



Only Study Guide for

MRL2601

Entrepreneurial Law

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LESSON 0:

Introduction and purpose of this module

WHAT THIS MODULE IS ALL ABOUT

In this module, we teach you about the main South African business forms. You will see that each business form has its own particular requirements in terms of membership and how it is constituted. There are also specific consequences attached to each business form.

Every would-be entrepreneur needs to consider the advantages and disadvantages of the various business forms in order to decide which one will best suit the commercial needs of the specific business he or she has in mind. You will learn how to advise such a person, considering the relevant legislation, the common law principles, and appropriate case law.

Our focus is on profit-oriented businesses. You are exposed to the law applicable to companies, partnerships, trusts, and close corporations. On completion of this module, you should have background knowledge of the legal principles governing the main business forms in South Africa. In addition, you should be able to apply the legal principles and solve practical problems that may arise within the context of these business forms.

As it is most important that you should be able to research a topic, analyse legal principles, and formulate logical arguments, you are expected to find and read a few court cases. This will help you to solve defined problems in practice.

You must study the general information in the lessons and read the prescribed sections in the textbook. We suggest that you first read the content of the lesson to provide you with an overview. The next step is to access and read the prescribed **legislation** under that heading. This can be done by reading the prescribed section in the textbook and/or the legislation itself. The textbook is often easier to study than the legislation.

The legislation is discussed and some excerpts from, and references to, cases are included in the lessons. You are only required to know and be able to refer to the case law to the extent that it is discussed here. Therefore, you will not be penalised if you are unable to access the case law that is discussed herein.

Activities are not included in the lessons. You should attempt to do the activities for the different learning units as provided under **Additional Resources** on the MRL2601 MyModule site, as well as in the discussions of the relevant themes in the discussion forum.

WHY YOU NEED TO READ CASE LAW

To make the module more practice-oriented and to ensure that it remains relevant and up to date, we have included case law. The cases that are mentioned in this guide under the respective topics need not be accessed and read. You only need to know the contents of a case to the extent that it is discussed in the lessons.

If you study case law, you will better understand the application of the legislation. It will further enhance the knowledge you acquire from the guide. The law will “come alive”, as case law is the application of the legislation. If you understand the court’s reasoning for arriving at a specific judgment, you should be able to apply the law to practical problems. The more case law you read, the easier it becomes to make sense of it. You will become aware of the relevant issues and the basis for the court’s decision sooner. You will also be able to apply the law to facts much like a judge would do in a court case.

When reading case law, it will become apparent that many cases deal with more than one aspect of the law. This is also common in practice. Reading legislation will make this clear to you. You will become capable of identifying various possible topics under a single set of facts.

The best way to test your knowledge is to think of practical scenarios and then apply the law to them. The best source of practical scenarios is case law.

In this module, we have summarised the principles that you must study. However, it is important that you can access the information yourself. Although accessing and studying the full case is optional for this module, it is advantageous to know how to use case law in practice.

When you do research on a specific legal topic, you always need to refer to relevant legislation first. This is your main source.

To see how the legislation has been applied, you should investigate case law.

Basic guidelines for the effective study of case law

- (1) Read the entire case.
- (2) Identify the key issues (there is usually more than one topic covered in a case). You need to investigate each issue by following the guidelines below.
- (3) Consider the relevant legislation, the common law, and, possibly, the influence of the Constitution, 1996, on each topic.

Determine what the relevant legislation is by answering the following questions:

- (a) Which facts did the court consider as relevant in the decision dealing with this specific aspect?
 - (b) Which common law principles (if any) and legislative principles did the court consider in order to make the decision? (The court can consider the common law and legislation, as well as international law.)
 - (c) Why did the court apply the sources as mentioned in (b)?
 - (d) How did the court apply the sources in (b) to the issues you identified in (a)?
 - (e) Did the court apply the sources in (b) correctly to the issues identified in (a)?
 - (f) If not, why not? Here you may substantiate your answer by referring to similar, relevant case law.
- (4) Study the facts so that you understand how the law was interpreted and applied to the specific set of facts.
 - (5) Read the decision carefully so you understand the presiding officer’s reasoning for the decision. The decision is the justification for the interpretation of the relevant legal principle. It is important that you understand the *ratio decidendi* (reasoning for the decision), as it forms the argument you would use in answering a factual problem.

We trust that you will enjoy studying this module and that you will find the knowledge you gain in the process to be of great value.

COMPANIES

IMPORTANT SECTIONS OF LEGISLATION:

COMPANIES ACT 71 OF 2008:

Section 1	–	Definitions
Section 4	–	Solvency and liquidity test
Section 7	–	Purposes of the Companies Act
Section 8	–	Categories of companies
Section 13	–	Right to incorporate a company
Section 14	–	Registration of a company
Section 15	–	Memorandum of Incorporation, shareholder agreements and rules of company
Section 16	–	Amending Memorandum of Incorporation
Section 19(1)	–	Legal status of companies
Section 19(3)	–	Personal liability companies
Section 19(4) & 19(5)	–	Abolishing the doctrine of constructive notice and exceptions
Section 20	–	Validity of company actions
Section 20(7)	–	Statutory <i>Turquand</i> rule
Section 20(9)	–	Abuse of juristic personality
Section 21	–	Pre-incorporation contracts
Section 38	–	Issuing shares
Section 44	–	Financial assistance for subscription of securities
Section 46	–	Distributions must be authorised by the board
Section 48	–	Acquisition of company's own shares
Section 57	–	Expanded definition of “shareholder” – Part F of Chapter 2
Section 58	–	Shareholder right to be represented by proxy
Section 60	–	Shareholders acting other than at meeting
Section 61	–	Shareholders' meetings
Section 62	–	Notice of meetings
Section 64	–	Meeting quorum and adjournment
Section 65	–	Shareholder resolutions
Section 66	–	Consent to serve as a director required for appointment
Section 67	–	First director or directors
Section 69	–	Ineligibility and disqualification of persons to be director
Section 71	–	Removal of directors
Section 76	–	Standards of directors' conduct
Section 76(4)	–	Business judgment rule
Section 77	–	Liability of directors and prescribed officers

Section 78	–	Indemnification and directors' insurance
Section 90	–	Appointment of auditor
Section 91	–	Resignation of auditors and vacancies
Section 92	–	Rotation of auditors
Section 93	–	Rights and restricted functions of auditors
Section 94	–	Audit committees
Section 158	–	Remedies to promote the purpose of the Act
Section 160	–	Disputes concerning reservation or registration of company names
Section 161	–	Application to protect rights of securities holders
Section 162	–	Application to declare director delinquent or under probation
Section 163	–	Relief from oppressive or prejudicial conduct
Section 164	–	Dissenting shareholders' appraisal rights
Section 165	–	Derivative actions
Section 166	–	Alternative dispute resolution
Schedule 1	–	Non-profit companies
Schedule 2	–	Conversion of close corporations to companies

CLOSE CORPORATIONS ACT 69 OF 1984:

Section 65	–	Abuse of separate juristic personality of corporation
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INTRODUCTION

The **Companies Act 71 of 2008 (hereinafter the “Companies Act”)** came into force on 1 May 2011. It repealed and replaced the Companies Act 61 of 1973, except for Chapter 14 of the Companies Act of 1973, which will continue to regulate the winding-up of insolvent companies. (The winding-up of companies is not included in the prescribed work for this module.)

Although **we only deal with the provisions of the Companies Act as amended and not those of its predecessor, the Companies Act 61 of 1973**, some principles of our **common law** continue to apply to the extent that these principles have not been repealed by the Companies Act. Our common law is featured mainly in decided cases of the High Court, the Supreme Court of Appeal, and the Constitutional Court. The Companies Act is not a complete codification of our company law. Although the common law will continue to develop under the Companies Act, some important concepts have already been clarified by our courts.

The common law features in many of the topics dealt with in the company law component of the course:

- (1) The common law is applicable in the discussion concerning agency and representation.
- (2) The common law duties of directors remain applicable.
- (3) The concept of piercing the corporate veil is a common law concept.
- (4) Common law alternatives to concluding pre-incorporation contracts still apply.
- (5) The common law *Turquand* rule has not been repealed.
- (6) Shareholders can still use the common law personal action and representative action to enforce their rights. Only the derivative action that previously existed in common law has now been expressly abolished.

Also read chapter 1 of the prescribed textbook, which provides an overview of the purposes of company law reform and highlights new concepts and entities that have been adopted.

LESSON 1:

The impact of the Constitution and Globalisation on Entrepreneurial Law

1 Introduction

The values and beliefs that govern the running of business operations are based on constitutional values and principles and often reflect African values that comprises the concept of ubuntu. Corporate law and the law regulating other forms of business enterprises, at first glance, is a technical commercial subject based mainly on statute. However, upon scrutiny, several transformation values are reflected in the module content.

This lesson consists of examples that illustrate the importance of constitutional principles and values in the interpretation and application of the law regulating different types of enterprises. The Constitution of the Republic of South Africa, 1996 ('the Constitution') and its values that also imbue values of ubuntu plays a significant role, particularly in the interpretation of legislation. Promoting these values in the development of the common law plays a pivotal role in ensuring that the law adapts to suit the community it serves. This evolving nature of law is foundational to the principle of transformative constitutionalism.

After studying this lesson, you should be able to answer the following **key questions**:

- What are the Ten Principles laid down in the UN Global Compact, and are these principles relevant to South African business?
- What African values comprise the concept of ubuntu?
- What is meant by transformative constitutionalism?
- What constitutional principles are important for purposes of South African business?
- What does 'Africanisation' mean?
- Which stakeholders are recognised as being affected by corporate behaviour underlying the concept of corporate social responsibility?
- In what ways could corporate social responsibility potentially benefit companies?
- How is corporate social responsibility reflected in the Companies Act?
- Which companies are required to appoint a Social and Ethics Committee?
- What are the functions of the Social and Ethics Committee?
- What is globalisation?
- What are the main characteristics of the modern corporate world?
- In what ways may the various business enterprises in South Africa be regarded as being global?
- In what ways does the Companies Act recognise globalisation?
- What does the *audi alteram partem*-rule entail?
- Name three cases in which the court has applied principles of ubuntu.
- Provide examples of how the law relating to different business forms is imbued by values underlying the ubuntu concept.
- What does corporate social responsibility entail?

- Explain whether it is possible to enforce the principles of ubuntu and the constitutional principles in a court of law.
- Mention examples of how the court has developed the common law to adapt to serving the community.
- Explain the test that is used by the court to determine whether it is necessary to develop the common law.
- List the pieces of legislation that have an impact on the various forms of business enterprises in South Africa.

2 The Ten Principles of the UN Global Compact

(accessible at <https://www.unglobalcompact.org/what-is-gc/mission/principles>)

The sustainability of a company is dependent on the value systems that the company adopts and the principles upon which the company is built. Companies must meet certain fundamental responsibilities insofar as human rights, labour, environment and anti-corruption is concerned. The UN adopted the Ten Principles of the UN Global Compact, which should be incorporated into company strategies, policies and procedures. The idea is to establish a culture of integrity in companies. Companies must uphold their basic responsibilities to people and planet in order to set the stage for long-term, sustainable success.

These Ten Principles are derived from the Universal Declaration of Human Rights, the International Labour Organization's Declaration on Fundamental Principles and Rights at Work, the Rio Declaration on Environment and Development, and the United Nations Convention against Corruption.

Principle 1 Businesses must support and respect the protection of internationally proclaimed human rights; and

Principle 2 ensure that they are not complicit in human rights abuses.

Principle 3 Businesses must uphold the right of freedom of association and recognise the right to collective bargaining;

Principle 4 they must eliminate all forms of forced and compulsory labour;

Principle 5 abolish child labour; and

Principle 6 eliminate discrimination in respect of employment and occupation.

Principle 7 Businesses must be mindful of their potential effects on the environment and support a precautionary approach to environmental challenges;

Principle 8 undertake initiatives to promote greater environmental responsibility; and

Principle 9 encourage the development and diffusion of environmentally-friendly technologies;

Principle 10 Businesses should work against corruption in all its forms, excluding extortion and bribery.

3 The importance of the infusion of African leadership philosophies and Constitutional values

Important terms	Meaning
Prescribed study material Textbook: Chapter 1 Constitution of the Republic of South Africa: sections 8, 9, 10, 39(2) Companies Act: sections 5, 7, 20(9), 58, 63(2), 72, 76, 162, 164, 165, 218(2) Companies Regulations: Reg 43 Close Corporations Act: section 65	
Africanisation	Renewing the focus on Africa and ensuring that teaching is adapted to African values, realities, and conditions.
Constitutional values/principles	Human rights based on democratic values and social justice.
Corporate social responsibility	A business approach that contributes to sustainable development by delivering economic, social, and environmental benefits for all stakeholders.
Globalisation	The integration of nations through the flow of goods, information, services, and capital. It is a process by which businesses develop international influence.
<i>Locus standi</i>	The right of a party to appear before a court and be heard.
Organisation for Economic Co-operation and Development 'OECD'	A group of 34 democratic member countries supporting free market economies that discuss and develop economic and social policy.
Stakeholders	Persons who can affect or be affected by a business's actions, objectives and policies, including creditors, directors, employees, government (and its agencies), owners (shareholders), suppliers, unions, and the community from which the business draws its resources.
Transformative constitutionalism	A long-term project of constitutional enactment, interpretation, and enforcement to transform the country's political, legal and social institutions and power relations in a democratic way.
Ubuntu	Ubuntu is based on the inherent belief that one is never alone, as expressed in the African idiom ' <i>Motho ke motho kabatho</i> ' ('I am because you are').

Africanisation aims to ensure that people in a particular context such as the community or family, in the case of traditional African societies, maintain sound relationships tailored to accommodate opposing views and conciliating competing interests. An inclusive approach of joint decision making in matters that affect the business as a whole is foundational to the ubuntu concept. A more horizontal approach is propagated where not all decisions are made from the top. Ubuntu means people are people through others. Ubuntu is an underlying concept of Africanism. Ubuntu comprises a set of values that finds expression in the Zulu saying '*umuntu ngumuntu ngabantu*', which means **a person is a person through other people**. Ubuntu was given explicit application in our jurisprudence in the highest court in *S v Makwanyane* 1995 (6) BCLR 665 (CC). Madala J noted that *ubuntu* advocates **social justice** and **fairness**.

In *Pharmaceutical Society of South Africa and Others v Tshabalala-Msimang and Another NNO; New Clicks South Africa (Pty) Ltd v Minister of Health and Another* 2005 3 SA 238 (SCA), at para 38, Harms JA describes ubuntu as a relationship of **mutual respect**. In similar vein, the *Koyabe and Others v Minister for Home Affairs and Others (Lawyers for Human Rights as Amicus Curiae)* 2010 (4) SA 327 (CC), Mokgoro J associated ubuntu with a general obligation to treat people with respect and dignity, to avoid undue confrontation and to give reasons for administrative decisions.

The second report issued by the Institute of Directors of South Africa, the *King Report on Corporate Governance*, 2002, first canvassed the notion of introducing African business values to be applied in South Africa, which is now summarised as 'ubuntu'. Although certain universal principles will always be applied in decision making in business, ubuntu has become an important principle which also permeates the latest King Report on Corporate Governance, 2016 ('King IV'). The importance of ubuntu in the South African context is recognised where it states that 'the common purpose of all human endeavours, individual or corporate, should be that of service to humanity' (King IV 24).

South African Broadcasting Corporation Ltd and Another v Mpofu [2009] 4 All SA 169 (GSJ) ('Mpofu') Victor J (with Jajbhay J and Horn J concurring), considered the importance of sound corporate governance, and leadership qualities of directors. The court held that the Constitution recognises the importance particularly in respect of state-owned companies that fall within the definition of "'organ of state'" in section 195. This section deals with basic values and principles governing public administration. It requires a high standard of professional ethics that must be promoted and maintained (*Mpofu* para 55).

The court in *Mpofu* stressed that African leadership philosophy and values must be applied so as to 'emerge from the past of subjugation and exploitation' that are remnants of the historical impact of slavery and colonialism, imperialism, and globalisation on the continent of Africa. Sound leadership is the catalyst for positive transformation (para 61).

In *Dikoko v Mokhatla* 2006 (6) SA 235 (CC), Sachs J expressed that *ubuntu-botho* is not only window-dressing that should be 'invoked from time to time to add a gracious and affirmative gloss to a legal finding already arrived at. It is foundational to our constitutional culture of reconciliation and bridge-building to overcome and transcend the devastating remnant effects of past divisions in South Africa' (See *Azanian People's Organisation (AZAPO) and others v President of the Republic of South Africa and Others* 1996 (4) SA 671 (CC) para 48 for a description of the historic inequities). Ubuntu represents 'the element of **human solidarity** that binds together liberty and equality'. It supports and adds to the fundamental rights in the Constitution (*Mpofu* para 65). That the values of ubuntu should underlie corporate decision making is bolstered further by the finding of the highest court in *Port Elizabeth Municipality v Various Occupiers* 2005 (1) SA 217 (CC); 2004 (12) BCLR 1268:

The spirit of ubuntu, part of the deep cultural heritage of the majority of the population suffuses the whole constitutional order. It combines individual rights with a communitarian philosophy. It is a unifying motif of the Bill of Rights, which is nothing if not a structured, institutionalised and operational declaration in our evolving new society of the need for human interdependence, respect and concern.

One of the rules of natural justice is the ***audi alteram partem***-rule. This principle is firmly entrenched in our law. It basically means that before any judicial functionary takes a decision on a matter, both sides of the story must be heard. It originates from the natural desire of man to be fair to his fellow human beings. This principle is similar to the principle found in traditional African societies with their strong emphasis on the due observance of procedure. All members of the community must be allowed to voice their opinions when their interests are affected. The ***audi alteram partem***-principle is reflected in ubuntu. Ubuntu ultimately dictates that one has to be fair in all one's relationships, which will include being quick to listen compassionately to other people's stories and slow to pass judgment.

In summary, the values of ubuntu are embodied in the following elements that apply in business:

- The ability to show compassion
- Social justice and fairness
- Harmony and humanity
- Recognising the inter-connectedness of people and the accompanying responsibilities
- Integrity and ethical behaviour
- Open channels of communications and transparency
- Due process and sensitivity in dealings with one another

Please note! Other similar values also form part of the concept of ubuntu. This list is not a closed list.

3.1 Constitutional principles/values

Section 8(2) of the Constitution provides that the Bill of Rights binds a natural or a juristic person (like a company or close corporation) to the extent that it is applicable, considering the nature of the right and the nature of any duty imposed by the right. When applying a provision of the Bill of Rights to a natural or juristic person, to give effect to a right in the Bill of Rights, a court must apply, or, if necessary, develop the common law to the extent that legislation does not give effect to that right (section 8(3)). A court may develop the rules of the common law to limit the right, provided that the limitation is in accordance with the limitation clause contained in section 36(1) of the Constitution.

The values of ubuntu are reflected in the Constitution:

The Republic of South Africa is one, sovereign, democratic state founded on the following values:

- (a) human dignity; the achievement of equality and the advancement of human rights and freedoms. (section 1)

Ubuntu underlies the building of our constitutional democracy therefore to develop African leadership values to be applied in companies, is consistent with the constitutional values.

The values/principles of ubuntu and the constitutional values are infused in the various

aspects in the module content. However, these values are subtle, underlying values and generally not in itself a course of redress.

Examples of how the values of ubuntu are imbued in the law regulating different South African businesses:

- It is a rule in all business enterprises that the chosen name should not be offensive, racist or impinge negatively on any individual/legal person's right to dignity.
- The values of ubuntu must inform the manner in which corporate decisions are taken by directors. Proper, constructive dialogue requires the infusion of the culture of ubuntu to promote social cohesion (*Mpofu* paras 62, 64 and 66).
- One of the purposes of the Companies Act is to promote compliance with the Bill of Rights in the application of company law. The Bill of Rights is contained in Chapter 2 of the Constitution (section 7 (a)). It enshrines the rights of all people and affirms the fundamental democratic values of human dignity, equality and freedom. In addition, it regulates the relationship between economic citizens and thus may have fundamental implications for company law.
- The Companies Act also aims to "continue to provide for the creation and use of companies in a manner that enhances the economic welfare of South Africa as a partner within the global economy" (section 7 (e)).
- Directors in performing their functions in companies, must consider the interests of other stakeholders such as the community and the environment in which the company that they serve, functions.
- Directors of companies can be removed by means of an ordinary resolution – this is despite any agreement that may have been concluded to the contrary and no special resolution is required (section 71 of the Companies Act). This may appear drastic. However, the law requires that before any such action may be taken, certain requirements should be met to ensure **ubuntu** and **fairness**. Certain procedural requirements must be adhered to before a removal can be lawfully affected.
- The Companies Act also provides protection for minority shareholders. This demonstrates the element of ubuntu and requires parties to be fair to one another.
- Principles of majoritarianism feature strongly throughout the legislation. Notably, collectivity or solidarity is also an element of ubuntu.
- The Companies Act provides for a system of informal dispute resolution before the Takeover Regulation Panel where appropriate, or other accredited forums. This is similar to the African practice where a dispute is referred to a '*Kgoro*' which will attempt to resolve the matter. During this process, the *audi alteram partem*-principle is applied.
- Ubuntu is also evident in light of the fact that **humanness is promoted** in that agreements must be respected and honoured by the parties to the contract. This is evident in distinct types of contracts: partnership agreements, contracts concluded for the formation of trusts, shareholders agreements, the Memorandum of Incorporation which is the constitutive document of a company, and association agreements in close corporations. Fairness also plays a significant role in the interpretation of shareholders' agreements.
- The disclosure requirements in the Companies Act reflect the value of

transparency of ubuntu. This is also reflected in the proposals of the second amendment Bill. The Bill proposes that a remuneration report be presented annually to shareholders, containing among others, improved disclosure requirements for senior company officials as well as the remuneration ratios between the top earners of a company and the bottom earners.

- The principle of transparency which is imbued in the requirement that directors must disclose any financial interest that they have in any transaction affecting the company that they serve is part of the common law and statutory duties of directors.
 - The law attaches certain consequences to misconduct committed in different business enterprises. This reflects an element of **ubuntu** and **fairness** and supports the principle that '**one reaps what one sows**'. It clearly discourages conduct which would be to the detriment of outsiders and participants in the business. Although companies are recognised as separate legal persons, it is possible to disregard the juristic personality of a company to hold individuals inside the company liable in certain circumstances (section 20(9) of the Companies Act). Members of close corporations can also be held personally liable if their conduct constitutes an 'unconscionable abuse' of the close corporation's separate juristic personality (section 65 of the Close Corporations Act).
- The remedies provided for in the Companies Act also reflect a focus on restorative restitution rather than the imposition of criminal sanctions. This is also reflected in the amendment bill to be promulgated imminently.
- The result of apartheid was that almost all South African firms were owned and run by whites. In 1995, it was estimated that less than one per cent of the market value of the Johannesburg Stock Exchange Limited was owned by black people. Since the introduction of the Broad-based Black Economic Empowerment Act 53 of 2003 to address the level of black ownership in the country, this figure has increased to above 23% (<http://www.fin24.com/BizNews/UPDATED-JSE-says-Blacks-own-at-least-23-of-SA-equities-not-3-Mr-Zuma-20150223>).
- As a strategic attempt to curb corruption, the Protected Disclosures Act 26 of 2000 was enacted. This piece of legislation provides protection in all types of business. On top of that, section 159 of the Companies Act has introduced protection against civil, criminal, or administrative liability for making a disclosure or 'blowing the whistle' on corruption or illegal conduct in a company.
- Different persons are involved and affected by the commencement of the business rescue. One of the purposes of the Companies Act is to provide for the efficient rescue and recovery of financially distressed companies in a manner that balances the rights and interest of all relevant stakeholders (section 7(k) of the Companies Act). Business rescue proceedings recognise, among others, the interests of employees. This is the first time that stakeholders, other than the shareholder and company creditors, have received direct protection in the Companies Act.

3.2 Constitutional interpretation and development of the common law

Constitutional values play a vital role in how the court interprets and applies the legislation and develops the common law. The guidelines for proper interpretation that have been provided by the Constitutional Court dictate that when a section of the

legislation is capable of more than one construct – one being more restrictive and the other providing for a wider net of protection – the broader construct be preferred, particularly if a constitutional right is at stake. One of the golden rules of interpretation dictate that the section of the legislation should be interpreted in the context of the purpose of the legislation (See *Investigating Directorate: Serious Economic Offences & others v Hyundai Motor Distributors (Pty) Ltd and others; In Re Hyundai Motor Distributors (Pty) Ltd & others v Smit NO and others* 2001 (1) SA 545 (CC) paras 23 – 24; *NEHAWU v University of Cape Town* 2003 (2) BCLR 154 (CC) par 14; *Carmichele v Minister of Safety and Security and another (Centre for Applied Legal Studies Intervening)* 2001 (4) SA 938 (CC) para 33).

This entails consideration of policy underlying the legislation and taking cognisance of the purpose of the particular section in context of the legislation, i.e., where it is placed in the legislation. Conceivably, jurisdictional context is also important: the economic and social aspects that are unique to the country in which it operates. In the South African context, it is likely that restitutive practices of employment equity and broad-based black economic empowerment would be considered, for instance in a scenario where the court is required to evaluate whether the board of directors should be held liable for their actions in certain instances.

The court has a duty to develop the common law so that the law keeps up and remains appropriate to address the changing needs of the community it serves. **Section 39 of the Constitution** determines that the court must, when developing common law principles, promote the spirit, purport, and objects of the Bill of Rights. Our common law has evolved through centuries of feudalism, colonialism, discrimination, sexism, exploitation, and apartheid. In *Everfresh Market Virginia (Pty) Ltd v Shoprite Checkers (Pty) Ltd* 2012 (1) SA 256 (CC) the highest court considered whether the common law should be developed to require that parties to a contract should be legally required to contract with each other in good faith and on reasonable terms. Shoprite argued that good faith is too vague a concept and should not be enforceable (para 22). The court disagreed. The court noted that the development of our economy and contract law has predominantly been shaped by colonial legal tradition represented by English law, Roman law, and Roman Dutch law. The common law of contract regulates the environment within which trade and commerce take place. Its development must consider the values of the vast majority of people who can, after democratisation of the country, participate in trade and commerce. The approach followed by the majority of South Africans places a higher value on negotiating in good faith than would have prevailed under colonial legal tradition (para 24). The adaptation of the common law by infusion of constitutional values is what is meant by **transformative constitutionalism**.

Although one may be tempted to, on that basis, exclude from the curriculum, any legislation or case law pre-dating the democratisation of the Republic of South Africa. However, the court recently in *Mighty Solutions t/a Orlando Service Station v Engen Petroleum Ltd and another* 2016 (1) SA 621 (CC) cautioned that precedents from the pre-democratic era can still provide important guidance and the age of the common law is not conclusive in deciding whether a reason exists to change the common law. Lessons learned from human experience are timeless and have passed the logical and moral tests of time. In deciding whether the common law must be developed, the court must in each case determine whether the common law fails to give effect to the section 39(2) objectives, and if so, the court must decide what development would appropriately address the shortcomings (*Everfresh Market Virginia (Pty) Ltd v Shoprite Checkers (Pty) Ltd* para 30).

An example of how courts have developed the common law is discussed in Lesson 2. The court has recognised in case law that a company has several constitutional rights like a natural person. Through development of the common law, the courts have clarified that a company has the following rights:

Right	Case
Equality	<i>Manong & Associates (Pty) Ltd v City Manager, City of Cape Town & another</i>
Reputation, a good name, and honour	<i>Dhlomo v Natal Newspapers (Pty) Ltd</i>
Privacy	<i>Financial Mail (Pty) Ltd v Sage Holdings Ltd</i>
Identity	<i>University of Pretoria v Tommie Meyer Films</i>

3.3 Corporate social responsibility

Corporate governance is the system used to regulate and oversee corporate conduct to balance stakeholders' interests and the interests of others that may be influenced by the conduct. The aim is to ensure responsible behaviour while ensuring the maximum level of efficiency and profitability for a company.

Corporate social responsibility seeks to make modern companies responsible members of the community. The term 'CSR' is generally understood to mean integrating economic, social, and environmental imperatives into the company's activities while at the same time addressing shareholder and stakeholder expectations. It is based on the idea that the modern company has a wide and diverse range of stakeholders, that is, both business and socio-economic stakeholders. Broadly, corporate social responsibility means that businesses have a responsibility towards the societies in which they operate, and that this responsibility needs to be managed. It refers to the involvement of companies in social projects that help to advance the society and the community in which they operate.

Stakeholders are those who may affect or may be affected by the company's activities. So, there is a greater interdependence between companies and their stakeholders. Examples of company stakeholders include:

- shareholders
- employees, trade unions or other representatives of employees
- communities surrounding the company's operations and communities from which the company's workforce is drawn
- business partners
- national and regional governments
- regulatory bodies
- suppliers
- customers
- non-governmental and community-based organisations
- the public in general
- the environment

CSR is, therefore, a voluntary commitment by companies to manage their role within society responsibly and to contribute to sustainable development through co-operation with their stakeholders: in general, to improve the stakeholders' quality of life. The concept of CSR, therefore, marks a departure from the traditional and outdated perception that the only object of business is to increase profits. The focus is now clearly wider than maximising short-term profits.

3.4 Arguments advanced against CSR

Critics of CSR argue that there is no direct link between the social behaviour of the company, on one hand, and the company's competitive advantage and performance, on the other. They argue that the role of businesses is to generate profits and that societal issues must be addressed by the State and not by businesses. It has

been argued in this regard that CSR measures tend to be burdensome on businesses.

3.4.1 Arguments advanced in favour of CSR

Proponents of CSR argue that CSR may benefit companies in a number of ways, including the following:

- CSR may improve the company's capability to generate sustainable value through mutually beneficial relationships with their stakeholders. Various stakeholders such as community groups, regulators and purchasing bodies will potentially favour socially responsible companies with business opportunities and this may enhance the profit potential of such companies.
- Socially responsible companies may benefit from preferential procurement and government cooperation in terms of the Broad-Based Black Economic Empowerment policies in South Africa.
- CSR may enhance the company's reputation and differentiate it from its competitors. A good reputation is an asset for a company. With the advent of social media, a company's reputation may be instantly advanced and promoted if it engages in corporate social responsibility.
- A company with a good social record, and which treats its employees with dignity, is likely to attract, motivate and retain a productive, stable, and loyal workforce.
- Increasing employee satisfaction leads to better performance by employees and this will assist the company to increase production, quality, reliability, and profits.

Ultimately, it is essential that companies should continue to make profit and to operate in an economically competitive manner, but they must do so in a socially responsible manner.

3.4.2 How CSR is reflected in the Companies Act

CSR is illustrated in certain sections of the Companies Act as well as in the objectives of the corporate law reform process that preceded the passing of the Companies Act. Some examples are:

- The extensive corporate law reform process which culminated in the passing of the Companies Act recognised the need for South African company law to be sensitive (amongst other things) to social and ethical concerns.
- One of the purposes of the Companies Act is to promote the development of the South African economy by encouraging transparency and high standards of corporate governance, *given the significant role of enterprises within the social and economic life of the nation* (section 7(b)(iii)). This manifests a realisation that companies play a vital role not only in the economy, but in the social life of the country as well.
- The Companies Act specifically seeks to reaffirm the concept of the company as a means of achieving economic and *social benefits* (section 7(d)).
- The Companies Act seeks to promote the development of companies within all sectors of the economy, and to encourage active participation in economic organisation, management, and productivity (section 7(f)).

- The Companies Act also seeks to encourage the efficient and responsible management of companies (section 7(j)). Sound management of companies may enhance corporate performance, lead to creation and retention of jobs and also helps to prevent corporate conduct which may negatively impact society. It also prevents corporate collapses due to mismanagement which may also have dire consequences on society.
- The Companies Act provides for non-profit companies that are incorporated for social activities, public benefits, cultural activities, or group interests. The objectives for which non-profit companies may be registered may include, for example: prevention of and education around HIV and AIDS, assistance of refugees, protection of the environment, and animal welfare or child welfare and protection.
- Corporate activities may affect a wide circle of stakeholders. As such, the Companies Act has extended *locus standi* to a broad category of stakeholders (not only company shareholders) to enforce its provisions and to seek redress where company directors have abused their position, for example, in the context of the derivative action (section 165) and application to declare a director delinquent or under probation (section 162). Such stakeholders may include directors, prescribed officers, trade unions or other representatives of employees, persons who have been granted leave by the court, and the Commission or Takeover Regulation panel. Moreover, *any person* who contravenes any provision of the Companies Act is liable to *any other person* for any loss or damage suffered by that person as a result of the contravention (section 218(2)).
- The Companies Act requires certain categories of companies to appoint a Social and Ethics Committee to monitor the company's activities with regard to matters relating to **social and economic development** (includes the company's standing in terms of the goals and purposes of the ten principles set out in the United Nations Global Compact Principles; the OECD recommendations regarding corruption, the Employment Equity Act; and the Broad-Based Black Economic Empowerment Act), **good corporate citizenship** (includes the company's promotion of equality, prevention of unfair discrimination, reduction of corruption, contribution to development of the communities in which the company's activities are predominantly conducted or its products or services are marketed; and recording of sponsorship, donations and charitable giving), **the environment, health and public safety, consumer relationships**, and **labour and employment issues** (section 72 and Regulation 43).

The following companies are required by the Companies Regulations to appoint a Social and Ethics Committee:

- Every state-owned company

- Every listed public company
- Any other company that has had a public interest score above 500 points in any two of the previous five years.

Note that CSR is also reflected in the King IV report, which emphasises the importance of stakeholder interests.

3.5 Globalisation

Globalisation refers to the integration of nations through the flow of goods, information, services, and capital. It is a process by which businesses develop international influence. The various business enterprises covered in this module are global in many ways. For example, the businesses enterprises may raise capital both domestically and internationally, the membership of the enterprises may be both local and international; there are some foreign businesses that are operating in South Africa, some South African businesses have operations in foreign jurisdictions, and some of the big listed public companies in South Africa are also listed on the stock exchanges of other countries.

