

**ASPECTS OF THE REGULATION OF SHARE CAPITAL
AND DISTRIBUTIONS TO SHAREHOLDERS**

by

KATHLEEN EMMARENCA VAN DER LINDE

submitted in accordance with the requirements for the degree of

DOCTOR OF LAWS

at the

UNIVERSITY OF SOUTH AFRICA

PROMOTER: PROF SM LUIZ

JUNE 2008

EX IPSO, ET PER IPSUM, ET IN IPSO OMNIA SUNT:
IPSI GLORIA IN SAECULA

AD ROMANOS 11:36

SUMMARY

It is in the area of the regulation of a company's share capital and distributions to shareholders that the inherent conflict between creditors and shareholders, and the fragile balance among shareholders internally, intersect. The share capital of a company underlies its corporate structure and represents not only its initial own funds from which creditors can be paid, but also the relative equity interests of the shareholders.

The balance between shareholders can be disturbed by capital reorganisations through increase, reduction or variation of share capital or through disproportionate contributions by, or distributions to, shareholders. Share repurchases are particularly risky in this regard. Creditor interests are affected when their prior right to payment is endangered by distributions to shareholders.

This study analyses the South African Law relating to share capital and distributions against the background of a comparative study of the laws of England, New Zealand, Delaware and California, as well as the provisions of the American Model Business Corporations Act.

Two main approaches to creditor protection are evident. The capital maintenance doctrine, which is followed in England and Delaware, protects creditors by emphasising the notional share capital of the company as a limit on distributions. In contrast, the solvency and liquidity approach focuses on the net assets of the company and on its ability to pay its debts. New Zealand, California and the Model Business Corporations Act represent this approach.

Regulatory responses to shareholder protection range from insistence on compliance with procedural requirements to minimal statutory intervention in the internal affairs of companies, instead relying on general principles of fairness and good faith. There is little correlation between a particular system's approach to creditor protection on the one hand, and to shareholder protection on the other. England, New Zealand and South Africa prescribe specific formalities, while the American approach is more relaxed.

South Africa is a hybrid system. Its transition from capital maintenance to solvency and liquidity has been incomplete and its protection of equity interests is relatively unsophisticated. A number of recommendations are made for an effective and coherent approach that will safeguard the interests of creditors and shareholders alike.

KEY TERMS

Share capital; Stated capital; Authorised capital; Capital maintenance; Legal capital; Solvency and liquidity; Distributions; Share repurchases; Dividends; Par and no par value shares; Share premiums; Creditor protection; Relative equity interest

ACKNOWLEDGEMENTS

I gratefully acknowledge a grant for doctoral research from the National Research Foundation which enabled me to conduct research abroad.

I extend my sincere appreciation to my promoter, Professor Stephanie Luiz, for her enthusiastic and excellent guidance. I am indebted to Professor Jopie Pretorius for his suggestions and to Professor Roshana Kelbrick for her editorial comments.

My husband Andrie deserves a very special word of thanks for showing his love and support in countless ways. I also thank my mother for her encouragement and my children for their patience and understanding.

June 2008

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CHAPTER 1

INTRODUCTION

1 INTRODUCTION

This thesis considers the regulation of share capital and of distributions to shareholders from two perspectives: the protection of creditors and the fair treatment of shareholders. Transactions through which share capital flows into or out of a company, as well as those giving a return on share capital, have significant potential to cause conflict between stakeholders.¹ Conflicts may thus arise between creditors and shareholders; between controlling and minority shareholders; and between management and shareholders.² The regulation of these three conflict situations, which may of course also arise from transactions unrelated to share capital, is a central concern of company law.³ I consider solutions adopted in several jurisdictions or systems to resolve share capital-related conflicts of interest.

In this chapter, I discuss the role of share capital, clarify the relationship between the different elements of my topic and expose the conflict situations pertinent to this thesis against the background of modern theoretical perspectives on company law.⁴ A brief overview of the regulation of distributions then follows,

¹ See Rock, Kanda & Kraakman “Significant Corporate Actions” 145.

² See Hansmann & Kraakman “Agency Problems and Legal Strategies” 22. Leader “Defining Interests” 87 distinguishes between different types of creditors such as employees and suppliers and so identifies more conflict situations.

³ Law and economics scholars view these conflict situations as ‘agency problems’ arising from the opportunistic and self-interested behaviour of market participants, see Wishart *Company Law in Context* 69ff. They regard the law as useful to the extent that it succeeds in reducing overall transaction costs. See Wishart *Company Law in Context* 73 for a succinct critique of agency cost theories. The contractual theory, based on a specific economic model of the company, regards the company as a *nexus* of contracts where parties get what they bargain for. As a result, contractarians prefer regulation based on default contract terms that save parties the cost of bargaining separately, but that can be overruled by agreement, see Easterbrook & Fischel “The Corporate Contract” 211 – 212. For an evaluation of the contractual theory, see Ferran *Corporate Finance* 10 – 12. Older theories tend to focus on explaining the nature of the company and devote little attention to the justification of regulation. The fiction theory, for example, sees regulation as an almost automatic consequence of the fact that the law created the entity in the first place, see Ferran *Corporate Finance* 9.

⁴ The scope of my thesis does not allow a comprehensive analysis of different theories, with the result that only the more influential theories can be covered, and then only in very broad outline. For useful accounts of different modern theories and their main proponents, see Wishart *Company Law in Context* 55 – 87; Ferran *Corporate Finance* 9 – 13. See Cheffins *Company*

focusing on conceptual issues. I conclude this chapter by explaining the methodology and structure of the thesis and the reference techniques I use.

