

FINANCIAL ASSISTANCE — A NEW APPROACH

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I INTRODUCTION

Legislation regulating companies in South Africa has, since 1939,¹ prohibited the giving of financial assistance by a company for the acquisition of its shares.² The prohibition in South Africa, which is currently contained in s 38 of the Companies Act ('the 1973 Act'),³ has its roots in England, where the Greene Committee⁴ first drew attention to the potential abuse that could arise from such transactions. The Committee considered that the practice whereby, in effect, the company provided the money for the purchase of its own shares, offended 'against the spirit if not the letter of the law which prohibits a company from trafficking in its own shares and the practice is open to the gravest abuses'.⁵

The objective of this article is to comment on the manner in which the legislature seeks to address the perceived problem in the new Companies Act ('the Act'),⁶ and to show that the relevant provision, s 44, in its current form requires amendment. The article also briefly comments on the amendments

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¹ See s 86bis of the Companies Act 46 of 1926, introduced by s 52 of the Companies Amendment Act 23 of 1939.

² Section 86bis was amended subsequently by s 69 of the Companies Amendment Act 46 of 1952 to include not only a purchase of shares, but also a subscription for shares.

³ Act 61 of 1973.

⁴ Company Law Reform Committee (1926) Cmnd 2637 para 30.

⁵ Ibid.

⁶ Act 71 of 2008. The Companies Bill, 2008, which introduced the new Companies Act, replacing the Companies Act 61 of 1973, was approved by the National Assembly on 28 September 2008 and adopted by Parliament on 19 November 2008. In terms of s 225 of the legislation, the Companies Act, 2008 will come into operation on a date fixed by the President by proclamation in the *Gazette*, which may not be earlier than one year following the date on which the President assented to the Act. The President assented to the Act on 8 April 2009. It is expected that all the provisions of the Act will come into force by late 2010.

made to s 38 by the Corporate Laws Amendment Act ('the CLAA')⁷ and, to the extent that these are relevant, to the provisions of s 40 of the 2007 Companies Bill ('the 2007 Bill') which was superseded by the Companies Bill, 2008.⁸

Section 44 of the Act provides:

- '(1) In this section, "financial assistance" does not include lending money in the ordinary course of business by a company whose primary business is the lending of money.
- (2) To the extent that the Memorandum of Incorporation of a company provides otherwise, the board may authorize the company to provide financial assistance by way of a loan, guarantee, the provision of security or otherwise to any person for the purpose of, or in connection with, the subscription of any option or any securities issued or to be issued by the company or a related or inter-related company, or for the purchase of any securities of the company or a related or inter-related company, subject to subsections (3) and (4).
- (3) Despite any provision of a company's Memorandum of Incorporation to the contrary, the board may not authorize any financial assistance contemplated in subsection (2), unless —
 - (a) the particular provision of financial assistance is —
 - (i) pursuant to an employee share scheme that satisfied the requirements of section 97; or
 - (ii) pursuant to a special resolution of the shareholders, adopted within the previous two years, which approved such assistance either for the specific recipient, or generally for a category of potential recipients, and the specific recipient falls within that category; and
 - (b) the board is satisfied that —
 - (i) immediately after giving the financial assistance, the company would be in compliance with the solvency and liquidity test; and
 - (ii) the terms under which the assistance is proposed to be given are fair and reasonable to the company.
- (4) In addition to satisfying the requirements of subsection (3), the board must ensure that any conditions or restrictions respecting the granting of financial assistance set out in the company's Memorandum of Incorporation have been satisfied.
- (5) A decision by the board of a company to provide financial assistance contemplated in subsection (2), or an agreement with respect to the provision of any such assistance, is void to the extent that the provision of that assistance would be inconsistent with —
 - (a) this section; or
 - (b) a prohibition, condition or requirement contemplated in subsection (4).

⁷ Act 24 of 2006.

⁸ There were in fact two Companies Bills published in 2008, the Companies Bill [B61-2008] and the Companies Bill [B61D-2008], the latter superseding the former.

- (6) If a resolution or agreement has been declared void in terms of subsection (5) read with section 218(1), a director of the company is liable to the extent set out in section 77(3)(e)(iv) if the director —
 - (a) was present at the meeting when the board approved the resolution or agreement, or participated in the making of such a decision in terms of section 74; and
 - (b) failed to vote against the resolution or agreement, despite knowing that the provision of financial assistance was inconsistent with this section or a prohibition, condition or requirement contemplated in subsection (4).⁹

Before addressing s 44 it is appropriate to sketch the background to the provision.

II BACKGROUND

Amendments to the 1973 Act in 1999 signalled a new approach to the concept of maintenance of capital which has been part of South African company law for so long. Prior to the Companies Amendment Act ('the Amendment Act'),⁹ buy-backs of shares were not permitted, companies could not acquire shares in their holding companies except in very limited circumstances and dividends could not be paid to shareholders out of capital. The Amendment Act made all these transactions permissible subject to certain requirements. A transaction of a company which could be regarded as falling into the same 'stable' as the aforementioned transactions is the transaction governed by the notorious s 38 of the 1973 Act. Section 38 prohibits, subject to limited exceptions, a company from giving financial assistance for the purchase of or subscription for shares in itself or its holding company. The Amendment Act, however, made no substantial change to s 38 other than to add another exception to the prohibition contained in the section, to facilitate buy-backs within a group of companies.¹⁰ There was no amendment lifting the prohibition along the same lines as the prohibition on the other transactions and one can only surmise that at that time the s 38 transaction was viewed as potentially too dangerous to warrant the more liberal approach adopted towards the other transactions.

The more liberal approach was, however, adopted in 2006 when the CLAA¹¹ added a further exception to the prohibition in s 38 to facilitate Black Economic Empowerment. The effect of this amendment was far-reaching and will bring to an end the notoriety of the prohibition.¹²

Section 38 now provides (including the further exception):

'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

⁹ Act 37 of 1999.

¹⁰ See s 38(2)(d).

¹¹ This Act came into force on 14 December 2007.

¹² The further exception is to be found in s 38(2)(2A) read with s 38(2)(2B).

- 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.
- (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 account for any contingent liabilities which may arise to the company, including any contingent liability which may result from giving the assistance.'