The law reform process that led to the passing of the Companies Act emphasised the following characteristics of the modern corporate world:

- There is increased globalisation.
- There is increased electronic communication.
- There is increased sensitivity to social concerns, corporate governance, and ethical concerns.
- The markets are rapidly evolving.
- There is greater competition for capital, goods, and services.
- There is an increase in international trade, foreign investment, and mobility of international capital.

In light of the above factors, it is necessary for South Africa's company law to be investor friendly and to be in harmony with the trends in the leading modern jurisdictions. South African company law, therefore, recognises globalisation in the following ways:

- One of the purposes of the Companies Act is to provide for the creation and use of companies, in a manner that enhances the economic welfare of South Africa as a partner within the global economy (section 7(e)). This manifests a realisation that South Africa is one of the participants in the wider global economy. The harmonisation of South Africa's corporate laws with the laws of other countries is, therefore, essential.
- The courts are allowed to consider foreign company law (to the extent that it is appropriate) when interpreting and applying the provisions of the Companies Act (section 5(2)).
- The effects of decisions by English courts may be seen in a number of common law principles and statutory provisions, for example, *Salomon v Salomon*, *Royal British Bank v Turquand*, *Attorney-General v Mersey Railway Company* and *Regal Hastings Ltd v Gulliver* (see, for example, the statutory version of the *Turquand* rule in section 20(7) of the Companies Act as well as the common law and partially codified duties of company directors).
- The influence of corporate laws of other modern jurisdictions such as the United States of America, United Kingdom, New Zealand, Canada, and Australia may be seen in a number of concepts, for example: the appraisal remedy (section 164); an objective duty of care, skill and diligence (section 76(3)(c)). Note that this test has some subjective elements; the business judgment rule (section 76(4)); and the statutory derivative action in terms of the Companies Act (section 165).
- The provisions relating to the appointment of proxies (section 58) and electronic communication at shareholder meetings (section 63(2)) are a manifestation of greater sensitivity to globalisation.

- The Companies Act provides for the registration of domesticated companies and external companies (section 13(5) to (11) and section 23).
- The Companies Act seeks to provide for increased standards of corporate governance, shareholder- and investor protection (section 7). The purpose is to encourage both local and foreign investment to stimulate economic growth in South Africa.

3.6 Entrepreneurial law and the South African legal system

In addition to the common law, the important pieces of legislation that regulate the business enterprises covered in this module are the Companies Act 71 of 2008 as amended, Close Corporations Act 69 of 1984 and the Trust Property Control Act 57 of 1988. There are, however, important sections of other pieces of legislation that are referred to in this module which (although not being the main pieces of legislation dealing with these enterprises) impact these business enterprises, for example, the Insolvency Act 24 of 1936, the Income Tax Act 58 of 1962, the Magistrates Courts Act 32 of 1944 and the Uniform Rules of the High Court. The other important pieces of legislation that may have an impact on companies include the Promotion of Access to Information Act 2 of 2000, the Competition Act 89 of 1998, the Labour Relations Act 66 of 1995, the Employment Equity Act 55 of 1998, the Broad-Based Black Economic Empowerment 53 of 2003, and environmental legislation. The legislative framework is to be viewed in the context of the Constitution of the Republic of South Africa, 1996. For example, one of the purposes of the Companies Act (which is the main piece of legislation governing South African company law) is to promote compliance with the Bill of Rights in the Constitution, in the application of company law.

3.7 Reflection

In this lesson, we have provided some insight into how the law applicable to different South African business forms have been affected by, and is susceptible to Africanisation, transformative constitutionalism, and globalisation. At first glance, one would think that law that is for the most part contained in legislation and subject to capitalistic values would not reflect values of ubuntu. However, the Constitution has had a major effect in this area of law, not only because of the constitutional principles that are applicable to business forms directly, but also because courts must take cognizance of the underlying constitutional values when interpreting legislation and when developing the common law. This is evident from the several examples mentioned, and others that you will discover during the course of the module. In the next lesson, we introduce the first type of business, namely companies.

Reflect on the way in which African values comprise the concept of ubuntu. Would you be able to argue convincingly for or against adopting a specific corporate social responsibility project in a company based on the principles of ubuntu and the constitutional principles?

LESSON 2:

Legal personality

1 Introduction



Prescribed study material

Textbook: chapter 2, paras 1.1–1.6, and Chapter 16, para 10.3 (close corporations)

- o Companies Act: sections 8(3), 13, 14, 19(1) and 20(9)
- o Close Corporations Act: section 65

Prescribed case law

The cases referred to as discussed herein:

- *Salomon v Salomon & Co Ltd* [1897] AC 22 (HL)
- *Dadoo Ltd and others v Krugersdorp Municipality Council* 1920 AD 530
- *Dhlomo v Natal Newspapers (Pty) Ltd* 1989 (1) SA 945 (A)
- *Ngcwase v Terblanche* 1977 (3) SA 796 (A)
- *Financial Mail (Pty) Ltd v Sage Holdings Ltd* 1993 (2) SA 451
- *Universiteit van Pretoria v Tommie Meyer Films* 1979 (1) SA 441
- *ABSA Bank Ltd v Blignaut and another and four similar cases* 1996 (4) SA 100
- *Manong and Associates (Pty) Ltd v City Manager, City of Cape Town and another* 2009 (1) SA 644 (EqC)
- *Ahmadiyya Ishaati-Islam Lahore (South Africa) v Muslim Judicial Council (Cape)* 1983 (4) SA 855 (C)

Important terms	Meaning
Legal personality	Also known as “juristic personality”. To be acknowledged in law as a person or bearer of its own rights, with liability for its own debts.
Incorporation	Formation of a company through registration with the Companies and Intellectual Property Commission.
Lifting or piercing the corporate veil	A process used to ignore a company’s separate legal personality in order to hold persons inside the company personally liable.

In this lesson, we consider the main benefit associated with companies as a business form, that is, legal personality. Laypersons often misunderstand the concept “juristic or legal personality”. An attorney or an advocate is not what is meant by a “legal person”! Two of the business forms that we teach you about – companies and close corporations – have the benefit of legal personality.

The principle of **legal personality** provides for the limitation of the liability of participants in the business. **Section 8(3) of the Companies Act** determines that no association of persons formed for the purpose of the acquisition of gain (i.e., to make a profit) will be recognised as a legal person unless it is registered as a company under this Act or is formed in terms of another Act.

There are three ways in which legal personality can be acquired:

- (1) by registration in terms of the Companies Act (which is discussed further here)
- (2) through registration in terms of other pieces of legislation, like the University of Pretoria (Private Act) 13 of 1930 that is mentioned in the textbook
- (3) by conduct (common law method)

Notably, the third option is excluded by the Companies Act (section 8(3) above) and only applies in respect of other types of business enterprises like, for instance, cooperative societies. Therefore, a company cannot acquire juristic personality by conduct.

The registration or **incorporation** of a company (by the issuance of a Registration Certificate) confers legal personality on the new entity. This means that the new entity can acquire its **own rights and duties separate from its shareholders or members**. It can **enter into contracts** in its own name and **sue and be sued**. Its shareholders or members are not liable for its debts and enjoy **limited liability**.

In ***Salomon v Salomon & Co Ltd***, it was held that the principle of separate legal personality has various implications:

- The estate of the company is assessed apart from the estates of the individual shareholders or members.
- The debts of the company are the company's debts and are separate from those of its shareholders or members. They (the shareholders or members) enjoy limited liability.
- Shares in a company entitle the holders thereof to certain interests in the company. However, the profits of the company belong to the company and not to its shareholders, and, only after the company has declared a dividend, may the shareholders claim that dividend.
- The assets of the company are its exclusive property. The shareholders have no proportionate, proprietary rights therein.
- No one is qualified by virtue of his or her shareholding or membership to act on behalf of the company.
- Only those who are appointed as representatives of the company in accordance with the articles can bind the company. Managerial and executive powers are to be exercised by directors.
- Where a company is wronged, the company must itself seek redress. This was also more recently confirmed in *Ahmadiyya Ishaati-Islam Lahore (South Africa) v Muslim Judicial Council (Cape)* 1983 (4) SA 855 (C), which is mentioned in the textbook.
- Another related implication of legal personality was mentioned in *Standard Bank v Hunky-Dory Investments (No 1)* 2010 (1) SA 411 (C), as noted in the textbook: Companies are the bearers of rights as well as duties in terms of Chapter 2 of the Constitution.

From later case law, it is evident that the courts acknowledge the importance of distinguishing between companies and their shareholders. In the case of *Airport Cold Storage (Pty) Ltd v Ebrahim* 2008 (2) SA 303 (C) the court confirmed that one of the most fundamental consequences of incorporation is that a company is a juristic entity separate from its shareholders. Joubert AJA, in *Ngcwase v Terblanche* (at 803H), held that a corporation is:

a statutory juristic person (*persona juris*) ... in law considered to be an abstract legal entity which exists as a juristic reality in the contemplation of law despite the fact that it lacks physical existence.

Our courts have also recognised that a juristic person has the right to a **reputation, good name, and fame** (*Dhlomo v Natal Newspapers (Pty) Ltd*). Companies also enjoy the **right to privacy** (*Financial Mail (Pty) Ltd v Sage Holdings Ltd*) and **identity** (*Universiteit van Pretoria v Tommie Meyer Films*).

In *Manong and Associates (Pty) Ltd v City Manager, City of Cape Town and another*, it was confirmed that the Constitution of the Republic of South Africa, 1996 (the "Constitution") vests a juristic person with the rights in the Bill of Rights (Chapter 2) to the extent required by the nature of the rights and the nature of the juristic person. In this case, it was held that a juristic person, like a natural person, could also enjoy the **right to equality**.

Against the backdrop of the Constitution, it is acknowledged that corporations enjoy most of the rights that natural persons enjoy. A juristic person is likewise bound by the duties and obligations flowing from such rights.

Separate legal personality ceases when a company is dissolved and deregistered after winding-up.

2 Legal personality of branches and divisions

A modern company usually operates through various divisions which, although having a single controlling mind or board, might in some cases even compete with one another. Questions of their separate legal personality might legitimately be raised. However, if such branches and divisions are not registered entities themselves, but merely operate separately for practical purposes, they do not for purposes of law have their own separate legal personality. In *Absa Bank Ltd v Blignaut* 1996 (4) SA 100 (O) the court acknowledged that a company can decide for practical purposes to have separate operating divisions, but that this separation of divisions does not in law result in different businesses that exist separately from its other divisions. The **branches or divisions** of a company are part of the company itself and do **not have their own separate legal existence**.

3 Trusts and partnerships are not juristic persons



Prescribed study material

Textbook: chapter 1

o **Companies Act: Section 1**

Although “juristic person” as defined in section 1 of the Companies Act includes trusts created inside or outside the Republic of South Africa, it should be noted that trusts are not usually acknowledged as juristic persons. It is just for purposes of application of the Companies Act that trusts are recognised as juristic persons. Trusts do enjoy one benefit that is associated with legal personality: **limited liability** for debts of the trust.

Although partnerships are in two exceptional circumstances viewed as being separate from their members, i.e., in the event of insolvency and litigation, they do not have any of the benefits attached to legal personality.

4 Disregarding separate juristic personality

4.1 Introduction

The exclusion of liability of persons inside business enterprises is not an absolute right. It is possible in certain circumstances to ignore the separation that is created between companies and their controllers. Likewise, in close corporations, the separate existence of the business can in certain instances be ignored so as to hold members personally liable. This can be done in two ways: either in terms of the common law principle that has been developed in the case law (piercing the corporate veil) or by means of the statutory provisions (section 20(9) of the Companies Act for purposes of companies and section 65 of the Close Corporations Act for close corporations). The law attaches certain consequences to misconduct committed in different business enterprises. This reflects an element of ubuntu and fairness and supports the principle that ‘one reaps what one sows’. It clearly discourages conduct which would be detrimental to outsiders and participants in the business. Although companies are recognised as separate legal persons, it is possible to disregard the juristic personality of a company to hold individuals inside of the corporation liable in certain circumstances (section 20(9) of the Companies Act). Members of close corporations can also be held personally liable if their conduct constitutes an ‘unconscionable abuse’ of the close corporation’s separate juristic personality (section 65 of the Close Corporations Act).



Prescribed study material

Textbook: chapter 2 para 1.6, and chapter 16 para 10.3

- o Companies Act: section 20(9)
- o Close Corporations Act: section 65

Prescribed case law

These cases you only need to know as discussed herein:

- ***Dadoo Ltd and others v Krugersdorp Municipal Council* 1920 AD 530**
- ***Cape Pacific v Lubner Controlling Investments (Pty) Ltd and others* 1995 (4) SA 790 (A)**
- ***Hülse-Reutter v Gödde* 2001 (4) SA 1336 (SCA)**
- ***Die Dros (Pty) Ltd and another v Telefon Beverages CC and others* [2003] 1 All SA 164 (C)**
- ***Le'Bergo Fashions CC v Lee and another* 1988 (2) SA 608 (C)**
- ***Botha v Van Niekerk & another* 1983 (3) SA 513**
- ***Ex parte Gore NO* [2013] 2 All SA 437 (WCC)**

Innes CJ, in *Dadoo Ltd and others v Krugersdorp Municipal Council* at 550-551, held as follows:

This conception of the existence of a company as a separate entity distinct from its shareholders is not merely an artificial and technical thing. It is a matter of substance; cases may arise concerning the existence or attributes which in the nature of things cannot be associated with a purely legal persona. And then it may be necessary to look behind the company and pay regard to the personality of the shareholders, who compose it.

Before the adoption of the principle of disregarding a company's separate existence by the Companies Act in section 20(9), this matter was only regulated by the common law and was referred to as '**lifting**' or '**piercing**' the corporate veil. The courts used it to place limitations on the principle of separate legal personality in order to avoid abuse.

Courts have made it clear that they will not allow the use of any legal entity to justify wrongs, to conceal fraud, or to defend or hide crime. In such cases, the courts may pierce or lift the corporate veil and hold directors and others personally liable for acts committed in the name of the company. In *Die Dros (Pty) Ltd and another v Telefon Beverages CC and others*, it was held that, where fraud, dishonesty and other improper conduct are present, the need to preserve the separate legal personality of a company must be balanced against policy considerations favouring piercing the corporate veil. In *Le'Bergo Fashions CC v Lee and another*, the court confirmed that it would pierce the corporate veil according to values of public policy. If a natural person, who is subject to a restraint of trade, uses a close corporation or a company as a front to engage in the activity that is prohibited by the agreement, the corporate veil will be pierced so as to give effect to the agreement.

However, to preserve the integrity of the principle of legal personality, the courts have said that they will only pierce or lift the corporate veil in exceptional circumstances where there is **no alternative remedy** available and where piercing the corporate veil will **prevent an injustice**.

In *Cape Pacific v Lubner Controlling Investments (Pty) Ltd and others*, the concept of piercing the corporate veil was described as disregarding the dichotomy between a company and the natural person behind it who controls its activities and attributing liability to a person who misused or abused the principle of corporate personality. In other words, the reality of the circumstances and substance, rather than the form, must prevail. This measure is used in exceptional circumstances where there is evidence of fraud, dishonesty, or improper conduct.

The courts are reluctant to lift the corporate veil, as this ignores the concept of separate legal personality and the consequences attached thereto. The court does not have a general discretion to disregard a company's separate existence. A factual investigation must be conducted in each case to decide whether it would be appropriate to lift the corporate veil. The process involves a balancing of public-policy considerations and the importance of the need to preserve the separate corporate identity.

The company need not have been established and run fraudulently or deceitfully for the full course of its existence to justify piercing the corporate veil. If, in a particular instance, it has abused its separate legal personality, such status may be disregarded for purposes of the transaction in question, while still giving effect to its separate legal personality for other purposes.

In *Botha v Van Niekerk & another*, a test to determine when the corporate veil should be disregarded, was formulated. In this judgment, it was held that only if an "unconscionable injustice" would result should the court lift the corporate veil.

In *Cape Pacific* (above), this test was held to be too rigid. A more flexible approach was propagated: that is, to take the facts of each case into consideration to determine whether or not it is appropriate to pierce the corporate veil. In *Hülse-Reutter v Gödde*, the court also held that it has **no general discretion** simply to disregard a company's separate legal personality. The corporate veil would only be lifted if there was evidence of **misuse or abuse** of the distinction between the company and those who control it, and this has enabled those who control the company to **gain an unfair advantage (a dual test was introduced by adding the element of unfair advantage)**. The court further confirmed that much depended on a close analysis of the facts of each case and considerations of policy.

Although piercing the corporate veil is an exceptional remedy in the sense that the courts do not have a general discretion to hold individuals personally liable, this remedy is not necessarily a remedy of last resort. Even if other remedies exist, a person can choose to apply to a court to pierce the corporate veil notwithstanding the other remedies at his or her disposal. However, the existence of another remedy, or the failure to pursue one that was available, may be a relevant factor when policy considerations come into play.

The requirements of company law and close corporation law for the piercing of the corporate veil are similar. Section 20(9) of the Companies Act follows the example of the Close Corporations Act by codifying the general principle of piercing the corporate veil. **Section 20(9) of the Companies Act** provides that, if a court finds that the incorporation of a company or any act by or use of a company constitutes an **unconscionable abuse** of its juristic personality, the court may declare that the company will be deemed not to be a juristic person in respect of rights, liabilities and obligations relating to the abuse. The wording is a **combination of section 65 of the Close Corporations Act and the judgment in Botha v Van Niekerk**. It ignores the view expressed in *Cape Pacific Ltd v Lubner Controlling Investments (Pty) Ltd* that described the test in *Botha v Van Niekerk* as too rigid.

The first case regarding the interpretation to be given to section 20(9) of the Companies Act was *Ex parte Gore NO*, which dealt with a group of companies that was being run as if it was a single company. No distinction was made between the business and finances of the different companies in the group. The court decided that an "unconscionable abuse" as required in terms of section 20(9) was not as stringent a requirement as a "gross abuse" as is needed in terms of section 65 of the Close Corporations Act. The court's view was that the interpretation to be given should be sufficiently wide so as to include "a sham" or "a device". In the court's opinion, there was no indication that section 20(9) had to be regarded as a remedy of last resort. In other words, the remedy is available to applicants despite the existence of other legal remedies. Finally, the court held that section 20(9) does not have the effect of nullifying the operation of the common law principle of piercing the corporate veil. Instead, it supplements the doctrine, and the case law that has been developed (as discussed above) should be used as a guideline by courts when applying the statutory principle.

→ Reflection

Legal personality entails various rights and privileges. Do you understand when a company acquires legal personality and what the **nature and implications of legal personality** are? Can you identify instances in which the legal personality of a company will be disregarded and responsible persons within the company will be held personally liable? Keep in mind that you can be asked to discuss either the **common law** principles pertaining to piercing the corporate veil, or the **statutory** principle of

disregarding the separate legal existence, or both.

Legal personality is acquired by companies **upon incorporation**. Companies are afforded most of the rights of **natural persons**. It is evident that a company's separate legal existence has many implications for the effective operation of companies.

There are certain instances where the **corporate veil will be lifted** (a common law principle that developed through the case law and which is applicable to both companies and close corporations) or the **legal personality will be disregarded** (the statutory principle which is made applicable to companies in terms of section 20(9) of the Companies Act, and to close corporations in terms of section 65 of the Close Corporations Act) in order to hold individuals within the company accountable for wrongs committed by them. Furthermore, separate legal personality will cease upon **deregistration** of the company after its dissolution.

Do you understand the reason/s why, despite the existence of several other remedies in the Companies Act, it is necessary to, in certain circumstances, disregard the separate existence of a company or a close corporation?

LESSON 3:

Types of company

1 Introduction

We learnt that a company acquires **legal personality** and is regarded as an entity that can acquire rights and duties which are separate from those of its members. However, this principle should not be abused, and the corporate veil can sometimes be lifted.

In this lesson, we highlight the distinct types of company that can be incorporated in terms of the Companies Act. There are two types of company recognised in South Africa – **profit companies** and **non-profit companies**.

Four types of entity qualify as profit companies:

- (1) Public companies
- (2) State-owned enterprises
- (3) Personal liability companies
- (4) Private companies

Each of these types of company has distinguishing characteristics.

You will know that you understand this lesson if you are able to answer the following **key questions**:

- What types of company does the Companies Act provide for?
- Through which body are companies registered?
- Which four entities are classified as profit companies? What are their characteristics?
- What is the distinction between profit companies and non-profit companies?
- What is an external company?
- What is a domesticated company?

2 Profit companies



Prescribed study material

Textbook: chapter 2 para 2.1 (See, also, the scheme at the end of chapter 2.)

- o **Companies Act: sections 1 (definitions) and 19(3) (personal liability companies)**

Important terms	Meaning
Domesticated company	A foreign company whose registration has been transferred to South Africa.
External company	A foreign company carrying on business or non-profit activities in South Africa.
Non-profit company	A company incorporated for a public benefit or object other than financial gain for its shareholders.
Profit company	A company incorporated for the purpose of financial gain for its shareholders.
Public company	A profit company that can issue its shares to the public and whose shares can be listed on the Johannesburg Stock Exchange.
Private company	A profit company that prohibits the issue of shares to the public and restricts the transfer of shares in its Memorandum of Incorporation.

Personal liability company	A profit company in which the directors and previous directors are held personally liable for the contractual debts of the company.
Company secretary	The Company secretary is defined in the act simply as 'an officer of the company'. In practice they are the most senior administrative officer, as they oversee the efficient administration and compliance of a company and are the primary source of advice on the conduct of the business.
Commission	Companies and Intellectual Property Commission (CIPC), a juristic person that functions as an organ of state (and replaces CIPRO [Companies and Intellectual Property Registration Office]) and with which companies must be registered.
Securities	Tradable financial assets. The term is wide enough to include debt securities like banknotes, promissory notes, and debentures, as well as equity securities like shares.

A **profit company** has the object of financial gain for its shareholders. A profit company may be incorporated by one or more persons and there is no limit to the number of shareholders that it may have.

Four entities qualify as profit companies: a public company, a state-owned company, a personal liability company, and a private company.

A public company ("Ltd"):

- Its shares may be offered to the public and are freely transferable.
- The company can be listed on the JSE Limited.
- One person can form it.
- It must have at least three directors.
- It is obliged to hold annual general meetings.
- It is obliged to appoint an auditor.
- It is obliged to appoint a company secretary.
- It is obliged to appoint an audit committee.

A state-owned company ("SOC Ltd"):

- It is registered in terms of the Companies Act and is either listed as a public entity in Schedule 2 or 3 of the Public Finance Management Act or is owned by a municipality.
- Examples of state-owned companies are Airports Company South Africa (ACSA); Denel; South African Airways.
- The majority of the provisions applicable to **public companies** apply to state-owned companies, except if the Minister has granted an exemption.
- It is obliged to appoint a company secretary.
- It is obliged to appoint an audit committee.
- Chapter 3 of the Companies Act applies, except to the extent that the Minister has exempted the company.

A personal liability company ("Inc" or "Incorporated"):

- It must meet the criteria for a private company.
- It is mainly used by professional associations (such as attorneys).
- Its Memorandum of Incorporation must state that it is a personal liability company.
- The directors are jointly and severally liable along with the company for debts and liabilities contracted during their term of office.
- One person can form it.
- It must have at least one director.
- The doctrine of constructive notice applies in terms of section 19(5) of the Companies Act.

Section 19(3) of the Companies Act uses the word 'contracted' and not 'incurred', which was held by the court in *Fundtrust (Pty) Ltd (In Liquidation) v Van Deventer* 1997 (1) SA 710 (A) to limit directors' liability to contractual debts, and to exclude delictual and statutory liabilities.

A provision that the directors and past directors will be liable jointly and severally, together with the company, for debts and liabilities of the company that were contracted during their periods of office must be included in the Memorandum of Incorporation of a personal liability company. The effect of the inclusion of such a clause is that creditors will be able to hold the directors jointly and severally liable for the company's contractual debts and liabilities. A director who has paid the debts will have a right of recourse against his or her fellow directors for their proportionate share (*Sonnenberg McLoughlin Inc v Spiro* 2004 (1) SA 90).

A private company (“(Pty) Ltd”)

- Its Memorandum of Incorporation prohibits the offering of any securities to the public and restricts the transferability of its securities.
- Private companies are no longer limited to 50 shareholders, as was the case under the Companies Act of 1973.
- In terms of section 8(2)(b) of the Companies Act, a private company's Memorandum of Incorporation must contain a prohibition against the offering of its securities to the public and must restrict the transferability of its securities.
- One person can form it.
- It must have at least one director.

3 Non-profit companies ('NPC')



Prescribed study material

Textbook: chapter 2 para 2.2

A **non-profit company** is a company that is not formed with the aim of making a profit for its **members**. (Note that a non-profit company has members and not shareholders like profit companies.) Its objects must relate to social activities, public benefits, cultural activities, or group interests. A non-profit company must be formed by at least three persons, who will be the company's first directors.

It must have **at least three directors**, but they are not allowed to obtain any financial gain from the company other than remuneration for the work they perform. A non-profit company does not have to have members. If these companies have members, some members may enjoy voting rights while others may not.

The income and property of non-profit companies are not distributable to its incorporators, members, directors, officers, or persons related to any of them. Upon liquidation, income and assets must be paid over to another non-profit company, voluntary association, or trust with a similar purpose.

4 External and domesticated companies



Prescribed study material

Textbook: chapter 2 paras 2.3 and 2.4

An external company is a 'foreign company' conducting business or non-profit activities in South Africa. It must always have at least one office within the Republic. (See the definition in section 1 of the Companies Act). It can be registered as either a profit or non-profit entity.

A foreign company is required to register as an 'external company' with the **Companies and Intellectual Property Commission** (hereafter 'the Commission') within twenty days after it first begins to conduct business or non-profit activities in South Africa. To do so, a form CoR 20.1 must be lodged with the Commission. Section 23(2A) of the Companies Act includes a list of activities that will **not**

solely be regarded as conducting business, such as establishing a bank account in South Africa or acquiring any interest in any property within the Republic.

Foreign companies may, in terms of the Companies Act, transfer their registration to South Africa from the foreign jurisdiction. A foreign company that has transferred its registration will be deemed to have been originally registered in South Africa. Foreign companies are treated exactly the same as companies that were originally incorporated in the Republic. They cannot be identified as being anything other than a South African company. These companies are referred to in the Companies Act as “**domesticated companies**”.

→ Reflection

You must familiarise yourself with the types of company for which the Companies Act makes provision, namely profit companies (which include public companies, private companies, personal liability companies, and state-owned companies) and non-profit companies.

The goal of profit companies is to make a profit for their shareholders, whereas non-profit companies are incorporated for a social, cultural, or other public purpose. Each of these companies has distinguishing characteristics. A private company, for instance, may not issue its shares to the public, while a public company's shares may be listed, etc. It is fairly easy to distinguish between the different types of company – one only needs look at the abbreviation that follows the company's name.

All companies with registered offices in South Africa, including foreign companies, must be registered through the Commission.

Two main types of company may be formed: profit companies and non-profit companies. Some foreign companies that are registered in South Africa, called “external companies”, are also recognised in the Companies Act.

Would you be able to identify the type of company that you are dealing with in a set of facts and the distinctive characteristics of such a company? This should enable you to advise a client on the requirements that need to be complied with in order to form a specific type of company.

LESSON 4:

Registration of companies

1 Introduction

You have learnt about the types of company that may be formed in terms of the Companies Act. They may have distinctive characteristics, but all companies have one thing in common: once they are registered, they are recognised as separate legal entities or juristic persons.

Before a company is recognised as a legal person, there are various steps that need to be taken. There is the registration of the company as well as the registration of the company's name. Moreover, it may be necessary to conclude pre-incorporation contracts. Below, we explain the process of incorporation of a company.

You will know that you understand this lesson if you are able to answer the following **key questions**:

- What documents must be filed to inform the Companies and Intellectual Property Commission of the intention to register a company?
- How flexible is the Memorandum of Incorporation?
- What may be included in the Memorandum of Incorporation?
- What is the legal status of the Memorandum of Incorporation and of the rules developed by the board of directors?
- How does the ring-fenced status of a company impact third parties dealing with it?
- How are alterations and amendments to, and translations of, the Memorandum of Incorporation effected?



Prescribed study material

Textbook: chapter 2 para 3

o **Companies Act: sections 7, 8 and 13**

Important terms	Meaning
Memorandum of Incorporation	The sole registration document of a company.
Notice of Incorporation	The document filed with the Companies and Intellectual Property Commission ("the Commission") together with the Memorandum of Incorporation in order to show the company's intention to register as a business.
Alterable provision	A provision of the Companies Act in which it is expressly contemplated that its effect on a particular company may be negated, restricted or limited in terms of the company's Memorandum of Incorporation.
Unalterable provision	A provision that may not be altered in substance in the Memorandum of Incorporation.
Registration certificate	The document issued by the Commission when all formalities for registration are in order.
Company rules	Rules that may be adopted by the board of directors after incorporation of a company that enjoy the same legal status as the Memorandum of Incorporation.

Before a company is recognised as a legal (juristic) person, the company and its name must be registered.

Key objectives of the Companies Act as found in **section 7(b)** include the promotion of the development of the South African economy through:

- the creation of flexibility in the formation and maintenance of companies
- simplicity in the formation and maintenance of companies
- the encouragement of corporate efficiency
- the encouragement of transparency
- the predictable regulation of companies

To promote the competitiveness and increased effectiveness of the South African economy, one of the aims of the Companies Act is to simplify the procedure for the incorporation of companies by reducing the associated costs and formalities. When dealing with the formation of companies, the objectives of flexibility and simplicity are clear. The Companies Act makes it possible to incorporate both simple business structures and complex business structures.

2 Procedure for the incorporation of companies

❓ **NB:** The registration documents are available online at <http://www.cipc.co.za/>



Prescribed study material

Textbook: chapter 2 para 3 (See, also, the forms in Appendix A)

o **Companies Act: sections 1 and 13**

To register a company, a Notice of Incorporation and a copy of the Memorandum of Incorporation must be lodged with the Commission and the prescribed registration fee must be paid. Section 1 of the Companies Act determines that to “lodge” the documents means to deliver them to the Commission (CIPC), which is responsible for registration.

The Notice of Incorporation is “the notice to be filed in terms of section 13(1), by which the incorporators of a company inform the Commission of the incorporation of that company, for the purposes of having it registered” (section 1).

The Notice serves as notification to the Commission of the incorporation of the company. Therefore, it is the way in which promoters of a company let the Commission know about the company being formed, and the fact that they wish to register the company.

The **Notice of Incorporation** (form CoR 14.1), which must be lodged together with the Memorandum of Incorporation, contains the following information:

- type of company
- incorporation date
- financial year-end
- registered address (main office)
- number of directors
- company name:
 - whether the company’s name will be the registration number
 - the reserved name and reservation number
 - list of four names to be checked by the Commission

The **Memorandum of Incorporation** is the document that sets out the rights, duties and responsibilities of shareholders, directors, and others within the company, and in relation to the company and other matters. Provisions in the Memorandum of Incorporation may be amended from time to time.

One or more persons may incorporate a **profit company**. For the formation of a **non-profit company**,

three or more persons are required. Each of these people must complete and sign the Memorandum of Incorporation.

The Companies Regulations of 2011 contain standard form (*pro forma*) examples of the Memorandum of Incorporation of the different types of company. Use of the standard form (*pro forma*) for a Memorandum of Incorporation (**CoR 15.1A-E**) is optional. Companies are allowed to draft their own unique Memorandum of Incorporation provided it includes the required information.

3 The role of the Commission



Prescribed study material

Textbook: chapter 2 para 3

- o **Companies Act: Sections 6(8), 13(4), 14 and 66(2)**

Once the Notice of Incorporation and a copy of the Memorandum of Incorporation have been filed with the Commission and the prescribed fee has been paid, the Commission may either accept or reject the Notice of Incorporation.

The Notice of Incorporation **may be** rejected by the Commission in the following circumstances:

- if it has not been completed in full (section 13(4)(a))
- if it has not been properly completed (section 13(4)(a))

The Notice of Incorporation **must** be rejected by the Commission in the following circumstances:

- if the initial number of directors is less than the prescribed minimum number (section 13(4)(b))
- where, as a result of a director's disqualification, the initial number of directors becomes less than the prescribed minimum number (section 13(4)(b))

❓ In terms of section 66(2) of the Companies Act, a private company must have at least one director, and a non-profit company must have a minimum of three directors in addition to the minimum number of directors that the company must have to satisfy any requirement to appoint an audit committee or a social and ethics committee. If the Commission realises that one of the directors does not qualify to be a director, this will reduce the number of directors. If the reduction leads to the number of directors being less than the prescribed number, the Commission has no choice. It must reject the Notice of Incorporation.

Where there is a deviation from the design or content of the prescribed form, the deviation will only invalidate the actions of the person if it affects the substance of the Notice of Incorporation negatively and materially, or if such deviation would reasonably mislead someone who reads the Notice of Incorporation (section 6(8)(b)(i) and (ii)).

The registration of a company is governed by section 14 of the Companies Act.

Once the Notice of Incorporation has been filed, the Commission:

- assigns a unique number to the corporation
- enters prescribed information regarding the company in the Companies Register
- issues and delivers a registration certificate to the company if all the other requirements have been complied with

❓ The date stated on the registration certificate is the date on which the company acquires legal personality. If the promoters have stipulated a specific date in the Notice of Incorporation, the date on the registration certificate will be the later one of that date and the date on which the certificate is issued by the Commission.

4 The Memorandum of Incorporation and the rules



Prescribed study material

Textbook: chapter 2 para 4

The Memorandum of Incorporation contains the following information:

- details of the incorporators
- the number of directors and alternate directors
- the share capital (maximum issued)
- the content of the Memorandum of Incorporation

4.1 Alterable and unalterable provisions of the Memorandum of Incorporation



Prescribed study material

Textbook: chapter 2 para 4.1

The Companies Act imposes certain specific requirements in respect of the content of a Memorandum of Incorporation as are necessary to protect the interests of shareholders in the company. Default company rules or alterable provisions are provided for.