2 THEORETICAL ISSUES

2.1 The relevance of share capital

The regulation of capital accumulation and the decision-making about that capital accounts for a considerable part of substantive company law.⁵ There is a view that the notion of corporate personality is merely a device to designate a specific pool of accumulated assets for a specified purpose.⁶ While these observations relate to the company's capital in the wider sense of total own funds, comprising contributed as well as accumulated capital,⁷ it is the existence of a share capital that distinguishes the typical modern company from unincorporated entities and from other company forms at a structural level.⁸ The company having a share capital, to which the present enquiry is restricted, is by far the most important form of company.⁹

The concept 'share capital' does not have a standard meaning or uniform content. Broadly speaking, share capital reflects the consideration paid to¹⁰ or due to¹¹ a company in exchange for the shares it issues. However, share capital need not be equal to the consideration received for the shares. It will be less if a company

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Law 3 – 46 for a more detailed discussion of the contribution of economic theories in the study of corporate law, and Bebchuck (ed) *Corporate Law and Economic Analysis*, a collection of essays applying economic perspectives to different company law topics.

⁵ Wishart *Company Law in Context* 94, 290 – 291 regards this as the purpose of company law. See also McGee *Share Capital* 1; Armour "Share Capital" 355.

⁶ Radin "Problem of Corporate Personality" 654. This view is echoed by Hansmann & Kraakman "What is Corporate Law?" 7 – 8 who argue that the only essential purpose of corporate law is to facilitate affirmative asset partitioning, see also Hansman & Kraakman "Essential Role" 390.

⁷ See Delpont *Verkryging* 10 – 19 for a discussion of the various meanings of 'capital'. See also Jones & Bellringer *Share Capital* 1.

⁸ McGee *Share Capital* 1.

⁹ The total number of active companies in South Africa as at 24 November 2003 included over 350 000 companies having a share capital, and fewer than 12 000 companies limited by guarantee. More than 99% of the companies limited by guarantee were section 21 companies. This information was obtained from www.cipro.co.za/about_us/registration_stats.asp (2008-01-28). Companies limited by guarantee are also rare in the UK, see McGee *Share Capital* 1.

¹⁰ This will constitute paid-up share capital.

¹¹ Amounts so due form part of issued share capital.

is not obliged to show the full issue price of its shares as share capital¹² or subsequently reduces its share capital. The share capital can exceed the consideration if profits are subsequently capitalised¹³ or if shareholders contribute capital to the company otherwise than in respect of shares.¹⁴ Share capital is usually expressed as an amount, although this is not always the case.¹⁵ The precise content of the term depends on a particular legal framework.¹⁶ Share capital is treated as a notional liability in the accounts of a company, as the shareholders do not have a legal claim to the return of the capital they contributed.¹⁷

According to Gansen the share capital of a company has three functions:¹⁸

- It is a way of obtaining funds with which to operate the company's business.
- It forms a protective cushion for the creditors of the company.
- It proportionates the interests of the shareholders in the company.

However, each of these functions can be performed without reliance on share capital, as I explain in more detail below. Clearly, the efficacy of the first two functions depends on the total size of the share capital. Cilliers recognises the relevance of the size of the share capital. He postulates that in order to have a significant influence on the behaviour of a company and its stakeholders, the share capital should be sufficiently high to achieve certain results. It should ensure that shareholders have an interest in the fortune of the company and its continued success, that creditors are buffered against default, and that society is protected

¹² If part of the price is reflected as a premium or as paid-in surplus, see eg the position in Delaware, discussed in Chapter 4 paragraph 2.2.4.

¹³ Through a bonus issue or otherwise.

¹⁴ See *Kellar v Williams* [2000] 2 BCLC 390 PC, also referred to in Chapter 2 paragraph 2.4.

¹⁵ Under the Model Business Corporation Act in the USA, it is not necessary to determine the monetary value of non-cash consideration, see Chapter 4 paragraph 4.3.1. Such an arrangement is possible because the amount of the share capital is not relevant to the distribution restrictions.

¹⁶ This will be illustrated in each of the comparative chapters. In particular, it will also appear that some systems regulate share premiums in much the same way as share capital. While this *quasi*-capital is subject to distribution restrictions, shareholders usually do not enjoy any participation rights in relation to it.

¹⁷ Delpont *Verkryging* 23.

¹⁸ See Gansen *Kapitalaufbringung* 3 – 8.

against abuse of incorporation and losses caused by corporate failure.¹⁹ Delpont adds a fourth result or function: the share capital should benefit the company by enhancing its creditworthiness so that it can attract investments that will reduce the cost of capital.²⁰ Despite the different assumptions of these sets of functions or results, there is a degree of overlap between them in that they emphasize the relevance of the share capital to the company, its creditors and its shareholders.

2.1.1 Share capital as working capital for the company

Although share capital is often regarded as a form of financing,²¹ it need not play a significant role in the provision of working capital for a company. In fact, companies may have a paid up share capital of nil.²² Subject to certain exceptions like banking companies, the law does not prescribe the size of the share capital or, for that matter, the value of the total assets that a company should have. Even where a statutory minimum share capital is prescribed, it is generally accepted that this requirement is aimed at discouraging frivolous incorporations and not at providing the company with sufficient working capital.²³ Companies are free to finance their business operations through other means of financing like loan capital or debt²⁴ and retained earnings.²⁵ Prudent business principles may dictate the use of a certain level of debt financing in order to maximise the potential return to shareholders.²⁶

It is beyond the scope of my thesis to analyse or explain corporate finance practices, save to draw attention to the diminishing role of share capital as a financing tool. The financing decisions of companies are influenced by various

¹⁹ Cilliers *Limited Liability* 280 – 281.