The 2007 Bill¹³ also prohibited financial assistance subject to certain exceptions but, like the CLAA, adopted a much more liberal approach. Financial assistance was dealt with in the 2007 Bill as follows:¹⁴

- '(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

¹³ This was published for public comment in February 2007.

¹⁴ Section 40.

- (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 conditions 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 satisfied the requirements of section 62; or
 - (bb) pursuant to a special resolution of the shareholders, adopted within the previous five 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.'

III COMMENT ON SECTION 44 OF THE ACT

(a) *Financial assistance*

Although the 2007 Bill provided no indication of what was meant by ‘financial assistance’, s 44 of the Act¹⁵ is more helpful: it prohibits the giving of financial assistance ‘by way of a loan, guarantee, the provision of security or otherwise’. Accordingly, the extensive case law¹⁶ that has built up around the meaning of the words ‘or otherwise’ in s 38(1) of the 1973 Act will continue to be applicable in the determination of what constitutes financial assistance for the purposes of s 44 of the Act. The ambit of the words ‘or otherwise’ as contained in the definition of ‘financial assistance’ (and consequently the ambit of the term ‘financial assistance’) is, however, still far from clear and it is unfortunate that the drafters of the Act did not seize the opportunity to provide more guidance in this regard. Also, in the Act the words ‘direct or indirect’, which preceded the term ‘financial assistance’ in both s 38(1) of the 1973 Act and s 40 of the 2007 Bill, have been omitted but replaced by a list of possible manifestations of financial assistance.¹⁷ The words ‘or otherwise’ indicate that this is not a closed list but presumably the illustrative examples included by the drafters are intended to indicate the range of forms which financial assistance may take, rendering the addition of ‘direct or indirect’ unnecessary.

The case law surrounding the meaning of the words ‘in connection with’ in s 38(1) of the 1973 Act, which also appear in s 44(2) of the Act, will presumably continue to apply.¹⁸

¹⁵ Like s 38(1) of the 1973 Act.

¹⁶ See *Gradiwell (Pty) Ltd v Rostra Printers* 1959 (4) SA 419 (A); *Lipschitz v UDC Bank Ltd* 1979 (1) SA 789 (A); *Lewis v Oneate (Pty) Ltd* 1992 (4) SA 811 (A); and *Gardner & another v Margo* 2006 (6) SA 33 (SCA). See also the commentary on s 38 in M S Blackman et al *Commentary on the Companies Act* vol 1 4-58 to 4-60-3 in this regard.

¹⁷ Section 38(1) of the 1973 Act also contains such a list.

¹⁸ See *Lipschitz NO v UDC Bank Ltd* 1979 (1) SA 789 (A) at 804–5. In regard to interpretation of the Act generally, s 5 thereof states that it must be interpreted in a manner that gives effect to the purposes set out in s 7. Section 7, in turn, lists some of the most fundamental underlying principles of the new legislation. Section 5(2) permits a court interpreting or applying the legislation to consider, to the extent appropriate, foreign company law. In light hereof, although the South African case law dealing with s 38 will most certainly remain relevant and applicable, courts should also look to the foreign jurisdictions from which certain of the new terms and concepts have been drawn as an aid to their proper interpretation. It is notable that the corresponding version of this section as contained in the 2007 Bill permitted a person, court or Tribunal interpreting or applying the legislation to consider, to the extent appropriate, foreign company law. In the current version ‘person’ and ‘Tribunal’ have been removed from this subsection. Presumably the drafters thought it would lead to confusion and legal uncertainty if natural and juristic persons were permitted to craft their own interpretations of sections of the legislation based on foreign company law and therefore deleted these words in the current version.

The words used in s 44(2) are somewhat confusing. The section begins, 'To the extent that the Memorandum of Incorporation of a company provides otherwise,' and then goes on to state the circumstances in which financial assistance by a company will be permissible. It is submitted that the better wording is that which is found in s 45(2) in relation to financial assistance to directors, namely, 'Except to the extent that the Memorandum of Incorporation of a company provides otherwise,' followed by a list of conditions for the provision of loans to directors.

(b) *Subscription*

Section 38(1) of the 1973 Act prohibits financial assistance in relation to a purchase of or subscription for shares. A 'purchase' obviously involves the acquisition of a company's shares from a shareholder of the company, whereas a 'subscription' involves an acquisition from the company itself. Section 40(1) of the 2007 Bill only referred to a 'purchase' which seemed to indicate that s 40 was more limited in its application than s 38. This interpretation would have resulted in a number of legal anomalies, including a real danger of impoverishment of a company assisting in a subscription which would not have been covered by the section in question. It seems that the omission of 'subscription' in the previous version of the section was therefore inadvertent and, happily, this has been remedied in the Act.

A further related improvement in the drafting since the 2007 Bill is that the term 'issuance' which was used in s 40(4)(a) has been dropped. The most likely explanation for the initial inclusion of the term is that the wording of the subsection was originally drawn from the Model Business Corporation Act ('the Model Act').¹⁹ The Official Comment published as part of the Model Act in relation to this provision states that it has long been recognized that the statutory structure which embodies, inter alia, 'par value and legal capital' (ie the equivalent of our capital maintenance provisions), is complex and confusing and fails to serve the original purpose of protecting creditors and shareholders. Indeed, the drafters of the Model Act state that to the extent that security holders are led to believe that these concepts do provide protection, they may be affirmatively misleading. The Model Act eliminated those concepts completely and replaced them with a system which, in relation to the *issuance* of shares, recognizes that the board of directors may issue shares for any type or amount of consideration which it determines to be adequate. In its assessment the board must adhere to the applicable standards of conduct and general principles set out in the legislation. American scholars argue that it makes no sense to give the board this power and then deny it the power to approve the provision of financial assistance to a prospective purchaser and accordingly the issue of financial assistance is not dealt with in the Model Act at all. The Model Act thus has no s 38 counterpart. This may also go some way toward explaining the omission of

¹⁹ Paragraph 6.21.

the word ‘subscription’ in s 40 of the 2007 Bill — it did not occur to the drafters to insert that word in our legislation as the entire section in the Model Act dealing with this issue centres on subscription, and is in fact entitled ‘Issuance of shares’.