Companies may accept or alter the following alterable provisions as long as the alteration remains consistent with the Companies Act.

4.1.1 Alterable provisions

- A company enjoys all the legal powers and capacity of an individual, except to the extent that a juristic person is incapable of exercising any such powers or having any such capacity; or the company's Memorandum of Incorporation provides otherwise (e.g., it may determine that the company's activities will be limited to a specific business).
- Private, non-profit, and incorporated companies may elect to comply with the extended accountability requirements of Chapter 3 (section (2)).
- Shares within the same class have the same rights, limitations, and terms, unless the Memorandum of Incorporation provides otherwise (section 37(1)).
- The Memorandum of Incorporation may exclude the right of first refusal of current shareholders of a private company in respect of shares issued by the company (section 39(3)).
- The Memorandum of Incorporation may forbid the board to render financial assistance to parties wanting to acquire shares in the company (section 45(2)).
- The Memorandum of Incorporation may provide for longer minimum notice periods for meetings.
- Electronic notice and electronic participation in meetings are allowed unless the Memorandum of Incorporation prohibits it (section 63(2)).
- Companies may determine a higher number of minimum directors than that prescribed by the Companies Act (section 66(2)).

4.1.2 Unalterable provisions

Unalterable provisions are provisions of the Companies Act which a company's Memorandum of Incorporation may not change, except to impose a higher standard, greater restriction, longer period of time, or any similar more onerous requirement than contained in an unalterable provision of the Companies Act. For instance, directors' duties and responsibilities, and accountability requirements for public and state-owned companies, cannot be excluded in the Memorandum of Incorporation. The

Companies Act allows companies to add provisions to address matters that are not covered in the Companies Act itself. However, all provisions included in the Memorandum of Incorporation must be consistent with the Act (section 15(1)(a) and (b)).

4.2 Restrictive conditions in the Memorandum of Incorporation



Prescribed study materialTextbook: chapter 2 para 4.3.

Ring-fenced companies

Section 15(2)(b) provides that the Memorandum of Incorporation of a company may contain special conditions applicable to the company, and requirements in addition to those stipulated in the Act, for the amendment of such conditions.

Section 15(2)(c) also allows the Memorandum of Incorporation to prohibit the amendment of any particular provision in the Memorandum of Incorporation. If the Memorandum of Incorporation of a company contains the provisions allowed by section 15(2)(b) or (c), the name of the company must be followed by the expression “(RF)”.

This is an abbreviation for the words “ring fencing” and is intended to warn outsiders dealing with the company that there are special conditions contained in the Memorandum which they should check.

The Notice of Incorporation filed by the company must also contain a prominent statement drawing attention to each such provision and where it is to be found in the Memorandum of Incorporation (section 13(3)).

5 Rules made by the board of directors



Prescribed study material

Textbook: chapter 2 para 4.4

o **Companies Act: section 15**

Where both the Companies Act and the Memorandum of Incorporation are silent regarding certain matters that have to do with the governance of the company, the board of directors of the company is generally allowed to:

- make rules
- amend any existing rules
- repeal any rules.

Such rules must not be in conflict with the Memorandum of Incorporation of the company or with the Companies Act. In terms of section 15(4)(a), where there is a conflict between a rule made by the board of directors and the Companies Act or the Memorandum of Incorporation, the rule will be void but only to the extent of its inconsistency.

Before the rules of the board become effective, the following must occur:

Publication of a copy of the rules (section 15(3)(a))

Rules made by the board must be published in the manner stated in the Memorandum of Incorporation. If there is no manner stated, the rules must be published in the manner stated in the rules themselves.

Filing of a copy of the rules with the Commission (section 15(3)(b))

The rules must be filed as required by the Companies Act. Ten business days after filing of the rules, or ten business days after the date stipulated in the rules, if applicable, whichever is the latest of the two dates, the **rules become effective**. As soon as the rules become effective, they are binding on an interim basis until put to the vote at the next general shareholders' meeting. For a rule to become permanent there must be ratification by way of an ordinary resolution at the general meeting. Note that, if a rule is rejected by the majority of the shareholders, the board is not allowed to make a similar rule until a period of twelve months has lapsed. The board may only make a similar rule within 12 months if this is approved in advance by way of ordinary resolution at the shareholders' meeting.

6 The legal status of the Memorandum and the rules



Prescribed study material

Textbook: chapter 2 para 4.5

o **Companies Act: section 15**

The Memorandum of Incorporation and the rules are binding:

- between the company and each shareholder
- between or among the shareholders of the company
- between the company and each director or prescribed officer of the company
- between the company and any other person serving the company as a member of a committee of the board.

The relationship created in terms of section 15 of the Companies Act seems to be of a contractual nature. The Companies Act entails fewer criminal offences than its predecessor, but there is a greater risk of personal liability arising from action in contravention of a company's Memorandum of Incorporation and rules.

7 Amending the Memorandum of Incorporation



Prescribed study material

Textbook: chapter 2 para 4.6

o **Companies Act: sections 15 and 17(1)**

Changes may be made to the Memorandum of Incorporation unless the amendment of a provision is prohibited by the Memorandum itself in terms of section 15(2)(c).

Such amendments may be in the form of

- a new Memorandum of Incorporation, or
- amendments to the existing provisions of the Memorandum of Incorporation.



Note that, if changes are in the form of a new Memorandum of Incorporation, the new Memorandum of Incorporation will replace the existing Memorandum of Incorporation.

A company's Memorandum of Incorporation may be amended:

- in compliance with a court order (An amendment in terms of a court order is given effect via a board resolution and there is no need for a shareholders' special resolution.)
- by the board in terms of sections 36(3) and (4) (These allow the board to amend the authorised share capital of the company unless the Memorandum of Incorporation provides otherwise.)
- by a special resolution of the shareholders proposed by
 - the board of directors, or

- shareholders who collectively exercise not less than 10% of the voting rights

(There is no need to convene a shareholders' meeting to adopt this special resolution. As it is sometimes difficult for some shareholders to attend meetings, the proposal to amend the Memorandum of Incorporation may be sent or hand-delivered to the shareholders who are entitled to vote. The proposal will be adopted, if approved by the required majority who voted in writing, within 20 days after the resolution was delivered to them (section 60 of the Companies Act).)

- in terms of the procedure set out in the company's Memorandum of Incorporation

To affect the amendment, a form **CoR 15.2** must be filed. Unless the amendment is made by a company that existed before the Companies Act came into operation, and the amendment is pursuant to compliance with the Companies Act, a filing fee must be paid. A copy of the special resolution (if this is required in terms of a company's Memorandum of Incorporation), or a copy of the amended Memorandum, must accompany the notice.

In the Amendment Bill it is proposed that section 16 be amended. In terms of the proposed amendment a Notice of Amendment of a company's Memorandum of Incorporation will take effect ten business days after the receipt of the Notice of Amendment to the Memorandum of Incorporation if the Commission after the expiry of the ten business days, has not endorsed the Notice of Amendment or has failed to deliver a rejection of the Notice of Amendment to the company with reasons, or on a later date as set out in the Notice of Amendment.

An amendment may result in a profit company no longer meeting the criteria for that category of profit company. When this happens, the name and the ending expression must also be amended in such a way that it reflects the new category that the profit company falls under.

If an amendment to the Memorandum of Incorporation of a personal liability company has the effect that the company falls into another category of company, the company must give at least ten days prior notice of the filing of the notice of amendment to any professional or industry regulatory authority that has jurisdiction over the business of the company, and to any person who may have relied on the personal liability of the directors in dealings with the company and who could suffer prejudice if that liability is terminated.

8 Alteration of the Memorandum of Incorporation

The Companies Act allows for changes or alterations to be made to the company's rules and to the Memorandum of Incorporation in order to correct minor errors such as grammar, punctuation, spelling, and references.

 Note that it is the board of a company, or an individual who has been given authority to do so by the board, that may make the changes.

For an alteration to be affected

- a notice of alteration must be published in accordance with the Memorandum of Incorporation and the rules
- a notice of alteration (form **CoR 15.3**) must be filed, and
- a filing fee must be paid.

9 Translations of a Memorandum of Incorporation



Prescribed study material

- o **Companies Act: section 17(3) and 17(4)**

A company which has filed a Memorandum of Incorporation has the right to file a translation thereof. The translation may be in any official language or more than one official language of the Republic of South Africa. A notice of translation (form **CoR 15.4**), a copy of the translated Memorandum of

Incorporation, and a sworn statement by the translator confirming that the translation is a true, accurate and complete translation of the Memorandum of Incorporation, must be filed. A filing fee is payable.

❖ Note that, in the event of a conflict between the Memorandum of Incorporation and the translated version, the original Memorandum of Incorporation prevails.

10 Consolidation of a Memorandum of Incorporation



Prescribed study material

- o Companies Act: section 17(5) and 17(6)

After filing the Memorandum of Incorporation, a company may make amendments or alterations to it. At any time thereafter, the company may file a consolidated revision of its Memorandum of Incorporation indicating all the new changes. The Commission may also require the company to consolidate its Memorandum of Incorporation by sending a form **CoR 15.6** request.

The consolidated revision has to be filed together with a notice (form **CoR 15.5**) as well as a sworn statement made by a director of the company or by an attorney or notary confirming that it is a true, accurate, updated, and a complete representation of the Memorandum of Incorporation. Payment of a filing fee is required.

11 Authenticity of versions of the Memorandum of Incorporation



Prescribed study material

- o Companies Act: section 18

In the event of a conflict between the Memorandum of Incorporation and its translated versions, the Memorandum of Incorporation, as altered or amended, prevails. The same applies to a conflict between the Memorandum of Incorporation, as altered or amended, and its filed, consolidated version. The consolidated version will prevail only if it has been ratified by special resolution at a general shareholders' meeting of the company.

In the event of a conflict between the latest version of the Memorandum of Incorporation endorsed by the Commission and any other document purporting to be a Memorandum of Incorporation, the latest version as endorsed by the Commission will prevail.

12 The Memorandum of Incorporation and shareholders' agreements



Prescribed study material

Textbook: chapter 2 para 4.7

- o Companies Act: section 15(7)

Shareholders may enter into agreements with each other regarding any matter concerning the company. Such agreements must be consistent with the Companies Act and the company's Memorandum of Incorporation. Where a provision of the agreement is inconsistent with the Act or with the Memorandum of Incorporation, it is void to the extent of its inconsistency.

13 Anti-avoidance



Prescribed study material

Textbook: chapter 2 para 5

o **Companies Act: section 6**

In terms of section 6 of the Companies Act, the Commission or Takeover Regulation Panel may apply to court to declare an agreement void if it is intended to defeat or reduce the effect of any prohibition or requirement established by, or in terms of, an unalterable provision of the Companies Act.

Shareholders' agreements regulating voting rights may fall foul of this provision.

14 Substantial compliance



Prescribed study material

Textbook: chapter 2 paras 6 and 9

Companies Act: section 6

So long as a company substantially complies with the prescripts relating to the content of documents, records, statements, or the process for lodging documents, etc., the conduct relating thereto will be valid. An exception is that companies are required to comply strictly with notice periods prescribed by the Companies Act.

→ Reflection

You have now learnt about the procedure for the incorporation of companies. You should, therefore, be able to advise a person wishing to start a company of the procedure.

The purpose of the Companies Act is to simplify the process for incorporation of companies. Only one constitutive document – the Memorandum of Incorporation – is required to register a company.

The board of directors, which is responsible for the management of the company's business, may, however, adopt rules to regulate internal processes.

LESSON 5:

Pre-incorporation contracts

1 Introduction

The common law does not allow a person to act as an agent for a principal who does not exist. This means that, under the common law, no person can act as an agent for a company which has not yet been incorporated, because the company does not exist before incorporation. Section 21 of the Companies Act allows for pre-incorporation contracts to be entered into on behalf of the company which has yet to be incorporated.

Section 21 does not exclude the common law, which means that a promoter may also use the common law alternatives.

In this lesson, we start off by looking at the available alternatives at common law for concluding a contract before incorporation of a company, whereafter the requirements for pre-incorporation contracts under the Companies Act are considered.

You will know that you understand this lesson if you are able to answer the following **key questions**:

- What are pre-incorporation contracts?
- What are the formal requirements for a contract to be binding on a company under section 21 of the Companies Act?
- Who is liable for performance if a pre-incorporation contract is concluded under section 21 of the Companies Act and the company is subsequently not registered?
- Who is liable for performance in terms of a pre-incorporation contract concluded under section 21 of the Companies Act if the company subsequently rejects the contract?
- List the common law alternatives for concluding a pre-incorporation contract.
- Explain the process for the conclusion of a contract to the benefit of a third party (*stipulatio alteri*).
- Explain the process of nomination of a company to be bound by terms of an agreement under the common law.
- Explain what is meant by “cession” and “delegation”. What is the risk attached to this alternative means of conclusion of a pre-incorporation contract?
- What are the benefits of concluding a pre-incorporation contract under the common law instead of under section 21 of the Companies Act?

Important terms	Meaning
Common law	Also known as case law or precedent. Law developed by judges through decisions of courts and similar tribunals rather than through legislative statutes or executive-branch action.
Pre-incorporation contract	A contract entered into by a person who is acting on behalf of a company that does not exist yet.
Promoter	The catalyst for the conclusion of a pre-incorporation contract. This is a more apt description than “agent”, as common law agency is impossible for the conclusion of pre-incorporation contracts.
Delegation	The transfer of duties.
Cession	The transfer of rights.
Option agreement	An agreement between two parties that provides one of the parties with the right, but not the obligation, to buy, sell or obtain a specific asset at an agreed-upon price at some time in the future.
<i>Stipulatio alteri</i>	A contract that is concluded for the benefit of a third party.

2 Common law methods of concluding pre-incorporation contracts



Prescribed study material

Textbook: chapter 2 paras 7.1 – 7.2

It is impossible for an agent to act on behalf of a principal who/which does not exist. In other words, the general principles of agency are unavailable for use before a company is registered and acknowledged as an existing entity. Nevertheless, it may be necessary for a company to conclude a contract before it is incorporated. The ways in which it is possible to conclude a contract which will, after its incorporation, bind the company are briefly highlighted:

2.1 Cession and delegation

“Cession” is the **transfer of rights** and ‘delegation’ means the **transfer of duties or liabilities**. When using this cession and delegation method, which is a combination of the two processes, to conclude a pre-incorporation contract, a person concludes the contract in his or her own name. After the company is registered, this person cedes the rights and delegates the obligations under the contract to the company.

The risk associated with this method is that the consent of all three parties is required for delegation of duties. In other words, the company and the other contracting party must agree to the substitution of the company as the new debtor. All rights and duties not accepted by the company will remain with the original person unless it is specifically agreed otherwise.

2.2 Nomination

A person concludes the pre-incorporation contract subject to a term that he or she will have the option to nominate a third party in his or her place within a specified period.

Upon incorporation of the yet-to-be-formed company, this person then nominates the company to become a party to the contract in his or her place. The risk is that the company may refuse the nomination or not be able to comply with the obligations in terms of the agreement. In such circumstances, the original debtor will only incur liability if this is specifically agreed on.

2.3 Option

The option granter (offeror) undertakes to keep the substantive offer open for a period of time. The option is then ceded to the company upon its incorporation.

If the company accepts the offer, a contract comes into being. Otherwise, the person who concluded the option agreement will only remain personally liable if the option agreement provides for liability.

2.4 Contract for the benefit of a third party (*stipulatio alteri*)

A person concludes a contract with another contracting party in terms of which the last-mentioned will offer certain benefits to the company to be formed. If the company is formed, it can accept the offer or decline it. The risk is that the company may not come into existence or may not accept the offer. The person who concluded the contract will only incur liability under the contract if specifically, so provided.

3 Statutory method of conclusion of a pre-incorporation contract (section 21)

Prescribed study material

Textbook: chapter 2 para 7.3

- o **Companies Act: sections 1 (definition of “pre-incorporation contract”) and 21 (requirements for preincorporation contracts)**

The common law does not allow a person to act as an agent for a principal who does not exist. This means that, under the common law, no person can act as an agent for a company which has not yet been incorporated, because the company does not exist before incorporation.

This may result in the company losing the chance to enter into beneficial contracts which present themselves prior to incorporation. To avoid this state of affairs, section 21 of the Companies Act allows for pre-incorporation contracts to be entered into on behalf of the company which has yet to be incorporated.

Section 1 of the Companies Act describes a **pre-incorporation contract** as “a written agreement entered into before the incorporation of a company by a person who purports to act in the name of, or on behalf of, the proposed company, with the intention or understanding that the proposed company will be incorporated and will thereafter be bound by the agreement”.

In terms of **section 21 of the Companies Act**, a pre-incorporation contract will be binding on a company if:

- (1) it is concluded by a person in the name of, or purporting to act in the name of, or on behalf of, a company yet to be incorporated in terms of the Companies Act, and
- (2) the contract was concluded in writing, and
- (3) the board of that company ratifies the transaction or does not reject the contract within the stipulated three-month period after its incorporation (In other words, if the above two formal requirements are complied with, and after the company's incorporation, the board “does nothing” about the transaction (i.e., neither ratifies nor rejects it), the contract will become binding on the company.).

However, section 21 provides for **joint and several liability** of the person or persons who concluded the contract on behalf of the company for liabilities created in terms of the pre-incorporation contract if:

- the company is not incorporated, or
- the board rejects the contract partially or in full (In such a case, the person who acted on behalf of the company may claim any benefit from the company that it receives in terms of the contract, but contract but may apparently not claim any benefit from the other contracting party).

Note, however, that joint and several liability does not apply where the contract is replaced with another similar contract after incorporation.

The common law alternatives (except for agency, which is impossible) could be used more effectively and safely to avoid possible personal liability. The common law constructions have a major advantage over the statutory method because, in terms of the common law, the person acting on behalf of the proposed company is not automatically liable if the company is not incorporated or fails to ratify the contract completely.

→ Reflection

You were introduced to the statutory position where contracts are concluded prior to the incorporation of a company, or **pre-incorporation contracts**. Keep in mind that the various common law options remain available for the conclusion of pre-incorporation contracts. The possible personal liability of the promoter that is brought about by the Companies Act might be riskier than the common law alternatives.

LESSON 6:

Registration of company names

1 Introduction

Company names play a vital role in providing a corporation with an identity. The public often associates a name with a specific product and with good or bad service. An example of how the values of ubuntu re-imbued in the law regulating different South African business forms is that it is a rule in all business enterprises that the chosen name should not be offensive, racist or impinge negatively on any individual/ legal person's right to dignity.

Therefore, it is imperative that there are rules to regulate what names may be chosen. The Companies Act provides for name reservations. If a proposed name is rejected, the company may usually still be registered, and the registration number then becomes the name of the company at incorporation until such time as an appropriate name has been reserved or approved.



Note that non-profit companies are not allowed to have registration numbers as their names.

In this lesson, the process for the reservation of a company's name will be considered. In addition, the situation when a company's name is objectionable will be set out.

You will know that you understand this lesson if you are able to answer the following **key questions**:

- What are the criteria for the names of companies under the Companies Act?
- Who can order a name change where a name to be registered is similar to an existing company's name?
- What factors are considered in order to ascertain whether or not a name is objectionable?
- How should the name and registration number of a company be used?

2 Reservation process



Prescribed study material

Textbook: chapter 2 para 3

o **Companies Act: section 11**

To reserve a name, form **CoR 9.1** must be completed, and a filing fee is payable.

The criteria for the acceptance of names have been reformed to give maximum effect to the constitutional right to freedom of expression.

The Companies Act restricts a company name only as far as it is necessary to

- protect the public from misleading names which falsely imply an association that does not exist
- protect the interest of the owners of names and other forms of intellectual property (such as trademarks) from other persons passing themselves off as such owners or coat-tailing on the owners' reputation and good standing, and
- protect the public from names that would fall within the ambit of expression that does not enjoy constitutional protection because of its harmful or other negative nature.

To avoid deception of the public, the name of a company may not

- be the same as the name of another company, external company, close corporation or cooperative; or the name of a business which has already been registered in terms of the Business Names Act 27 of 1960; or a trademark which has been filed for registration in terms of the Trade Marks Act 194 of 1993; or a mark, word or expression protected in terms of the

Merchandise Marks Act of 1941

- be confusingly similar to a name, trademark, mark, word, or expression as described above (subject to specific exceptions)
- give the false impression that the company is associated with the government or with a particular person or government office, etc., and
- include any word, expression or symbol that may constitute propaganda for war, incitement of imminent violence, or advocacy of hatred based on race, ethnicity, gender or religion, or incitement to cause harm.

Also note the following:

- The Companies Act does not make provision for the registration of a shortened or translated name.
- A name reservation in a foreign language must be accompanied by a certified translation and certificate of translation.
- In terms of the **Consumer Protection Act 68 of 2008**, members of the public are required to register their business/trading name/sole proprietorship/partnership names with the Commission.
- Where, according to the Commission, there is a possibility that the name is similar to the name of another company or another business undertaking or trademark, or that the name gives the impression that there is a connection between the company that is applying and another entity or state organ, the Commission may compel the applicant to inform parties that may be interested by serving them with a copy of the application and name reservation. If the company's name is to be associated with another existing business, the Commission will require proof from the applicant company that the associated company was made aware before registration that a similar name would accordingly be allowed.
- The Companies Act also allows any person who has an interest in the name of a company to apply to the **Companies Tribunal**, to determine if the name is acceptable in terms of the Companies Act.

3 Effect of a name reservation



Prescribed study material

- o **Companies Act: section 12 and 160**

A name reservation is valid for six months. It is possible to apply for an extension of a name reservation for an additional 60 business days by lodging form **CoR 9.2** and paying a filing fee.

In terms of section 12 of the Companies Act, a name may be reserved for use at a later stage, to be used for a newly incorporated company, or to be used as a replacement for an existing name of a company.

Someone who has applied for the reservation of a name may transfer the reserved name to another person by lodging a form **CoR 11.1**.

Disputes regarding names may be referred to the **Companies Tribunal** or the **Human Rights Commission** in terms of section 160 of the Companies Act.

4 Change of name



Prescribed study material

- o Companies Act: section 11(3)

Prescribed case law

You only need to know the following case as discussed herein:

- ***Peregrine Group (Pty) Ltd & others v Peregrine Holdings Ltd & others 2001 (3) SA 1268 (SCA)***

Where a name that is to be registered is the same as another name as described above, the Commission may make use of the registration number of the company as an interim name.

The company will be provided with another opportunity to file a Notice of Incorporation containing an acceptable name. Upon receipt of the Notice of Incorporation with the amended name, the Commission must enter the new name in the Companies Register. It must also issue an amended Registration Certificate reflecting the amended name.

In *Peregrine Group (Pty) Ltd & others v Peregrine Holdings Ltd & others*, the seven applicant companies and 11 respondent companies were all registered under names with the word “Peregrine” as the first and dominant word. The applicants sought an order directing the first eight respondents to change their names by excluding the word “Peregrine” and restraining them from passing off their businesses as that of or associated in the course of trade with that of the applicant.

The Registrar of Companies indicated that his office did not “allow the monopoly of an ordinary generic word”. Therefore, he had permitted the registration of twenty-nine entities bearing some designation containing the name “Peregrine”. The court looked at the **activities** that the companies engaged in, to decide whether the **similarity in the names** would cause confusion. In addition, the **client bases of the respective companies** were considered to establish whether there was an overlap. It was made clear that a court may direct a company to change its name if the name is undesirable and calculated to cause harm to the applicant.

It was held that the court enjoyed a wide discretion to hold that a company’s name is undesirable. Where the **names of companies are the same, or substantially similar**, and where there is a **likelihood that members of the public would be confused** in their dealings with the competing parties, these would be crucial factors considered in deciding whether or not a name was undesirable. However, the mere fact that the names of companies are the same or similar is not a conclusive factor in determining whether or not a name is objectionable.

The **date of registration of the companies** would also play a role. The company that first registered the name would enjoy preference over companies that later changed their names.

In order to prove passing off, it has to be shown that the applicant had acquired a reputation in respect of the services which it offered with the name and that the respondent had made a representation which would lead members of the public to associate the respondent’s business with that of the applicant.

5 Use of name and registration number



Prescribed study material

o Companies Act: section 32

Section 32 requires that a company furnish its full name or registration number to any person on demand. It further prohibits the misstating of the name or registration number, and the stating of the name in such a way that it may mislead or deceive a person. A company must use its registered name at all times, and not a modified version of such name. In the case of a profit company, the name may consist of a registration number only, followed by the words 'South Africa'.

Where the Registration Certificate is issued with an interim name by the Commission, the company is obliged to use its interim name. The interim name is used until the company's name has been amended.

→ Reflection

You have learnt that there are prescribed criteria for company names. Although it is not always required of companies to reserve a name, it is preferable, as the Commission may require a company to change its name if it is too similar to another already existing company's name or objectionable for some other reason. There are measures in place to protect a company's goodwill and avoid deception of the public as a result of the registration of undesirable names.

LESSON 7:

Capacity and representation of a company

1 Introduction

A company's capacity is determined by the **sphere of actions that it may legally perform**. Representation occurs when somebody acts on behalf of, or in the name of a company. You will learn what actions a company may legally perform or what capacity the company enjoys. In addition, you will be introduced to the corporate-law principles applicable to representation in companies. Therefore, this unit deals with the **validity of company actions** and the **authority of a person** to act on behalf of the company.

You will know that you understand this lesson if you are able to answer the following **key questions**:

- What is meant by the 'capacity' of a company?
- What is the *ultra vires* doctrine?
- In which circumstances does a person have the authority to represent a company and bind it to an agreement?
- What is the purpose of the *Turquand* rule and how does it operate under the Companies Act?

2 Capacity of a company



Prescribed study material

Textbook: chapter 5 para 1

- o **Companies Act: Sections 19(1) and 20**

The capacity of a company is determined by the sphere of actions that it may legally perform.

Important terms	Meaning
Estoppel	The legal principle that prevents someone who made a representation from subsequently denying the truth of such a representation if certain requirements are met. The representor is therefore estopped from denying the truth of the representation.
<i>Turquand</i> rule	The rule established in <i>Royal British Bank v Turquand</i> in terms of which an outsider dealing in good faith with a company may assume that all aspects of the company's internal management have been duly complied with.
<i>Ultra vires</i> doctrine	The rules pertaining to the consequences of a company acting outside the scope of its powers and competency.

3 The *ultra vires* doctrine



Prescribed study material

Textbook: chapter 5 para 3

In terms of our **common law**, a contract is *ultra vires* the company when the conclusion of the transaction is beyond its legal capacity. In other words, if a company's principal business is, for instance, catering, it would be outside the company's capacity to buy an expensive yacht on behalf of the company. The *ultra vires* doctrine is based on the understanding that a company exists in law only for the purpose for which it was incorporated.

According to the *ultra vires* doctrine, when an act on behalf of the company falls outside its main and ancillary objects, the company does not exist in law and, consequently, such an act is not binding on the company. Such an act is described as an *ultra vires* act. In the catering example mentioned above, it would be within the scope of the principal business (*intra vires*) for the company to purchase a refrigerator that it needs for catering.

In *Attorney-General v Mersey Railway Co*, the court explained that whether a particular contract falls within the capacity and powers of the company is a question of fact. If the main purpose of the company was to carry on the business of a hotel, it is clear that acts necessary to achieve this purpose, for example the purchasing of furniture and the hiring of staff, are *intra vires*.

In terms of section 19(1)(a) of the Companies Act, a company becomes a separate legal person upon incorporation. This legal personality continues until the name of the company is removed from the Companies Register. One of the main advantages of incorporation is that a company enjoys perpetual existence. A company does not die like a natural person, and the business is unaffected by a change in the shareholders or members of the company. A company can only be terminated by means of a legal process, deregistration, and dissolution.

Section 19(1)(b) of the Companies Act provides that a company has all the legal capacity and the powers of a natural person, except to the extent that a juristic person is incapable of exercising any such power, or the company's Memorandum of Incorporation provides otherwise. Therefore, the capacity of a company is no longer limited by its main or ancillary objects or business, and these objects need not even be stated in the Memorandum of Incorporation. Although the company's Memorandum of Incorporation may limit, restrict or qualify the purposes, powers or activities of the company (in other words, impose restrictions on the legal capacity of the company) in terms of section 19(1)(b)(ii), any such restrictions would not render any contract invalid that conflicts with these restrictions (section 20(1)(a)). **Therefore, the contract remains valid and binding on the company and the other party to the contract even if it is an *ultra vires* transaction.**

Furthermore, the Companies Act no longer requires that a company's principal business be stated in its Memorandum of Incorporation, as was the case under the previous legislation. Although the company's Memorandum of Incorporation may restrict the company's legal capacity, such restriction will not, in terms of section 19(1)(b)(ii), invalidate a contract that is in conflict with the restrictions (section 20(1)(a)). Thus, the contract will remain valid and binding on the company and the other contracting party.

Even though an *ultra vires* transaction will be binding on the company, the shareholders are provided with recourse to claim back their losses from the person who acted beyond the scope of the company's capacity. **Section 20(6) of the Companies Act** provides that each shareholder has a claim for damages against any person who fraudulently, or due to gross negligence, causes the company to do anything inconsistent with the Companies Act or a limitation, restriction or qualification on the powers of the company as stated in its Memorandum of Incorporation, unless ratified by special resolution in terms of section 20(2). This is in addition to the remedy provided in section 165.

If the company or directors have not yet performed the planned action (e.g., concluded the contract) that is inconsistent with a limitation or qualification of the company's powers contained in the Memorandum of Incorporation, one or more shareholders, directors or prescribed officers of the company may obtain a court order restraining (i.e., preventing) the company or directors from doing so. A third party who did not have actual knowledge of this limitation or qualification and acted in good faith

will, in such a case, have a claim for damages suffered as a result. In terms of section 20(4), shareholders, directors, prescribed officers, and a trade union representing employees of the company may also institute proceedings to prevent the company from doing anything inconsistent with the Act. Note that it is only in the last-mentioned case that a trade union may prevent the company from acting.

4 Representation



Prescribed study material

Textbook: chapter 5 para 4

Representation relates to a person acting under the company's authority. Authority can be given expressly (in writing or orally) or by implication. Whether authority has been conferred is a question of fact.

If a company gives an agent authority to act on its behalf, the agent possesses **actual authority** and will bind the company in acts which fall within the scope of the mandate given to him or her.

Sources of actual authority:

- Memorandum of Incorporation
- Rules
- Express mandate

A company may also be bound by a contract on the basis of estoppel where the person purporting to conclude the contract on its behalf lacked actual authority, expressly or implied, but the other party to the contract had been misled by the company into believing that he or she did have authority. This is referred to as **ostensible or apparent authority**.

In other words, a company may be liable to a bona fide third party if it is represented by someone who does not have actual authority, and where the company allows such a person to represent the company as if that person did have authority.

5 Doctrine of constructive notice



Prescribed study material

Textbook: chapter 5 para 2

- o **Companies Act: section 19(5) and (6)**

The doctrine of constructive notice provides that third parties dealing with a company are deemed to be fully acquainted with the contents of the public documents of the company. **Section 19(4)** of the Companies Act partly abolishes this doctrine. Therefore, third parties contracting with the company will no longer be deemed to have had notice of the contents of the public documents of a company merely because they have been filed with the Commission or are accessible for inspection at the office of the company.

However, **section 19(5) of the Companies Act** provides for **two exceptions**: **Firstly**, a person is deemed to have knowledge of any provision of a company's Memorandum of Incorporation in terms of section 15(2)(b) (relating to special conditions applicable to the company and additional requirements regarding their amendment).

This is subject to the condition that the name of the company includes the ending 'RF', and that the company's Notice of Incorporation contains a prominent statement drawing attention to such a provision as required by section 13(3). In other words, the **doctrine of constructive notice still**

applies to “ring-fenced” companies.

Section 15(2)(b) of the Companies Act determines that a company may include restrictions and conditions in its Memorandum of Incorporation pertaining to the company’s capacity. Before a third party dealing with the company would be required to acquaint themselves with these restrictions and conditions, certain requirements must be met in terms of the Companies Act:

- (1) There must be a restriction or conditions in the Memorandum of Incorporation of the particular company.
- (2) A prohibition against amendment of the restriction or condition must be included in the Memorandum of Incorporation.
- (3) ‘RF’ must follow the company’s name to warn the third party of the special restrictions or conditions.
- (4) The Notice of Incorporation that is lodged together with the Memorandum of Incorporation must include a provision that draws attention to the fact that special restrictions or conditions apply to the company.

The **second exception** applies to a **personal liability company**. A person is also regarded as having received notice and as possessing knowledge of the effect of section 19(3) on a personal liability company. Section 19(3), in turn, provides that the directors and past directors of a personal liability company are jointly and severally liable, together with the company, for any debts and liabilities of the company contracted during their respective periods of office.

6 The *Turquand* rule



Prescribed study material

Textbook: chapter 5 para 5

o **Companies Act:** section 20(7)

Prescribed cases:

These cases you only need to know as discussed herein:

- ***Royal British Bank v Turquand* (1856) 6 E & B 327, 119 ER 886**
- ***Wolpert v Uitzigt Properties (Pty) Ltd* 1961 (2) SA 257 (W)**
- ***Tuckers Land and Development Corporation (Pty) Ltd v Perpellief* 1978 (2) SA 11 (T)**

6.1 Common law *Turquand* rule

The *Turquand* rule was derived from *Royal British Bank v Turquand*. According to the common law *Turquand* rule, if the person acting on behalf of the company has the authority to do so, but this is subject to an internal formality, such as approval by the board, an outsider contracting with the company in good faith is entitled to assume that this internal requirement has been complied with. The company will be bound by the contract even **if the internal formality has not been complied with**. The exceptions are: if the outsider was aware of the fact that the internal formality had not been complied with; or if the circumstances in which the contract was concluded were suspicious.