²⁰ Delpont “Capital Rules” 407.

²¹ See Cilliers & Benade *Corporate Law* 199 where it is called the ‘primary’ source of capital and Cox & Hazen *Corporations* 515 where it is referred to as ‘permanent financing’.

²² See Chapter 2 paragraph 2.2 read with paragraph 3.4 (private companies in England); Chapter 3 paragraph 3.4 (New Zealand); Chapter 4 paragraph 3.4.3 (California) and paragraph 4.3.4 (MBCA).

²³ See *Gower & Davies’ Company Law* 7 ed 229; Armour “Share Capital” 365; Schön “Wer schützt den Kapitalschutz?” 4; Schön “Future of Legal Capital” 438; Prentice “Protection of Creditors” 102 note 23.

²⁴ See Ferran *Corporate Finance* 43; Hamilton *Corporations* 356; Cilliers & Benade *Corporate Law* 199 – 200.

²⁵ See Ferran *Corporate Finance* 69 – 72 where the author states that in the UK, retained earnings constitutes the primary source of capital for established companies, followed by debt and lastly by share capital.

factors including taxation, capital-raising expenses and macro-economic factors such as the relative abundance or scarcity of capital.²⁷ The ability to mobilise capital was one of the driving forces in the development of the modern company.²⁸ However, share capital has decreased in importance as a source of funding for companies, while alternative asset-oriented financing techniques have become prevalent.²⁹

Tax systems may discriminate against equity financing and encourage companies to use debt financing.³⁰ Securities regulation may also have adverse cost implications for the raising of share capital, particularly because of strict regulation of public offerings of shares and other securities. This may create an incentive to use forms of financing that are not subject to securities regulation.

2.1.2 Share capital as safety net for creditors

Share capital is sometimes viewed as a 'protective cushion', 'buffer', 'safety margin' or 'guarantee fund' for creditors or even as the 'price for limited liability'.³¹ These metaphors can be deceiving because the share capital is an artificial sum or notional

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²⁶ Ferran *Corporate Finance* 59ff; Hamilton *Corporations* 381.

²⁷ See Slater "Capital Accumulation" 430 – 431; Schmidt "Eigenkapitalausstattung" 772. See also Wishart *Company Law in Context* 148 – 149 for a discussion of factors influencing the choice between debt and equity. Also refer to the discussion of 'gearing' in paragraph 1.2 below.

²⁸ Cilliers & Benade *Corporate Law* 4 – 5, 198; Berle & Means *Modern Corporation* 18. The need for vast amounts of capital to finance new business ventures during the Industrial Revolution played an important role in the development of the corporate form, see Berle & Means *Modern Corporation* 11 – 17 for an account of the order in which companies gradually became popular in different sectors of the economy in America. Also see Newmyer "Justice Story" 825.

²⁹ See Slater "Capital Accumulation" 433. See also KPMG *Feasibility Study on Capital Maintenance – Main Report* (Contract ETD/2006/IM/F2/71) 146, 164 for figures on the ratio of subscribed capital to total shareholder's equity in the EU and in the USA respectively.

³⁰ Slater "Capital Accumulation" 433; Schmidt "Eigenkapitalausstattung" 773. On the tax advantages of thin incorporation in general, see Miller "Non-tax Aspects" 754 – 755. See Schmidt "Eigenkapitalausstattung" 774 – 775 for a discussion of tax and other measures that can be taken to promote equity financing. See also McLure "Tax Neutrality" 1076 – 1078 for an analysis of considerations that influence the choice between financing operations through retained earnings or distributing earnings as dividends and raising fresh capital. Levmore "Positive Role of Tax Law" 280 argues that there is a positive interplay between tax law and corporate law and illustrates how policy objectives of corporate law can be supported by tax rules.

³¹ See Jones & Bellringer *Share Capital* 6; Gower & Davies' *Company Law* 7 ed 275.

liability.³² It does not represent money or assets that have been set aside for the specific purpose of creditor payment and consequently does not ensure that there will indeed be funds available to satisfy creditor claims, because the company's assets may be dissipated in the ordinary course of its business. Share capital can protect creditors by acting as a buffer only to the extent that the company has retained the contributed funds or applied it to acquire available assets.

It is not an automatic function of share capital to act as a restriction on distributions. The capital maintenance principle, which I discuss in more detail below,³³ relies on share capital as a restriction on distributions. These legal rules prohibiting the return of share capital to shareholders offer a measure of creditor protection because they restrict the distribution of corporate funds to shareholders. Even if the share capital is negligible, the company would still have to have an excess of assets over liabilities (plus that negligible share capital) before it may make distributions. While it is difficult to conceive of distribution restrictions that achieve precisely the same as share capital-based restrictions,³⁴ it is possible to design alternative restrictions requiring a specified margin or buffer over solvency, such as prescribing a ratio of debt to equity.³⁵

2.1.3 Share capital as allocation tool for shareholders

Shareholders are entitled to participation in the general meeting of their company, and to share in the company's prosperity, by reason of their interests in its share capital. These interests cover three main areas, namely the return of share capital, returns on share capital and control.³⁶ However, the relative interest of a shareholder is not necessarily determined by the amount of capital contributed by that shareholder, and a shareholder may further hold different proportions of the rights in each of the three areas. Any proportionality between the contributions of different shareholders and the rights they enjoy can be substantially eroded by a

³² See Manning *Legal Capital* 92; McLennan "Abolition of Par-value" 43; *South African Company Law for the 21st Century - Guidelines for Corporate Reform* GN 1183 in GG 26493 of 23 June 2004 8, 12.