The upshot of this comparative exercise is that the choice of particular wording in s 40(1) of the 2007 Bill could be ascribed to the influence of foreign legislation rather than fundamental South African company-law principles and it is gratifying that this has been remedied in the Act.

(c) *Securities*

Section 44 refers to financial assistance for the subscription of ‘securities’. Section 38(1) of the 1973 Act prohibits financial assistance in relation to ‘shares’. Section 1 of the Act provides that ‘securities’ has the meaning set out in s 1 of the Securities Services Act (‘the SSA’).²⁰ Section 1 of the SSA provides the following definition:

“securities” —

(a) means —

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

(b) excludes —

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

Needless to say, this casts the net of the prohibition on financial assistance far wider than s 38 does, and it will be interesting to observe which types of

²⁰ Act 36 of 2004.

commercial transactions which did not previously fall within the ambit of the section may be affected.

(d) *Options*

Section 44(2) refers not only to financial assistance for the subscription of²¹ or purchase of 'securities', but also to financial assistance for the subscription of 'options'. The provision does not state what the options are in respect of. The intention, one suspects, was to cover an option to purchase or subscribe for securities of the company giving the assistance. However, the wording is wide enough to cover options to acquire any property of the company. There is also no reference to the purchase of options. Clarity in this respect is called for.

It is not clear whether s 38(1) of the 1973 Act prohibits financial assistance for the purchase of an option to purchase or subscribe for shares. There is no doubt that such options should be included, and the Act is to be commended for expressly providing to that effect. It may be arguable that the words 'directly or indirectly' in s 38(1) of the 1973 Act currently have the effect, *inter alia*, of including options. It may, however, be that this is only the case if the option is exercised and there is actually a purchase. If there is no exercise of the option and therefore on ensuing purchase, it is arguable that there is no contravention. On the other hand, it may be arguable that what is important is the purpose of the assistance, and if the purpose is to assist in the purchase of the option, the purpose is indirectly to assist in the purchase of the shares and the fact that the option is never exercised is irrelevant. The more precise wording of s 44(2) in the Act has also put paid to this uncertainty. In the past similar problems of interpretation existed in relation to debentures convertible to shares, *ie* whether financial assistance in regard to such instruments was prohibited or not. Fortunately the new definition of 'securities' in the Act has settled this debate as s 1 of the SSA specifically provides that securities means, *inter alia*, debentures.

An ancillary question to consider is when the financial assistance occurs for purposes of the Act in terms of the option and convertible debenture constructions. Is it when the option is acquired or exercised or the debenture is converted to a share (*ie* the share is actually acquired) or prior to that, at the time that the company in question grants or agrees to grant the financial assistance? The answer to this question obviously impacts on the manner in which the solvency and liquidity requirements will be applied 'immediately after providing the financial assistance.'²² If there is a substantial time lapse between, for example, granting financial assistance to enable a third party to acquire an option and the ultimate exercise of that option, must these requirements be met when the option right is acquired by the third party or when it is actually exercised or at both stages? It may be that the third party

²¹ Presumably the intended wording was 'subscription for'.

²² Section 44(3)(b)(ii).

never exercises the option and, in those circumstances (and in contemplation of that possibility), is it correct to require that the company be liquid and solvent and/or that a special resolution be adopted at the time the assistance is granted? Is the transaction not at that point and until the option right is in fact exercised akin to any financial loan transaction which the board may ordinarily be at liberty to approve itself (such as lending money to a third party for purposes other than the acquisition of shares in the company)? Does the need to protect shareholders and creditors not only become legally relevant if and when the option or pre-emptive right is exercised or the debenture conversion is effected and, if so, is this not the point at which the protective requirements should be met? To illustrate, the company may provide the assistance to acquire the option right or debenture at a time when things are looking financially rosy and in terms of a resolution passed nearly two years previously as contemplated in s 3(a)(ii) of the Act, but the actual transaction (ie the exercise of the option or the debenture conversion) occurs later when it is not liquid and solvent and when the authority granted in terms of the resolution has expired. Is this permissible and does it adequately protect shareholders and creditors or do those requirements need to be met again at that later stage?

It is submitted that the provisions of the Act need to be amended so as to make it clear at what point(s) in time the requirements of s 44(3)(b) need to be met in the case of an option and convertible debenture respectively.

(e) *Assistance for purchases already made*

Section 38(1) of the 1973 Act prohibits financial assistance for the purchase of or subscription for shares 'made or to be made'. Thus the assistance does not have to be given before the purchase or subscription in order for it to fall within the ambit of the section, it can be given afterwards. This is understandable. Section 44(2) of the Act merely refers to 'the subscription of any option, or any securities' and 'the purchase of shares', which does not clearly indicate whether the financial assistance must be given before the subscription or purchase takes place or whether financial assistance given after a subscription or purchase is covered by the section as well. The inclusion of the words 'made or to be made' which appear in s 38 would have put the matter beyond any doubt.

(f) *Assistance in relation to shares 'to be issued'*

The prohibition in s 44(2) of the Act relates to securities 'issued or to be issued' by the company concerned. These words were possibly included to counter the technical argument that financial assistance for the purchase of shares not yet in existence is not assistance for shares of the company. It seems possible that such an argument could hold sway in relation to s 38 of the Act, although it is submitted that the argument is tenuous.

(g) *Extension to a 'related or inter-related' company*

A curious aspect of s 44 of the Act is that the prohibition applies not only to financial assistance by a company for the acquisition of securities in itself but

also securities in 'a related or inter-related company'.²³ This goes much further than s 38 of the 1973 Act, which only covers financial assistance by a company for the acquisition of shares in itself or its holding company. An obvious illustrative example of the new extended ambit of the section is that, whereas in the 1973 Act there is no bar to a company providing financial assistance for the purchase of shares in its subsidiary or a fellow-subsubsidiary, these transactions would now fall squarely within the ambit of s 44.

The definitions of related and inter-related persons are wide. Section 2(1)(c) of the Act provides that 'a juristic person is related to another juristic person if — (i) either of them directly or indirectly controls the other, or the business of the other, as determined in accordance with subsection (2); (ii) either is a subsidiary of the other; or (iii) a person directly or indirectly controls each of them or the business of each of them, as determined in accordance with subsection (2)'.