The *Turquand* rule was formulated to keep an outsider’s duty to inquire into the affairs of the company within reasonable bounds. To trigger the protection provided by the *Turquand* rule, there must have been an internal requirement present.

- A company’s Memorandum of Incorporation determines who has authority to act on behalf of the company.
- The *Turquand* rule applies where the authority is subject to an internal requirement.

Example: Company A's Memorandum of Incorporation determines that the board of directors has authority to conclude all contracts on behalf of the company. If the amount of the transaction exceeds R50 000, consent must be obtained from the shareholders at a general meeting.

The underlined part in the block above contains an internal requirement. Even though the Memorandum of Incorporation is registered and available to the public, a third party contracting with the company would have to conduct a further investigation to ascertain whether or not consent was obtained from the shareholders.

The *Turquand* rule makes this unnecessary, as, in terms of this rule, third parties who act in good faith may assume that such internal requirement has been complied with.

Practical effect of the *Turquand* rule:

A company cannot escape liability under an otherwise valid contract on the ground that an internal formality or procedure was not complied with.

The *Turquand* rule does not protect:

- directors, prescribed officers or shareholders or anyone who should have been aware whether the internal requirements had been complied with, or
- a third party who has relied on a forged document.

However, the *Turquand* rule does not convey ostensible authority as when estoppel may be used. The person who represented the company must have had **actual authority which was subject to an internal requirement** in order to rely on the *Turquand* rule.

In Wolpert v Uitzigt Properties (Pty) Ltd, the Articles of the company provided that the board of directors could authorise a person to sign promissory notes on its behalf. Therefore, the board could authorise anyone to sign promissory notes on its behalf. One of the company's ordinary promissory notes on behalf of the company without authorisation and the question arose whether the outsider was entitled to assume that the director was authorised to do so.

The court found that an outsider with express or constructive notice of the articles could assume that someone was authorised to sign the notes, but not that a specific person was so authorised.

For the *Turquand* rule to come into operation, the person who acted must have possessed actual authority which was subject to an internal formality. In *Tuckers Land and Development Corporation (Pty) Ltd v Perpellief*, the court held that third parties may not automatically assume that a branch manager or an ordinary director has authority to act on behalf of the company. The company may still escape liability on the grounds that the person had no authority.

6.2 'Statutory *Turquand* rule' – section 20(7) of the Companies Act

Section 20(7) of the Companies Act now contains a provision that in some respects resembles the *Turquand* rule by providing that a person dealing with a company in good faith is entitled to presume that the company, in making any decision in the exercise of its powers, has complied with all the **formal and procedural requirements** in terms of the Act, the company's Memorandum of Incorporation and any rules of the company, unless the person knew, or reasonably ought to have known, of any failure by the company to comply with any such requirement.

However, this provision does not replace the *Turquand* rule, because section 20(8) provides that subsection (7) must be interpreted concurrently with, and not in substitution for, any relevant common law principle relating to the presumed validity of the actions of a company.

The exceptions to the application of the statutory rule are not expressed in exactly the same way as the common law exceptions: section 20(7) determines that the rule will not apply if the third party knew or **reasonably ought to have** known that the internal requirement had not been complied with.

7 The doctrine of estoppel



Prescribed study material

Textbook: chapter 5 para 4.1.2.2

Prescribed case:

You only need to know the case below as discussed herein:

- ***Freeman & Lockyer v Buckhurst Park Properties (Mangal) Ltd [1964] 2 QB 480***

Estoppel applies only when the **agent did not have actual authority** to bind the company. Take particular note of the fact that the misrepresentation (i.e., that the agent had the necessary authority when, in fact, he or she did not) must have been made by the **company** as principal.

Based on such misrepresentation, the company will be prevented (estopped) from denying liability if the third party can prove that

- (a) the company misrepresented, intentionally or negligently, that the agent concerned had the necessary authority to represent the company
- (b) the company made the misrepresentation
- (c) the third party was induced to deal with the agent because of the misrepresentation
- (d) the third party was prejudiced by the misrepresentation.

In *Freeman and Lockyer v Buckhurst Part Properties (Mangal) Ltd*, the court decided that estoppel could not only arise from the Articles (note that this would be the Memorandum of Incorporation in terms of the current Companies Act), but also because the company with full knowledge and approval allowed an ordinary director to act as the managing director and, in this manner, culpably represented that he was entitled to act.

Examples:

Companies can conclude *ultra vires* contracts:

The Memorandum of Incorporation of ToyZ Ltd states that the main business of the company is to sell toys. Suppose that the board of directors of ToyZ Ltd decides to buy a luxury yacht on behalf of the company.

Note the following:

- A company has the capacity to conclude any type of contract that it can do by virtue of the fact that it is a juristic person (section 19 of the Companies Act).
- This is a valid transaction even though the company has exceeded its capacity (section 20 of the Companies Act).
- The Companies Act no longer requires companies to indicate what their principal business is in the Memorandum of Incorporation.
- The effect is that the company would usually be bound by contracts – even those outside the scope of their operations – unless the third party knows of the restriction in capacity (RF companies and personal liability companies as envisaged in section 19(5) of the Companies Act).
- Even if the third party was aware of the restriction, it is still possible for the shareholders to ratify the *ultra vires* action (section 20 of the Companies Act).
- If the transaction is not yet completed, it is possible to apply to the court to prevent completion thereof.
- If the contract has already been concluded, any shareholder(s) that suffered damages as a result thereof can claim compensation.

Application of the *Turquand* rule:

Steelbelts Railway Carriages (Pty) Ltd's Memorandum of Incorporation provides that only the board of directors, or any person authorised by the board, has the power to conclude contracts on behalf of the company. In addition, any transaction that exceeds R100 000 must first be authorised by the company at a general meeting by way of an ordinary resolution. (Note: This is an internal requirement.)

Mr Buckley, one of the directors, is authorised by the board of directors to act on behalf of the company. Mr Buckley concludes a contract with Mr Matthews for the purchase of equipment that will be used in the process of manufacturing railway carriages to the value of R150 000 without the authorisation of the company at a general meeting. Mr Matthews knows about this provision because he has dealt with the company before. He, however, assumes that the approval of the general meeting has been obtained, since it had always been obtained for previous transactions.

Note the following:

- The *Turquand* rule and section 20(7) of the Companies Act can apply to the same set of facts.
- The exceptions to the common law *Turquand* rule are slightly different: If the third party knew that the internal requirements were not complied with, or if the circumstances were **suspicious**, the third party would not be able to rely on the rule. In terms of section 20(7), the third party had to have known or **reasonably ought to have known**.
- The *Turquand* rule and section 20(7) both only protect third parties acting in good faith.
- The effect of the *Turquand* rule and section 20(7) is that the company would be bound by the transaction even if the internal requirement had not been complied with.

Application of the doctrine of constructive notice:

The rules of Concord Ceramics (Pty) Ltd (RF) provide that the board of directors has authority to deal on behalf of the company. The rules further provide that, for any transaction in respect of which the value exceeds R1 million, the approval of a general meeting by way of a special resolution is required.

Note the following:

- Section 19(4) of the Companies Act determines that a third party is not deemed to know the contents of a company's documents just because they have been filed with the Commission.
- But, in terms of section 19(5), the doctrine of constructive notice still applies to RF companies and personal liability companies.
- Third parties would be deemed to know the consent of a general meeting is required for transactions more than R 1 million if RF follows the name **and if, in terms of section 13(3)**, the company's Notice of Incorporation specifically draws attention to the requirement.
- The effect would be that the company could escape liability for the *ultra vires* contract if the general meeting did not consent.

Application of estoppel:

Mike, a site manager at one of the company's plants, regularly contracts on behalf of the company without having a mandate to do so. The board of directors takes note of this behaviour, but never takes any steps to caution Mike against contracting on behalf of the company. Mike enters into a contract with Timothy for the purchase of raw materials. The company now argues that Mike did not have authority to enter into the contract and that it is not bound by the contract. Advise Timothy on whether the company can be held bound by the contract.

Note the following:

- Mike, in the facts above, did not have actual authority. However, the company has allowed him to conclude binding contracts on behalf of the company on previous occasions.
- Estoppel can be raised if a company denies liability since Mike lacked actual authority, because, here, the impression was created that he was in fact so authorised. This gives rise to **ostensible authority**.
- The result is that the company will be held to the misrepresentation which it had made previously by having allowed Mike to conclude contracts in the company's name.

- If it had been Mike who made the misrepresentation and the company had been unaware of it, the contract would not have bound the company, as Mike would not have had any form of **authority**.
- It would have been wrong to apply the *Turquand* rule here, as Mike, in this scenario, did not have actual authority which is made subject to an internal requirement.

→ Reflection

Even though companies enjoy separate legal personality, it is still necessary for individuals to act on their behalf. Only individuals with some type of authority may represent companies. This authority need not always be express authority.

This would be the case where the requirements for estoppel can be proven, that is, that the company negligently or intentionally misrepresented that a director did in fact have the necessary authority, the third party was induced to deal with the agent because of the misrepresentation, and the third party was prejudiced by the misrepresentation. Reference should be made to *Freeman and Lockyer v Buckhurst Park Properties (Mangal) Ltd*.

You have now learnt that companies are able to conclude any contract, whether it falls inside or outside the scope of their business. If the person who is representing the company has authority to do so, any act performed by him or her on behalf of or in the name of the company will usually bind the company.

The doctrine of constructive notice has largely been abolished by the Companies Act. Now only third parties dealing with **“ring-fenced” companies** and **companies with personal liability** are deemed to know about these special restrictions in their Memorandum of Incorporation.

Although a company may set restrictions to the scope of its actions in its Memorandum of Incorporation, such restrictions will not influence the validity of its actions unless the other contracting party (third party) is aware of the situation or reasonably should have had knowledge thereof. The *Turquand* rule also protects third parties against the possible invalidity of contracts. In terms of this rule, a third party may assume that the internal requirements have been complied with if he or she is acting in good faith and is unaware of any failure to comply with such internal requirements.

LESSON 8:

Corporate finance

1 Introduction

One of the main advantages of running one's business in the form of a company is that a company has a separate legal or juristic personality from its shareholders. This means that a company is the owner of its own assets and is responsible for its own obligations.

Another major advantage of the company as a business form is that it affords the opportunity to raise money from a wide range of investors. In this chapter, we explain the different ways in which a company can raise money. You will also learn how dividend payments work.

In certain circumstances, a company may buy back shares it previously issued, and financially assist a person to buy shares in that company. You will learn when a company may buy back shares. Finally, we pay attention to the circumstances in which a company may assist a person financially to purchase shares in that company.

A company obtains the funds it needs for its business by two possible means: equity financing and debt financing. Equity financing entails the issuance of shares in return for money, which then makes up the company's share capital. Debt financing takes the form of loans, either in the form of bank loans or debt securities. Debt securities are issued in a similar way to shares. The traditional debt security is called a debenture.

The providers of equity financing are the company's shareholders. They receive a return on their investment in the form of dividends. If the company is wound up, and after all the company's creditors have been paid, the shareholders are entitled to the balance of the company's assets.

The providers of loan capital are called company creditors. The return on their investment is interest and the principal amount of the loan which must be paid back at a specified time as agreed.

We only highlight the characteristics of shares and debentures, the procedure for the issuance of shares, and the procedure for making distributions. **In other words, you are only required to study para 1 (including its sub-paragraphs) and para 4 in chapter 3. In chapter 4, you only need to study paras 1, 2 (including all sub-paragraphs) 4 and 5 in the textbook.**

You will know that you understand this lesson if you are able to answer the following **key questions**:

Textbook: chapter 3 para 1

- **Companies Act** Which types of preference share may a company issue?
- When must the board of directors obtain the approval of the shareholders before issuing shares?
- What are the differences between shares and debentures?

2 The definition of a share



Prescribed study material

Textbook: chapter 3 para 1

- o **Companies Act: section 35**

Important terms	Meaning
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Distribution	Any direct or indirect transfer of money or other property of the company, whether out of capital or profits, to shareholders in their capacity as shareholders.
Share	Incorporeal, movable property transferable in the manner provided for by the Companies Act.
Deferred shares	A class of shares commonly issued to the founders of the company. (The right of the holder to receive dividends is deferred (delayed) until dividends have been issued to all the holders of other classes of shares in the company.)
Debenture	A document issued by a company acknowledging that it is indebted to the holder in the amount stated therein.
Dividend	A distribution by a company to its shareholders of part or all its profits.
Ordinary shares	The residual category of a company's shares that does not carry any special class rights, such as special voting rights or preferential rights to payments of dividends.
Preference shares	A class of share that provides a preferential right, including a preference to receive dividends when declared, for its holder.

The Companies Act defines a “share” as “one of the units into which the proprietary interest in a profit company is divided” (section 1). Shares are movable, transferable property without a nominal or par value.

A shareholder is essentially one of the contributors to the fund that sets up a company. This fund is the share capital of the company. A “share” is the unit of the contribution made to the share capital. It is property and can be traded.

The number of shares must be authorised in the Memorandum of Incorporation. The Memorandum of Incorporation of a company must set out the classes of shares and the number of each class that a company is authorised to issue. This is referred to as the “**authorised share capital**” of a company. A company may only issue shares that are authorised by the Memorandum of Incorporation. However, a company's board of directors may increase or decrease the authorised share capital. They may further reclassify any shares authorised but not issued.

If a company issues 100 shares and the price per share that a shareholder pays is R1, the company will have a share capital of R100. In other words, the company will have raised R100 to use in its business. After the initial issue, the share will be worth what the market is willing to pay for it.

In *Standard Bank of SA Ltd v Ocean Commodities Inc*, the court held that a share usually entitles its holder to vote at a shareholders' meeting, to share in dividends if declared by the board, and to share in any assets of the company after it has been wound up. Therefore, there are personal rights attached to shares. The extent of these rights depends on the class of shares held.

3 Classes of shares



Prescribed study material

Textbook: chapter 3 para 1.1–1.3

o **Companies Act: sections 36 and 37**

A company may divide its shares into different classes of shares

Shares are divided into classes according to the specific rights that a share confers on its holder. The rights, which differ among the various classes, can usually be divided into the following:

- the right to vote
- the right to information
- the right to share in the profits that have been declared as a dividend

- the right to share in the assets that are left on the winding-up of a company after the company's creditors have been paid

The classes of shares most commonly found are **preference shares**, **ordinary shares**, and **deferred shares**.

3.1 Preference shares

Preference shares provide their holders with a preference over other shareholders to dividends and/or return on capital on winding-up. One needs to consult the Memorandum of Incorporation of the company, as well as the terms of issue of the preference shares, to find out in which respect they confer a preference on their holders. If the preference shareholders have the right to receive dividends first, this right is usually subject to a dividend being declared. In other words, if the company has not made any profit, or if the directors decide rather to use profits in the business than to declare them as dividends, the preference shareholders do not have a right to demand a dividend payment.

In return for the preferential rights to dividends, the right of preference shareholders to vote is usually curtailed in the Memorandum of Incorporation. However, even if the Memorandum of Incorporation provides that preference shareholders do not have the right to vote, the Companies Act provides that they have an irrevocable right to vote on any proposal to amend the preferences, rights, limitations, and other terms associated with their shares.

There must always be at least one class of shareholders of the company that can vote at a meeting of shareholders, and at least one class of shareholders that is entitled to the net assets of the company upon its liquidation. In other words, a company is not allowed to issue only preference shares that do not grant their holders the right to vote.

The following types of preference share can be distinguished:

- *Cumulative preference shares*: Holders enjoy a right of priority in respect of both arrear dividends and current dividends. If a dividend is not declared in a specific year, the shareholder's right to a dividend is carried over to the next year. When a dividend is declared the next year, the preference shareholder will have to be paid two years' dividends before the ordinary shareholders can receive their dividends.
- *Participating preference shares*: After receiving their preference dividends, preference shareholders may be given the right to also receive normal dividends along with the ordinary shareholders or just after the ordinary shareholders.
- *Preferential right to capital on winding-up*: Preference shareholders could be given the preferential right to receive repayment of the capital they contributed to the company on its winding-up. Additionally, they can be given the right to share in any surplus assets of the company upon its winding-up after receiving their capital contributions, but this is the exception rather than the rule.
- *Convertible preference shares*: The right to convert the preference shares to shares of another class after a certain date attaches to the preference shares.

3.2 Ordinary shares

Such shares constitute the equity share capital of the company; the amount of the dividend paid fluctuates in accordance with the profits of the company.

Ordinary shareholders usually receive dividends after the preference shareholders have received theirs. Ordinary shareholders also usually have the right to receive any surplus assets of the company after it has been wound up.

Normally, ordinary shareholders will have the right to vote at meetings of shareholders. In terms of the Companies Act, this right may be curtailed, so that one class of ordinary shareholders will not have the right to vote.

However, there must always be at least one class of shareholders that has the right to vote, and, if there is only one class of shareholders, they must all have the right to vote.

3.3 Deferred shares

Occasionally, shares are issued to the founders of a company that entitle them to dividends only if the dividend amount exceeds a certain threshold, and after the ordinary shareholders have been paid. In other words, deferred shareholders are last in line to receive dividends.

4 Issue of shares



Prescribed study material

Textbook: chapter 3 para 1.3

o **Companies Act: sections 38 and 41**

The **board of directors** has the power to issue shares without approval of the shareholders, but these shares must be authorised by the Memorandum of Incorporation, either before the shares are issued or within 60 business days after the issue. The board of directors has the authority to increase or decrease the authorised number of shares, except to the extent that the company's Memorandum provides otherwise. The shareholders may also amend the scope of the authorised share capital by way of an amendment to the Memorandum of Incorporation by means of a special resolution.

In the following circumstances, a resolution by the board of directors to issue shares must be approved by a **special resolution of the shareholders**:

- where the shares are issued to a current or future director or prescribed officer of the company (A "future director" or "future prescribed officer" does not include a person who becomes a director or officer more than six months after the shares were issued.)
- where the shares are issued to a person related or interrelated to the company, a director, or a prescribed officer of the company
(A natural person is related to another natural person if he or she is married to that person or lives together with that person as if they were married, or if they are separated by no more than two degrees of natural or adopted consanguinity; in other words, a person's parent, child, sister or brother, or grandparents. A natural person is related to a company when she or he directly or indirectly controls the company by either having the majority of voting rights or by having the right to appoint the majority of directors of the company. A juristic person is related to another juristic person if it directly or indirectly controls the other by either having the majority of voting rights or by having the right to appoint the majority of directors of the company, or if it is a subsidiary of the company, or if it controls the business of the company.)
- where the shares are issued to a nominee of a director or prescribed officer
- where the shares are issued to a nominee of any of the persons mentioned above
- where the voting power of the shares to be issued will exceed 30% of the voting power of the shares of that class held immediately before the issue.

No special resolution is required where the issue is:

- in terms of an underwriting agreement
- in the exercise of pre-emptive rights
- in proportion to existing shareholdings and on the same terms and conditions as have been offered to all shareholders
- in pursuance of an employee share scheme
- in pursuance of an offer of shares to the public

A company may not issue shares to itself.

5 Right of pre-emption or pro rata offer



Prescribed study material

Textbook: chapter 3 para 1.4

- o **Companies Act: sections 39 and 40**

In terms of section 39 of the Companies Act, every shareholder in a private company (and a personal liability company) has the right, before any other person who is not a shareholder of the company, to be offered and to subscribe (within a reasonable time) for a percentage of any shares issued or proposed to be issued equal to the voting power of that shareholder's general voting rights immediately before the offer was made. However, a company's Memorandum of Incorporation may limit, negate, or restrict this right with respect to any or all classes of shares of that company.

A company's Memorandum of Incorporation may, however, restrict or exclude this right in respect of any or all classes of shares in the company. (See the discussion on alterable provisions contained in the Memorandum of Incorporation.)

Therefore, the general rule is that shareholders of private companies have a right of pre-emption to new shares issued by the company. This means that, when the company issues new shares, these shares must be offered to existing shareholders first, pro rata to their current shareholdings. However, the right of pre-emption will not apply if the shares are issued in terms of options or conversion rights as capitalisation shares or if the shares are issued for future consideration.

The reason this provision was included in the Companies Act is to guard against the dilution of ownership in private companies. Dilution of ownership can be explained as follows: Suppose that Fidelity (Pty) Ltd has two shareholders who each hold ten shares. At a meeting of shareholders, they will have equal voting power. Suppose that Fidelity (Pty) Ltd wants to issue twenty more shares. If a third person acquires all twenty of these shares, that person will have half of the voting rights at a meeting of shareholders. The original shareholders will now only have 25% each of the voting power at meetings of shareholders. If they had exercised rights of pre-emption, each of them would have been entitled to half of the twenty shares, and, consequently, they would retain the same percentage voting power in the company.

6 Debentures



Prescribed study material

Textbook: chapter 3 para 4

- o **Companies Act: section 43**

Prescribed case law

You need only know the following case as discussed herein:

- ***Coetzee v Rand Sporting Club 1918 WLD 74***

A debenture is an acknowledgement by a company that the company owes the debenture holder a certain sum of money, as evidenced by the document. Debenture holders are creditors of the company by virtue of having extended loans to the company.

The duties of the company towards the debenture holders can be secured or unsecured. A trustee will usually be appointed to hold security on behalf of the debenture holders. If the company defaults on its commitments to the debenture holders, the trustee will be able to enforce the security on their behalf, without the need for every debenture holder to institute action individually.

The board of directors may authorise the company to issue debentures without approval of the shareholders, unless otherwise indicated in the Memorandum of Incorporation.

Distinctions between shareholders and debenture holders:

- A shareholder of a company has the right to a share in the profits of that company (provided that a dividend is declared by the company), and a right to a share in the net assets of the company if it is wound up. However, a shareholder is also under a duty to abide by the company's Memorandum of Incorporation.
- As a debenture is a debt instrument, the holder of a debenture has effectively loaned a sum of money to the company on certain terms.
- Accordingly, the debenture holder is entitled to repayment of the sum of money loaned to the company and is, therefore, a creditor of the company. A debenture is a document issued by a company acknowledging that it is indebted to the debenture holder in the amount stated therein (*Coetzee v Rand Sporting Club* 1918 WLD 74).
- Debenture holders may have a right to attend and vote at general meetings and to appoint directors, and have special privileges regarding the allotment of securities, unless the Memorandum of Incorporation provides otherwise (section 43(3)). This was, however, not previously the case under the Companies Act 61 of 1973.

7 Company distributions



Prescribed study material

Textbook: chapter 4 para 4

- o **Companies Act: sections 1 (definition of “distribution”) and 46 (requirements for distributions)**

Section 46 of the Companies Act regulates distributions. A distribution is any direct or indirect transfer by a company of money or other property of the company (except its shares) to one or more of its shareholders or beneficial holders of shares, whether as the payment of dividends, payment for the purchase by a company of its previously issued shares, the incurrence of a debt for the benefit of one or more of the shareholders of the company, or the forgiveness of a debt owed to the company by one or more of the shareholders of the company.

A distribution may be made in the following circumstances:

- The board of directors must authorise the distribution.
- It must reasonably appear that the company will be able to satisfy the solvency and liquidity tests immediately after the distribution has been made.
- The board must acknowledge by way of a resolution that it has applied the solvency and liquidity tests and reasonably concluded that the company will satisfy the tests immediately after completion of the proposed distribution.

◆ The solvency and liquidity tests are set out in section 4 of the Companies Act:

Solvency test: That, in considering all reasonably foreseeable financial circumstances of the company at that time, the assets of the company, fairly valued, equal or exceed the liabilities of the company.

Liquidity test: That, in considering all reasonably foreseeable financial circumstances of the company at that time, 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 12 months after the distribution. If the distribution was in the form of giving a loan to a shareholder or forgiving a loan made to a shareholder, the period runs from 12 months after the test was considered.

The distribution must be made within 120 days after the test was applied, otherwise the resolution by the board must be taken again and the test must be applied again.

If these requirements are met, dividends can be paid out of the share capital of a company. However, usually dividends are paid from the profits of a company. The board of directors decides how much of the profits it wants to pay out to shareholders. It is free to decide that it is going to keep all profits for the expansion of the business of the company. Normally, in such circumstances, the shareholders are not entitled to dividends.

8 Company or subsidiary acquisition of a company's shares



Prescribed study material

Textbook: chapter 4 para 5

- o **Companies Act: sections 46 and 48**

The board of a company may determine that the company will acquire a number of its own shares. The board of a subsidiary company may determine that it will acquire a number of shares in its holding company. The company or subsidiary may then, in terms of section 48 of the Companies Act, make an offer to the shareholder/shareholders. This offer may then be accepted or rejected.

Section 48 of the Companies Act does not require that an offer be made to all shareholders or that the offer must be made according to the interest that the shareholders hold in the company.

If the shares are to be acquired from somebody who is related to the company or from a prescribed officer of the company, the board's decision to acquire the shares must be approved by the shareholders by way of a special resolution. If a company wishes to acquire more than 5% of the shares of a particular class, specific requirements apply. A subsidiary may likewise not own more than 10% of the number of any class of shares after acquiring shares from its holding company, and the shares so acquired will not enjoy voting rights in the holding company for as long as the subsidiary remains a subsidiary. An acquisition of shares which would have the effect of leaving only convertible or redeemable shares is prohibited.

The acquisition of its own shares by a company is a "distribution". Therefore, the requirements of section 46 of the Companies Act must be complied with. If the solvency and/or liquidity criteria as required in section 46 as well as section 48 of the Companies Act are not complied with, the acquisition of shares cannot be enforced. In such a case, the company may within two years after the acquisition apply to court for an order reversing the acquisition of the shares. The court has a discretion to order the return of the amount paid by the company and the return of the shares.

Directors who are present at a meeting, or who participate in authorising the acquisition, may be held personally liable for the loss or damages suffered by the company resulting from a failure to vote against a decision, despite knowing that the requirements of sections 46 and 48 of the Companies Act were not complied with.

Should the company have agreed to buy back shares, and it later becomes clear that it will not be capable of complying with its obligations in terms of the agreement, since it will not be able to satisfy the requirements of section 48(2) and (3) – which includes the requirements of section 46 regarding a distribution (thus the solvency and liquidity tests) – the agreement between the shareholder and the company in terms of which the company would buy back the shares, remains enforceable. The company, in such a case, must apply to the court for an order suspending the acquisition of the shares. The company bears the onus of proving that it is unable to comply with the requirements of the Companies Act. The court may make any order that it deems justified and fair which ensures that the person from whom the shares were purchased will be paid at the earliest opportunity, which is feasible for the company, and that the company will also be able to meet its other financial obligations as they become payable.

9 Financial assistance for the purchase of securities



Prescribed study material

Textbook: chapter 4 para 2

- o **Companies Act: section 44**

Prescribed case law

You only need to know the following cases as discussed herein:

- ***Lipschitz v UDC Bank Ltd* 1979 (1) SA 789 (A)**
- ***Gradwell (Pty) Ltd v Rostra Printers Ltd* 1959 (4) SA 419 (A)**

In terms of section 44 of the Companies Act, a company may give financial assistance by way of a loan, guarantee, provision of security, or otherwise to a person for the purpose of, or in connection with, the acquisition of shares and other securities in the company, provided that such assistance is not prohibited by the Memorandum of Incorporation and that certain requirements are met.

The decision to assist a person to acquire shares in the company rests with the board of directors, but only where the assistance is in terms of an **employee share scheme** or where a **special resolution** by the shareholders taken within the previous two years authorised such assistance to a specific person, or to persons that fall in a specific class or category. In the latter case, the person to whom the assistance will be given must fall in that class.

Section 44 further requires that the board must be satisfied that the **solvency and liquidity requirements** will be satisfied immediately after providing the financial assistance (see above), and that the assistance is given on terms that are fair and reasonable to the company. The Memorandum of Incorporation may place further restrictions on the provision of financial assistance, and the board must ensure that these requirements are also met.

The *Lipschitz v UDC Bank Ltd* decision dealt with the prohibition of financial assistance in terms of the 1973 Companies Act. However, the decision is still important for the application of section 44, because it gives us guidelines on when the provisions of the section will be applicable to a particular scenario.

In *Lipschitz v UDC Bank Ltd*, it was held that the transaction must be assessed in two phases:

- Firstly, it must be ascertained whether there was financial assistance. In *Gradwell (Pty) Ltd v Rostra Printers Ltd*, the “impoverishment test” was formulated to assist in determining whether financial assistance was provided. In terms of the impoverishment test, one considers whether a transaction will have the effect of leaving the company poorer. If so, financial assistance will have been provided. In *Lipschitz*, the court held that this is not the only measure of financial assistance, but that exposing the company to risk will also qualify as financial assistance for purposes of the Act. For example, if the person obtained a loan to purchase shares in the company, and the company stood surety for that loan, this will count as financial assistance. If the company buys an asset from the person to enable that person to purchase shares in the company, it will depend on the facts whether there was financial assistance. Factors that have emerged from case law to assist in this regard are whether the company needs the asset in its normal business and whether the company paid a fair price for it.
- Secondly, it must be determined whether that assistance was for the purpose of acquiring shares in the company. Suppose Company A is a major creditor of Company B. Company A acquires most of the shares in Company B. After the acquisition, Company A causes Company B to grant security over its movable assets to secure the loans. This will be financial assistance in terms of the first test, but it is not in connection with the purchase of shares. The assistance is to secure a loan.

When a transaction passes these two phases, it will have to comply with **section 44 of the Companies Act to be valid**. If it was not financial assistance, or if the assistance was not in connection with the purchase of shares, section 44 is not relevant to the transaction.

→ Reflection

The importance of capital maintenance to ensure that company creditors are not prejudiced by some of the transactions companies may enter into, is clear. Can you recall the circumstances in which the solvency and liquidity criteria must be adhered to before a company is allowed to take action?

Companies issue shares and debentures to raise capital. They, however, confer different rights on their holders. You should be able to identify these differences. We have also explained the circumstances in which a company may make distributions.

LESSON 9:

Corporate governance: Shareholders

1 Introduction

You have learnt that a company may divide its shares into different classes and that the holders enjoy different rights according to the class of shares that they hold.

You will now learn who is responsible for taking decisions in companies. These decisions are taken at different types of meeting. Below, we explain what happens at these meetings and the significant role that shareholders play.

You will know that you understand this lesson if you are able to answer the following **key questions**:

- Why and how are meetings convened?
- What is the quorum requirement under the Companies Act?
- What are the requirements for valid notice of a meeting under section 62 of the Companies Act?
- What is representation by proxy?
- What is the difference between an ordinary and a special resolution?
- Is it possible to pass a resolution without holding a formal meeting?
- What matters must be dealt with at the annual general meeting?
- When must a meeting be postponed or adjourned?

2 The meaning of “shareholder”



Prescribed study material

Textbook: chapter 6 para 1.1

o **Companies Act: sections 1 and 57**

Important terms	Meaning
Proxy	A person who is appointed to represent a shareholder at a meeting of shareholders.
Majority rule	In the affairs of a corporation, the will of those holding a majority of votes must ultimately prevail.
Ordinary resolution	A decision taken at a shareholders' meeting, with the support of more than 50% of the voting rights exercised or as indicated in the Memorandum of Incorporation.
Special resolution	A decision taken with the support of more than 75% of the voting rights exercised or as determined in the Memorandum of Incorporation.
Quorum	The number of persons needed to be present at a shareholders' meeting for the meeting to begin.
Unanimous assent	Where all the shareholders agree to pass a resolution.

The Companies Act uses only the term ‘shareholder’ in respect of a profit company. The term ‘member’ of a company is reserved for non-profit companies that do not have shareholders. There is a definite difference in meaning between a member and a shareholder.

There are two definitions of a shareholder in the Companies Act. The definition in section 1 is more

limited, as it refers to the holder of a share issued by a company and who is entered as such in the company's securities register. A 'shareholder' is defined in section 57(1) as a person who is entitled to exercise any voting rights in relation to a company, irrespective of the form, title, or nature of the securities to which those voting rights are attached. Therefore, the last-mentioned definition also includes a debenture holder who has voting rights. This definition is only for purposes of Part F of Chapter 2 of the Act that deals with the governance of companies.

3 Notice of meetings



Prescribed study material

Textbook: chapter 6 para 1.4

o **Companies Act: section 62**

A section 62 notice of a meeting must

- be in writing
- indicate the date, time, and place of the meeting
- indicate the general purpose of the meeting
- contain a statement that a shareholder is entitled to appoint a proxy who may participate in the meeting and vote on his or her behalf
- indicate that participants in the meeting must provide proof of identification
- be accompanied by a copy of any proposed resolution to be discussed at the meeting
- be given at least ten (10) days prior to the meeting (fifteen (15) days for public companies and non-profit companies with members).

If there has been a material defect in the giving of notice, the meeting may proceed only if every person who is entitled to vote in respect of any item on the agenda is present at the meeting and votes to approve the ratification of the defective notice.

A company may provide for a shareholders' meeting to be conducted by electronic communication. Where a company allows for participation in a meeting by electronic communication, a notice convening the meeting must inform the shareholders or their proxies of the opportunity to participate electronically. The shareholder bears the costs of participation.

4 Representation by proxy



Prescribed study material

Textbook: chapter 6 para 1.7

o **Companies Act: sections 58 and 60**

A shareholder may appoint someone (including someone who is not a shareholder) to act, speak or vote on his or her behalf at a shareholders' meeting or provide or withhold consent in terms of section 60.

Requirements in respect of the appointment of a proxy:

- The appointment must be in writing and must be signed by the shareholder.
- The appointment is valid for one year.
- The appointment may be for a specific period.
- The appointment may be for two or more persons concurrently exercising voting rights for different shares.

- A proxy may delegate authority to act on behalf of the shareholder to another person.
- A copy of the proxy appointment form must be delivered to the company before the shareholders' meeting.
- A shareholder is not compelled to make an irrevocable proxy appointment.
- A shareholder may alter a proxy by cancelling it in writing, appointing another proxy and delivering a copy of the revocation to the proxy and the company.