³³ See paragraph 2.1 below.

³⁴ Because the particular margin depends on the size of each company's share capital.

³⁵ For an example, see the Californian financial restrictions, discussed in Chapter 4 paragraph 3.4.2.2.

company's constitution, especially where the company has more than one class of shares. The rights and interests of each shareholder depend on the constitution of the company and the type and number of shares held.

2.2 Legal and economic roles of share capital

The preceding analysis of the three functions attributed to share capital points to a distinction between the economic and legal roles of share capital.³⁷ The first two functions I discussed, namely the financing of the company and the margin of safety for creditors, are of an economic nature.³⁸ These economic functions rely on the share capital as a 'fund'.

The legal role of share capital is to create rights, duties and legal relationships. The capital maintenance doctrine, which prohibits the return of capital to shareholders, gives share capital a legal role. In this role, it is not the contributed funds that are relevant, but rather an abstract amount or figure. Share capital is thus a 'yardstick'. I do not regard this yardstick function as an inherent function of share capital.

There is a further legal role of share capital, reflected in the share capital structure of a company. Clearly, the third function discussed - that of allocation - is a legal one which can be fulfilled regardless of the size of the contributed fund. In this role, share capital organises the rights of shareholders in relation to creditors and among themselves. Share capital can be seen as a 'system'.

Although the proportioning of shareholder interests is primarily a legal role, it also has economic implications. The device of a share representing a transferable proportionate interest in the business of the company facilitated the development of what Berle and Means term 'passive ownership' meaning that ownership of the company is greatly diversified and control has been relinquished to managers.³⁹ It is

Continued

³⁶ See McGee *Share Capital* 65.

³⁷ Eisenberg "Modernization" 199 regards the funds generated by the issuance of stock as economic capital and distinguishes it from legal capital which is a 'mere legal construct'.

³⁸ Unless restrictions on distributions are also based on share capital, in which case this function has a legal as well as an economic element.

³⁹ Berle & Means *Modern Corporation* 304. The free transferability of shares is an important feature of company law because it facilitates the withdrawal by shareholders of their investments without leading to the liquidation of the company, see Hansmann & Kraakman "What is Corporate Law?" 10 – 11. See also Ireland, Grigg-Spall & Kelly "Conceptual

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through passive ownership that the resources of many different investors can be combined, promoting the accumulation of capital.

In economic theory shareholders are regarded as subordinated creditors occupying the lowest rank in a hierarchy of creditors.⁴⁰ Their position as investors is explained with reference to the same considerations that influence the conditions upon which credit is extended to the company, namely the duration of the investment, the expected return on investment, the risk involved and the degree of control that can be exercised over the company.⁴¹

The legal difference between shareholders and creditors is well established. Although the shareholders contribute share capital to the company, they have no legal right to the return of that capital. As a separate legal entity, the company owns its assets, including its share capital funds, and is liable for its debts.⁴² This principle of 'separate patrimony'⁴³ forms the basis of the wider protection of company funds. It underpins two further rules, namely a 'priority rule' and a 'liquidation protection rule'.⁴⁴ The priority rule entails that the creditors of the company enjoy preference over the personal creditors of the shareholders in respect of the company's assets.⁴⁵ Liquidation protection means that the shareholders cannot withdraw their 'share' of company assets at will, as this amounts to a partial liquidation.⁴⁶ Also, the personal creditors of the shareholders have no claim to the shareholder's share of

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Foundations" 152 – 153 for a brief account of the evolution of the share from co-ownership of company property to the modern concept of a bundle of rights.

⁴⁰ Berle & Means *Modern Corporation* 245 – 246. This view of shareholders as a particular type of investor or resource holder is adopted in company law theories that see the company as a *nexus* of contracts. Because of the existence of equity markets where shareholders can realise the growth in their investments, proponents of this theory often argue that shareholders should be protected by market regulation rather than by company law, see Hill "Changes in the Role of the Shareholder" 191.

⁴¹ See Cheffins *Company Law* 42 – 44; Ferran *Corporate Finance* 47 – 49; Wishart *Company Law in Context* 17 – 22.

⁴² Ireland, Grigg-Spall & Kelly "Conceptual Foundations" 160 argue that the modern notion of separate legal personality was made possible not by incorporation, but by the recognition of a share as an independent form of property.

⁴³ See Hansmann & Kraakman "What is Corporate Law?" 7.

⁴⁴ Hansmann & Kraakman "What is Corporate Law?" 7.

⁴⁵ Hansmann & Kraakman "What is Corporate Law?" 7. This principle is not restricted to juristic persons but is also found in partnership law where the partnership assets are regarded as a separate pool of assets.