It is submitted that it may not always prove to be factually or legally simple to determine whether companies are related or inter-related, especially in complex group structures. The Act does, however, contain an ameliorating provision which enables a court, the Companies Tribunal, or the Takeover Regulation Panel to exempt any person from the application of a provision of the Act if the person can show that, in respect of that particular matter, there is sufficient evidence to conclude that the person acts independently of any related or inter-related person.²⁴ Although this provides some relief, the onus remains on the company to prove that it is acting independently and, even if such an application is not made or proves unnecessary, the directors will need to apply their minds to determine whether a particular transaction falls within the ambit of s 44 or not. This may prove to be difficult, time-consuming and expensive for the company and may make the practical application of s 44 as challenging as that of its predecessor, s 38, without necessarily providing significant additional protection for creditors and shareholders.

(h) *Fair and reasonable terms*

In terms of the Act,²⁵ the board may not authorize any financial assistance contemplated in subsec (2) unless the board is satisfied that 'the terms under which the assistance is proposed to be given are fair and reasonable to the company'. It will be recognized that this requirement makes the section in the Act tougher to negotiate than s 38. As a result of the exception to s 38 introduced by the CLAA in 2006,²⁶ as long as there is a special resolution and the solvency and liquidity criteria are met, there is no contravention of s 38 even if the terms under which the assistance is given are not fair and reasonable to the company. The proposed change is to be welcomed,

²³ See s 2 of the Act as to what constitutes a 'related or inter-related person'.

²⁴ Section 2(3).

²⁵ Section 44(3)(b)(ii).

²⁶ See text to note 11.

although it is not clear what is meant by ‘the terms under which the assistance is proposed’ being ‘fair and reasonable to the company’. Does it mean that viewed from a commercial perspective, the transaction, whatever it might be, will benefit the company? In other words, must there be a reasonable quid pro quo? Or does it simply mean that the company is provided with ‘fair and reasonable’ security? If the latter, and this needs to be clarified, it may be appropriate to include the provisions of s 37(3)(c) of the 1973 Act. Section 37 regulates loans and security provided by a company on behalf of its holding company or fellow subsidiary. Section 37(3)(a) imposes liability on a director or officer of the company where the ‘terms or conditions’ of the loan or the provision of security ‘were not fair to the company or failed to provide reasonable protection for its business interests’. Section 37(3)(c) enlarges on what is meant here by providing that in:

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

It may also be appropriate to exclude this requirement where all the members of the company have consented to the assistance (see s 37(5)).

It is to be noted that the provision in the New Zealand Companies Act²⁷ dealing with financial assistance also requires the terms and conditions under which the assistance is given to be fair and reasonable to the company²⁸ but in addition to this that ‘giving the assistance is in the best interests of the company’.²⁹

The relevant part of s 76 of the New Zealand Act reads as follows:

- ‘(2) A company may give financial assistance . . . if the board has previously resolved that —
- (a) The company should provide the assistance; and
 - (b) Giving the assistance is in the best interests of the company; and
 - (c) The terms and conditions under which the assistance is given are fair and reasonable to the company.
- (3) The resolution must set out in full the grounds for the directors’ conclusions.’

²⁷ New Zealand Companies Act, 1993.

²⁸ Section 76(2)(c).

²⁹ Section 76(2)(b).

The fact that the 'fair and reasonable terms' requirement in the New Zealand Act is preceded by the requirement that the assistance must also be in the best interests of the company provides some context for the phrase which we do not currently have (there is, of course, no 'best interests of the company' requirement in the Act). One can reason that while 'best interests' is aimed at protecting the shareholders of the company, 'fair and reasonable terms' is possibly aimed at protecting its creditors. However, this raises the question whether, in our interpretation of the phrase, we must assume that the drafters have intentionally omitted the 'best interests' requirement from the South African legislation. If so, does this mean that 'fair and reasonable' is intended to serve as a protection mechanism for both creditors and shareholders or that the focus here is on the protection of creditors rather than shareholders of the company?

By way of analogy, it is interesting to note that s 60(3) of the New Zealand Companies Act requires that a general offer by a company to acquire its own shares may be made only if the board has resolved that the acquisition is in the best interests of the company and that the terms and price of the offer are fair and reasonable to the company. In relation to this requirement and to the requirements in relation to financial assistance (which also include, in the current context, a board resolution that giving the assistance is of benefit to those shareholders not receiving the assistance and that the terms and conditions under which the assistance is given are fair and reasonable to those shareholders not receiving the assistance), a New Zealand author³⁰ has commented as follows:

'In exercising the power to repurchase the shares of a company, directors of the company must do so in good faith, and in what each director considers to be in the best interests of the company, as required by the duty of loyalty imposed on each director by the 1993 Act. An interesting issue is whether the duty of loyalty subsumes the requirements of s 60(3) [this subsection includes the best interests and fair and reasonable requirements] . . . In large part it probably does so.'

With respect to the financial assistance requirements Jones states:

'As with the power of the board to repurchase shares, the directors of a company in exercising the power to provide financial assistance must do so in what each director considers to be the best interests of the company, as required by the duty of loyalty imposed on each director by the 1993 Act. It is difficult to give guidance to directors in these circumstances as to what additional considerations are required of them to be satisfied that the assistance is of benefit to shareholders not receiving the assistance and the terms and conditions of the assistance are fair and reasonable to those shareholders. The better view is that if the directors satisfy the duty of loyalty in resolving to give the financial assistance, then they will probably satisfy these additional requirements.'³¹

³⁰ David O Jones *Company Law in New Zealand — A Guide to the Companies Act 1993* (1993) 34.

³¹ Ibid.