A shareholder may appoint more than one proxy. Shareholders can be requested on the company's form for the appointment of proxies to appoint a proxy from the list that is provided by the company. However, a shareholder is not obliged to choose one or more persons from this list. The appointment form must allow sufficient space in which the shareholder can indicate whether the proxy will vote for or against the proposal.

5 Demand to convene a shareholders' meeting



Prescribed study material

- o **Companies Act: section 61**

A shareholders' meeting may be called by the board of directors, or any person authorised to do so by the Memorandum of Incorporation. A meeting **must** be convened if required by the Companies Act or the Memorandum of Incorporation, or if demanded by shareholders holding at least 10% of the voting rights that may be exercised at that meeting.

6 Shareholders acting other than at a meeting



Prescribed study material

Textbook: chapter 6 para 2

- o **Companies Act: section 60**

Prescribed cases:

You only need to know the cases as discussed herein:

- ***Gohlke and Schneider v Westies Minerals (Pty) Ltd* 1970 (2) SA 685 (A)**
- ***In re Duomatic Ltd* [1969] 1 ALL ER 161 (Ch)**

In English and South African case law, the common law rule of **unanimous assent** has been accepted. In terms of this rule, certain decisions may be valid without a meeting being held, provided that all the members are fully aware of the facts and all of them have assented thereto, although this need not be in writing. In *Gohlke and Schneider v Westies Minerals (Pty) Ltd*, the court held that members may validly appoint a director to the board without any formal meeting being held, because there was evidence of their unanimous consent.

The court, in *In re Duomatic Ltd*, held that the unanimous approval of directors' remuneration by the two directors holding all the voting shares in a company could be regarded as a resolution of a general meeting approving the payment.

Although it is still possible to apply the common law principle of unanimous assent, the Companies Act now provides another option. The general principle remains that shareholders exercise their rights through resolutions at meetings. However, in terms of **section 60** of the Companies Act, a resolution may be submitted to shareholders and, if adopted in writing by the required majority, will have the same effect as if it had been adopted at a meeting without holding a general meeting of shareholders. This means that the unanimous assent (where it is required that each shareholder agrees) is not

required under **section 60**. If the **required majority agrees** in writing, a decision may be validly passed without convening a shareholders' meeting. However, any business of a company that must be **conducted at an annual general meeting may not be conducted by using the section 60 procedure**.

If there are dissenting shareholders (i.e., some shareholders who are not in agreement), it may be possible to use the procedure as prescribed in section 60 of the Companies Act, as long as the required majority agrees, and it is not a matter reserved for the annual general meeting in terms of the Companies Act (see list below). The shareholders may then, by written polling of all shareholders entitled to vote on the election, pass the resolution. The company must deliver a statement within ten business days after adopting the resolution, describing the results of the vote, consent process or election to every shareholder entitled to vote on the resolution.

7 Annual general meeting (AGM)



Prescribed study material

Textbook: chapter 6 para 1.2

o **Companies Act: section 61(7)–(10)**

In terms of the Companies Act, only public companies have a statutory obligation to convene annual general meetings. However, other companies may voluntarily hold such meetings.

Section 61 stipulates that at least the following matters must be transacted at the AGM:

- election of directors to the extent required by the Companies Act or the company's Memorandum of Incorporation
- appointment of an auditor for the following financial year
- appointment of an audit committee
- presentation of the directors' report
- presentation of audited financial statements for the immediately preceding financial year
- presentation of an audit committee report
- any matter raised by shareholders

8 Convening a meeting in special circumstances



Prescribed study material

Textbook: chapter 6 para 1.3

o **Companies Act: section 61(11)–(12)**

If a company cannot convene a meeting because it has no directors, or all its directors are incapacitated, section 61(11) of the Companies Act applies. In terms of this section, it is possible to authorise another person in terms of the Memorandum of Incorporation to convene a meeting in these circumstances. Should it happen that no provision is made in the Memorandum of Incorporation, any shareholder may request the Companies Tribunal to convene a meeting. Section 61(12) of the Companies Act applies to the situation where, for reasons other than the lack of or incapacity of directors, a company fails to convene its annual general meeting, or a meeting required by its Memorandum of Incorporation or shareholders. In these circumstances, any shareholder may apply to court for an order to convene a meeting.

9 Quorum



Prescribed study material

Textbook: chapter 6 para 1.5

- o **Companies Act: section 64**

Section 64 provides that a meeting may not begin until sufficient persons holding at least **25%** of all the voting rights in respect of at least one matter to be decided on at the meeting are present. The percentage (25%) may be increased or reduced in the Memorandum of Incorporation. However, if a company has more than two shareholders, at least three shareholders must be present.

If a quorum is not achieved within an hour after the time at which the meeting was scheduled, the meeting must be postponed for one week. Where a quorum is not present at the postponed or adjourned meeting, those present in person or by proxy will be deemed to constitute a quorum.

10 Conduct of meetings



Prescribed study material

Textbook: chapter 6 para 1.5.1

- o **Companies Act: section 63**

Prescribed case:

You only need to know the following case as discussed herein:

- ***Sammel v President Brand Gold Mining Co Ltd 1969 (3) SA (SCA)***

The requirements for both a special and an ordinary resolution clearly state that the required percentage of votes **exercised** in respect of the resolution must be in favour of the resolution to have it validly adopted. Only the votes of shareholders who exercise their votes are taken into consideration.

Majority rule:

Companies take decisions through majority vote. This rule is not contained in the Companies Act itself but is a common law rule.

In *Sammel v President Brand Gold Mining Co Ltd* (at 678), Trollop J summarised the position as follows:

By becoming a (minority) shareholder in a company, a person undertakes by his contract to be bound by the decisions of the prescribed majority of shareholders, if those decisions on the affairs of the company are arrived at in accordance with the law, even where they adversely affect his own rights as a shareholder.

11 Exercise of voting rights



Prescribed study material

Textbook: chapter 6 para 1.6

- o **Companies Act: section 57(2)–(6)**

Three possible situations are discussed in section 57 of the Companies Act. Briefly summarised, they are the following:

- (1) A profit company (other than a state-owned enterprise) with only one shareholder:
 - The shareholder may exercise all the voting rights.
 - Rules in respect of the setting of a record date (section 59), written polling (section 60), convening a shareholders' meeting (section 61), notice of meetings (section 62), and the normal quorum requirements do not apply.
- (2) A profit company (other than a *state-owned enterprise*) with only one director:
 - The director may exercise any power or perform any function of the board at any time, except when the Memorandum of Incorporation provides otherwise.
- (3) A company (other than a *state-owned enterprise*) where every shareholder is also a director:
 - Shareholders may decide on any matter to be referred by the board at any time, without notice or compliance with any internal formalities, except when the Memorandum provides otherwise, subject to certain specified conditions.

Where every shareholder is also a director of the company (except in the case of a state-owned company), they can decide on any matter that must be referred to the shareholders by the board without having to give notice or comply with any other internal formalities, except as provided otherwise in the Memorandum of Incorporation (section 57(4)). Every director must be present at the board meeting at which the matter is referred to them in their capacity as shareholders. Both the quorum requirements for the meeting and the requirements pertaining to the taking of the decision must be complied with, irrespective of whether it is an ordinary or a special resolution.

12 Shareholder resolutions



Prescribed study material

Textbook: chapter 6 para 1.5.1

- o Companies Act: section 65(7)–(11)

Section 65(7) and (9) of the Companies Act provides for two types of resolution that may be taken by shareholders: an **ordinary resolution**, requiring more than 50% of the votes exercised, and a **special resolution**, requiring at least 75% of the voting rights exercised. A company is allowed to stipulate a higher percentage for approval of an ordinary resolution (except for the removal of a director) or a different percentage (i.e., higher or lower) for special resolutions in its Memorandum of Incorporation, on condition that there must always be a difference of **at least 10% between the highest percentage required for an ordinary resolution and the lowest percentage required for any special resolution**.

13 Decisions that require a special resolution



Prescribed study material

- o Companies Act: section 65(12)

A **special resolution** is required at least:

- for the amendment of the Memorandum of Incorporation

- to approve the voluntary winding-up of a company
- to approve proposed fundamental transactions.

A special resolution may also be required for other transactions by the Memorandum of Incorporation.

14 Postponement and adjournment of meetings



Prescribed study material

Textbook: chapter 6 para 1.5

- o **Companies Act: section 64(4)–(13)**

If, after one hour of the appointed time of a meeting, a quorum is not present, the meeting must be postponed for one week. In exceptional circumstances, it is possible to extend the one-hour period. A company's Memorandum of Incorporation or rules may specify other time limits. No new notice needs to be issued regarding the meeting that has been postponed for one week unless the venue changes.

The shareholders entitled to vote may, despite achieving a quorum, at any time decide to adjourn a meeting and set a date for a subsequent meeting at any agreed-upon time, provided it is not later than 120 business days after the date of the original adjourned meeting.

→ Reflection

You learnt that shareholders are important in the decision-making process of companies. Shareholders enjoy **voting rights** attached to the class of shares that they hold. You were also familiarised with the procedure for calling a meeting where a decision, either by **ordinary resolution** or by **special resolution**, is to be passed. Ensure that you know the different **notice periods** for the different companies, the **quorum** requirements, and how and when a meeting may be postponed or adjourned.

LESSON 10:

Directors and board committees

1 Introduction

You have already been introduced to one of the organs of a company: the general meeting of shareholders. The shareholders of a company exercise their rights and functions entrusted to them in the Companies Act and the Memorandum of Incorporation by adopting resolutions at a meeting of shareholders. We now introduce the other main organ of a company: the board of directors. We also introduce you to one of the office bearers of the company, namely the director.

You will show your understanding of this lesson by answering the following **key questions**:

- What are the different types of directors recognised in the Companies Act and the King IV?
- What is the difference between a director and a manager?
- Who are ineligible to become a director?
- Who are disqualified from becoming directors?
- How are directors appointed and removed?
- What are the duties of directors under the Companies Act?
- What does the business judgment rule entail?

2 Meaning of the word 'director'

Prescribed study material

Textbook: chapter 7 para 1

- o **Companies Act: sections 1, 66(4)(a)(i)–(iii), 66(4)(b) and 68**

Important terms	Meaning
<i>Ex officio</i> director	A director who holds office as a director of a company because of him or her holding another office or title or status. An individual who becomes a director because of his/her holding another position. Their directorship is tied to their position, and they do not need a separate election or appointment process to assume the role.
Alternate director	A person appointed to the board of directors of a company in substitution for a particular elected director of that company.
Executive director	A director who participates in the day-to-day management functions within a company. (Usually, such a director is also an employee of the company.)
Independent director	A director appointed to the board of directors from outside, who is independent and unrelated to the company and its subsidiaries.
King IV	King Report on Corporate Governance , 2009, or King III; the reports on corporate governance principles for South African companies.
Non-executive director	A director who does not participate in the day-to-day management of a company. (These directors are usually not recognised as employees of the company in terms of labour law principles.)
Ineligible	The term for a person who is absolutely prohibited from becoming a director of a company.
Disqualified	The term for a person who is prohibited from being a director unless a court gives him or her permission.
Board of directors	The group of directors responsible for the management of the business and affairs of a company.
Codification	A systematic and comprehensive compilation of the entire body of law.

Business judgment rule	The principle that a director is not in breach of his or her statutory duties if he or she took reasonably diligent steps to inform himself or herself of the matter in question, had no personal interest, and had a rational basis for believing that his or her decision was in the best interests of the company.
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A **director** is a member of the board of a company and includes any person occupying the position of a director or alternate director. A person becomes a director only:

- when that person has given his or her written consent to serve as director
- after having been appointed or elected to hold office in accordance with the provisions of section 66 of the Companies Act.

2.1 Types of director

Different types of director have been recognised by both King IV and the Companies Act. Remember that the King Codes are soft-law principles. They are not enforceable, except for provisions that have been included in legislation or have been made compulsory in another way, for example by being included in the listing requirements of the JSE Ltd for companies that wish to list on the Stock Exchange. They are guidelines to indicate the principles that a company should adhere to for purposes of good governance.

The King IV report differentiates between the following three types of director:

- executive directors
- non-executive directors
- independent directors

However, the court in *Howard v Herrigel*, held that it is unhelpful or even misleading to classify company directors as “executive” or “non-executive” **for purposes of determining their duties** to the company or when any specific or affirmative action is required of them. Once a person accepts an appointment as director, he or she is obliged to display the utmost good faith towards the company, irrespective of whether such a person is an “executive” or “non-executive” director.

The **Companies Act** recognises the following types of director:

- an *ex officio* director
- a director appointed in terms of the Memorandum of Incorporation
- an alternate director
- an elected director
- a temporary director who is appointed to fill a vacancy

The following explanation may be helpful in deciding which type of director a person would qualify as:

- Shareholders must elect at least 50% of the directors of a profit company. These directors will be classified as **elected directors**.
- A director can hold the office of director because she or he holds another office. For example, the Memorandum of Incorporation may provide that any person who is appointed as legal adviser of the company will also be a director of the company. In such a case, a person appointed as legal adviser will automatically be a director – **an ex officio director**.
- A director can hold the office of director because she or he was appointed by name in the Memorandum of Incorporation, or because she or he was appointed by someone who was given the authority in the Memorandum of Incorporation to appoint a director – **a Memorandum of Incorporation-appointed director**.
- A director can hold the office of director because she or he is an **alternate director**. Depending on the Memorandum of Incorporation, these directors may either be appointed by the board or elected by the shareholders, but at least 50% of the alternate directors must be elected by the shareholders.
- A director can hold the office of director because she or he is a **temporary director**. Depending on the Memorandum of Incorporation, the board of directors may appoint these directors.

3 Number of directors and consent



Prescribed study material

Textbook: chapter 7 para 1

The different types of company should each have a specified minimum number of directors in terms of the Companies Act:

Type of company	Number of directors
Private company	1
Personal liability company	1
Public company	3
Non-profit company	3

NOTE: Where a company does not have the prescribed number of directors, any act performed by the board of directors or the company will nevertheless remain valid.

A person becomes a director of a company when that person:

- has been appointed or elected as a director in terms of the Companies Act or Memorandum of Incorporation, or
- holds an office, title, designation, or similar status entitling that person to be an *ex officio* director of the company.

A person will only become a director once he or she has delivered written consent accepting such a position.

4 Directors: The Companies Act and a company's Memorandum of Incorporation

Prescribed study material

- o **Companies Act: sections 66(2)(a) and (b), 66(4)(a)(ii) and (iii), 66(10) and 66(11)**

Certain provisions of the Companies Act, including some related to directors, may be changed by the provisions of a company's Memorandum of Incorporation, while others may not. (Also refer to the discussion on alterable and unalterable provisions in the Memorandum of Incorporation.)

A public company may, in terms of its Memorandum of Incorporation, specify a higher number than the minimum number of directors required in terms of the Companies Act. Section 66(4) of the Companies Act provides that the Memorandum of Incorporation of a profit company must provide that the shareholders will be entitled to elect at least 50% of any alternate directors. A company's Memorandum of Incorporation may provide for the payment of remuneration to its directors and for the term of office.

5 Ineligible and disqualified persons



Prescribed study material

Textbook: chapter 7 paras 2–3

- o **Companies Act: sections 69(7)(a) to (c), 69(8)(a) and (b)(i)–(iv)**

Prescribed case law

You only need to know the following case as discussed herein:

- ***Ex Parte Barron* 1977 (3) SA 1099 (C)**

Certain people are **ineligible** to be appointed as a director of a company, whilst certain people are disqualified.

❖ **NOTE:** If a person is ineligible to be appointed as a director, this means that such a person is absolutely prohibited from becoming a director, without any exceptions.

If a person is **disqualified** from being appointed as a director, this means that, apart from a person who has been prohibited from being a director by a court of law, a person may still be appointed as a director of a company with the permission of the court. Therefore, the other disqualifications are **not absolute**. The court has a discretion on application to allow such disqualified persons to be appointed as directors.

In Ex Parte Barron, the court held that it could be more lenient in a case where a private company is affected than where a public company is affected. This is because a director of a public company deals with funds in which a vast number of people are involved. Such a director should obviously be under more scrutiny than a director of a private company.

Ineligible: (May never be) A person who is ineligible to be a director is absolutely prohibited from becoming a director.

There are no exceptions to the prohibition. The following are absolutely prohibited from becoming a director:

- a juristic person
- an unemancipated minor/a person under legal disability
- a person who is ineligible in terms of the provisions of the Memorandum of Incorporation

Disqualified: A disqualification from being a director is not absolute.

A court has a discretion to permit a disqualified person to accept appointment as a director.

The following persons are disqualified from being a director:

- a declared delinquent
- an unrehabilitated insolvent
- a person prohibited from being director in terms of a public regulation
- a person removed from an office of trust for misconduct/dishonesty
- a person convicted of fraud, dishonesty, theft, or a related offence
- a person disqualified in terms of the provisions of the Memorandum of Incorporation

6 Application to declare a person delinquent or under probation



Prescribed study material

Textbook: chapter 7 paras 3.2 and 3.3

o **Companies Act: section 162**

The power given to a court to declare a director either delinquent or under probation has been introduced into South African company law for the first time by the Companies Act. Note that this provision can also be applied to members of close corporations.

Depending on the grounds on which a person has been declared to be a delinquent, he or she will subsequently be either unconditionally disqualified from being a director for the rest of his or her life or disqualified for a period of at least **seven years** and subject to any conditions that the court considers appropriate. An order of probation, on the other hand, may not exceed a period of **five years** and may be made subject to any conditions the court considers appropriate, such as a designated remedial programme.

A director may be declared delinquent or under probation in terms of section 162 of the Companies Act.

The Commission must keep a public registry of persons who are subject to an order of the court in terms of this section.

6.1 Delinquency

Any one of the following may apply for a delinquency order:

- a company
- a shareholder
- a director
- a company secretary or prescribed officer
- a registered trade union/other employee representative

The **Commission or Takeover Regulation Panel or a state organ** may also in certain circumstances apply to declare a director delinquent.

Grounds for the order:

The person

- served as a director while disqualified, or
- acted as a director while under probation in a manner that contravened the order of probation
- grossly abused the position of director
- took personal advantage of information/an opportunity
- intentionally/because of gross negligence inflicted harm on the company/subsidiary
- acted in a manner that amounts to gross negligence, willful misconduct or breach of trust.

The court may, in a declaration of **delinquency**, order that the person:

- undergo remedial education
- carry out a designated programme of community service and/or
- pay compensation.

6.2 Probation

Applicants:

- a company

- a shareholder
- a director
- a company secretary or prescribed officer
- a registered trade union/other employee representative

The **Commission or Takeover Regulation Panel** may also in certain circumstances bring an application.

A person may be placed under probation **on the same grounds** as for delinquency, and, **in addition**, on the following grounds:

- While serving as a director, the person was present at a meeting and failed to vote against a resolution despite the inability of the company to satisfy the solvency and liquidity tests.
- While serving as a director, the person acted in a manner materially inconsistent with the duties of a director.
- While serving as a director, the person acted in a way that had a result that was oppressive or unfairly prejudicial to a shareholder or another director, or that unfairly disregarded the interests of a shareholder or another director.
- While serving as a director, the person acted in a way that had a result that the business of the company, or a related person, was being or had been carried on or conducted in a manner that was oppressive or unfairly prejudicial to a shareholder or another director, or that unfairly disregarded the interests of a shareholder or another director.
- While serving as a director, the person exercised his or her powers in a manner that was oppressive or unfairly prejudicial to a shareholder or another director, or that unfairly disregarded the interests of a shareholder or another director.
- Within any period of ten years after the effective date, the person has been a director of more than one company, or a managing member of more than one close corporation, irrespective of whether concurrently, sequentially or at unrelated times; and during this time two or more of those companies or close corporations each failed to fully pay all their creditors or meet all of their obligations, except in terms of a business rescue plan.

The court may, in a declaration of **probation**, order that the person

- undergo remedial education
- carry out a designated programme of community service
- pay compensation
- be supervised by a mentor/be limited to serving as a director of a private company or company of which he or she is the only shareholder.

6.3 Application to court to suspend or set aside a delinquency order

Note that this application may be made only in those cases where the declaration was not made unconditional and for the lifetime of the person declared delinquent. Also note that the applicant first must apply for a suspension of the order and then, after a further two years, may apply for it to be set aside.

7 First directors of a company



Prescribed study material

Textbook: chapter 7 paras 1 and 2

o **Companies Act: section 67**

Upon incorporation of a new company, every incorporator is deemed to be a director of such company until sufficient directors have been appointed to meet the required minimum number of directors.

If, after its incorporation, the number of directors of that company is lower than the minimum number of directors required for that company, the board of directors must call a meeting within **40 business days** after the date of incorporation for the purpose of electing sufficient directors to fill all vacancies.

8 Vacancies on the board



Prescribed study material

Textbook: chapter 7 para 4

- o **Companies Act: section 70**

Prescribed case law

You only need to know the following case as discussed herein:

- ***Rosebank Television & Appliance Co (Pty) Ltd v Orbit Sales Corporation (Pty) Ltd* 1969 (1) SA 300 (T)**

A vacancy will arise on the board of a company if, for example, a director resigns, dies or is unable to perform his or her duties as director.

In *Rosebank Television & Appliance Co (Pty) Ltd v Orbit Sales Corporation (Pty) Ltd*, the court confirmed that a resignation becomes effective once it has been communicated to a company, irrespective of whether it was only later accepted.

If a vacancy arises on the board, other than because of an *ex officio* director ceasing to hold that office, it must be filled by a new appointment or by a new election as prescribed by the Companies Act.

9 Removal of directors



Prescribed study material

Textbook: chapter 7, para 2

- o **Companies Act: section 71**

A director can be removed by shareholders and, in some circumstances, by the board of directors. Despite any provision contained in the company's Memorandum of Incorporation or any agreement between the company and the director, removal may be affected by an ordinary resolution. The director must receive notice of the contemplated removal and be afforded the opportunity to make representations before the resolution to remove him/her is put to the vote.

A director who has been removed from office may apply to a court to review the determination of the board. This application must be brought within twenty (20) business days from the date of a decision taken by the board. The court has a discretion whether to confirm the determination of the board.

A removal in terms of section 71 does not detract from any right that the director so removed to claim compensation or damages resulting from the loss of his/her office.

As not all directors are recognised as employees in terms of the Labour Relations Act 66 of 1995, the procedure prescribed for the valid removal is a welcome addition. The court has found that a directorship does not in itself render someone an employee. Non-executive employees are not recognised as employees of the company, whereas executive directors usually are. You may wonder what the interaction would be between the principles laid down in terms of the Labour Relations Act 66 of 1995. Section 210 of the Companies Act provides that the labour law principles should still be applied if someone is recognised as an employee.

10 Board committees



Prescribed study material

Textbook: chapter 7 para 5.2

o **Companies Act: section 72 and 94**

The board of directors may, except to the extent that the Memorandum of Incorporation provides otherwise, appoint committees, and may delegate any of the authority of the board to such committees. You should, however, note that a director will remain liable for the proper performance of his or her duties despite the delegation of a duty to a committee.

The Minister of Trade and Industry may, in terms of the Companies Act, prescribe that a company, or a certain category of company, must have a social and ethics committee. In terms of section 94(2), every **public** or **state-owned** company must appoint an audit committee of at least three members. The King IV report also proposes that board committees should be established to assist the directors by giving detailed attention to important areas. Examples of such committees include an audit committee and a remuneration committee.

In terms of the King IV report, a public listed company should at least have both an audit committee and a remuneration committee. The establishment of a nomination committee is also recommended. The respective committees make certain recommendations and assist the board of directors about a specific area of expertise.

11 Board meetings



Prescribed study material

Textbook: chapter 7 para 5.1

o **Companies Act: section 73**

Board meetings may be called by directors who are authorised. The necessary notice must be given to all directors before any meeting is held. A majority of the directors of the board must be present at a meeting before a vote may be called. Every director has one vote per meeting, while the chairperson has a deciding vote in the event of a tie. Minutes of all decisions as well as any resolution taken by the board at a meeting must be kept.

12 Duties of directors

12.1 Sources of duties



Prescribed study material

Textbook: chapter 7 paras 6.1 and 6.2 (See, also, the scheme at the end of chapter 7)

o **Companies Act: sections 66(1) and 75–78**

There are four sources from which the duties of directors arise: their employment contracts with the company (if any), the company's constitution (Memorandum of Incorporation), the Companies Act, and the common law. The rights and duties created by contract are determined by reference to the specific contract. The duties imposed by the Companies Act, as well as by the common law, are now discussed.

Apart from the specific duties and limitations placed on directors by the Companies Act of 1973, such as the duty to disclose to the board any interest in contracts of the company, most of the duties of directors were determined by common law. At common law, directors are subject to *fiduciary duties* to exercise their powers bona fide (in good faith) and for the benefit of the company, and to the duty to exercise their powers with care and skill.

12.2 Partially codified directors' duties

The Companies Act of 2008 introduced a **partially codified** regime of directors' duties, which includes the common law fiduciary duties and the duty to perform their functions with reasonable care and skill. The common law is not excluded by the statutory provisions and will continue to apply, except as far as it is specifically amended by the Companies Act or is in conflict with its provisions.

❖ Note that, for purposes of these codified duties, "director" includes an alternate director and a member of a committee of the board who is not a director.

Briefly summarised, the partly codified (**statutory**) duties of directors in the Companies Act entail the following:

- For the first time, the Companies Act places a specific duty on the board of directors to manage the company (section 66(1)).
- To disclose to the board any personal financial interest in matters of the company (section 75).
- Not to use the position of director or information obtained as director to gain an advantage for himself/herself or another person, or to cause harm to the company or a subsidiary (section 76(2)(a)).
- To disclose to the board of directors any material information (section 76(2)(b)).
- To act in good faith and for a proper purpose (section 76(3)(a)).
- To act in the best interests of the company (section 76(3)(b)).
- To act with reasonable care, skill, and diligence (section 76(3)(c)).

The provisions in the Companies Act are subject to, and not in substitution of, any of the duties of directors under the common law. The courts must still have regard to the common law, including past case law, when interpreting the provisions of the Companies Act. Therefore, the prescribed case law remains of great value and should be taken into account when studying the Companies Act. It should also be kept in mind that the provisions in the Companies Act relating to directors' duties are a **partial codification** (adopting the general principles while allowing room for the development of the common law) of company law. These statutory duties are elaborated on below with reference to some of the common law standards (laid down in cases) that influenced them.

12.2.1 Directors must not abuse their position or information (section 76(2)) and must act in a certain way when there is a personal financial interest (section 75)



Prescribed study material

Textbook: chapter 7 para 6.2

- o **Companies Act: sections 75 and 76(2)**

Prescribed case law

You only need to know the following cases as discussed herein:

- ***Regal Hastings Ltd v Gulliver* [1942] 1 All ER 378 (HL)**
- ***Robinson v Randfontein Estate Gold Mining Co Ltd* 1921 AD 168**
- ***CyberScene Ltd and others v i-Kiosk Internet and Information (Pty) Ltd* 2000 (3) SA 806 (C)**
- ***Gheri and others v Timber Developments (Pty) Ltd and others* 2007 (4) SA 536 (SCA)**
- ***Sibex Construction SA (Pty) Ltd v Injectaseal CC* 1988 (2) SA 54 (T)**

The ubuntu principle of transparency is imbued in the requirement that directors must disclose any financial interest that they have in any transaction affecting the company that they serve is part of the common law and statutory duties of directors.

Firstly, section 75 of the Companies Act prescribes how a director should act when his or her personal financial interests conflict with those of the company. Two different situations are regulated in this provision. If a director is the only director, but not the only shareholder of the company, he or she must disclose any personal interest in an agreement or other matter of the company to the shareholders and obtain their prior approval by an ordinary resolution before he or she enters into this agreement or deals with the matter. In all other cases, disclosure must be made to the board of directors of any personal financial interest of the director in a matter to be considered at a board meeting, and such director may not be present or take part in the discussion. A director may also make an advance general disclosure of his or her personal financial interests to the shareholders or board, as the case may be.

Secondly, in terms of section 76(2)(a) of the Companies Act, a director may not abuse his or her position as director, or information obtained while acting as a director, to gain an advantage for himself/herself or for another person other than the company or a wholly owned subsidiary of the company, or to knowingly cause harm to the company or a subsidiary of the company.

The third duty is the duty of a director to disclose any information that comes to his or her attention, subject to stated exceptions.

In *Regal Hastings Ltd v Gulliver*, the court held that directors should avoid placing themselves in a position where their duty to the company conflicts with their own interests. In this case, a director who had since resigned was held liable for personal profits made in the course of his performance of his duties in the company. The court held that it makes no difference if the profit is made in good faith with full disclosure and whether the company suffered any loss as a result of the director's actions. This was also the stance of the court in the case of *Robinson v Randfontein Estate Gold Mining Co Ltd*, where the court held as follows:

Where one man stands to another in a position of confidence involving a duty to protect the interest of that other, he is not allowed to make a secret profit at the other's expense or place himself in a position where his personal interest conflicts with his duty.

Also note the case of *CyberScene Ltd and others v i-Kiosk Internet and Information (Pty) Ltd* in which it was confirmed that the duty applies to a **non-executive director** too. There are, however, limits to the duties that a director owes to his or her company. The court held, in *Gheri and others v Timber*

Developments (Pty) Ltd and others, that the facts of each case are important in determining whether a person has acted in breach of the fiduciary duty owed to his or her company.

12.2.2 Acting in good faith and with a certain degree of care, skill, and diligence



Prescribed study material

Textbook: chapter 7 para 6.2.4.1

Prescribed case law

You only need to know the following case as discussed herein:

- ***Philotex (Pty) Ltd v Snyman and others; Braitex (Pty) Ltd and others v Snyman and others 1998 (2) SA 138 (SCA)***

The duties to act in good faith and for a proper purpose, and in the best interests of the company, are equally important. Whereas the duty to act in the best interests of the company speaks for itself, the duty to act for a proper purpose perhaps needs explanation. This is one of the fiduciary duties recognised in terms of our common law as well and requires that directors should use their powers for the real or true purpose for which these powers were given. One example of a breach of this duty that has often occurred in practice is where boards issued shares to dilute the voting rights of other shareholders or obtain more votes for themselves in order to ensure their continued control over the company, instead of using this power for its real purpose: to obtain more capital for the company.

Regarding the duty to act with care and skill, the court, in *Philotex (Pty) Ltd v Snyman and others; Braitex (Pty) Ltd and others v Snyman and others*, held that, although the test is an objective one, it contains subjective elements in that the general knowledge, skill and experience of the particular director in question are taken into account. A director who is a chartered accountant, therefore, needs to be more skillful when it comes to the company's financial affairs, than a director who is an electrician by trade.

13 The business judgment rule



Prescribed study material

Textbook: chapter 7 para 6.2.4.2

- o **Companies Act: section 76(4)**

Prescribed case law

You only need to know the following case as discussed herein:

- ***Fisheries Development Corporation of SA v Jorgenson 1980 (4) SA 156 (W)***

The Companies Act introduced what is called the **business judgment rule**. Section 76(4) states that a director will be regarded as having acted in the best interests of the company and with the required degree of care, skill, and diligence if the director:

- took reasonable steps to become informed about the matter,
- had no material personal financial interest in the subject matter of the decision or knew of anybody else having a financial interest in the matter, or disclosed his/her interests, and
- made or supported a decision in the belief that it was in the best interests of the company.

A director is also entitled to rely on information provided by certain persons specified in the Companies

Act.

In any proceedings against a director, other than for willful misconduct or willful breach of trust, a court may relieve the director of liability if it appears to the court that the director acted honestly and reasonably, or it would be fair to excuse the director.

A director will also escape liability where he or she had a rational basis for believing, and actually believed, that the decision was in the best interests of the company.

14 Liability of directors and prescribed officers



Prescribed study material

Textbook: chapter 7 para 6.3

o **Companies Act: section 77**

Directors may be held liable for certain losses or harm sustained by the company due to their actions. These actions may include acting without the necessary authority, fraudulently or in contravention of the provisions of the Companies Act or the company's Memorandum of Incorporation. The first item in this list refers to the liability of a director for breaching the newly codified common law duties described above. The remaining influence of the common law is clear when considering this liability, because the Companies Act states that, for a breach of the first five duties in the list, a director will be held liable in accordance with the common law principles relating to breach of a fiduciary duty, while, for a breach of the duty of care, skill and diligence, liability will be on the basis of the common law principles of delict.

A director will be jointly and severally liable with any other person who is, or may be, held liable for the same act. The court may, however, relieve a director of liability, other than for willful misconduct or willful breach of trust, if it appears to the court that the director acted honestly and reasonably.

15 Indemnification and director's insurance



Prescribed study material

Textbook: chapter 7 para 6.3.5

o **Companies Act: section 78**

A company may not indemnify a director in respect of liability arising out of certain circumstances, such as a breach of his or her fiduciary duties. In certain circumstances, a company may not indemnify a director. Indemnity insurance may also not be taken out for such circumstances.

A company is, however, entitled to take out indemnity insurance to protect a director against any liability or expenses for which the company is **permitted to indemnify** a director. The company may also take out insurance to insure itself against expenses that the company is permitted to advance to a director to defend litigation.

The Companies Act makes it impossible to indemnify directors for personal liability arising out of negligence, an omission, failure to carry out their duties, or a breach of trust. The Memorandum of Incorporation may also not conflict with any statutory provisions.

→ Reflection

The ownership of a company is vested in the general meeting of shareholders/members, and control of the company is vested in the board of directors. Do you think it is a sound principle to separate ownership and control, or should the members of the company also manage it? It is here that the principle of the separate **legal personality** of the company comes into play again. It is the company that owns its assets and that is responsible for its liabilities, not the shareholders. The shareholders only hold a right to share in those assets should the company be wound up.

LESSON 11:

Company auditors

1 Introduction

Compulsory disclosure of financial information concerning the company plays a key role in protecting the interests of shareholders, investors and creditors. To undertake certain projects, companies usually depend on capital investments made by members of the public. For example, members of the public may purchase shares or debentures in the company or advance loans to the company.