⁴⁶ This protection is absent in the case of business entities that are not juristic persons.

the company's assets.⁴⁷ Hansmann & Kraakman term the pattern of creditors' rights that arises when both these rules apply 'strong form' legal personality and view it as the converse of limited liability: while limited liability protects the assets of the shareholders against claims by the company's creditors, strong form legal personality protects the assets of the company against claims by the creditors of the shareholders.⁴⁸ Limited liability results in 'defensive asset partitioning' while the shielding of the company's assets against the shareholders and their creditors - the result of separate legal personality - results in 'affirmative asset partitioning'.⁴⁹

In return for their contribution to the company, shareholders acquire property in the form of shares and can thus be distinguished from creditors who have a personal rather than a proprietary right.⁵⁰ Shareholders merely have a residual or reversionary interest in the company's net assets upon its dissolution and so bear the ultimate risk of failure of the company. Shareholders are also not entitled to a return on the capital they contributed to the company. They have an expectation, but not a right, to share in the profits of the company during its existence and in any surplus assets upon its dissolution. In recognition of the risk they assume, shareholders are given control over the company through the general meeting. The share capital structure of the company defines and allocates the income rights, the incidence of risk of loss (priority rights in respect of capital) and the power of control among shareholders.⁵¹ Regulation of the continued share capital structure of a company and of its variation is important to shareholders.⁵²

⁴⁷ Hansmann & Kraakman "What is Corporate Law?" 7. Creditors of a shareholder may, of course, attach the shareholder's interest in the company.

⁴⁸ Hansmann & Kraakman "What is Corporate Law?" 8. I think that through liquidation protection strong form legal personality also protects the company's assets against premature withdrawal by the shareholders.

⁴⁹ Hansman & Kraakman "Essential Role" 390. They see the role of corporate law as deviation from property law rather than from contract law, because the separate estate of the corporation is paramount, as are the priority rights to it.

⁵⁰ Leader "Defining Interests" 88 sees shareholding as dual in nature. On one hand the shareholder acquires a (personal) proprietary right in the value of her shareholding and on the other, a derivative collective right in the company.

⁵¹ See Odith "Takeovers, Share Exchanges and the Meaning of Loss" 426 – 427.

⁵² Schön "Wer schützt den Kapitalschutz?" 5 argues that it is difficult to find a replacement rule for this function of the legal capital rules as they regulate the relationship between shareholders and company pertaining to the unlawful reduction of corporate funds with great precision. See also Rock, Kanda & Kraakman "Significant Corporate Actions" 147.

Shareholders are often described as the 'owners' of a company, because they may share in its net income and control its affairs,⁵³ ensuring that the company is managed in their interest.⁵⁴ There is a qualitative rather than just a quantitative difference between the 'investments' of shareholders and of creditors. Company law requires a residual beneficiary, explaining why a company with share capital must have at least one issued share with unrestricted potential to receive profits and assets on dissolution. The potential gains to be made by the shareholders as residual claimants are unlimited and do not depend on the actual size of the share capital risked, but on the overall profitability of the company. Share capital is sometimes regarded as the price for limited liability.⁵⁵ However, it is also the price for unlimited entitlement.

The fairness of this outcome is not universally accepted.⁵⁶ Greenwood argues that shareholders should not have the residual rights to income and capital, but should be entitled to a return on capital commensurate with the cost to them of providing that capital.⁵⁷

The relationship between shareholders and creditors, and the role of share capital as a 'risk allocation device'⁵⁸ is well illustrated by the concept of gearing or leveraging in terms of which the ratio of loan capital to share capital will influence the potential return to shareholders and also the potential risk faced by creditors.⁵⁹ Debt incurred at a fixed or predictable cost to the company will be cheaper for the company than share capital in times when the company prospers because unlike shareholders expecting a return on their investment, the creditors cannot participate

⁵³ In practice, shareholders in large companies have very little effective control, a situation that has become known as the 'separation of ownership and control', see Berle & Means *Modern Corporation* 112 – 116; 250.

⁵⁴ Hansmann & Kraakman "What is Corporate Law?" 13 describe this phenomenon as 'investor ownership'.

⁵⁵ See Jones & Bellringer *Share Capital* 6; Gower & Davies' *Company Law* 7 ed 275.

⁵⁶ See Greenwood "Dividend Puzzle" 155 who regards the fact that shareholders are residual claimants as unjustifiable and argues that the explanation for this irrational result can be found in the false rhetoric of ownership, agency and contract, as well as in the political alignment between management and shareholder interests.

⁵⁷ Greenwood "Dividend Puzzle" 117.

⁵⁸ Westerbeck "Stated Capital" 828.

⁵⁹ See Ferran *Corporate Finance* 60 for a practical example of the effect of gearing on the earnings of shareholders in prosperous and less prosperous times.

in the profits beyond their specified returns.⁶⁰ The shareholders will exert pressure for a larger return on the capital they contributed. When the company is facing financial difficulties, however, the risk of default faced by creditors will increase.⁶¹

2.3 Creditor protection

The primary concern of creditors is that they will receive payment of their debts when due. This is the case regardless of whether their debtor is a company, another kind of entity or an individual. However, every company law system protects creditors of companies, mainly because the company form is perceived to pose unique risks arising from the abuse of limited liability.⁶² Protection through company law is also efficient because the category of ‘creditors’ is wide enough to include a variety of parties who deal with companies: not only parties who contract with companies, including employees and suppliers, but also victims of the company’s wrongful conduct, who are involuntary creditors.⁶³ The existence of involuntary creditors is a cogent argument for regulation, because unlike voluntary creditors, they cannot contract with the company for protection.⁶⁴

⁶⁰ See Cheffins *Company Law* 70, 75. Modigliani & Miller “Cost of Capital” postulated a formula to determine the capitalisation rate for uncertain income streams (265) and concluded that in a perfect market, the overall cost of capital of a company would be constant regardless of the mix of debt and equity (268). Their original idealistic assumptions were subsequently qualified, primarily to take into account the effect of taxation, see Miller “The Modigliani-Miller Propositions” 111. Ferran *Corporate Finance* 61 states that these revised assumptions still do not take into account tax bias and the costs of insolvency in the event of a failure. See, however, Miller “Credit risk” 480ff for an analysis of the effect of bankruptcy costs.