The directors' duty of loyalty to which the author refers is the duty contained in s 131(1) of the New Zealand Act which requires a director to act in good faith in what the director believes to be in the best interests of the company which, according to Jones, preserves the common-law duty of loyalty.³² The South African Act, in s 91(1)(b), also spells out the duty of a director to 'act honestly and in good faith, and in a manner the director reasonably believes to be in the best interests of, and for the benefit of, the company'. It seems therefore that in the South African context one could possibly make the same statement in relation to the interplay between directors' duties and what is required of the board under s 44 of the Act — if a director satisfies the requirements of s 91(1)(b) in deciding whether to grant financial assistance, he or she will probably satisfy any additional requirements posed by s 44. If this is correct, the only rationale for the inclusion of the 'fair and reasonable' criterion in s 44(3)(b)(ii) seems to be the possible liability of a director to the company or its shareholders created in s 44(6) of the Act.

It is interesting that the same 'fair and reasonable' requirement appeared in s 45, which deals with loans or other financial assistance to directors, and was included in the 2007 Bill but deleted from the Act in terms of the amendments agreed to and made by the Portfolio Committee, probably at least partly as a result of the public comments received in this regard. It is not clear why the two sections were dealt with differently.

(i) *Specific exemptions*

Apart from meeting the solvency and liquidity requirements to the satisfaction of the board, in order for the financial assistance to be legally valid, any relevant conditions or restrictions set out in the Memorandum of Incorporation must be satisfied and the financial assistance must either be pursuant to a s 97 employee share scheme, or pursuant to a special resolution adopted within the previous two years which approved such assistance for a specific recipient or generally for a category of potential recipients (and the specific recipient falls within that category).

The part of this section which may prove to be problematic is the resolution approving financial assistance generally for a category of potential recipients. Needless to say, this requirement will have administrative and cost implications for companies (especially large public companies and listed companies). A pragmatic board may therefore decide to propose a suitably drafted resolution at, for example, the annual general meeting every two years. The question then arises whether a category or categories of potential recipients may be so widely framed so as effectively to give the board the discretion as to whether to provide the assistance or not without consulting the shareholders again. So, for example, would it satisfy the requirements of the section if the shareholders resolve that the company may provide

³² Ibid.

financial assistance to any person if, in the opinion of the directors, the provision of such financial assistance would serve to further the BEE objectives of the company? This possibility would largely remove the protection ostensibly afforded to shareholders by the resolution requirement because in these circumstances the board will be able to provide financial assistance without obtaining shareholder approval. However, there is nothing which appears from the section which militates against such an interpretation, nor is there anything in the Act which prevents the passing of a number of such 'boilerplate' resolutions, widely framed, in respect of a number of different categories of recipients every two years as a matter of course. It is to be noted that the previous version of this section as contained in the 2007 Bill provided for an identical resolution to be valid for a period of five years, so the reduced period represents improved protection in at least this respect.

It is also interesting to note that two of the specifically exempted actions contained in the 1973 Act at present, namely the making of loans to bona fide employees³³ and the provision of financial assistance for the acquisition of shares in a company by the company or its subsidiary,³⁴ have not been repeated in the Act. In these circumstances, a company will therefore have to comply with the general requirements of a special resolution and liquidity and solvency as well as the 'fair and reasonable' determination, which makes the requirements more onerous than they are at present.

(j) *Effect of contravention of s 44 on transaction*

Section 44(5) of the Act explicitly states that a board decision or agreement to provide financial assistance is void to the extent that the provision of that assistance would be inconsistent either with s 44 or with any conditions or restrictions respecting³⁵ the granting of financial assistance set out in the Memorandum of Incorporation of the company. This provides welcome clarification and certainty on the status of resolutions or agreements which contravene the financial assistance section. It is not clear from the wording of s 38 of the 1973 Act that this is the effect of a contravention of the prohibition. Of course, the courts have consistently treated a transaction which falls foul of s 38 in this manner.³⁶ An agreement in terms of which a company agrees to give financial assistance for the purchase of its own shares is null and void ab initio and unenforceable.³⁷ However, this is the first time it has been specifically stated in the legislation and puts paid to any potential argument that an agreement for the giving of financial assistance within the meaning of the section is not void although the actual giving of the assistance

³³ Section 38(2)(c).

³⁴ Section 38(2)(d).

³⁵ Presumably the intended wording was 'in respect of'.

³⁶ *Lipschitz NO v UDC Bank Ltd* 1979 (1) SA 789 (A).

³⁷ *Ibid* at 802B-803C.

would be hit by the section.³⁸ Unfortunately, this aspect is somewhat confused by the provisions of s 218(1), which appears under the part in the Act entitled ‘Miscellaneous matters’ and which provides:

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

This raises questions regarding the status and effect of the court’s ruling made in terms of s 218. Presumably it is not the declaration of the court that actually makes the prohibited transaction void. The effect of the inclusion of s 44(5) is that in law the transaction is automatically void *ab initio* by operation of law. What then is the effect of the declaration of the court? If it merely serves to confirm the existing legal position, ie that factually s 44 has been contravened and that therefore the transaction is struck by s 44(5), it is difficult to see why the legislature has deemed it necessary to include this provision in the Act as this has been the legal position all along. Assuming that there is an identifiable rationale behind the insertion of s 218 and that it somehow changes the natural legal consequences of a legislative provision providing for voidness, does this imply that the court has a discretion (for example, for reasons of public policy or if it deems a specific s 44 transaction to be in the best interests of the company) to elect not to declare the affected transaction void? If this is the case it would seem that it is the actual declaration of the court which brings about voidness and not the provisions of s 44(5), in which case the legislature should perhaps have omitted the latter provision altogether or, alternatively, drafted it so as to correspond with the effect of s 218.

From a comparative perspective, it is interesting to note that in order to deal with prohibitions contained in the Competition Act (‘the Competition Act’),³⁹ s 65 thereof provides:

‘65. Civil actions and jurisdiction. — (1) Nothing in *this Act* renders void a provision of an agreement that, in terms of *this Act*, is prohibited or may be declared void, unless the Competition Tribunal or Competition Appeal Court declares that provision to be void.’

However, a comparable provision in the Consumer Protection Act (‘Consumer Protection Act’)⁴⁰ has the opposite effect. Section 115 states:

‘Civil actions and jurisdiction

115. (1) If an agreement, provision of an agreement, or a notice to which a transaction or agreement is purported to be subject, has been declared by a provision of this Act to be void, that agreement, provision or notice must be regarded as having been of no force or effect at any time, unless a court has

³⁸ This was held to be the case in *Victor Battery Co Ltd v Curry's Ltd* 1946 Ch 242, but this approach seems since to have fallen into disfavour in England and elsewhere.