Investors and financiers are usually not willing to invest or lend money unless there is proper financial reporting and disclosure of how the company's funds are applied. The availability of reliable financial information regarding the company's affairs is conducive to a healthy economic climate. The whole aim of a company's financial statements is to inform the existing shareholders, as well as prospective investors in the company, of its financial standing. The financial statements reflect the general financial state of the company. They disclose whether its assets exceed its liabilities, whether it has sufficient liquid funds, and the extent of the company's working capital (liquid assets as well as credit facilities).

You will know that you understand this lesson if you are able to answer the following **key questions**:

- Which companies are obliged to appoint an auditor?
- Who may be appointed as an auditor?
- Which people are disqualified from becoming an auditor?
- At which meeting must an auditor be appointed?
- How frequently must an auditor be appointed?
- Which companies are obliged to appoint an audit committee?
- For how long may the position of auditor remain vacant in a company?
- Explain the procedure for the appointment of an auditor to fill a vacancy.
- For how many consecutive years may the same auditor compile a company's financial statements?
- What rights do company auditors enjoy?
- How is the audit committee appointed?
- What are the duties of the audit committee?

2 Registered office and records



Prescribed study material

Textbook: chapter 2 paras 8 and chapter 9 paras 1.1–1.6

- o **Companies Act: sections 24–30**

The accounting records must be kept in the prescribed manner and form and must be kept at, or be accessible from, the company's registered office. The type of accounting records that must be maintained by a company depends on factors such as the type of company, its purpose, and the nature and extent of its activities.

The annual financial statements that must be placed before the annual general meeting consist of the following:

- a balance sheet
- an income statement

- a statement of cash flow information
- a directors' report
- an auditor's report

The law regulating the disclosure of financial information and the auditing profession is incorporated in the **Companies Act** and the **Auditing Profession Act 26 of 2005 as amended**. The Companies Act contains sections which regulate a company's financial disclosures and its maintenance of accounting records. The Companies Act imposes certain minimum financial disclosure requirements on all companies, and more stringent disclosure requirements on public companies and certain private companies. Section 24(3) of the Companies Act sets out a number of records that must be maintained by the company, including copies of all accounting records for the current and previous seven financial years. In terms of section 28, a company is required to keep accurate and complete accounting records, in one of the official languages, as necessary to enable the company to satisfy its obligations under the Companies Act and any other law with respect to the preparation of financial statements (see the definition of 'financial statements' in section 1).

Section 29 states that the financial statements of a company must satisfy the financial reporting standards, must present fairly the state of affairs and business of the company, and must explain the transactions and financial position of the business of the company.

The financial statements must also show the company's assets, liabilities, and equity, as well as its income and expenses and any other prescribed information. Section 30 of the Companies Act requires all public or state-owned enterprises to prepare annual financial statements within six months after the end of their financial year. The annual financial statements must include an auditor's report (section 30(5)).

In terms of section 44 of the Auditing Profession Act 26 of 2005, it is the duty of an auditor to examine a company's financial statements and accounting records and to express an opinion as to the truth and fairness, in all material respects, of the statements and the accountant's adherence to financial reporting standards. Section 1 of the Auditing Profession Act states that an "audit" means the examination, "in accordance with prescribed or applicable accounting standards, [of] (a) financial statements with the objective of expressing an opinion as to their fairness or compliance with an identified financial reporting framework and any applicable statutory requirements; or (b) financial and other information, prepared in accordance with suitable criteria, with the objective of expressing an opinion on the financial and other information". By attesting that the financial statements fairly present the financial condition and past performance of a company, an auditor plays a vital function in reinforcing the reliability of financial information.

3 Audit requirements under the Companies Act



Prescribed study material

Textbook: Chapter 9 paras 1.7 and 1.8

Public companies are required to audit their annual financial statements (section 30(2) of the Companies Act). The Companies Regulations of 2011 include a Public Interest Score (PIS) calculation which determines what the reporting duties of other categories of companies are. If a company holds assets in a fiduciary capacity with an aggregate value of over R5 million, an audit is required. The Companies Regulations of 2011 provide for both activity and size criteria to determine whether companies require audited financial statements.

The Regulations state that every entity is required to calculate its PIS at the end of each financial year. The score is calculated as the sum of the following:

- a number of points equal to the average number of employees (as determined by the Labour Relations Act 66 of 1995) of the company during the financial year;
- one point for every R1 million (or portion thereof) in third-party liabilities at year-end (these exclude shareholder loans and intercompany loans with common shareholdings);
- one point for every R1 million (or portion thereof) in turnover during the financial year; and
- one point for every individual who, at the end of the financial year, is known by the company to

directly or indirectly have a beneficial interest in the business.

Furthermore:

- For companies with a score below 100, an independent review is required if such companies are not owner managed.
- If the company has a score below 100 and is owner-managed, there is no requirement for outside professional assistance.
- “Owner-managed” means that all shareholders are directors, or, in the case of a trust, that at least one of the trustees is a director.
- If the company is not owner-managed, and obtains a PIS score of 100 to 350, an audit is required if reports are internally compiled or an independent review if they are externally compiled
- If the company is owner-managed with a score of 100 to 350, no professional intervention is required if reports are externally compiled, but an audit will be needed if the reports are internally compiled.
- If a company scores over 350 points, an audit is required regardless of whether the company is owner-managed or not.
- A company can subject itself to audits by choice (voluntarily).

4 Appointment of an auditor



Prescribed study material

Textbook: chapter 9 para 2.2.1

- o **Companies Act: sections 34, 84, 85, 90–91**
- o **Auditing Profession Act: section 37**

Public companies, state-owned companies and certain types of private companies are required to appoint an auditor every year at the annual general meeting (see sections 34, 84, 85, 90 and 91 of the Companies Act).

Other companies such as private companies, personal liability companies or *non-profit companies* need not comply with the extensive accounting requirements set out in Chapter 3, except to the extent that the company’s Memorandum of Incorporation provides otherwise (section 34 of the Companies Act).

Section 85 of the Companies Act requires that every company that appoints an auditor must file a notice of the appointment with the Registrar within ten business days after the appointment. The notice must reflect the name of the auditor and the date of appointment. Section 85(4) requires that the incorporators of a company file a notice of the appointment of the company’s first auditor as part of the company’s Notice of Incorporation. The auditor may be an individual person or a firm and is appointed by a company by way of a contract. In companies with an audit committee, the audit committee is required, in terms of section 94(7) of the Companies Act, to nominate for appointment a registered auditor who is independent of the company and to determine the auditor’s fees and terms of engagement.

Only a registered auditor may be appointed as auditor of a company. In terms of section 37 of the Auditing Profession Act, only a person who has complied with the prescribed education, training and competency requirements, who has made arrangements regarding his or her continued professional development where that individual is not a member of an accredited professional body, who is a “fit and proper person” to act as an auditor, and who is resident within South Africa, may be registered as an auditor.

The Auditing Profession Act states, further, in section 37(3) that any person who has been removed from an office of trust as a result of misconduct, who has been convicted of theft, fraud or forgery or other act of dishonesty or corruption, or who has been declared by a court to be of unsound mind and unable to manage his or her own affairs, may not be registered as an auditor.

To ensure a required level of skill and that the auditor is independent of the company it is auditing;

section 90(2) of the Companies Act disqualifies certain persons from being appointed as the auditor of a company. Such persons include: a director or prescribed officer of the company; an employee or consultant of the company who was or has been engaged for more than one year in the maintenance of any of the company's financial records or the preparation of any of its financial statements; a director, officer or employee of a person appointed as company secretary; a person who, alone or with a partner or employees, habitually or regularly performs the duties of accountant or bookkeeper, or performs related secretarial work, for the company; a person who, at any time during the five financial years immediately preceding the date of appointment, was a person contemplated above or is a person related to a person contemplated above.

5 Resignation and vacancies



Prescribed study material

Textbook: chapter 9 para 2.2.4

- o **Companies Act: section 91**

An auditor may resign at any time during his or her period of office. The resignation is effective when the notice of resignation is filed. A new auditor must be appointed to replace an auditor who resigns within 40 business days after the filing of his or her resignation. Public and state-owned companies are required to have an audit committee.

Prior to making an appointment, the board must propose to the audit committee, within 15 business days after the vacancy occurs, the name of at least one registered auditor to be considered to replace the auditor who resigned. The board of directors may appoint the person proposed if, within five business days of making the proposal, the audit committee does not give notice in writing to the board rejecting the proposed auditor.

6 Rotation of auditors



Prescribed study material

Textbook: chapter 9 para 2.2.1

- o **Companies Act: section 92**

Section 92 of the Companies Act makes provision for the rotation of auditors. In terms of this section, the same individual may not serve as the auditor or designated auditor of a company for more than five consecutive financial years. This rotation requirement applies to individual auditors only and not to firms and does not apply to private companies. If a company appointed two or more joint auditors, the company is obliged to manage the rotation requirement in a way to ensure that all of the auditors do not stop acting as auditors within the same year.

If an auditor has served for two or more consecutive years and then ceases to be an auditor of the company, he or she will not be permitted to return before the expiry of at least another two financial years.

7 Rights and restricted functions of auditors



Prescribed study material

Textbook: chapter 9 para 2.2.2

- o **Companies Act: section 93**
- o **Auditing Profession Act: sections 21(2)(a) and 44(6)**

Section 93 of the Companies Act provides that the company auditor has a right to access, at all times, the accounting records and all books and documents of the company. The auditor may attend any general meeting held by the company.

Section 44(6) of the Auditing Profession Act provides that a registered auditor may not conduct the audit of any financial statements of an entity, whether as an individually registered auditor or as a member of a firm, if the registered auditor has or had a conflict of interest in respect of that entity, as prescribed by the **Independent Regulatory Board for Auditors (IRBA)**. The IRBA is required to define in the Code of Professional Conduct (see section 21(2)(a) of the Auditing Profession Act) which non-audit services an auditor is prohibited from rendering to the company it is auditing.

8 Audit committees



Prescribed study material

Textbook: chapter 9 para 2.3

- o **Companies Act: section 94**

Section 94 of the Companies Act requires that, at each annual general meeting, a public company, a state-owned enterprise, and any other company which has voluntarily decided to have an audit committee, must appoint an audit committee for every financial year. The audit committee must have at least three members and consist only of non-executive directors of the company who have not been involved in the day-to-day management of the company in the preceding three financial years.

The audit committee must, for the year it is appointed, perform the following functions:

- nominate and appoint a registered, independent auditor
- determine the fees to be paid to the auditor and the auditor's terms of engagement,
- ensure that the appointment of the auditor complies with the Companies Act and other legislation
- determine the nature and extent of non-audit services that the auditor may provide or must not provide
- pre-approve any proposed agreement with the auditor for the provision of non-audit services.
- prepare a report to be included in the annual financial statements
 - describing how the audit committee has performed its functions
 - indicating that the audit committee is satisfied that the auditor was independent of the company
 - stating that accounting practices have been complied with in the company and that internal financial control has been exercised by the company
- receive and deal with complaints pertaining to the accounting practices and internal audit of the company or related matters
- make submissions to the board on accounting policies, financial control, records, and reporting
- perform other functions as determined by the board, including the development of policy to

- improve governance
- consider whether the auditor's independence may have been prejudiced
- consider compliance with other criteria relating to independence or conflict of interest as prescribed by the IRBA.

→ **Reflection**

Certain companies are obliged to appoint auditors. The Companies Act requires auditors to be independent. A rotation period is prescribed. Public companies and state-owned companies are also required to appoint an audit committee to oversee the appointment of an auditor, the performance of the functions of the appointed auditor, and the terms of his or her engagement.

LESSON 12:

The company secretary

1 Introduction

Company secretaries are particularly important **prescribed officers**. The perception many students have regarding company secretaries is completely wrong. Company secretaries do not just type letters and make tea! Company secretaries as the **principal administrative officers** in companies need to be knowledgeable about all legislation applicable to companies. They must be informed to such an extent that they can advise directors of their legal duties and those of the company. In this lesson, you learn how a company secretary is appointed, what his or her duties and functions are, and how a company secretary can be removed from office.

You will know that you understand this lesson when you are able to answer the following **key questions**:

- What type of company must appoint a company secretary?
- Who is disqualified from appointment as a company secretary?
- What are the duties of a company secretary?
- How can a company secretary be removed?

2 Mandatory appointment of company secretary



Prescribed study material

Textbook: chapter 9 para 2.1.1

The company secretary is the principal administrative officer of his or her company. Every public company or state-owned enterprise must appoint a company secretary who is knowledgeable about, or experienced in, the relevant laws. A private company, personal liability company or a non-profit company may voluntarily appoint a company secretary.

The first company secretary of a public company or state-owned enterprise may be appointed by

- the incorporators of the company; or,
- within 40 business days after the incorporation of the company, by either the directors of the company or an ordinary resolution of the company's shareholders (section 86(3)).

Within 60 business days after a vacancy arises in the office of company secretary, the board must fill the vacancy by appointing a person whom the directors consider having the requisite knowledge and experience.

Every company secretary must be a permanent resident of the Republic and must remain so while serving in that capacity.

3 Disqualification to serve as company secretary



Prescribed study material

- o **Companies Act: sections 69(8), 84(5), 86 and 87**

A person who is disqualified in terms of section 69(8) to serve as a director of a company may not be appointed as a company secretary.

A person is disqualified from being appointed as a company secretary if he or she:

- has been prohibited from being a director or has been declared to be delinquent by a court order;
- is an unrehabilitated insolvent;
- is prohibited in terms of any public regulation from being a director of the company;
- has been removed from an office of trust on the grounds of misconduct involving dishonesty; or
- has been convicted, in the Republic or elsewhere, and imprisoned without the option of a fine, or fined more than the prescribed amount, for theft, fraud, forgery, perjury, or an offence (i) involving fraud, misrepresentation or dishonesty; (ii) in connection with the promotion, formation or management of a company; or (iii) under the Companies Act or some other Acts listed in the section.

Section 87 provides that a juristic person or partnership may be appointed to hold the office of company secretary, provided that every employee of that juristic person, or partner and employee of that partnership, as the case may be, satisfies the requirements contemplated in section 84(5), and at least one employee of that juristic person, or one partner or employee of that partnership, as the case may be, satisfies the requirements contemplated in section 86.

4 Duties of the company secretary



Prescribed study material

Textbook: chapter 9 para 2.1.2

- o **Companies Act: sections 33(3) and 88**

Section 33(3) of the Companies Act provides that every company must, in its annual return, designate a director, employee or other person as the company's *compliance officer*. Therefore, in the case of a company having a company secretary, the company secretary will automatically be the compliance officer. Section 88 of the Companies Act provides that a company secretary is accountable to the company's board.

The company secretary's duties include, but are not restricted to,

- providing the directors of the company collectively and individually with guidance as to their duties, responsibilities, and powers
- making the directors aware of any law relevant to or affecting the company
- reporting, to the company's board, any failure on the part of the company or a director to comply with the Companies Act
- ensuring that minutes of all shareholders' meetings, board meetings and meetings of any committees of the directors, or of the company's audit committee, are properly recorded in accordance with the Companies Act
- certifying, in the company's annual financial statements, whether the company has filed required returns and notices in terms of the Companies Act, and whether all such returns and notices

- appear to be true, correct and up to date
- ensuring that a copy of the company's annual financial statements is sent, in accordance with the Companies Act, to every person who is entitled to it
- carrying out the functions of a person designated in terms of section 33(3) (i.e., a person responsible for filing the company's annual return).

5 Resignation or removal of company secretary



Prescribed study material

- o **Companies Act: section 89(1)**

In terms of section 89(1), a company secretary may resign from office by giving the company one month's written notice, or, with the approval of the board, less than one month's written notice. If the company secretary is removed from office by the company's board, the company secretary may require the company to include a statement in its annual financial statements relating to that financial year setting out the company secretary's contention as to the circumstances that resulted in the removal.

6 Registration of company secretaries and auditors



Prescribed study material

- o **Companies Act: section 85**

In addition to the record of company secretaries and auditors that a company must keep, section 85 of the Companies Act also requires every company that appoints a company secretary or auditor to file a notice of the appointment, or the termination of such an appointment, with the Registrar within ten business days after the appointment or termination, as the case may be. Section 85(4) allows the incorporators of a company to file a notice of the appointment of the company's first company secretary as part of the company's Notice of Incorporation.

→ Reflection

Company secretaries must ensure that they know the latest developments in the law relating to companies. They are advisors to the directors and the chief administrative officer. Note the requirements for the appointment, resignation, and rotation of auditors, as well as their rights and restricted functions. The Auditing Profession Act regulates auditors' conduct. A public company or state-owned enterprise must appoint a company secretary. Secretaries and auditors must be registered.

All these legislative principles would mean little if they are not enforced. In the following lesson, we look at the different mechanisms provided for in the Companies Act to ensure effective enforcement of its stipulations.

LESSON 13:

Remedies and enforcement

1 Introduction

In this lesson, we shall highlight the different remedies against directors who have abused their position, as well as other statutory remedies for shareholders. The remedies provided for in the Companies Act shows that restorative restitution in line with the principle of ubuntu is promoted rather than imposing criminal sanctions.

We shall revisit the principle of piercing the corporate veil when there is potential liability of different persons for the abuse of the separate juristic personality of a company by different individuals. We shall also look at the enforcement agencies and alternative dispute resolution (ADR) measures provided for in the Companies Act.

You will know that you understand this lesson if you are able to answer the following **key questions**:

- What legal remedies are available against directors who have abused their positions?
- Who may apply for the declaration of delinquency or probation of a director?
- What are the consequences for directors who have been declared delinquent?
- When may a court place a director under probation?
- Discuss the derivative action in terms of section 165 of the Companies Act.
- What remedies are available to shareholders to protect their own rights?
- Discuss the remedy of relief from oppressive or prejudicial conduct in terms of section 163 of the Companies Act.
- What procedure must be followed in order to implement a dissenting shareholder's appraisal right in terms of section 164 of the Companies Act?
- Which body is responsible for enforcement of the Companies Act?
- Name four alternatives envisaged in the Companies Act for addressing suspected contraventions of the Companies Act.
- What are the functions of the Companies and Intellectual Property Commission?
- How may the Companies and Intellectual Property Commission respond to a complaint that has been lodged?
- What are the functions of the Companies Tribunal?
- What is alternative dispute resolution?

Important terms	Meaning
Derivative action	A lawsuit brought by a corporation shareholder against the directors, management and/or other shareholders of the corporation for a failure by management. (In effect, the suing shareholder claims to be acting on behalf of the corporation, because the directors and management are failing to exercise their authority for the benefit of the company and all its shareholders.)
Personal action	A legal action instituted personally by the person who has been wronged himself or herself; a lawsuit initiated in order, among other things, to recover damages for some injury to a plaintiff's personal right or property.
Alternative dispute resolution (ADR)	Alternative measures to resolve disputes outside of the court. (The process involves compulsory conciliation or mediation and arbitration.)
Conciliation	The process of settling disputes by extra-judicial means through seeking an agreed settlement between the parties.
Arbitration	The determination by an impartial referee (the arbitrator) of a dispute between parties by means of a legally binding ruling.

Remedy	A legal remedy (also judicial relief) is the means by which a court of law enforces a right, imposes a penalty, or makes some other court order to impose its will. (Here, it will also be used in the context of alternative dispute resolution.)
Dissenting shareholders	Minority shareholders
Appraisal rights	The statutory rights available to a company's minority shareholders, who object to certain extraordinary corporate actions, to have a fair price of their shares determined in a judicial proceeding prior to the action and to require the corporation to repurchase their shares at that price.

2 Remedies against directors who have abused their position

Two remedies are available against directors who have abused their position: an application to declare a director delinquent or under probation, and the derivative action in terms of section 165 of the Companies Act.

2.1 Application to declare a director delinquent or under probation



Prescribed study material

Textbook: chapter 7 paras 3.2 and 3.3

- o **Companies Act: section 162**

A court may declare a director to be a delinquent director or place a director under probation in terms of section 162 of the Companies Act. Notably, this remedy is also made applicable to close corporations.

2.2 Derivative action in terms of section 165



Prescribed study material

Textbook: chapter 12 paras 5.1–5.6

- o **Companies Act: section 165**

Section 165 abolishes any right at common law of a person other than a company to bring or prosecute any legal proceedings on behalf of that company.

Specific steps must be taken to institute an action in terms of section 165. The procedure provides for the appointment of an independent and impartial person or committee by the company to investigate the demand and report back to the board.

Demand (notice) to company

A person can deliver a notice to a company demanding that it institute legal proceedings or take other steps to protect the company's legal interests.

A demand may be delivered by:

- a shareholder/person entitled to be registered as a shareholder
- a director
- a prescribed officer
- a registered trade union that represents employees, or another representative of the employees
- any person who is granted leave by the court to do so

The company may apply to court within 15 days of receipt of a demand to have the demand set aside if it is frivolous, vexatious or without merit. If the demand is not set aside, the company must appoint an independent person or committee to investigate the demand. This person or committee must report to the board. Within 60 days (or as long a court permits), action must be instituted, or a refusal notice must be served on the person who made the demand.

2.2.1 Personal derivative action

The person who made the demand may apply to the court for leave to continue with proceedings in the name of or on behalf of the company if:

- the company failed to take steps as required;
- the company appointed a person or committee that is not independent;
- the company accepted an inadequate report;
- the company acted in a way inconsistent with the reasonable report of an independent, impartial investigator; or
- the company has served a refusal notice.

3 Remedies available to shareholders to protect their own rights

There are three statutory remedies for shareholders: relief from oppressive or prejudicial conduct in terms of section 163, dissenting shareholders' appraisal rights in terms of section 164, and an application in terms of section 161 to protect the rights of the holders of securities.

3.1 Relief from oppressive or prejudicial conduct in terms of section 163



Prescribed study material

Textbook: chapter 12 para 4.3

- o **Companies Act: section 163**

In terms of section 163 of the Companies Act, a shareholder or a director may bring an application requesting the court to provide relief against oppressive or unfairly prejudicial conduct by the company.

The court enjoys a wide discretion to provide such relief. The order may include:

- restraining the conduct complained of;
- appointing a liquidator if the company appears to be insolvent;
- placing the company under supervision and commencing business rescue proceedings;
- regulating the company affairs by amending the Memorandum of Incorporation or amending a shareholders' agreement;
- directing an issue or exchange of shares;
- appointing directors in place of, or in addition to, all directors in office, or declaring any person delinquent or under probation;
- directing the company or any other person to repay the consideration that the securities holder paid for shares with or without conditions;
- varying or setting aside a transaction/contract;
- requiring the company to produce financial statements for the court or an interested person;
- ordering payment of compensation to an aggrieved person;
- directing rectification of the registers or records of the company; or
- an order for the trial of any issue as determined by the court.

3.2 Dissenting shareholders' appraisal rights in terms of section 164



Prescribed study material

Textbook: chapter 12 paras 6.1–6.4

o Companies Act: section 164

An appraisal right is the right of a shareholder to require his/her company to buy his/her shares at their fair value if his/her company takes any of the listed triggering actions. The shareholder must follow a specific procedure once his/her company has taken a triggering action.

Section 164 provides a remedy for dissenting shareholders who are aggrieved by the variation of class rights. This remedy only becomes available when the resolution which is to the detriment of the shareholders is taken and cannot be used before the adverse decision has been taken.

The appraisal remedy is available in the following instances:

- where the company has adopted a special resolution to amend its Memorandum of Incorporation by altering the preferences, rights, or other terms of any class of its shares in a manner that is materially adverse to the rights or interests of the holders of that class of shares
- where a company is considering adopting a resolution concerning the disposal of the greater part of the assets of the company
- in circumstances where the company is considering merging or amalgamating with another corporate entity
- where a company is considering entering into a scheme of arrangement

Procedure

Dissenting shareholders may, **before** the meeting, lodge a **written objection** to the resolution of the company.

Within **ten business days** after adoption of the resolution, the company must send a notice that the resolution has been adopted to each security holder who filed an objection and has not withdrawn the objection, or who voted in favour of the resolution. The shareholder may then **demand payment of a fair value** for the shares held by him or her.

The demand must be sent **within 20 business days** after receiving notice from the company that the resolution has been adopted, or, if no notice is received, within 20 business days after learning that the resolution has been adopted. The company must then, within **five business days**, make a **written offer** to pay an amount considered by the company's directors to be a fair value, accompanied by a statement showing how the value was determined.

The offers made by the company to dissenting shareholders must all be on the same terms. The **offer must be accepted within 30 business days** after it was made. The company must pay the agreed amount within **ten business days** after the shareholder accepted the offer and tendered the share certificates or transferred the shares to the company or the company's transfer agent. If the company fails to make an offer, or the offer is considered to be inadequate, the shareholder may apply to court to determine a fair value and for an order requiring the company to pay the shareholder that fair value.

If compliance with a court order would result in a company being unable to pay its debts as they fall due and are payable for the next 12 months, the company may apply to court for an order varying its obligations.

3.3 Application to protect the rights of securities holders in terms of section 161



Prescribed study material

Textbook: chapter 12 para 4.2

- o **Companies Act: section 161**

The holder of issued securities may apply to court for a declaratory order regarding his/her rights. Alternatively, the holder of the securities can apply for an appropriate order to protect his/her rights or to rectify any harm done to him/her by the company as a result of an act or omission in contravention of the Act, the Memorandum of Incorporation, the rules, or applicable debt instrument, or harm done by any of the company's directors, but only to the extent that they may be held liable under section 77.

4 Liability for abuse of separate juristic personality of company



Prescribed study material

Textbook: chapter 2 para 1.6

- o **Companies Act: section 20(9)**

The third category of remedies pertains to liability for abuse of the separate juristic personality of a company.

Effectively, this remedy entails the *lifting of the corporate veil* and the consequent imposition of personal liability if the separate juristic personality of a company has been abused. The court may declare that the company is to be deemed not to be a juristic person in certain respects.

5 Alternative remedies



Prescribed study material

Textbook: chapter 12 para 7 up to the end of the chapter

Unlike its predecessor, which extensively provided for criminal sanctions, the Companies Act generally uses a system of administrative enforcement. There are very few remaining offences – only those arising out of a refusal to respond to a summons, to give evidence, perjury, and the situation where, in order to improve corporate accountability, the Company Act states that it will be an offence, punishable by a fine or up to ten years' imprisonment, for a director to commit a breach of confidence (section 213), or sign or agree to a false or misleading financial statement or prospectus, or to be reckless in the conduct of the company's business (section 214).

The body that is normally responsible for the enforcement of the Companies Act is the Companies and Intellectual Property Commission. Among other things, the Commission must monitor proper compliance with the Companies Act, investigate complaints concerning contraventions of the Act, promote the use of ADR by companies for resolving internal disputes, keep a Companies Register, and advise the Minister on changes to the law.

The Commission plays a significant role in the enforcement of the Companies Act. Any person may file a complaint with the Commission. The Commission may also initiate complaints on its own motion, or at the request of another regulatory authority. The Commission may respond to complaints in

different ways.

The Companies Act also establishes a new entity, the Companies Tribunal. Its two main functions are to serve as a forum for voluntary ADR in any matter arising under the Companies Act and to carry out reviews of administrative decisions made by the Commission.

As an alternative to applying to court or filing a complaint with the Commission, an applicant or complainant may refer a matter to the Companies Tribunal, or to an accredited entity for resolution by mediation, conciliation, or arbitration. There are certain differences between these three methods of ADR. Use of ADR is voluntary, and all parties must agree to the use of the process.

→ Reflection

Various remedies are available to companies and shareholders. You should be able to advise a client concerning the grounds for instituting the various actions and regarding the onus of proof.

There are alternative forums (not only courts) available for the referral of complaints. Would you be able to advise an aggrieved shareholder of the procedure to follow in the case of conduct on the part of the company that is prejudicial to his or her rights? Remember that alternative dispute resolution must be agreed upon by the parties, and that the less formal process may exclude the necessity for legal representation.

LESSON 14:

Trusts

1 Introduction

A trust is an adaptable concept with various uses, including carrying on a business. Although originally an English legal concept, it has found favour in South African law because of its practical value. As a business form, the main advantage of a trust over a company and close corporation is that it does not involve the complexities and expenses associated with the other two.

A close corporation and company differ from a trust because they are formed by completing and lodging certain statutory forms with the Companies and Intellectual Property Commission, and, after registration thereof, come into existence. A trust is created by a contract or a will or a legal document, commonly referred to as a "trust deed". A trust is separate from its founder. It never dies or is terminated unless it is terminated by agreement, or it is sequestrated if it is unable to pay its debts. These qualities make trusts the only entities that will afford total asset protection and estate duty savings along with a myriad of other benefits.

A trust is a legal relationship that is created by virtue of a trust deed or instrument. This trust deed must be drafted by a person who has the intention of establishing a trust. Such a person is known as the founder, donor, or settler.

Once the trust deed is created by the founder, assets specified in the trust deed are put under the control of a person who is tasked with the administration of the trust. This person is known as the trustee. A trust may be created during a founder's life (an *inter vivos* trust) or after his or her death (a testamentary trust). The purpose of creating a trust is not to benefit the trustee, but rather to allow him or her to take control of the trust assets and instruct the trustee to manage these assets to the benefit of a specified beneficiary.

We briefly set out the legislative principles applicable to trusts as a business form. The focus is on business trusts.

IMPORTANT SECTIONS OF LEGISLATION

TRUST PROPERTY CONTROL ACT 57 of 1988 as amended:

Section 6(1)	–	Authorisation of trustee by the Master of the High Court
Sections 9, 11, 16 & 17	–	Duties of trustees

2 The trust

Important terms	Meaning
Trustee	Any person (juristic or natural) who acts as trustee by virtue of an authorisation under section 6 of the Trust Property Control Act.
Trust instrument	Also known as a trust deed; a written agreement or a testamentary writing or a court order according to which a trust was created. (Certain documents representing a reduction to writing of an agreement to establish a trust also qualify as a trust instrument (section 2).)
Trust property	Movable or immovable property, including contingent interests in property, which, in accordance with the provisions of a trust instrument, are to be administered or disposed of by a trustee.
Founder of a trust	Also known as the donor or settler; the person (juristic or natural person) who establishes a trust.
Trust beneficiary/beneficiaries	Person/s stipulated in the trust instrument or trust deed who is/who are earmarked to reap the benefits of the trust. (The beneficiary may be a legal (juristic person).

Business trust	A trust that carries on business.
<i>Bewind</i> trust	A trust in which the beneficiary owns the trust assets, but the trustee only manages them.
<i>Nomine officio</i>	Latin term loosely translated as “in his or her capacity as ...” (Trust assets vest in trustees only in their official capacity and not in their personal capacity.)



Prescribed study material Textbook:

chapter 14 paras 3.1–3.2

Prescribed case law

This case you only need to know as discussed herein:

- ***Land and Agricultural Bank of South Africa v Parker and others 2005 (2) SA 77 (SCA)***

A trust is an arrangement through which ownership of a person's property is, by virtue of a trust instrument, made over or bequeathed to a trustee under the trust instrument to be administered for the benefit of beneficiaries. Trusts were designed to protect the weak and to safeguard the interests of those who are absent or dead (*Land and Agricultural Bank of South Africa v Parker and others*).

The **founder** creates the trust, the **trustee** manages and controls the trust property, and the beneficiary is the party on whose behalf the trust is created and managed. All the parties to a trust may be legal (juristic) persons. In other words, any one of the parties to a trust may be a company or a close corporation.

The trustee is responsible for administering the trust and for carrying out his/her duties to achieve an outcome envisaged in the trust instrument in favour of the trust beneficiaries. A trust, however, is not automatically brought into existence when an executor, tutor or curator administers another person's estate under the Administration of Estates Act 66 of 1965. A trust instrument, which must be lodged with the Master of the High Court, is required. If trust property is disposed of in terms of a will, jurisdiction lies with the Master of the High Court in whose office the testamentary writing or a copy thereof is registered and accepted, or with the Master in whose area of appointment in terms of the Administration of Estates Act the greater or greatest portion of the trust property is situated, provided that a Master who has exercised jurisdiction shall continue to have jurisdiction notwithstanding any change in the situation of the greater or greatest portion of the trust property.

3 Legal nature of trusts



Prescribed study material

Textbook: chapter 14 paras 2.1–2.3

A trust is either created by a **contract** (*inter vivos* trust) or through a **will** of a testator (testamentary trust). It must be reduced to writing and its existence evidenced by a document.

Some of the legal attributes of a trust include the following:

A trust has no separate existence and cannot contract in its own name. Note that, for purposes of the limited application of the Companies Act to trusts, a trust is considered a legal person. In other words, generally speaking, trusts do not enjoy legal personality, but, when the Companies Act applies to this business form, there is an exception to the rule.

- Although the trustee is legally the owner of the trust assets, a distinction is drawn between the trust's assets and the private assets of the trustee.
- Insolvency of any of the two estates does not entitle its creditors to attach the assets of the other estate, and official acts of the trustee will not bind his/her private estate.
- The trust deed may provide for the continued existence of a trust despite changes in the trustees.
- Both natural and juristic (legal) persons may be parties to a trust, whether as founders, trustees, or beneficiaries.
- Parties to a trust enjoy protection against liability for the debts of the trust. The parties do not stand to lose more than what is held in the trust.

4 Creation of a trust

A trust is created by a document called a trust deed. A trust deed comes either in the form of a contract (for an *inter vivos* trust) or a will of a testator (for a testamentary trust). It constitutes a trust's constitutive charter.

5 Parties to a trust

5.1 The founder



Prescribed study material

Textbook: chapter 14 para 3.1

The founder establishes the trust in the form in which he or she chooses to do so. The founder decides who the beneficiaries will be, what assets will be placed in the trust, and nominates a trustee/s to administer the trust. There is no rule against juristic persons like companies and close corporations being the founders of trusts. The founder can also be a trustee in terms of the trust.

