financial assistance may be given under Section 76(1)(b) of this Act only if the board has previously resolved ...

- a) that giving the assistance in question is of benefit to those shareholders not receiving the assistance; and
- b) that the terms and conditions under which the assistance is given are fair and reasonable to those shareholders not receiving the assistance.

There is no equivalent section in the South African Act. This oversight may prove to have unfortunate consequences as South African Company Law does not provide for a fiduciary duty by the director towards the individual members of the company.<sup>140</sup>

Section 78 has similar provisions to Sections 76(5) and 77(3) with regard to the situation where the board ceases to be satisfied with regard to the provision of assistance. However, Section 78 pertains to the situation where the shareholders who are not receiving assistance are prejudiced. Section 78(7) provides as follows:

(7) A shareholder or the company may apply to the court for an order restraining the proposed assistance being given on the grounds that ...

- a) it is not in the best interests of the company and of benefit to those shareholders not receiving the assistance; or
- b) the terms and conditions under which the assistance is to be given are not fair and reasonable to the company and to those shareholders not receiving the assistance;

This section incorporates applications to court by dissatisfied shareholders.

In terms of Sections 76 – 80 any director who does not comply with the terms of the section may be penalized. In terms of Section 78 the company may also be penalized.

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<sup>140</sup> Corporate Law (2<sup>nd</sup> edition) by HS Cilliers et al. p144

## **Section 79**

Section 79 provides the following:

79. disclosure document ... for the purposes of Section 78 of this act, a disclosure document is a document that sets out ...

- a) the nature and terms of the financial assistance to be given, and to whom it will be given; and
- b) if the financial assistance is to be given to a nominee for another person, the name of that other person; and
- c) the text of the resolution required by Section 78(1) of this act, together with such further information and explanation as may be necessary to enable a reasonable shareholder to understand the nature and implications for the company and its shareholders of the proposed transaction.

## **Section 80**

Section 80 relates to the issue of the shares of the company. This section only permits assistance up to an amount of 5% of the shareholders funds. The term "shareholders funds" refers to the aggregate of amounts received in respect of the issued shares together with the retained reserves of the company.

Section 38 of the South African Act does not include equivalent provisions.

## **Section 81**

Section 81 provides as follows:

81. Enforceability of transactions ... (1) failure to comply with Section 76 or Section 78 or Section 79 or Section 80 of this act does not affect the validity of a transaction.

(2) This section does not affect a liability of a director or any other person for breach of a duty, or as a constructive trustee, or otherwise.

Section 81(d) is contrary to the terms of the Section 38 of the South African Act but corresponds to Section 260D of the Australian Act.

Section 81(2) refers to the fact that the section does not affect the liabilities of directors or any other person for a breach of duty.

## **XXIV. ENGLISH COMPANY LAW**

The English Companies Act was amended in 1985. Sections 151 to 158 Chapter VI contain the law relating to the provision of financial assistance by a company for the acquisition of its own shares. Unlike the South African and Australian Laws but similarly to the New Zealand Law the English Act contains extensive provisions relating to financial assistance. The fears relating to the relaxation of the prohibition against the provision of financial assistance are reflected in the Act. It was considered that the prohibition would prevent abuses especially with regard to takeovers which were in effect financed from the company's resources. However, evaluation of the way Section 54 (the predecessor to the

sections contained in Chapter VI) was being interpreted led to concern that unobjectionable transactions were 'being shot down' by the courts.

In this respect Gower's Principles of Modern Company Law – Sixth Edition on page 264 refers to the following cases:

- Belmont Finance Corp v Williams Furniture Ltd.<sup>141</sup>
- Armour Hick Northern Ltd. v Whitehouse.<sup>142</sup>

In contrast to the laws relating to financial assistance referred to above Section 151 provides that subject to the provisions of Chapter VI, it shall not be lawful for a company or a subsidiary to provide financial assistance directly or indirectly for the purpose of the acquisition before or at the same time as the acquisition takes place. It would also not be permissible for the company to assist any person in discharging a liability which had been previously incurred relating to the acquisition of shares.

Any company acting in contravention of the section shall be subject to a fine and every officer shall be liable to imprisonment or a fine or both.

Section 152 defines 'financial assistance' in great depth and includes financial assistance given as follows:

1. as gifts;
2. guarantee, security or indemnity;
3. loans;
4. any other financial assistance given by a company the net assets of which are thereby reduced to a material extent or which has no net assets;

In respect of the above it is clear that the company's manipulations of the past are still present in the national psyche.

The section continues with a definition of distributable reserves – those profits from which the company could lawfully make a distribution.

'Net assets' is defined as the difference between the aggregate of the company's assets less the aggregate of its liabilities as defined in the Act.

Section 153 schedules transactions not prohibited by Section 151.

This section attempts to provide as detailed a schedule as possible. The exempted transactions include the following:

Where in terms of Section 153(1);

- (i) (a) the company's principal purpose in giving that assistance is not to give it for the purpose of any such acquisition, or the giving of the assistance for that purpose is but an incidental part of some larger purpose of the company, and
- (b) the assistance is given in good faith in the interests of the company;

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<sup>141</sup> Supra

<sup>142</sup> Supra

The above subsection caused problems for the judges in the cases of *Brady v Brady*<sup>143</sup>.