⁶¹ Cheffins *Company Law* 75 – 78 asserts that nearing insolvency increases the opportunistic behaviour of shareholders to shift risk to creditors by engaging in risky projects. Excessive leveraging has several further implications, including decreased creditworthiness of companies leading to decreased economic growth, increased outsider control and increased risk of failure, see Slater “Capital Accumulation” 431; Schmidt “Eigenkapitalausstattung” 773.

⁶² Hertig & Kanda “Creditor Protection” 71.

⁶³ See Hertig & Kanda “Creditor Protection” 72 – 76.

⁶⁴ The protection of involuntary creditors has been widely debated. Hansmann & Kraakman “Toward Unlimited Shareholder Liability”; Leebron “Limited Liability”; Mendelsohn “Control-Based Approach”; Parkinson *Corporate Power and Responsibility* all propose exceptions to the principle of limited liability in respect of damages payable to delictual creditors. These appeals are countered by Goddard “Limited Recourse” who argues that the problem of involuntary creditors is less extensive than portrayed, the benefits of personal liability uncertain, and adverse cost implications likely to arise. Cheffins *Company Law* 504 – 507 also notes the problem, but does not recommend personal liability, arguing that the wrongdoers are usually large corporations in which such claims seldom cause insolvency and that insurance is available. Similar calls for restrictions on limited liability are made in respect of groups, see Parkinson *Corporate Power and Responsibility* 363; Parkinson “Non-Commercial Transactions” justifying an exception with reference to the dangers of transfer pricing. Small companies are another

In addition to restrictions on the distribution of corporate funds, various other measures protect creditors. These mostly address the increased risk to creditors when a company is approaching insolvency and include the imposition of personal liability on directors for reckless, unlawful or insolvent trading⁶⁵ and the recognition of fiduciary duties of directors towards creditors in certain circumstances.⁶⁶ Insolvency law makes a contribution by providing for the setting aside of certain distributions of corporate funds.⁶⁷

Hertig and Kanda conclude that although the type of regulation may differ between jurisdictions, overall creditor protection across jurisdictions is roughly similar.⁶⁸

My thesis analyses creditor protection when companies make distributions representing either a return on or a return of share capital. However, I refer briefly to alternative protection mechanisms where it contributes to an overall assessment of creditor protection in a particular jurisdiction.

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target of arguments against limited liability, see Halpern, Trebilcock & Turnbull "Limited Liability" 148 – 149; Ziegel "Incorporation" 1081 – 1084, 1093. Ziegel argues that it is too late to reverse limited liability for small companies, necessitating the introduction of second order protection such as financial disclosure and director liability for insolvent trading.

⁶⁵ Schön "Future of Legal Capital" notes an increased tendency to move liability to managers through fraudulent trading rather than recognise a direct fiduciary duty or regard incorporation as a privilege that should be conferred with circumspection.

⁶⁶ Trethowan "Directors' Personal Liability" 48 raises the argument that in liquidation the creditor's interest, which is a personal right, becomes proprietary like that of a shareholder. This view is based on an analysis of Australian and New Zealand case law and in particular on *Kinsela v Russel Kinsela Pty Ltd* (1986) 4 NSWLR 722 at 730. Wishart "Duties to Creditors" discusses different theoretical issues in this regard. Tompkins "Duties to Corporate Creditors" 189 – 191 argues that directors will be in an untenable situation if they owe duties to different interest groups, and experience difficulty in assessing when the company reaches the stage where the focus of their duty should shift. See also Parkinson *Corporate Power and Responsibility* 87; Sealy "Wider Responsibilities" 187 – 188 regarding practical and conceptual difficulties of extending duties to creditors. On the South African position, see Lombard *Directors' Duties to Creditors*.

⁶⁷ Wheeler "Swelling the Assets" 257 – 258 notes various options for setting aside dispositions and holding other persons personally liable for the debts of a company in liquidation in England. Parkinson "Non-Commercial Transactions" 65 also advocates better insolvency protection. Hertig & Kanda "Creditor Protection" 73 further identify more general protective measures such as encouraging timeous liquidation.

⁶⁸ Hertig & Kanda "Creditor Protection" 78. They point out that the same strategies can be used by both debtor-friendly and creditor-friendly systems, namely mandatory disclosure which acts as an entry strategy giving creditors a choice before contracting (79), rules such as legal capital and group regulation (83), and standards such as fiduciary duties (88). Ramsay "Mandatory/Enabling" 257 has a wider view of creditor protection, stating that creditors are also protected by the reputational interests of managers and by the separation of ownership and control.

2.4 Share-capital related conflict situations

2.4.1 *The inflow of further share capital*

The issuing of further shares in a company changes its share capital structure and can significantly dilute the relative interests of the existing shareholders. Responses to this problem include limiting, through the notion of authorised capital, the number of additional shares that may be issued, preserving the balance of power through pre-emptive rights,⁶⁹ and subjecting the issuing of shares to approval by shareholders.