5.2 The trustee



Prescribed study material

Textbook: chapter 14 para 3.2

The trustee is the person (whether natural or juristic) that administers the trust after his or her appointment. He or she takes control of the trust assets in his or her official capacity and does not acquire any rights thereto in a personal capacity. There can be more than one trustee. If a trustee is not nominated in the trust deed, or if the person who was nominated declines to take up the position, the court can appoint a trustee.

In *Land and Agricultural Development Bank of SA v Parker and Others* [2004] 4 All SA 261 (SCA), the Supreme Court of Appeal suggested that each family trust should appoint an independent trustee. Thereafter, in March 2017, the Chief Master of the High Court issued a Directive that makes the appointment of an independent trustee a requirement for all new family business trusts being registered.

An independent trustee plays a crucial role in the administration of a trust. No new trusts can be registered without a truly independent trustee (not a beneficiary and also with no family relation or connection, blood or other to any of the other trustees, beneficiaries or founder of the trust). The primary responsibility of an independent trustee is to act in the best interests of the beneficiaries and

ensure that the trust's assets are managed and distributed according to the terms of the trust deed.

The amendments carry profound consequences for trustees. A trustee commits an offence if they fail to adhere to the new requirements regarding reporting etc. These obligations include –

- informing an accountable institution, with whom they engage as a trustee, that the transaction or business relationship pertains to trust property;
- documenting the details of the accountable institution as prescribed in regulation 3B;
- establishing and recording the beneficial ownership information of a trust, as outlined in regulation 3C;
- maintaining an updated record of the beneficial ownership information stipulated in regulation 3C; and
- submitting a register of the beneficial ownership information, as prescribed in regulation 3C, to the Master of the High Court.

If a trustee (not just an independent trustee) is found guilty of any of the aforementioned offences, they will face severe penalties. These penalties may include a fine of up to R10 million, imprisonment for a maximum period of five years, or both the fine and imprisonment.

5.3 The trust beneficiary



Prescribed study material

Textbook: chapter 14 para 3.3

A trust cannot be formed without a beneficiary. A founder may also identify a class or group of beneficiaries and not a specific person. If a discrepancy exists regarding the identification of a beneficiary, the court can declare a trust valid or void. A founder cannot create a trust which infringes on the human dignity of a certain group or discriminates unfairly.

Beneficial ownership of a trust must now be reported in terms of the Trust Property Control Act 1988 as amended by the General Laws (Anti Money-Laundering and Combating Terrorism Financing) Amendment Act. These amendments have been effective as from 1 April 2023 and prescribe, among other things, that the information about a 'beneficial owner' as defined in the TPCA, that trustees of mortis causa or *inter vivos* trusts must now record and keep in a register to be lodged with the Master of the High Court.

6 Regulation of trusts



Prescribed study material

Textbook: chapter 14 para 1

Prescribed case law

This case you only need to know as discussed herein:

- ***Braun v Blann and Botha NNO 1984 (2) SA 850 (A)***

Trusts are mainly regulated by the **Trust Property Control Act 57 of 1988 as amended (Trust Property Control Act)** and the trust deed. The Trust Property Control Act consists of only 27 sections dealing mainly with the administration of trusts. The **common law** forms the basis of trusts as a business form. As mentioned in *Braun v Blann and Botha NNO*, owing to the fact that many principles related to this business form were derived directly from English law, which is foreign to Roman-Dutch law, there remain uncertainties regarding the regulation of trusts. This is why it is of utmost importance to ensure that the **trust deed** regulates the proper administration of the trust.

7 Types of trusts



Prescribed study material

Prescribed case law

This case you only need to know as discussed herein:

Estate Price v Barker and Price (1905) 22 SC 321 (C)

The definition as set out in the Trust Property Control Act envisages two types of trust, **ordinary trusts** and **bewind trusts**. An ordinary trust is a trust in terms of which the ownership and control of the trust property vests in the trustee. In a *bewind* trust, on the other hand, the beneficiaries have ownership of the trust assets, but they are under the control of the trustee.

An example of a *bewind* trust is that where someone bequeaths assets to a minor child. Upon the death of the testator (who is the founder of the trust), ownership of the trust assets vest in the child, but, until the child attains majority, the trustee controls the trust assets.

There are also different classifications of trusts in South Africa that fall within these two main types of trusts:

- *Testamentary trusts* are formed upon the death of the founder as part of his/her Will.
- *Trusts inter vivos* are formed while the founder is still alive, often as part of an estate plan to avoid payment of estate duty and other taxes.
- *Business (or trading) trusts* provide the trustees with wide powers to carry on business, while granting the beneficiaries the right to sell their interests in the trust. These trusts can be either public or private.
- *Public trading trusts* are trusts where the public is invited to become income beneficiaries by contributing money or assets to the trust and then being issued with certificates as proof of their share.
- *Private trading trusts* are created by private individuals wishing to channel funds towards a business and are used to drive the business.
- *Realisation trusts* are formed specifically for developing and selling fixed property.
- *Statutory trusts* are created by a particular statute to achieve a specific objective.
- *Court order trusts* are set up in terms of an order of court.
- *Offshore (or international) trusts* are established outside South Africa and fall outside the jurisdiction of the Master of the High Court.

Trusts are not registered with the Companies and Intellectual Property Commission. Trusts are created by virtue of a trust deed or instrument. To form a trust, the intention to create a trust must exist. This intention or instruction to the trustee to manage the trust assets for the beneficiaries must be expressed as an obligation in a written trust deed.

In *Estate Price v Baker and Price*, a will provided for a usufruct in favour of the surviving spouse "in order that she may be better enabled to maintain our children until they become of age, or they marry".

The court held that no trust had been created and that the children were not beneficiaries, as the

words in the will only expressed a desire, and not an obligation. The surviving spouse in terms of the will was enabled to use the income to maintain the children, but not obliged. This is insufficient for the formation of a trust.

The trust must be established for a lawful purpose and the trust property must be clearly defined. Beneficiaries of the trust must be clearly identified. At least one beneficiary needs to exist and at least one trustee must be appointed either in terms of the trust deed or, alternatively, by the Master. A trust deed must be concluded in writing. If the trust is formed in a will, the required formalities for a valid will must also be adhered to. In other words, two witnesses above the age of 16 years, along with the testator, must sign the testament in which the trust is created, and such witnesses may not be a beneficiary of the will.

Consequences of a valid trust

Upon the formation of a trust, trustees incur certain obligations/duties and acquire some powers. These are found in the Trust Property Control Act, the common law, and the trust deed. The beneficiaries also acquire some rights and protection, which are set out in the trust deed and the Act. The scope of the beneficiaries' rights is set out in the trust deed. Unless otherwise prohibited by the trust deed, these rights can be ceded or otherwise disposed of.

8 Authorisation of trustees



Prescribed study material

Textbook: chapter 14 para 4

- o **Trust Property Control Act: section 6(1)**

Prescribed case law

These cases you only need to know as discussed herein:

- ***Kropman v Nysschen* 1999 (2) SA 567 (T)**
- ***Simplex (Pty) Ltd v Van der Merwe and others* NNO 1996 (1) SA 111 (W)**

Only after a written authorisation by the Master can a trustee act as such. In *Simplex (Pty) Ltd v Van der Merwe and others* NNO, the court held that section 6 of the Trust Property Control Act was intended to provide proof to outsiders of the fact that someone is authorised to act as a trustee and not only for the beneficiaries.

The court held that, if a person is not authorised by the Master, any act performed before such authority is received by him or her will have no legal consequence. The court continued to consider whether it would be possible to ratify a contract retrospectively and held that it was not, as "there can be no ratification of an agreement which a statutory prohibition has rendered *ab initio* void".

In terms of section 6(1) of the Trust Property Control Act, only after authorisation by the Master can a trustee act as such. In *Kropman v Nysschen*, the court confirmed that any act performed by a trustee in the absence of authorisation from the Master is null and void.

9 Duties of trustees



Prescribed study material

Textbook: chapter 14 para 3.2.1

- o **Trust Property Control Act: sections 9, 11, 16 and 17**

Prescribed case law

These cases you only need to know as discussed herein:

- ***Sackville West v Nourse and another* 1925 AD 516**
- ***Doyle v Board of Executors* 1999 (2) SA 805 (C)**

Every trust is formed for a specific purpose. A trustee enjoys the powers inferred inherently in the type of business carried out in the trust. The powers of a trustee are stipulated in the trust deed. No other powers not provided for in the trust deed may be inferred. Therefore, a trustee is limited in his or her capacity by what is stipulated in the trust deed. If he or she acts outside of the authority provided, he or she can incur personal liability.

Section 9(2) of the Trust Property Control Act states that any provision in the trust deed which has the effect of exempting a trustee from one of his/her duties is void. Therefore, it is impossible to exempt a trustee from personal liability for failure to comply with his or her duties.

Owing to the fiduciary nature of the trustees' responsibilities, onerous duties are imposed on them.

These duties include the following:

- a duty of care, skill, and diligence
- to open a separate trust account at a banking institution
- to indicate in his or her bookkeeping the property held as trustee
- to register trust property as such
- to make trust and trust investment accounts identifiable as such
- to keep all documents as proof of investments for five years
- to protect and conserve trust property and collect debts in favour of the trust diligently
- to observe good faith in dealing with trust property
- to give effect to the terms of the trust deed

Although a trustee is usually not allowed to expose trust assets to risks (this would constitute a breach of his/her fiduciary duties), a trustee in a **business trust** is empowered to carry on a business or to trade. This implies authority to expose the trust to risks inherent in the type of business concerned. In *Sackville West v Nourse and another*, it was held that part of this duty entails not exposing trust assets to undue risk. An unsecured loan or a loan in respect of which the repayment is below the ordinary market rate will not be considered a sound investment.

In *Doyle v Board of Executors*, it was held that a trustee must show the utmost good faith in his or her dealings on behalf or with the beneficiaries of the trust. This includes the duty to sufficiently account to beneficiaries.

Unless specifically prohibited by the trust deed, a beneficiary can freely cede any of his or her rights in a trust, including discretionary rights.

The **advantages** of a business trust are:

- ease of formation
- limited liability
- extreme flexibility
- absence of legal regulation
- continuity.

Although it is not enumerated in the textbook, it can also be viewed as an advantage of a business

trust that the trustees are restricted to acting within the specific bounds as laid down in the trust deed.

The **disadvantages** of a business trust are:

- limited access to capital (which is usually obtained by means of loans for which security is provided)
- the potential for conflict between parties
- a trust may be confused with a partnership due to similarities in management structure.

Trusts enjoy many benefits – the formation of a trust is economical, there is no complex legislative structure, and trusts enjoy limited liability. There are different parties to trusts: the founder, trustee, and the beneficiary. All or any of the parties may be juristic persons.

A trust generally does not enjoy separate juristic personality. **The recognition of trusts as juristic persons in the Companies Act is not a general recognition, but only applies in respect of the provisions of that specific piece of legislation in as far as it impacts on trusts.** The trustee owns the trust assets in an official representative capacity. The trustee of a business trust is held liable for the trust's debts in his or her capacity as trustee. However, the only assets that the trustee stands to lose are the assets held in his or her capacity as a trustee and not the assets in his or her own personal estate. The effect is that liability is limited to what is held in trust.

A trustee is regarded as having two separate estates: a personal estate out of which his or her personal debts are paid, and the trust estate which is liable for trust debts only. A trust can be created for any period. Therefore, trusts enjoy perpetual existence. The existence of a trust does not depend on the identity of the trustee or its beneficiaries.

Trustees manage trusts. The founder exercises control over the trustees, as they have a right to amend the trust deed. In a business trust, the management structure is similar to that of a partnership and the Master of the High Court oversees the trustee's functions.

It is easy and cheap to establish a trust. All that is required is a trust deed, usually in the form of a contract or a will. The trust deed must identify the trust property, trustees and beneficiaries and must set out the powers of the trustees. There is little regulation of trusts when compared with the regulation of other enterprise forms. The lack of certainty in the regulation of trusts can be a disadvantage. A trust deed must be properly formulated, and trustees must be carefully selected.

The main advantage of a business trust is that the beneficiaries enjoy limited liability without the complexities and expenses of a company or close corporation. Its disadvantage is the danger of being deemed a partnership owing to the two entities often sharing similar elements. A business trust can be structured in such a way that it resembles a company or close corporation, including the enjoyment of limited liability, but without being burdened with the complexities and expenses associated with either a company or close corporation.

→ Reflection

A trust is created by means of a **trust instrument**. It is always created for a specific purpose. The trust instrument determines what the functions of the trustee are in relation to the trust assets. Trustees perform their duties under the direction of the Master of the High Court.

LESSON 15:

Partnerships

1 Introduction

Partnerships are one of the oldest, simplest business forms used in South Africa. Partnerships are extremely easy and cheap to form and provide a lot of flexibility. A partnership is formed by the conclusion of a partnership agreement. The basis of a partnership is for the partners to work together to make a profit. Partnerships do not enjoy separate legal (juristic) personality. Therefore, it is important for partners to maintain good relations and the utmost good faith to ensure continuance of their business.

Partnerships are mainly regulated by common law principles and there is no Partnerships Act in South Africa.

IMPORTANT SECTIONS OF LEGISLATION

INSOLVENCY ACT 24 OF 1936:

Section 13(1)	–	During sequestration, a partnership's estate should be dealt with separately from partners' personal estates.
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COMPANIES ACT 71 OF 2008:

Section 8(3)	–	No association formed for the purpose of acquisition of gain by the association or its members will be a legal person unless it is registered as a company.
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INCOME TAX ACT 58 OF 1962:

Section 24H	–	Each partner is deemed to be a participant in the partnership business.
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HIGH COURT AND MAGISTRATE COURT RULES:

Rule 14 of the Uniform Rules of the High Court and Rule 54 of the Magistrates' Courts Act 32 of 1944

Important terms	Meaning
Co-owners	An individual or group that shares ownership in an asset with another individual or group. (Partners are co-owners of partnership assets.)
Joint liability	The situation when two or more persons are both/all responsible for a debt, claim or judgment.
Joint and several liability	A designation of liability by which members of a group are either individually or mutually responsible to a party in whose favour a judgment has been awarded.
Partnership agreement	A specific nominate contract (with certain <i>essentialia</i>) between partners which sets out the terms and conditions of the relationship between the partners.
Universal partnership	A partnership where the partners agree to put in common all their property, <i>universorum bonorum</i> , not only what they have presently but also future assets and obligations.
Particular partnership	A partnership formed for a single transaction or enterprise.
Anonymous partnership	Also known as a 'silent partnership'. (A partner/s may enjoy limited liability so long as he/she/they remain anonymous in their capacity as partners and do not participate in the operation of the partnership.)
Partnership <i>en commandite</i>	An extraordinary partnership in terms of which a partner (or partners) enjoys limited liability to co-partners for the losses of the partnership up to an agreed amount, on condition that he or she receives a fixed share of the profits.

A partnership may be described as a contractual relationship between two or more – but usually not more than twenty persons (called partners) who operate a lawful business with the object of making a profit. Partners may be natural or juristic persons. The essential characteristics of a partnership are that each partner must contribute something to the partnership, the partnership must be carried on for the joint benefit of the partners, and each partner should have the expectation of sharing in the profit. The continued existence of a partnership is dependent on the involvement of the partners. It is also largely dependent on the legal capacity of the partners. As a result of the risks associated with the continued existence of partnerships, as well as other risks associated with this enterprise form, a relationship of utmost good faith is required among partners.

A partnership **does not have legal personality**. The partners in their personal capacity, rather than the partnership as such, jointly enter into all transactions or contracts. The assets contributed to or accumulated by the partnership belong to all the partners jointly as co-owners. The partners are also jointly liable for all the partnership debts. Although a partnership is not a juristic person, the law nevertheless regards a partnership as an entity for certain limited purposes.

During the existence of the partnership, the partners are jointly liable for all claims against the partnership, regardless of who was responsible for bringing about the claim. A creditor must either sue all the partners jointly or sue them in the name of the partnership. If the partnership assets are insufficient to meet the claim of the creditor, the partners are liable for the debt out of their personal estates. Therefore, personal possessions of the partners are not protected against any claim.

Once a partnership has been dissolved, the partners are jointly and severally liable for partnership debts. This means that a creditor can recover the full debt from one partner only, leaving it to the partner who settled the claim to claim the necessary proportionate contributions from his or her co-partners.

The partners have joint control and authority over the business. However, the partners can adjust the control and authority aspect in their partnership agreement by, for example, excluding one or more partners from representing or participating in the management of the partnership. This would, however, not necessarily exclude liability in terms of transactions concluded by such an excluded partner. The principle of mutual mandate provides for liability of the partners for contracts concluded by any partner in the name of the partnership if such transaction falls within the scope of the partnership business. Therefore, the partners will, during the existence of the partnership, be held jointly liable in terms of any transaction concluded by a partner if such contract is not outside the scope of the business. A partner who is excluded from participating in the management of the partnership and concludes a contract within the scope of the partnership will, however, be in breach of his/her fiduciary duty to his/her co-partners.

The joint management of the partnership can lead to problems if the partners have different opinions or work ethics. A partnership may even be terminated because of personal circumstances of its partners or their incompatibility in running the business.

2 Definition of a partnership



Prescribed study material

Textbook: chapter 15 paras 1, 2 and 7

Prescribed case law

These cases you only need to know as discussed herein:

- ***Pezzutto v Dreyer and others* 1992 (3) SA 379 (A)**
- ***Bester v Van Niekerk* 1960 (2) SA 799 (A)**

In *Pezzutto v Dreyer and others*, a partnership was defined as a legal relationship created by way of a contract between two or more persons, in terms of which each of the partners agrees to make some

contribution to the partnership business which is carried on for the joint benefit of the parties with the object of making a profit.

3 Types of partnership

Apart from ordinary partnerships, which form the subject of the discussion in this study unit, there are also universal, particular, and extraordinary partnerships.

3.1 Universal and particular partnerships

Universal partnerships differ from other types of partnerships in their ambit – they are not restricted to a particular transaction or a specific business. Two types of universal partnerships can be distinguished: the *societas universorum bonorum* and the *societas universorum quae ex quastu veniunt*.

The *societas universorum bonorum* is a partnership of all property that will generally take place within the context of marriage. The *societas universorum quae ex quastu veniunt* is a partnership of all profit which occurs within the context of commercial undertakings.

A partnership can be established in respect of a specific project, for example the construction of a block of flats. In *Bester v Van Niekerk*, it was held that, if persons who are not partners in other business, share the profits and loss of one particular transaction, they become partners as to that transaction, but not as to anything else. This is known as a **particular partnership**.

3.2 Ordinary and extraordinary partnerships

Extraordinary partnerships differ from other types of partnerships in that the liability of certain partners to third parties may be limited. Three types of extraordinary partnerships can be distinguished: the anonymous partnership (also called the 'silent partnership'), the partnership *en commandite*, and special partnerships which were registered under the now repealed Special Partnerships Limited Liabilities Act of the Cape Province and Natal.

In an **anonymous or silent partnership**, the business is conducted by **one** of the partners in his or her name. While an anonymous or silent partner remains undisclosed to the public, he or she is not liable to third parties for the debts of the partnership. He or she, however, remains liable to his or her partner/s for his or her proportional share of the partnership losses. In other words, he or she **shares the full risk of the enterprise**.

In a **partnership en commandite**, the business of the partnership is also carried on in the name of one or more of the partners, but **every partner whose name is not disclosed is only liable to the other parties to the extent of the fixed amount** of the agreed capital contribution made by him or her. Therefore, if the partnership incurs losses, the liability of the partner *en commandite* will not exceed the fixed amount.

Special partnerships which were registered under the now repealed Special Partnerships Limited Liabilities Act of the Cape Province and Natal were partnerships where the limited liability of a special partner would be lost if his or her name was employed in the name of the firm or if he or she personally entered into a transaction on behalf of the partnership.

4 Differences between partnerships and companies

Some of the most pertinent differences between a partnership and a company are the following:

- A company has a separate legal personality, while a partnership does not.
- A company comes into existence through incorporation in terms of the Companies Act. A partnership is formed by agreement, and no formalities are required.
- The main object of a partnership is to make a profit. Companies can be incorporated even where their main object is not to make a profit for members, that is, non-profit companies.
- A change in the membership of a company does not have any effect on the company's existence, while any change in the membership of a partnership leads to the dissolution of a partnership.
- The company is the owner of company assets and the members do not have any property rights

therein, whereas the partners in a partnership are joint co-owners of the partnership assets.

- All profits made belong to the company and shareholders only become entitled to profits after the company has declared a dividend, whilst partners are entitled to share in the net profit available for division.
- Partners, unless otherwise agreed, have the authority to bind the partnership to transactions that fall within the partnership business (mutual mandate applies), whereas a shareholder cannot in his or her capacity as shareholder act on behalf of and bind the company to transactions that fall within the company business.
- There must be at least two partners in a partnership, while, in some companies, like private companies, only one shareholder is required.
- In a partnership, there are partners, while, in a company, there are shareholders (in profit companies) or members (in non-profit companies).

5 Advantages and disadvantages associated with partnerships

Partnerships offer the following **advantages**:

- ease of formation
- diversification of the skills and abilities of the partners
- increased opportunity for accumulation of capital
- minimal legal formalities and regulation

Partnerships have the following **disadvantages**:

- the personal liability of partners
- the relative difficulty in disposing of an interest in the partnership
- the potential for conflict between partners
- lack of continuity (but this can be overcome by agreement)

6 The *essentialia* of a partnership



Prescribed study material

Textbook: chapter 15 paras 3 and 4.1–4.3

Prescribed case law

You only need to know the following cases as discussed herein:

- ***Joubert v Tarry and Co* 1915 TPD 277**
- ***Ally v Dinath* 1984 (2) SA 451 (T)**
- ***Harrington v Fester and others* 1980 (4) SA 424 (C)**

Important terms	Meaning
<i>Essentialia</i>	The essential elements that distinguish a nominate contract like a partnership agreement.
Contribution	The economic input (something with an economic value as agreed upon in the partnership agreement) that must be provided by each partner to qualify for partnership. (The contribution can be in the form of money, assets, labour, skills, or knowledge. Two requirements apply: it must have an economic value and it must be exposed to the risk of the business.)

There can never be a partnership that is formed by less than two persons. It is impossible to unilaterally conclude a partnership agreement. The Companies Act has removed the prohibition of exceeding 20

participants, but the nature of partnerships envisages a small number of participants. The contracting parties to a partnership agreement are known as the **partners**. From the moment that a partnership agreement is concluded, a special relationship is created between the partners. The relationship goes to the core of the business and, if the relationship is destroyed, the enterprise cannot continue to exist. We now consider how valid partnerships are formed and what factors the courts consider to ascertain whether a valid partnership has been brought into existence.

The *essentialia* are those elements that must form part of an agreement for such agreement to constitute a partnership agreement. These *essentialia* of a partnership agreement were set out in *Joubert v Tarry and Co*. The elements will now be discussed under separate headings.

6.1 Contribution by partners



Prescribed study material

Textbook: chapter 15 para 4.1

Each partner must contribute something or give a binding undertaking to make some kind of contribution to the partnership that has commercial value, like money, property, skill, knowledge, expertise, contacts, experience, etc. A partner's contribution must be **exposed to the risks** of the partnership business. If a partner makes a contribution on condition that it will be returned to him or her even if the enterprise fails, that contribution will not meet with this requirement of the *essentialia*.

However, take note that partners can agree that a partner will retain full ownership of the goods that he or she contributes to the partnership, in which case only the use of the goods is made available to the partnership. As the use still has an **economic value**, the contribution would remain valid despite his or her retention of ownership.

6.2 The business should be carried on for the joint benefit of the partners



Prescribed study material

Textbook: chapter 15 para 4.3

It is one of the *essentialia* of a partnership that each partner must be entitled to share in the net profit of the partnership, but partners need not receive equal shares in the profit. An agreement that a partner will only share in the profit if the net profit exceeds a stipulated profit margin is also valid. Although such a partner will not share in the profit if the profit margin is not exceeded, he or she at least has a right to share in it when the business of the partnership improves. One partner cannot be entitled to all the benefits while another must bear all the losses. However, it is possible, as an exception to the general rule, to exclude a partner from sharing in a net loss.

6.3 The business should be carried on with the object of making a profit



Prescribed study material

Textbook: chapter 15 para 4.2

According to the court, in *Ally v Dinath*, the profit motive does not refer to purely pecuniary profit, but also to the achievement of another material gain such as a joint exercise for the purpose of saving costs. However, sports clubs and welfare or charitable institutions cannot be partnerships.

6.4 The contract should be a legitimate contract



Prescribed study material

Textbook: chapter 15 para 3

A partnership is established by means of a valid agreement and the contracting parties must have the intention of establishing a partnership.

In *Harrington v Fester and others*, there was no written partnership agreement, and the applicant claimed the existence of a partnership, but certain correspondence indicated that the applicant had treated the respondent as an employee, which is inconsistent with the existence of a partnership.

If the intention is not to establish a partnership, no partnership will come into existence despite the presence of the *essentialia*.

6.4.1 Other legal formalities

A partnership is nothing more than a specific type of contract. A valid contract must be lawful, parties must have contractual capacity, they must reach an agreement (consensus), and the agreed performance must be possible.

A partnership must comply with the law and cannot conduct business that is prohibited by law or public policy. The Companies Act changed the restriction on the number of partners in a partnership. Previously, no more than 20 persons could conclude a partnership agreement. No such restriction now exists under the Companies Act.

There is no limit on the number of partners in any partnership. At least two partners are required for a partnership to come into existence. There are no formal requirements for the actual partnership agreement and, therefore, the agreement may be concluded in writing or orally or be implied by conduct, unless the partners agree on certain formalities.

6.5 The *essentialia* as an aid



Prescribed study material

Textbook: chapter 15 para 4.4

Prescribed case law

The following cases you only need to know as discussed herein:

- ***Pezzutto v Dreyer* 1992 (3) SA 397 (A)**
- ***Purdon v Muller* 1961 (2) SA 211 (A)**

The *essentialia* play a key role in determining whether or not a partnership is formed. If all the *essentialia* are present and the parties to the contract had the intention to conclude a partnership agreement, a valid partnership is formed.

In *Pezzutto v Dreyer*, it was held that the fact that partners considered themselves to be partners is important, but not conclusive, in deciding whether a partnership was brought into existence. In the absence of even a single essential element of a partnership agreement, no partnership would come into existence.

The presence of all the *essentialia* of a partnership agreement does not necessarily mean that a partnership was formed. In *Purdon v Muller*, it was decided that the court will give effect to the intention of the partners – despite the presence of the *essentialia* of a partnership agreement – where the

parties intended to conclude another type of contract, for instance a lease contract and not a partnership agreement.

7 Legal nature of a partnership



Prescribed study material

Textbook: chapter 15 para 2

- o **Companies Act: section 8(3)**

Prescribed case law

The following case you only need to know as discussed herein.

- ***Sacks v Commissioner for Inland Revenue 1946 AD 31***

A company enjoys legal personality. This is one of the main advantages associated with this form of business. Partnerships differ from companies in the sense that they do not have to be registered with the Registrar, but they also do not acquire their own separate legal personality. The effect is that partnerships do not enjoy all the rights and benefits attached to legal personality. There are only two instances in which a partnership will be deemed separate from its members. These two exceptions are discussed here.

A partnership does not exist independently from the partners. Section 8(3) of the Companies Act determines that no association formed for the purpose of acquisition of gain by the association or its members will be a **legal person** unless it is registered. Partnership agreements are not registered with the Companies and Intellectual Property Commission under any law. The rights and obligations of the partnership are those of the partners and the assets belong to the partners. When one of the partners dies or retires, the partnership dissolves.

In *Sacks v Commissioner for Inland Revenue*, the court held that, unless a partnership agreement provided otherwise, receipts of income of a partnership were so received by the partners in common, and only when the time arose at the end of an accounting period would a partner become entitled to claim a separate determinable share of the partnership profits. However, this position has been altered by section 24H of the Income Tax Act 58 of 1962, which ensures that each partner is regarded as carrying on the business of the partnership.

The general rule is that a partnership does not exist independently of the partners. The way a partnership is dealt with in the case of insolvency and litigation are exceptions to this rule.

7.1 Insolvency



Prescribed study material

Textbook: chapter 15 para 2.2

- o **Insolvency Act 24 of 1936: section 13(1)**

Prescribed case law

The following case you only need to know as discussed herein:

- ***Michalow NO v Premier Milling Co Ltd 1960 (2) SA 59 (W)***

Section 13(1) of the Insolvency Act provides that sequestration of a partnership estate is to be treated as distinct from the estates of the individual members. If the estate of an insolvent partnership is sequestered, the partnership estate (which comprises the contributions of partners and further assets

acquired by the partnership), and the estates of the partners must be sequestrated simultaneously.

The debts of the partnership are first paid from the partnership estate before the private estates of the partners will be looked at to pay the partnership debt. In *Michalow NO v Premier Milling Co Ltd*, the court held that the Insolvency Act departed from the common law by retaining the partnership estate as a separate estate from the estates of the partners.

7.2 Litigation



Prescribed study material

Textbook: chapter 15 para 2.1

- o **Uniform Rules of the High Court: Rule 14**
- o **Magistrates' Courts (Act 32 of 1944): Rule 54**

The rights and obligations of the partnership are the rights and duties of partners jointly. Therefore, an individual partner cannot be sued for a partnership debt during the subsistence of the partnership, and an individual partner cannot generally enforce a partnership claim.

In principle, all the partners must sue and be sued jointly in their own names during the subsistence of the partnership. However, in terms of **Rule 14 of the Uniform Rules of the High Court**, a partnership may be sued and may sue in its business name. A similar provision is to be found in **Rule 54 of the Magistrates' Courts Act**. When judgment is levied against a partnership, the partnership assets must first be exhausted before execution can be levied against the separate property of the partners.

The fact that a partnership generally does not enjoy separate legal personality has some negative consequences: partnerships do not grant partners limited liability, the business enjoys no perpetual succession, and the business may be terminated if, for any reason, the membership should change. It is possible, in the course of a partnership, to sue a partnership in either the Supreme Court or the Magistrates' Court in the partnership's name, and this will have the same effect as suing each partner jointly. After dissolution of the partnership, partners may be held **jointly and severally liable** for all the debts of the partnership.

If a partner becomes insolvent or the partnership is insolvent, the business will have to dissolve. "Partnership" debts and personal debts of partners are deemed separate from each other for as far as this is possible.

8 Relationships in partnerships

Important terms	Meaning
<i>essentialia</i>	Terms of a contract that identify the contract as a particular type of contract.
<i>naturalia</i>	Terms that are implied in a specific contract by law.
<i>incidentalia</i>	Other terms of the contract that the parties must agree to. (These terms may vary the <i>naturalia</i> of an agreement.)
<i>actio pro socio</i>	A general action by which either partner could compel his/her co-partners to perform their social contract. (The grounds on which this action may be brought are non-specific.)
<i>actio communi dividundo</i>	A right enjoyed by a partner as co-owner of partnership assets if partners cannot agree on the method of dividing a particular jointly owned asset to apply to a court for a fair division.
fiduciary duty	Also known as the "duty of good faith"; a duty imposed by law on persons in a fiduciary position to act in the best interest of the person to whom they owe the duty.
joint liability	The situation when two or more persons are both responsible for a debt, claim or judgment. (In the course of a partnership, all the partners are jointly liable for partnership debts.)
joint and several liability	Designation of liability by which partners are either individually or mutually

	responsible to a party in whose favour a judgment has been awarded. (Partners become jointly and severally liable for partnership debts upon dissolution of a partnership.)
ratification	Acceptance of an approved action which was not authorised prior to performance thereof. (It often has a retrospective effect of validating the action.)
ostensible authority	Authority as it appears to the outside world, the authority of an agent based on estoppel which may exist even though he or she did not have actual authority.

Certain rights and obligations arise naturally from partnership agreements (*naturalia*). The partners may, however, agree to change these automatic consequences by including specific stipulations to the contrary (or *incidentalia*) in the partnership agreement. The *naturalia* of a partnership are highlighted below. We also look at the internal relationship between partners, and the relationship that partners have with outsiders or third parties.

8.1 Natural consequences of a partnership agreement (*naturalia*)



Prescribed study material

Textbook: chapter 15 para 5

There are certain natural consequences (or *naturalia*) which ensue from a partnership agreement. In contrast with the *essentialia* of a partnership, as discussed earlier, partners are free to alter the *naturalia* of a partnership. If the partners do not alter these consequences, the *naturalia* are the legal rules which will apply to the partnership.

The most important *naturalia* are the following:

- It is one of the *essentialia* of a partnership that each partner must be entitled to share in the net profits of the partnership, but partners need not receive equal shares in the profits. In the absence of an agreement on how profits are to be shared, profits are shared between the partners in proportion to the value of their respective contributions to the partnership, but, if the value of the contributions cannot be ascertained, the partners share the profits equally.
- The losses of the partnership are shared in the same proportion that the profit would have been divided. Although it is permissible for partners to exclude one or more partners from sharing in the losses should the partnership make no profit and sustain a net loss, there must be at least one ordinary partner who will carry the losses of the partnership.
- Each partner has the power to represent the partnership in transactions which fall within the usual scope of the business of the partnership.
- A partner is not entitled to compensation for his or her contribution to the partnership. Partners are, however, entitled to come to a different arrangement.
- The assets of the partnership belong to the partners jointly. They are co-owners of each partnership asset.

8.2 The relationship between partners



Prescribed study material

Textbook: chapter 15 paras 8–9

Prescribed case law

The following cases you only need to know as discussed herein:

- ***Purdon v Muller* 1961 (2) SA 211 (A)**
- ***Mattson v Yiannakis* 1976 (4) SA 154 (W)**

A close mutual fiduciary relationship exists between partners. In *Purdon v Muller*, the court held that, under our common law, a partnership is considered to be a contract of the utmost good faith.