Gower's *Principles of Modern Company Law*<sup>144</sup> refers to the speech by Lord Oliver as follows:

“Lord Oliver, in a speech concurred in by the other Law Lords, subjected the wording of paragraph (a) to detailed analysis. He pointed out that ‘purpose’ had to be distinguished from ‘reason’ or ‘motive’ (which would almost always be different and wider) and that paragraph (a) contemplated alternative situations. The first is where the company has a principal and a subsidiary purpose; the question then is whether the principal purpose is to assist or relieve the acquirer or is for some other easy to grasp corporate purpose. The second situation is where the financial assistance is not for any purpose other than to help the acquirer but is merely incidental to some larger corporate purpose. As regards the first alternative, he accepted that an example might be where the principal purpose was to enable the company to obtain from the person assisted a supply of some product which the company needed for its business. As regards the second, he offered no example, merely saying that he had ‘not found the concept of larger purpose’ easy to grasp.”

- (ii) Legal distributions of dividends, the issue of bonus shares, the reduction of capital confirmed by the court and assistance in respect of the winding up of the company or compromises with the creditors.
- (iii) Lending money in the ordinary course of the company's business.
- (iv) Assistance in good faith in respect of employees share schemes.
- (v) Section 153(4) permits assistance by the company or its subsidiaries to enable shares to be bought in the company or another member of the group by employees, former employees, their spouses, widows, widowers or children or stepchildren under the age of 18.
- (vi) Assistance to employees other than directors to purchase shares in the company to be held by them by way of beneficial ownership.

The terms of Section 153(4) are similar to those contained in Section 38(2) of the South African Act.

Section 154 is only applicable to public companies.

- 154(1) In the case of a public company, Section 153(4) authorizes the giving of financial assistance only if the company has net assets which are not thereby reduced or, to the extent that those assets are thereby reduced, if the assistance is provided out of distributable profits.
- (2) For this purpose the following definitions apply –
  - (a) “net assets” means the amount by which the aggregate of the company's assets exceeds the aggregate of its liabilities (taking the amount of both assets and liabilities to be as stated in the company's accounting records immediately before the financial assistance is given);
  - (b) “liabilities” includes any amount retained is reasonably necessary for the purpose of providing for any liability (the nature of which is clearly

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<sup>143</sup> *Supra*

<sup>144</sup> 6<sup>th</sup> Edition pages 269 and 270

defined and) which is either likely to be incurred, or certain to be incurred but uncertain as to amount or as to the date on which it will arise.

Section 155 provides for the relaxation of Section 151 for private companies. This section provides that Section 151 which prohibits the granting of financial assistance will not be applicable to private companies or where the company is a subsidiary of a private company and not a public company. This relaxation will only be possible if there is compliance with the formalities including those referred to in Section 156 – 158. South African Law does not distinguish between public and private companies.

Section 156 details the extensive details relating to the provision of assistance. This section once again indicates the intense fear that the relaxation of the prohibition against “the provision of financial assistance could result in considerable ‘mischief’”.

The details required in the statement to be made by a company’s directors in terms of Section 155(6A) are set out below.

- (a) the names and addresses of all the directors of the company;
- (b) whether the business of the company is that of a banking company or insurance company or some other business;
- (c) that the company or (as the case may be) a company (naming such company) of which it is the holding company is proposing to give financial assistance in connection with the acquisition of shares in the company or (as the case may be) its holding company (naming that holding company);
- (d) whether the assistance is for the purpose of that acquisition or for reducing or discharging a liability incurred for the purpose of that acquisition;
- (e) the name and address of the person to whom the assistance is to be given (and in the case of a company its registered office);
- (f) the name of the person who has acquired or will acquire the shares and the number and class of the shares acquired or to be acquired;
- (g) the principal terms on which the assistance will be given;
- (h) the form the financial assistance will take (stating the amount of cash or value of any asset to be transferred to the person assisted), and
- (i) the date on which the assistance is to be given;

The bulk of the above information would be contained in the notice of a meeting called in South Africa with regard to approving a special resolution required in terms of Section 38 (2A)(b) . In South Africa it is considered that the other sections of the Act would be sufficient to ensure that proper notice is given.

The English Act provides the directors report must have an auditors report annexed wherein the auditors confirm that the directors report is reasonable. The South African Law does not contain a similar provision relating to an auditor’s report. A director who makes a statutory declaration without having reasonable grounds will be liable for imprisonment or a fine or both.

Section 157 provides that the special resolution relating to the provision of assistance must be passed within one week following the directors’ statement.

Section 157(2) once again confirms the legislative fear that the removal or relaxation of the prohibition against the provision of financial assistance could open a “Pandora’s Box” of “mischief”.

Section 157(2) reads as follows:-

“Where such a resolution has been passed, an application may be made to the court for the cancellation of the resolution –

- (a) by the holders of not less in the aggregate than 10 per cent in nominal value of the company’s issued share capital or any class of it, or
- (b) if the company is not limited by shares, by not less than 10 per cent of the company’s members; but the application shall not be made by a person who has consented to or voted in favor of the resolution.

Section 158 provides time frames for the finalization of the various aspects of the formalities relating to the provision of financial assistance.

## **XXV. CONCLUSION**

For many years South African business transactions had been shackled by the restrictions of the vexatious Section 38 which had the effect of forcing otherwise law abiding business persons to break the law in order to conclude transactions desired by parties to agreements. Unfortunately such agreements were vulnerable to be repudiated on the grounds that the agreements were not fulfilling the requirements of Section 38. Despite amendments to the Act in 1999 which removed the emphasis on the maintenance of capital concept in respect of the reduction of capital and companies purchasing its own shares, Section 38 remained unaltered. As was emphasised above, the section was heavily criticized by legal writers. The section as amended in 2006 has removed the severe legal complications as prevailed in the past. It does not attempt to be unduly controlling as is the case with the English and New Zealand Laws. In this respect, it is similar to the Australian Law.

Section 38 as amended will surely achieve the object of assisting in the growth of attracting foreign investments in South Africa. However, the Companies Bill of 2007 will drastically change South African company law to the extent of making it one of the world’s most modern.

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