³⁹ Act 89 of 1998.

⁴⁰ Act 68 of 2008.

declared that the relevant provision of this Act does not apply to the impugned agreement, provision or notice.’

It is submitted that the approach adopted in the Consumer Protection Act is preferable to the approach taken by the drafters of the Competition Act and the Act as it provides greater legal certainty. Furthermore, it does not deprive the court of its power to adopt a more flexible approach should the circumstances require and to rule that an act or agreement is valid notwithstanding the fact that it constitutes a transgression of a particular legislative provision.

It is to be noted that, in terms of s 77(3)(e) of the Act, directors only become liable for loss or damage sustained by a company as a result of a s 44 contravention if, and to the extent that, the resolution or agreement has been declared void in terms of s 218(1). The cross-referencing required to navigate between these sections is quite extensive and it may have been preferable for the drafters to repeat certain subsections rather than to keep the Act as short as possible but sacrifice simplicity and accessibility in the process.

The fact that s 44(5) provides that a board resolution or agreement to provide financial assistance is void to the extent that the provision of that assistance would be inconsistent with the section or a prohibition, condition or requirement contained in the company’s Memorandum of Incorporation, also raises the issue of severability. To the extent that certain elements or provisions of an agreement or resolution do not contravene s 44, these will therefore be and remain valid and enforceable. The section does not state that the remaining elements or provisions must be legally severable from the void portions of the agreement in order to remain, but it is submitted that this should be inferred as the most sensible approach as it accords with the principles of contract law. However, a board of directors which intends a resolution or agreement to operate either as an indivisible whole or not at all would be well advised to provide specifically for this in drafting the resolution or agreement if even the remotest possibility exists that the transaction in question may contravene s 44.

A further interesting aspect of the Act is the inclusion of a type of statutory Turquand rule in s 20(7) and (8). The Turquand rule is a rule of common law⁴¹ which is generally expressed by saying that a person dealing with a company in good faith is entitled to assume that all internal formalities or acts of management have been duly performed and carried out by the company. The relevant provisions of the Act provide:

- ‘(7) A person dealing with a company in good faith, other than a director, prescribed officer or shareholder of the company, is entitled to presume that the company, in making any decision in the exercise of its powers, has complied with all of the formal and procedural requirements in terms of this Act, its Memorandum of Incorporation and any rules of the company unless, in the circumstances, the person knew or reasonably ought to have

⁴¹ *Royal British Bank v Turquand* (1855) 5 E and B 248; affirmed (1856) 6 E and B 327; [1843-60] All ER Rep 435.

known of any failure by the company to comply with any such requirement.

- (8) Subsection (7) must be construed concurrently with, and not in substitution for, any relevant common-law principle relating to the presumed validity of the actions of a company in the exercise of its powers.’

To illustrate by way of an example, this implies that where a company contracts to provide financial assistance to a third party to enable that third party to acquire shares in the company and the board of directors has failed to satisfy itself, as required by s 44(3)(b)(ii) of the Act, that ‘the terms under which the assistance is proposed to be given are fair and reasonable to the company’, or the board has agreed to provide financial assistance in conflict with conditions or restrictions in respect of the granting of financial assistance (as set out in the Memorandum of Incorporation of the company), the third party is protected and can presume that the company has complied with all the formal and procedural requirements of the legislation. (Note that once the third party becomes a shareholder⁴² in terms of the Act, he loses the protection of s 20(7).)⁴³

Section 44(5) of the Act explicitly states that a board decision or agreement to provide financial assistance is void to the extent that the provision of that assistance would be inconsistent either with s 4 or with any conditions or restrictions regarding the granting of financial assistance in the Memorandum of Incorporation of the company. It is not clear how s 20(7) and s 44(5) are intended to work together. If the agreement is void the third party is not protected. This confusion is compounded by the fact that although s 20(7) provides that the third party may presume compliance with the Act, it does not specify what the legal effect of this presumption is on the validity of the transaction in question. Furthermore, the reference in s 20(8) to the fact that s 20(7) should be construed concurrently with ‘any common-law principle relating to the presumed validity of the actions of a company in the exercise of its powers’ is puzzling. The relevant common-law principle which springs to mind is the doctrine of estoppel, but it is hard to fathom why it would be necessary to prove estoppel when it is far easier to use s 20(7) and hence why (and how) these constructs would be used in conjunction with one another.

⁴² In s 1 of the Act ‘shareholder’ is defined as ‘the holder of a share issued by a company and who is entered as such in the certificated or uncertificated company register, as the case may be.’

⁴³ Thus it is fair to state that the problem sketched in the example is self-limiting. There will come a point in the third party’s dealings with the company when he is no longer entitled to presume that the company has complied with all the formal and procedural requirements of the Act. However, at the time that he initially deals with the company (and when the board must consider the terms of the assistance), he is an ordinary third party who is not privy to the internal workings of the company. This raises the question whether, when he in fact does become a shareholder, he is deemed to have knowledge of whether company decisions prior to his becoming a shareholder complied with the Act or the Memorandum of Incorporation in the manner contemplated or not, ie does he lose the protection of s 20(7) retrospectively?

It also raises the question whether the application of the Turquand rule under common law is excluded by the statutory provision or whether, under s 20(8), it could be used instead of or in conjunction with s 20(7),⁴⁴ notwithstanding the apparent negation of the doctrine of constructive notice by s 19.⁴⁵ Unfortunately a detailed examination of these sections and their impact on the common law is beyond the scope of this article.