The requirements of the fiduciary relationship are not strictly defined, but three broad categories of duties may be distinguished:

- that a partner must comply with his or her duties in terms of the partnership agreement
- that a partner must further the interests of the partnership unselfishly and avoid a conflict between his or her personal interests and the interests of the partnership
- that a partner must disclose to his or her co-partners all information which affects the partnership

The rights of partners between themselves include:

- a right to share in the profits of the partnership
- a right to participate in the management of the business
- the right to compensation
- the right to inspect the partnership books
- the right to distribution of assets on dissolution

The duties to the partnership include:

- the duty to make a contribution to the partnership
- a duty to share in the losses
- a duty of care and skill
- a duty of full disclosure or a duty to account

As indicated above, one of a partner's duties to the partnership is a duty of care and skill. To ascertain the reasonableness of an act by a partner, regard is had to the degree of care which the partner displays in the management of his or her own affairs. No basic level of expertise or any qualifications are required. Partners choose each other and have only themselves to blame if they take into the partnership an incompetent partner without restricting his or her management powers. However, if a partner undertakes to contribute any particular skill or expertise to the partnership, he or she will be liable for loss caused by any failure to display such skill or expertise.

For example, if a partner undertakes to render professional services to the partnership, he or she will be liable for any losses caused to the partnership if his or her services fail to comply with applicable professional standards.

Separate duties that flow from the principle of utmost good faith include:

- a duty to accept and fulfil the obligations of the partnership agreement (*Purdon v Muller*);
- a fiduciary duty to fellow partners and a duty not to compete with the partnership (*Mattson v Yiannakis*);
- a duty to guard against a conflict of interest (*De Jager v Olifants Tin "B" Syndicate*); and
- a duty to disclose to all co-partners all information in his or her possession which affects the partnership.

Remedies available to partners

There are two specific actions with which a partner can enforce his or her rights as a partner against any of his or her co-partners: the *actio pro socio* and the *actio communi dividundo*:

- The *actio pro socio* is a general multipurpose partnership action with which partners can enforce their mutual rights. It can be used, for example, to enforce compliance with the partnership agreement, to request an interdict against a partner, to obtain the return of a partnership asset, etc.
- The *actio communi dividundo* is an action with which co-owners effect physical division of tangible things which they hold in joint ownership. After dissolution of the partnership, a partner can bring this action to obtain physical division of jointly owned partnership assets. In practice, the process for handling partnership assets post-dissolution typically involves accounting and distribution rather than actual physical division of tangible things.

9 Representation in partnerships



Prescribed study material

Textbook: chapter 15 paras 8.11.1 and 10.3

Prescribed case law

The following case you only need to know as discussed herein:

- ***Goodrickes v Hall and another 1978 (4) SA 208 (N)***

Each partner is liable jointly and severally for partnership debts. However, during the existence of the partnership, creditors of the partnership cannot sue partners individually for partnership debts.

When a partner contracts with a third party on behalf of the partnership, he or she binds all his or her partners, provided that he or she acts within the scope of his or her authority. His or her authority to bind his or her partners may be based on actual or ostensible authority.

Furthermore, actual authority may be express or implied. Each partner has implied authority to perform all acts that are necessary for, or are incidental to, the proper conduct of the business of the partnership. This is sometimes referred to as “the principle of mutual mandate”. If a bona fide third party wishes to hold the partnership liable in terms of a contract concluded by a partner, it is sufficient for him or her to prove that the contract fell within the scope of the business of the partnership. If it can be shown that a transaction fell outside the scope of the partnership business, then the contracting partner has exceeded his or her implied authority. Remember that, if a partner has been granted express authority to contract on behalf of the partnership, the partnership will be bound even if the transaction falls outside the scope of the partnership business. A partner’s implied authority to bind his or her partners can be limited or excluded by agreement between the partners. However, a third party who is *bona fide* and unaware of a limitation on a partner’s authority will be able to hold the partnership to a contract concluded within the scope of the partnership business (*Goodrickes v Hall and another*).

In partnerships, all partners are representatives of the partnership for any transaction which falls within the scope of the partnership business. Each partner has implied authority to conclude a contract in the name of the partnership as long as it benefits the partnership. This implied/tacit authority is known as ‘**mutual mandate**’.

As soon as a transaction falls outside the scope of the partnership business, the situation is different. Then, the contract will not be binding on the other partners (in other words, only the contracting party will remain liable for performance), unless the contracting party was expressly authorised to conclude the contract in the partnership’s name or if it is subsequently ratified by the other partners.

The relationship between partners in the course of the partnership towards outsiders (third parties) is different from their relationship after termination of the partnership. While a partnership exists, partners are jointly liable for all debts incurred. After termination of a partnership, partners become jointly and severally liable to outsiders.

10 Dissolution of partnerships



Prescribed study material

Textbook: chapter 15 paras 11.1–11.9

Prescribed case law

The following case you only need to know as discussed herein:

- ***Lee and another v Maraisdrif (Edms) Bpk 1976 (2) SA 536 (A)***

Partnerships do not enjoy separate legal personality, and they are, to a great extent, dependent on the

partners. Partners are **joint owners** of the partnership's assets and **jointly liable for the debts** of the partnership. They all have the power to conclude binding contracts that fall within the scope of the partnership business. It makes sense that partners must have a remarkably close relationship to make this kind of business work for everyone.

The different ways in which a partnership may be dissolved or terminated include:

- effluxion of the term of the partnership
- the end of the undertaking (completion of the partnership business)
- mutual agreement
- a change in membership (which can occur because of the death or retirement of a partner or the admission of a new partner)
- the death of a partner
- insolvency and sequestration of the partnership estate or the estate of any partner
- a bona fide notice of dissolution by any partner
- the situation where partners become alien enemies on or after the outbreak of war
- an order of court

Regarding an order of court for the dissolution of a partnership, the following should be noted: an order may be granted upon application by one or more of the partners for **good cause**. What constitutes good cause is a factual question which will need to be determined in each individual case. The courts have indicated reasons that would constitute good cause. A court will also grant an order in the case of a breach of the fiduciary relationship between the partners. It should be noted that the situations under which a court will grant an order are not synonymous with grounds for automatic dissolution of a partnership. Examples of automatic dissolution include effluxion of time, completion of partnership business, change in membership, and other grounds mentioned above.

If the court is approached for an order for the dissolution of a partnership, it has a discretion to make the order and the partnership will only dissolve upon the granting of such order.

As indicated above, a partnership dissolves when the partnership estate or the estate of any of the partners is sequestered or, should the partner be a company or a close corporation, when its estate is liquidated. The sequestration of the partnership estate leads to the simultaneous but separate sequestration of the personal estates of the partners, with the exclusion of the estates of extraordinary partners and estates that cannot be sequestered under the Insolvency Act, for instance because it is a company or a close corporation. A partner can also avoid sequestration of his or her estate by furnishing an undertaking that he or she will pay the partnership debts and by giving security for such payment.

In principle, private creditors cannot claim against the partnership estate and partnership creditors cannot claim against the different estates of the partners. If a residue remains in one of the private estates after all the creditors of that partner have been paid, the balance will be available to the trustee of the partnership estate as far as it may be required to pay partnership debts. Should a surplus remain in the partnership estate, it will be divided, and each partner's proportional share will be made available

to the trustee of his or her personal estate.

Consequences of termination of a partnership include the following:

- A proper rendering of an account must be completed before amounts owed to the individual partners can be claimed.
- Upon termination, any creditor of the partnership can sue the partners as individuals, jointly and severally, for partnership debt – see *Lee and another v Maraisdrif (Edms) Bpk*. Therefore, creditors of the partnership can hold any of the partners liable for the total amount of their claims after dissolution of the partnership. A partner who pays the total amount of a claim has a right of regression. He or she can recover from his or her former co-partners that portion of the payment that exceeded his or her proportional share.
- After termination, no partner has implied authority to bind the partnership.
- After termination, each partner may demand an account from his or her co-partners.

→ Reflection

Partnerships are probably the simplest to form of all enterprise forms in South Africa. All that is required is the conclusion of a valid partnership agreement. However, there are risks attached to this type of enterprise. Can you think of risks that will give rise to financial losses for partners?

The partnership is one of the oldest organised business forms. In South Africa, there is no Partnership Act. Therefore, this type of enterprise is **mainly regulated by common law**. Partnerships are formed by means of a contract. The partnership does not enjoy any separate legal personality. The existence of a partnership is dependent upon its partners.

You should now know how partnerships are formed. In addition, you should be able to explain the relationships between partners towards third parties and among themselves during the existence of the partnership as well as after its dissolution.

In the next study unit, we deal with a different type of enterprise aimed specifically at small businesses, namely close corporations. In contrast to partnerships, close corporations, like companies, enjoy the benefits of separate legal personality.

You have now reached the end of the study unit dealing with partnerships. We hope that you have found it interesting and that you feel that you have learnt something about this South African business form.

LESSON 16:

Close corporations

1 Introduction

The **Close Corporations Act 69 of 1984** ("Close Corporations Act") introduced a new and cheaper option for the incorporation of small enterprises. This form of business is a combination of partnership attributes and some of the corporate attributes. It provides a simple, inexpensive, and flexible form of incorporation for the enterprise consisting of a single entrepreneur or small number of participants. The aim was to deregulate the system of incorporation of enterprises and to create an enabling business environment for the South African small-business sector.

A close corporation, like a company, acquires legal personality upon incorporation. A legal person is regarded as an entity that can acquire rights and duties separate from its members. Close corporations also enjoy perpetual succession, which means that, unlike partnerships, they remain in existence even if the members should change.

With all the benefits attached to incorporation, in addition to the fact that running the business is unostentatious by onerous regulation, entrepreneurs and owners of micro- and small businesses were presented with a most viable option appropriate to their business.

Although it cannot be said that the future of close corporations is under threat under the Companies Act, existing close corporations continue to exist alongside companies, but no further registrations of close corporations or conversions of companies to close corporations are permitted by the Companies Act.

IMPORTANT SECTIONS OF LEGISLATION

CLOSE CORPORATIONS ACT 69 OF 1984:

Section 34(1)	–	Mandatory procedure for disposal of an insolvent member's interest
Section 36	–	Disposal of a member's interest and cessation by order of court
Sections 38 and 39	–	Acquisition of a member's interest by the close corporation
Section 40	–	Financial assistance by close corporation in respect of the acquisition of a member's interest
Sections 42 & 50	–	The fiduciary duties of members towards the close corporation
Section 43	–	Personal liability of member for negligence (not acting with reasonable skill and care)
Section 44	–	Association agreements
Section 49	–	Statutory personal action
Section 50	–	Statutory derivative action
Section 51	–	Payments to members
Section 52	–	Prohibition of the making of certain loans or provision of security
Section 54	–	Representation in close corporations
Section 56	–	Personal liability for not keeping proper accounting records
Section 58 (2)	–	Accounting requirements in close corporations
Section 62	–	Duties of accounting officers
Section 62A	–	Application of accountability provisions of Companies Act

Section 63 - Joint liability for failure:

- o to use 'CC' after corporation's name (section 22)
- o to contribute the agreed contribution (section 24)
- o to qualify as a member
- o to comply with the rules relating to giving of financial assistance under section 39
- o vacancy of auditor position in excess of six months or managing the close corporation when disqualified to do so

Section 64 - Liability for reckless and fraudulent trading

Section 65 - Gross abuse of the legal personality of a close corporation

2 Transitional arrangements and close corporations

Even though close corporations remain mainly regulated by the Close Corporations Act 69 of 1984 ("Close Corporations Act"), various provisions contained in the Companies Act have been made applicable to this type of enterprise in terms of Schedule 3 of the Act. These provisions regulate name reservations, dissolution and deregistration, and orders to place persons on probation or to declare them delinquent.

3 Legal personality and piercing the corporate veil



Prescribed study material

Textbook: chapter 16 para 10.3

- o **Close Corporations Act: section 65**

Important terms	Meaning
Legal personality	Also known as "juristic personality"; to be acknowledged in law as a person or bearer of its own rights, with liability for its own debts.
Founding statement	(Form CK 1) Sole constitutive or registration document for close corporations.
Perpetual succession	Indicating independence from the members of the close corporation. (The close corporation will continue to exist even if the members should change.)

You learnt that companies acquire legal personality upon incorporation. Likewise, in the case of close corporations, separate legal personality is acquired upon registration of the **founding statement**. Sometimes, the court may be called upon to lift or "pierce the corporate veil" or disregard the separate legal personality of the close corporation. Revise study units 1 and 2 (legal personality and abuse of juristic personality). Note that, when dealing with close corporations, reference should be made to section 65 of the Close Corporations Act and not section 20(9) of the Companies Act.

Close corporations, like companies, also enjoy **perpetual succession**, which means that the entity exists separate from its members and changes in membership will not influence its future existence.

4 The number and nature of members



Prescribed study material

Textbook: chapter 16 para 3.1

- o **Close Corporations Act: sections 28–30**

As close corporations were intended mainly for small businesses, the number of members is limited to ten.

It is not permitted for more than one person to hold a member's interest jointly. In principle, only natural persons are permitted to be members of a close corporation.

Therefore, juristic persons are excluded from membership, and, apart from specific exceptions, a company or another close corporation may not be a member of a close corporation.

A minor, an insolvent, or a person under legal disability may become or remain a member of a close corporation with the necessary assistance from a guardian, trustee, or the court. A natural or juristic person in the capacity of a trustee of a testamentary or *inter vivos* trust may become a member of a close corporation subject to conditions set out in the Close Corporations Act. The restriction in membership to the maximum of ten members, still applies.

Should the membership of a close corporation change, an amended founding statement must be lodged for registration.

5 The formation of a close corporation and members' interests

Important terms	Meaning
Founding statement	(Form CK 1) The only constitutive document required for registration of a close corporation.
Amended founding statement	(Form CK 2) The document which must be lodged should particulars of members or the business change after registration of the founding statement.
Member's contribution	Each member must make a contribution. (It can consist of money, a thing or services contributing to the business of the close corporation.)



Prescribed study material

Textbook: chapter 16 paras 1–2

Under the Companies Act, it is **no longer possible to register new close corporations**. However, it may still be necessary to acquire information regarding a close corporation, or to amend the founding statement by lodging a **form CK2** with the Companies and Intellectual Property Commission.

The founding statement indicates the following particulars of the business:

- (1) the full name of the business/translations of the business name/any abbreviation of the business name
- (2) the principal business
- (3) the number of members
- (4) the date of the end of the financial book year
- (5) the aggregate member's contribution
- (6) the postal address
- (7) the address of the registered office
- (8) The name and postal address of the accounting officer
- (9) the particulars of the founding members (names, copies of identity documents, residential addresses)
- (10) the member's interest of each member expressed as a percentage

Should any of the particulars in the founding statement change after the close corporation's registration, an amended founding statement CK 2 must be lodged.

5.1 Characteristics of a member's interest



Prescribed study material

Textbook: chapter 16 para 3.4

- A member's interest is expressed as a percentage (out of a total of 100%) in the founding statement.
- A member's interest may not be jointly held.
- The aggregate members' interests must at all times be 100%.
- A member's interest in a close corporation is similar to a share in a company.
- Member's interest is an incorporeal, moveable thing.
- Member's interest is a personal right to share in the close corporation's profits after its creditors have been paid.

Member's interest can be acquired by:

- acquiring member's interest from existing members; and
- making a contribution to the close corporation.

6 Disposal of member's interest



Prescribed study material

Textbook: chapter 16 paras 3.6–3.10

As a close corporation is intended for small businesses with few members in a close relationship to each other, changes in membership can affect the operations of the business very negatively. For this reason, the disposition of member's interest is controlled by the members to a large extent.

Requirements for disposal of member's interest:

- must be made in accordance with association agreement; or
- the consent of all members is required.

As a member's interest is part of his or her estate and has an economic value, it is important to establish the manner in which it will be dealt with should the member die, become insolvent, or if judgment is taken against a member by his or her creditors.

6.1 Death of a member



Prescribed study material

Textbook: chapter 16 paras 3.3, 3.7.2 and 3.10

- o **Close Corporations Act: section 35**

A member may bequeath his or her member's interest to his or her heir/legatee in a will. Transfer of the member's interest to the heir/legatee may, however, only occur with the consent of the other members.

Should the members not permit such transfer, the executor of the estate may:

- sell the member's interest to the close corporation
- sell the member's interest to other members
- sell the member's interest to a third party subject to the other members' pre-emptive right to purchase the member's interest

The money value will thereafter be paid over to the heir/legatee.

6.2 Insolvency of a member



Prescribed study material

Textbook: chapter 16 paras 3.7.2, 3.8 and 3.9

- o **Close Corporations Act: section 34(1)**

Section 34(1) of the Close Corporations Act prescribes a mandatory procedure for disposal of an insolvent member's interest. The purpose is to balance the rights of the other members with the rights of creditors of the insolvent member's estate.

If the estate of a member is sequestrated, the trustee of the insolvent estate may realise the member's interest and

- sell the member's interest to the close corporation
- sell the member's interest to the other members
- sell the member's interest to a third party subject to the other members' pre-emptive right to purchase the member's interest

The money value will thereafter be paid over to the creditors.

6.3 Attachment and sale in execution



Prescribed study material

- o **Close Corporations Act: section 34A**

Section 34A of the Close Corporations Act applies in instances where a member's interest is attached after judgment is taken against a member.

The member's interest may then be sold to the close corporation, other members, or an outsider subject to the right of pre-emption in favour of the close corporation and other members.

7 Duties members owe to the close corporation



Prescribed study material

Textbook: chapter 16 paras 4.1–4.2

- o **Close Corporations Act: sections 42, 43, 50 and 51**

Members owe two duties to the close corporation:

- a fiduciary duty (duty of good faith) in terms of section 42 of the Close Corporations Act 69 of 1984; and
- a duty of care and skill.

7.1 Fiduciary duty



Prescribed study material

Textbook: chapter 16 para 4.1

- o **Close Corporations Act: section 42**

A member's fiduciary duties **to the close corporation** are similar to the fiduciary duties that a director owes to a company.

The Close Corporations Act provides that a member should

- act honestly and in good faith, and, in particular,
 - exercise powers in order to manage or represent the corporation in the interest of the corporation
 - not act without or exceed such powers
- avoid a conflict of interest between his or her own interests and those of the close corporation, and, in particular,
 - not derive any personal financial gain to which he or she is not entitled by virtue of being a member of the close corporation

- disclose any material interest in a transaction to the other members of a close corporation as soon as possible
- not compete with the close corporation's business activities in any way

7.1.1 Contracts concluded between member and close corporation



Prescribed study material

Textbook: chapter 16 para 4.1

o **Close Corporations Act: section 42(3)**

As indicated above, a member of a close corporation is in a fiduciary relationship to the close corporation and to the other members of the close corporation.

Should a member have a material interest in a contract of a close corporation, this must be disclosed to the other members and all material facts regarding the interest must be divulged as soon as possible.

Should a member fail to disclose his or her interest, the contract will be voidable at the option of the close corporation. Application can, however, be made to the court to declare the contract as binding on the parties despite the failure to disclose.

In the event that the fiduciary duties are breached, a member may be held personally liable for any loss suffered by the corporation or for debts incurred as a result of such a transaction (section 42(3)). The member would, in such an event, have to repay any profit made by him or her unless all the members approve this conduct in writing.

7.1.2 Personal liability for debts

A member may incur personal liability for the debts of the close corporation should a contract be concluded in conflict with his or her fiduciary duty to the close corporation. Personal liability can, however, be avoided by disclosing all material facts regarding the member's interest in a transaction to the other members of the close corporation and acquiring prior or subsequent written approval from all the other members.

7.2 Duty of care and skill



Prescribed study material

Textbook: chapter 16 para 4.2

o **Close Corporations Act: section 43(1)**

A member will be liable for a breach of the duty of care and skill only if the close corporation suffers a loss as a result of the breach of this duty. Also, in this instance, no liability will be incurred if all the members give their prior or subsequent approval in writing.

The member's conduct is measured against the conduct which could reasonably have been expected from a person with the same skill and knowledge as the member (to establish negligence).

In the case of a breach, another member may institute action against the close corporation or its members in his or her personal capacity.

7.3 Remedies in the case of breach

7.3.1 Statutory derivative action



Prescribed study material

Textbook: chapter 16 para 8.2

- o **Close Corporations Act: section 50**

Section 50 of the Close Corporations Act provides for an action to be instituted by a member against fellow members on behalf of the close corporation for liability to the company on the specified grounds, including a breach of a fiduciary duty or the duty of care and skill. Therefore, this is a statutory derivative action.

The duties of members of a close corporation are similar to those of directors of a company. Members must act in good faith and must conduct their functions with a reasonable degree of care and skill. If a member breaches his or her duty, any other member can take legal steps on behalf of the close corporation against such member. The fact that the person instituting the action will be liable for legal costs should the action be unsuccessful, and should the court find that the action was instituted without prima facie grounds is aimed at preventing the misuse of this action.

7.3.2 Cessation of membership by order of court



Prescribed study material

Textbook: chapter 16 para 3.3

- o **Close Corporations Act: sections 36 and 49**

Prescribed case law

In the following case, you only need to know what is discussed herein.

- ***Gatenby v Gatenby and De Franca v Exhaust Pro CC 1996 (3) SA 118 (E)***
- ***De Franca v Exhaust Pro CC [1996] 4 All SA 503 (SE)***

There are two remedies for members against other members:

- section 36: order of court terminating membership
- section 49: assistance from court regarding unfairly prejudicial conduct

In terms of **section 36 of the Close Corporations Act**, a member(s) may apply for the termination of another member's membership by order of court.

In order to do so, the member(s) will have to prove:

- that the member is unable to perform his/her part in carrying on the business
- that the member's conduct is likely to have a prejudicial effect on the carrying on of the business of the close corporation
- that the member's conduct has made it reasonably impossible for the other member(s) to associate with him/her in the carrying on of the business of the close corporation
- that, in the circumstances, it is just and equitable that such a person should cease to be a member of the close corporation

Relevant information relating to how the members' interests in the close corporation should be

adjusted once the person's membership of the close corporation ceases should be presented. The court may then order cessation of a member's membership and make any order it deems necessary regarding the disposal of the member's interest.

The remedy in section 49 of the Close Corporations Act is available to a member whose rights are unfairly and prejudicially affected by the close corporation's conduct or by the conduct of one or more of the other members. The court may make any order that it deems fit to remedy the situation.

In *Gatenby v Gatenby*, it was held that the court enjoys a wide discretion as to the order it may make to provide relief for the victim of oppressive conduct. In this case, the court ordered the sale of the corporation's sole asset in order to place the close corporation in a financial position to buy back an aggrieved member's interest.

In *De Franca v Exhaust Pro CC*, the court held that it enjoyed a discretion to order the purchase of any member's interest by other members or by the corporation if the court finds it just and equitable to do so. The court, however, requires proof of the value of the member's interest in order to establish a fair price for the member's interest.

Section 49 is a remedy available to a member where there was a particular act or omission in the conduct or affairs of the business by the corporation or other member/s which was unfairly prejudicial to such member. The court will only intervene if it is just and equitable to do so. The court may then direct that the aggrieved act or omission be stopped, may order that the corporation amend its founding statement or association agreement, or, in certain cases upon application, make an order to wind up the corporation.

8 Acquisition of a member's interest by the corporation



Prescribed study material

Textbook: chapter 16 para 3.6

o **Close Corporations Act: sections 37–40**

Important terms	Meaning
Solvency	The corporation's assets, fairly valued, must exceed its liabilities.
Liquidity	The corporation must be able to, and remain able to, pay its debts as they become due in the normal course of business.

It is possible for a close corporation to acquire a member's interest from one of its members.

Requirements for acquisition of member's interest by a close corporation:

- the corporation must have at least one other member
- the aggregate members' interest must remain 100%
- written consent from all members is required prior to payment
- the corporation must be **solvent after payment for the acquisition** and **liquid both before and after payment**

It is also possible for a close corporation to give financial assistance to a person to enable the person to acquire a member's interest in the close corporation.

In order to do so, section 40 of the Close Corporations Act requires:

- prior written consent from every member
- that the close corporation be solvent after assistance has been given and liquid both before and after assistance has been given

9 Internal relations and association agreements

Important terms	Meaning
Association agreement	A non-compulsory agreement to arrange internal affairs within the close corporation.
Internal relationships	The relationships between members <i>inter se</i> (amongst each other) and the relationship between the close corporation and its members.

9.1 Association agreements

Although it is advisable for members to conclude such an agreement, it is not compulsory. The internal relations between members may be regulated by an association agreement. The members of the corporation may change provisions to suit their specific needs in an association agreement, on condition that it is consistent with the Act.

Association agreements may arrange:

- the rights of the members to carry on business and manage the close corporation
- what the requirements are for decision-making and voting
- the procedure and proportions for payments to members

An association agreement is not lodged with the Registrar and is not a public document. However, should such an agreement be concluded, it must be held at the registered offices of the business. Close corporations have only one compulsory constitutive document: the founding statement. Although association agreements are optional, it is preferable for members to conclude such an agreement in order to regulate internal relationships in the management of the business.

An association agreement must be in writing and must be signed by or on behalf of each member. This document is not viewed as a public document and only members may inspect it. In the association agreement, the members may agree on how the corporation will be managed and on how decisions will be taken, and the agreement may establish the proportion of payments to members.

No stipulation in contravention of the Close Corporations Act which is included in the association agreement will be valid. The Close Corporations Act clearly sets out certain issues that may not be varied by any agreement between the members. A clause stating that certain members will not be permitted to call a meeting, or allowing disqualified members to participate in the management, or specifying how the member's interest of an insolvent member will be disposed of, will be void.

10 Representation of a close corporation



Prescribed study material

Textbook: chapter 16 paras 7.1–7.2

- o **Close Corporations Act: section 54**

Prescribed case law

This case you only need to know as discussed herein:

- ***J&K Timbers (Pty) Ltd v GL&S Furniture Enterprises CC 2005 (3) SA 223 (N)***

Section 54 of the Close Corporations Act states that every member has the authority to conclude contracts on behalf of the close corporation in relation to a person who is not a member (an outsider or third party).

The doctrine of constructive notice does not apply to close corporations. This means that, even if the

association agreement (which is in any event not a public document) states otherwise, every member can conclude contracts on behalf of the corporation. It does not matter whether or not the transaction falls within the scope of the primary business of the corporation.

In *J&K Timbers (Pty) Ltd v GL&S Furniture Enterprises CC*, the court confirmed that a member of a close corporation is an agent, even though no authority, expressed or implied, has been conferred upon him or her by the corporation. The corporation is bound by an act performed on its behalf by a member, unless the third party knew, or reasonably ought to have known of the absence of the required power. Therefore, a close corporation will be bound by most agreements concluded on its behalf by its members. Corporations will, however, not be held liable if the outsider or third party knew or reasonably ought to have known that the member who concluded the contract on behalf of the close corporation lacked authority.

11 Payments by corporation to members



Prescribed study material

Textbook: chapter 16 para 9.1

- o **Close Corporations Act: section 51**

In terms of section 51, no payment may be made to members in their capacities as such if the **solvency** and **liquidity** criteria are not complied with and the other members have not all provided their written consent for such a payment.



Note that section 51 applies only to instances where payments are made to members in their capacity **as members** and not if the payment is made to a member in his/her capacity as creditor.

Before any type of distribution can be made to members in their capacity as members, the requirements set out in section 51 must be adhered to. If a payment must be made to a member in his or her capacity as a creditor, these principles will not be applicable. Should a creditor claim payment when it is due and payable, the close corporation will be liable. Should the close corporation be unable to pay, such a creditor may apply for the winding up of the corporation.

12 Prohibition of loans to and security on behalf of members



Prescribed study material

Textbook: chapter 16 para 9.1

- o **Close Corporations Act: section 52**

The Close Corporations Act contains a prohibition against the provision of loans and security to members. Only if all the other members consent in writing may such loan or security be extended. Should the requirements of section 52 not be adhered to, any loan or security provided will be invalid and members who permitted the transaction will incur liability.

13 Accounting officer, records, and financial statements



Prescribed study material

Textbook: chapter 16 para 11

- o **Close Corporations Act: section 58(2) and (2A)**
- o **Companies Act: section 30**

Close corporations are not exempted from financial reporting. An annual financial statement must be drawn up. A close corporation need not, in terms of the Close Corporations Act, appoint an auditor. However, an accounting officer must be appointed who must account in conformity with generally accepted accounting practice. He or she also plays a particularly important reporting function. If an accounting officer becomes aware of irregularities in the accounting policies or practices within the corporation, this must be disclosed to the members. The Registrar must also be informed should the accounting officer be removed, if the corporation is not carrying on business, or if its liabilities exceed the assets at the end of the financial year.

Accounting records must be kept and approved by members holding at least 51% of the member's interest in the close corporation annually. The accounting records need not be submitted to the Registrar. A report must be drawn up by the appointed accounting officer.

❖ **NB!** The Companies Act requires some close corporations to audit their financial statements in the same circumstances as a private company.

14 Circumstances when members and others can be liable for a corporation's debts



Prescribed study material

Textbook: chapter 16 paras 10.1–10.4

- o **Close Corporations Act: sections 23, 52, 64, 65**

Prescribed case law

This case you only need to know as discussed herein:

- ***L&P Plant Hire CC v Bosch 2002 (2) SA 662 (SCA)***

A close corporation is a separate legal person. Despite this fact, the court at times may “pierce the corporate veil” in order to hold the guilty parties liable. In some instances, the members and/or other guilty parties (such as the accounting officer) incur personal liability (sections 23; 26; 42; 43; 52; and 65), and, in other circumstances, they are held jointly liable (section 63) for the losses incurred as a result of their actions.

If a member (or members) of a close corporation trades in the name of the close corporation without using the identifying abbreviation (‘CC’) or its equivalent in another language (for instance ‘BK’ in Afrikaans), such a member would incur personal liability in terms of section 63 of the Close Corporations Act for any losses incurred as a result of the transaction by a third party who was unaware of the fact that it was dealing with a close corporation due to the omission.

The aim of section 64 of the Close Corporations Act is to protect creditors. A person who knowingly conducts or is party to conducting the business of the close corporation in a reckless or fraudulent manner will be held liable for all debts of the corporation. The test used to determine whether trading was reckless is whether a reasonable businessperson in the position of the CC's member would

continue trading in the belief that creditors would receive payments as they become due.

The court held, in *L&P Plant Hire CC v Bosch*, that a creditor can only claim in terms of section 64 of the Close Corporations Act if he or she is capable of proving:

- (1) that the reckless conduct has a negative effect on the claim that he or she has against the close corporation; and
- (2) that, as a result of the reckless trading, the close corporation is no longer in a position to pay the debt amount.

15 Advantages and disadvantages associated with close corporations

The **advantages** of a close corporation are the following:

- the relative ease of formation
- the limited liability of the members by virtue of the fact that it enjoys legal personality
- increased capital-acquisition potential
- continuity

A close corporation has the following **disadvantages**:

- No new close corporations can be formed under the Companies Act.
- Close corporations are subjected to some of the legislative principles contained in the Companies Act of 2008 in addition to those contained in the Close Corporations Act.
- Membership is limited to ten.
- Juristic persons may not be members.

→ Reflection

Close corporations originated as a result of a proposal to introduce a new form of enterprise specifically aimed at small businesses. Since its introduction, this form of enterprise has become increasingly popular. Close corporations have been an attractive option, as they offer the advantages associated with separate legal personality. Moreover, the legislative framework is less complex than in the case of companies, while the management structure is also simpler.

Consider the effect of the incorporation of the Companies Act 71 of 2008 on the continued existence of existing close corporations.

→ CONCLUSION

You have now been introduced to companies, trusts, partnerships, and close corporations.

You should now be able to refer to important sections in the various pieces of legislation applicable to the different forms of South African businesses. You should also be able to discuss the application of these sections by referring to the interpretation given to them by our courts in case law. You have also been exposed to legal material, and you learnt how to access, read and summarise cases. You should now be able to advise clients on the main characteristics of these different forms of enterprises, indicating the advantages and disadvantages associated with each business form. You should also be able to explain some of the most pertinent regulatory measures pertaining to the respective enterprises.

We hope that you are now in a position to apply, in practice, all that you have learnt!

	Companies	Trusts	Partnerships	Close corporations
Regulated	Companies Act 71 of 2008 Common law Other legislation also applicable	Trust Property Control Act Common law	Common law	Close Corporations Act Companies Act
Formation	Registration in terms of the Companies Act 71 of 2008	Conclusion of a valid trust deed (can be in a will or in the form of a contract)	Conclusion of a valid partnership agreement	No longer possible to register new close Corporations
Legal personality	Yes	Generally, no, but for purposes of Companies Act, yes	No	Yes
Limited liability of participants	Yes, except in personal liability companies – directors are liable for contractual debts of this type of company Legal personality can be disregarded in certain circumstances	Trustee holds trust assets in official capacity and is not liable for trust debts	No. Partners are co-owners of partnership assets (co-creditors and co-debtors) during the course of the partnership	Yes. Members are usually not liable for debts of business Legal personality can be disregarded in certain circumstances
What participants are called	Directors Shareholders (in profit companies) Members (in non-profit companies)	Parties: founder, trustee and Beneficiary	Partners	Members
Types	Profit companies (public, private, personal liability and state-owned) and non-profit companies	Ordinary trusts <i>Bewind</i> trusts	Ordinary Universal Particular Extraordinary (anonymous and <i>en commandite</i>)	n/a Can be formed for profit and not for profit
Representation	Person must be authorised Estoppel can apply if no actual authority Section 19 – Unrestricted capacity, except if it is a juristic person Section 20: <i>Ultra vires</i> acts also valid <i>Turquand</i> rule/section 20(7): Company bound even if internal requirements not complied with, unless third party knew or reasonably ought to have known that not complied with	Trustee is restricted by terms of trust deed in business trust	<u>Mutual mandate</u> : any partner is authorised to conclude a contract in the name of the partnership if transaction falls within scope of partnership's business Transactions outside scope: Authority required Estoppel can apply if no actual authority	Members can conclude any contract and bind close corporation, unless third party knew or reasonably ought to have known that the member lacked the required authority (section 54 of the Close Corporations Act)