The price at which the company issues the further shares can obviously also affect the value of the shareholding of existing shareholders. When shares are issued at a price below the present value of the existing shares, it will dilute the value of the existing shares. This present value does not depend on the par value of the shares, nor, in the case of no par value shares, on the consideration paid by the existing shareholders. The basic idea of the par value of a share as the minimum consideration payable to the company does not achieve effective protection for shareholders. The fiduciary duties of the directors oblige them to obtain for the company the maximum reasonable consideration for the share issue.⁷⁰ The interests of the company thus overlap with those of the existing shareholders who are not taking up further shares.⁷¹

Creditors may also have an interest in the adequacy of the contributions made by shareholders. Where distribution restrictions rely on the maintenance of share

⁶⁹ Although in South Africa the term 'pre-emptive right' is known in the context of a sale of existing shares, the term is also used to refer to a right of existing shareholders to take up new shares being issued by their company (see, on American law: *Clark Corporate Law* 17.1.4; on English law: *Gower and Davies' Company Law* 7 ed 63 and on New Zealand law: *Morison's Company and Securities Law* 13.12. Etymologically the noun 'pre-emption' and the adjective 'pre-emptive' derive from the Latin *prae-* + *emere* (to buy), see *Merriam-Webster Online Dictionary* sv 'preemption' at www.merriam-webster.com/dictionary (2008-06-30). See also Chapter 4 paragraph

⁷⁰ See Delpont *Verkryging* 405.

⁷¹ However, the same remedy is not necessarily appropriate, see Dine "Content of Duties" 127 – 129. Dine embraces the distinction between personal and derivative rights made by Leader "Defining Interests" 88, briefly discussed in footnote 50 above. Dine argues that the application of fiduciary duties would be easier and not seem to conflict if this distinction is made. For example, she argues that it would be wrong to rely on the proper purpose principle to protect a shareholder's personal proprietary interest in maintaining the value of her shares. Rather, the

capital, the creditors' interest in the amount reflected as share capital is obvious. In other instances their interest in the consideration accepted by the company does not differ from the indirect interest they have that any other commercial transaction of their debtor company should be at a fair price that will promote its financial health.

2.4.2 Distributions

Eisenberg identifies distributions as one of four critical areas for statutory corporate law.⁷² The term 'distribution' includes both returns on share capital and the return of share capital.

The expected return on share capital invested is uncertain.⁷³ Yet, in the preface to a revised edition of the seminal work he co-authored with Means, Berle describes the expectation of shareholders to receive dividends as 'vivid' in contrast with their very 'remote' expectation to ultimately share in the net assets of the company.⁷⁴

The expectation of shareholders to share in the profits of the company during its existence must be balanced against the expectation of creditors to receive payment. Similarly, creditors expect that their prior right to payment will not be endangered by a premature return of capital to shareholders. The response to this essential conflict depends on basic assumptions as to the nature of companies and the purpose of regulation. Those who view a company as a nexus of contracts assume that parties to the various contracts can agree on an appropriate level of protection. They favour default contract rules that will reduce transaction costs.⁷⁵ On the other hand, those who regard incorporation as a privilege that should be balanced by responsibility are in favour of mandatory rules protecting weaker

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remedy should be based on the contractual nature of the constitution or on unfair prejudice (127 – 129).

⁷² Eisenberg "Modernization" 187. The others are corporate combinations (mergers), shareholders' informational rights and corporate structure (governance).

⁷³ This is true even of preference shareholders because they face the risk that the company may not declare a dividend, see Ferran *Corporate Finance* 53.

⁷⁴ Berle & Means *Modern Corporation* xxxi.

⁷⁵ Klausner "Networks of Contracts" 828 asserts that more companies will adhere to these default rules, because companies tend to adopt 'plain vanilla charters'. The legislature should preferably provide a menu with several options, see 851.

parties. Nevertheless, there seems to be consensus that company law should regulate distributions.

The primary form of regulation in favour of creditors is the imposition of financial restrictions on distributions, although it is not the only mechanism that limits the outflow of funds to shareholders.⁷⁶ Financial restrictions can take various forms. I outline the two main approaches below.⁷⁷

Distributions to shareholders can potentially disturb the rights and expectations of shareholders. This is even possible in companies with only one class of shares where dividends are proportionate.⁷⁸ Dividends may be withheld to squeeze out minority shareholders⁷⁹ or excessive dividends may be paid to deprive the company of investment opportunities.⁸⁰ Similarly, selective distributions to some shareholders of a class are problematic, as they divert corporate assets to controlling shareholders at the expense of minority shareholders.⁸¹ They infringe the basic principle that each share in a class represents a homogeneous claim on the wealth of the company.⁸² According to this principle, shareholders in a class are entitled to formal as well as substantive equality.⁸³

The problem is more acute in instances where the company has more than one class of shareholders. The existence of preference shares poses peculiar

⁷⁶ Calnan “Corporate Gifts” 92 argues that financial restrictions on distributions to shareholders are supplemented by the application of various rules that apply to gratuitous disposals in general, like the *ultra vires* doctrine, the rules on the avoidance of pre-liquidation transactions and increasingly also by the recognition that directors have to take into account the interests of creditors when the company is experiencing financial difficulties. This last duty is particularly useful when a distribution has been made while the company was in fact solvent, but was experiencing financial difficulties at the time, see at 96.

⁷⁷ See paragraph 2 below.

⁷⁸ See Rock, Kanda & Kraakman “Significant Corporate Actions” 149; Sommer “Whom should the Corporation Serve?” 51 regarding shareholders with long-term and short-term views.

⁷⁹ See *Dodge v Ford Motor Co* 170 Nw Rep 668 (Mich SC 1919).

⁸⁰ See Rock, Kanda & Kraakman “Significant Corporate Actions” 149.

⁸¹ See Brudney “Equal Treatment” 1073.