(k) *Criminal consequences*

The 1973 Act makes a contravention of s 38 a criminal offence.⁴⁶ Section 44 of the Act, on the other hand, contains no criminal liability provision. A punitive sanction that appears possible is a fine of an administrative nature flowing from a failure to comply with a compliance notice issued by the Companies and Intellectual Property Commission established in terms of s 185 of the Act.⁴⁷ An administrative fine can be imposed by the court in an amount not exceeding the greater of 10 per cent of the respondent's annual turnover during the preceding financial year and an amount to be prescribed by the Minister by way of regulation subject to a maximum fine of R1 000 000.⁴⁸ It is submitted that, although the decriminalization of company legislation in many respects is an appropriate and positive development, the threat of potential criminal liability for directors was an effective deterrent in certain contexts and the criminal liability provision should have been retained for the purposes of sections such as this one. Commercially, the potential gain to be made by a company or individuals where financial assistance is provided otherwise than in accordance with the section, may well exceed the maximum administrative fine and if the criminal sanction has been removed this means there is less legal imperative for compliance,

⁴⁴ Section 20(7) and (8) should be read with s 19(4) and (5), which provides:

- '(4) Subject to subsection (5), a person must not be regarded as having received notice or knowledge of the contents of any document relating to a company merely because the document —
 - (a) has been filed; or
 - (b) is accessible for inspection at an office of the company.
- (5) A person must be regarded as having received notice and knowledge of —
 - (a) any provision of a company's Memorandum of Incorporation contemplated in section 15(2)(b) if the company's Notice of Incorporation or a Notice of Amendment has drawn attention to the provision, as contemplated in section 13(3); or
 - (b) the effect of subsection (3) on a personal liability company.'

⁴⁵ This approach seems to indicate that the drafters rejected the idea of the modern formulation of the Turquand rule as an extension of the doctrine of estoppel. The modern formulation holds that all the rule does is to temper the doctrine of constructive notice. The rule simply prevents the company from arguing that a third party is precluded from relying on estoppel due to its deemed knowledge of the internal requirement in question. See in this regard Blackman *op cit* note 16 vol 1 at 4-46 to 4-49.

⁴⁶ See s 38(3) of the 1973 Act.

⁴⁷ See s 171 of the Act.

⁴⁸ See s 175(1) of the Act.

especially if, as discussed above, it is not the contravention of the legislation but the court ruling which renders the tainted transaction void. The constitutionality of the administrative fine may be questionable, but a discussion of this issue is unfortunately beyond the scope of this article.

(l) *Liability of directors*

Section 38 of the 1973 Act imposes no civil liability on the directors of a company responsible for a contravention of s 38 by the company. This hiatus is filled in the Act by s 44(6) read with s 77(3)(e)(iv).

The relevant sections provide that a director is liable for any loss, damages or costs sustained by the company as a direct or indirect consequence of the director having been present at a meeting, or participated in the making of a decision adopted by written consent of a majority of the directors, and failing to vote against the provision of financial assistance as contemplated in s 44, despite knowing that the provision of such financial assistance was inconsistent with the requirements of the section, to the extent that the resolution or agreement has been declared void in terms of s 44(5) read with s 218(1). Thus subjective knowledge on the part of the director seems to be a requirement. This can be contrasted with s 77(4)(a), which deals with the liability of a director who has failed to vote against a distribution in contravention of s 46. In terms of that section, liability arises only if the company does not satisfy the liquidity and solvency test and 'it was unreasonable at the time of the decision to conclude that the company would satisfy the liquidity and solvency test' — clearly an objective test. The reason for the discrepancy between these sections is not apparent, but the effect is arguably to make it more difficult to hold a director liable for a contravention of s 44 than s 45.

Section 77(7) provides that proceedings to recover any loss, damages or costs for which a person is or may be held liable in terms of the section may not be commenced more than three years after the act or omission that gave rise to the liability. This therefore constitutes a type of statute of limitations provision as far as actions against directors and prescribed officers of a company are concerned. It is interesting to note the difference between the wording of this subsection and the provision of the Prescription Act,⁴⁹ which states that the three-year prescription period for extinction of a debt shall begin to run as soon as the debt is due and that a debt shall not be deemed to be due until the creditor has knowledge of the identity of the debtor and of the facts from which the debt arises.⁵⁰ It is therefore quite conceivable that the commencement dates of the three-year period in terms of these two pieces of legislation may be different and it is not clear which would prevail in the event of such conflict.

The confusion regarding the voidness of a transaction contravening s 44 referred to above also continues in this section. In terms of s 77(3)(e)(iv) it

⁴⁹ Act 68 of 1969.

⁵⁰ Section 12.

appears that the directors' liability only arises once the relevant resolution or agreement has been declared void, yet the three-year prescription period runs from the date of the act or omission that gave rise to the liability. Are we to understand from this that the taking of a prohibited resolution marks the beginning of the three-year period but that the liability attached to that transgression only arises once the court has declared the resolution void, ie possibly three years or more (depending on the length of the case) after the act occurred? How does this interact with the potential common-law liability based on the directors' duties of care and skill in a prohibited act of this nature — does liability arise at the time of the act (as one would expect and as seems to be the case in terms of s 77(2)(a)), which would mean that this occurs at a different point in time than the statutory liability? Does common-law liability still exist in this context irrespective of whether the act which gives rise to such liability is ultimately declared void in terms of s 77(3)(e)(iv) or not? Finally, it would seem that the simplest way for a director to avoid liability in terms of this section would be not to attend the meeting or participate in the making of the decision at all if he or she is uncertain whether the requirements of s 44 will be complied with or not, or if he or she would prefer not to vote against a particular resolution for political reasons.

Section 40(4) of the 2007 Bill imposed liability on the director responsible for the contravention to compensate not only the company but also any shareholder for any loss, damages or costs that the shareholder may have sustained or incurred in relation to the transaction. It was unclear whether this meant that a shareholder could bring an action based on a drop in the value of his or her shares brought about by the contravention. Furthermore, the meaning of s 40(4)(i)(b) was unclear. The provision stated that a director 'may be held as responsible as the company, in terms of this Act, for the contravention'. There was no indication of what responsibility of the company the provision was referring to. In the Act s 44 is silent on the issue. However, s 20(6) states:

- '(6) Each shareholder of a company has a claim for damages against any person who causes the company to do anything inconsistent with —
 - (a) this Act; or
 - (b) a limitation, restriction or qualification contemplated in this section, unless that action has been ratified by the shareholders in terms of subsection (2).'

This presumably means that a shareholder has a claim for damages against a director who causes the company to provide financial assistance in a manner inconsistent with the provisions of s 44. In addition s 218(2) states:

- '(2) Any person who contravenes any provision of this Act is liable to any other person for any loss or damage suffered by that person as a result of that contravention.'

This constitutes grounds for a claim against a director for a s 44 contravention but also once again raises the question of whether a shareholder could

bring an action based on a drop in the value of his or her shares brought about by the contravention.

It is unfortunate that liability is not extended to the directors of the holding company of the company contravening the section. After all, they are usually the main culprits. Section 86 of the 1973 Act extends liability to the responsible directors of a company's holding company where there has been a buy-back of the company's shares contrary to the solvency and liquidity requirements of s 85(4) of the Act. If such an extension is appropriate in those circumstances, why not also in the 'financial assistance' scenario? It is noteworthy that the Act does not extend liability to the directors of the holding company in the buy-back situation,⁵¹ a position that should also be rectified.

IV SOLVENCY AND LIQUIDITY TEST

In terms of s 38(2)(2A) introduced by the CLAA into the 1973 Act, it appears that the enquiry as to whether or not the solvency and liquidity test is satisfied is a subjective enquiry. As long as the particular board is satisfied with the solvency and liquidity of the company, that will suffice. It is not necessary that a reasonable person would have been satisfied. This may be contrasted with the requirement for buy-backs⁵² and 'payments' to shareholders⁵³ in the 1973 Act that there must be 'reasonable grounds for believing that' the company is solvent and liquid. The Act is stricter: s 44 provides that the board may not authorize any financial assistance unless it is satisfied that 'the company would satisfy the solvency and liquidity test': s 46 of the Act provides that no 'distribution', which includes a buy-back,⁵⁴ may be made by a company unless 'it reasonably appears that the company will satisfy the solvency and liquidity test'.⁵⁵ It appears that the test for financial assistance is only satisfied if the company is *actually* solvent and liquid and whether or not the board or a reasonable person is satisfied that it is solvent and liquid (as is the case with a distribution) is irrelevant. Section 4(1), on the other hand, provides that for the purposes of the Act a company is liquid and solvent if, 'considering all the reasonably foreseeable financial circumstances of the company at that time', its assets exceed its liabilities and it is able to pay its debt as they become due in the ordinary course of business. There seems to be no justification for the different solvency and liquidity requirements; they are confusing and an overall objective reasonableness test appears to be the most appropriate.

In terms of s 44(3)(b)(i), the board must be satisfied that 'immediately after giving the financial assistance' the company would be in compliance with the solvency and liquidity test. What is the significance of the words 'immedi-

⁵¹ Section 46(6).

⁵² Section 85(4).

⁵³ Section 90.

⁵⁴ See definition of 'distribution' in s 1 of the Act.

⁵⁵ Section 46(1)(b).

ately after'? This differs substantially from the wording in the 1973 Act relating to the time period of application of the solvency and liquidity test. In the 1973 Act the test is whether the company's board is satisfied that 'subsequent to the transaction', the consolidated assets of the company fairly valued will be more than its consolidated liabilities; and '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. This apparently attracted much public comment and criticism due to the fact that a possible interpretation of these words implied that a company had to be solvent and liquid after the transaction and remain liquid for the duration thereof, ie for as long as it takes for the transaction to be finalized or completed. The liquidity could conceivably (depending on the legal structuring and timing of the transaction) be expected to endure for a number of years, something which would be practically impossible for the board of the company to predict and/or satisfy itself of. Presumably the amendment of this part of the section (by the introduction in s 44 of a requirement that the board need only satisfy itself that 'immediately after giving the financial assistance' the company will be liquid and solvent) is a result of those comments and it effectively solves the problematic application of 'duration of the transaction'.

However, the current drafting introduces its own interpretation problems. It may be possible to argue that, because s 44(b)(i) provides that a company must be solvent immediately after giving the financial assistance, it is permissible and acceptable for it to be insolvent shortly thereafter and still properly provide the assistance.⁵⁶ This interpretation problem does not arise in relation to liquidity, as s 4 of the Act enjoins those considering the liquidity of a company to consider whether it appears that the company will be able to pay its debts as they become due in the ordinary course of business for a period of twelve months after the date on which the test is considered.

It is noteworthy that, in applying the solvency test to a distribution, the Act expressly states that unless the Memorandum of Incorporation of the company provides otherwise, the preferential rights of preference shareholders upon liquidation are not to be treated as liabilities.⁵⁷ Thus the test fails to protect the interests of preference shareholders and consequently undermines their rights. Section 4 is silent with regard to the preferential rights of preference shareholders when the solvency requirement is applied and there is nothing in the s 44 scenario which provides protection for preference shareholders either.⁵⁸ The rights of preference shareholders while the

⁵⁶ Note, however, that the wording of this provision is contradicted by s 4(1), which provides that for the purposes of the Act a company satisfies the liquidity and solvency test at a particular time, if, 'considering all the reasonably foreseeable financial circumstances of the company at that time', it is solvent and liquid.

⁵⁷ Section 4(2)(c).

⁵⁸ See Blackman *op cit* note 16 vol 1 Revision Service 3 at 5-70, where the view is taken that s 85 of the 1973 Act, which deals with buy-backs and which is silent with

company is a going concern (ie other than upon liquidation), such as preferential dividend rights, are not addressed at all and it would seem that here, too, preference shareholders are therefore unprotected.

5 CONCLUSION

The new s 44 represents a distinct change in the legislative approach regarding financial assistance and can now more correctly be described as the regulation (rather than the prohibition) of financial assistance by a company for the subscription or purchase of its securities. This is, of course, partly as a result of the shift to a liquidity and solvency regime for the protection of shareholders and creditors. As regulation invariably requires more legislative direction than prohibition, the additional provisions necessary to regulate the implementation of the section will no doubt occasion a host of new legal issues to be dealt with by the legislature and the courts (not that the lawyers will complain!). Although certain areas can immediately be identified as requiring further clarity or explanation and drafting improvement is always possible, this is a complex area of our law and the feasibility and efficiency of the section will only be truly tested once it finds application in commercial transactions.

regard to whether preference shareholders are to be considered when applying the solvency test, does not protect the rights of preference shareholders.