⁸² See Brudney “Equal Treatment” 1074. Brudney explains that while the ‘investment contract’ between the company and investors in preferred and ordinary shares respectively accommodates differentiation between these classes, the contract usually does not embody explicit consent for discrimination within a class, see at 1075.

⁸³ Brudney “Equal Treatment” 1078 – 1079 asserts that dividends in particular have to be substantively and formally equal. This is because of the underlying assumptions of corporation statutes as well as the fiduciary principle extending to majority or controlling shareholders.

problems.⁸⁴ This may explain why several jurisdictions give express recognition to the interests of preferent classes of shareholders in their statutory regulation of distributions.

Selective distributions to certain holders of a class often take the form of share repurchases.⁸⁵ Share repurchases have a composite nature in that they combine a distribution to selling shareholders with an increase in the shareholding of remaining shareholders.⁸⁶ While shareholders can usually rely on the fiduciary duties of directors to exercise their powers for a proper purpose, some jurisdictions address this problem through legislation that subjects selective repurchases to additional requirements compared to proportionate repurchases or self-tender offers. However, even self-tender offers, which are regarded as proportionate repurchases, can be used to disturb the balance of power in a company.⁸⁷ For this reason, some commentators propose an outright ban on repurchases while others focus on the abuses associated with specific types of repurchases.⁸⁸

Some of the most debated abuses of share repurchases occur in the context of takeovers.⁸⁹ The problem of 'greenmail' arises where a potential bidder for the

⁸⁴ Ip "Share Capital Puzzle" 293 – 295 analyses advantages and disadvantages of preference shares and explains that while the issue of further preference shares has the advantage of preserving voting rights, it not only dilutes value, but also disturbs priority rights. She concludes that preference shares complicates the application of fiduciary duties.

⁸⁵ Rock, Kanda & Kraakman "Significant Corporate Transactions" 149 state that the biggest risk is posed when shares are acquired from controlling shareholders, but they also refer to greenmail where dissidents are bought out at a premium in order to entrench incumbent management. Distributions in partial liquidation of the company and going private transactions will be proposed by controllers only if they intend getting more than their *pro rata* share of corporate assets, see Brudney "Equal Treatment" 1078.

⁸⁶ See Brudney "Equal Treatment" 1106. Another view is that it is a constructive dividend to non-vendors which they use to buy out vendors, see Dugan "Repurchase" 98 who regards repurchases as tripartite in nature, comprising a distribution of assets (with the attendant risks of asset stripping and debt avoidance), a reorganisation of ownership (with the risk of unfair and discriminatory treatment of shareholders), and a transfer of shares (which may lead to insider trading and market manipulation).

⁸⁷ This will be the case where the controlling shareholders who approve the offer have no intention of accepting it in respect of their own shares, see Blackman, Jooste & Everingham *Companies Act* 5-78. Rock, Kanda & Kraakman "Significant Corporate Transactions" 149 refer to the imbalance of knowledge between insiders and public shareholders. Chirelstein "Optional Redemptions" 100, 117 regards repurchases as inherently coercive.

⁸⁸ See McCabe "Share Buy-Back Power" 138 who is opposed to a buy-back power and Magner "Purchase" 119 who recommends extensive regulation of abuses.

⁸⁹ See Bradley & Rosenzweig "Defensive Stock Repurchases" 1396 – 1399 who argue that defensive open market repurchases should be prohibited as they are essentially coercive, but that self-tender defensive repurchases should be allowed subject to conditions (1406 – 1411). Bradley & Rosenzweig "Defensive Repurchases and Appraisal" 329, 335 argue that the

company is bought out at a substantial premium in order to thwart a takeover attempt.⁹⁰ Management buy-outs are also problematic as these often occur in going private transactions as a first step to provide management with the level of shareholding enabling them to ‘freeze out’ the remaining minority through a compulsory acquisition.⁹¹ The scope of my thesis does not allow a detailed consideration of takeover-related abuses of the repurchase power, although they are by implication included in any discussion of coercive or selective repurchases.⁹²

The advantages and disadvantages of share repurchases, and the appropriate regulation of the possible abuse of the power, is the subject of an ongoing academic debate. A possibility regarded as an advantage by some, may be seen as a disadvantage by others.⁹³ Different considerations apply to public and private companies.⁹⁴

In private companies the main advantages usually cited are that repurchases facilitate the retention of family control, provide a market for the shares of deceased or retiring shareholders and are useful in relation to employee share schemes.

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appraisal remedy should not be available in these circumstances. Gordon & Kornhauser “Takeover Defense Tactics” 297 propose that all defensive repurchases should be outlawed.

⁹⁰ For an overview of arguments for and against regulating greenmail, see Hartnett “Greenmail” 1301 – 1308; Anon “Greenmail” 1047–1051. Hartnett analyses different options for the regulation of greenmail (1308 – 1317) and concludes that the continued evolution of fiduciary principles offers the best solution (1318). Anon “Greenmail” 1064 is in favour of a complete ban on greenmail, arguing that revision of the business judgment rule will not prevent greenmail and that shareholders face difficulties in enforcing fiduciary obligations (1061). For a pro-greenmail view which nevertheless recognises possible abuses, see Macey & McChesney “Corporate Greenmail” 50.

⁹¹ Brudney “Going Private” 1019. Brudney concludes (1053) that going private repurchases should be prohibited, forcing inside shareholders to use their own funds should they wish to work out public shareholders. See also Kofele-Kala “Unfinished Business” for a discussion of the regulation of going private transactions.

⁹² However, Brudney “Equal Treatment” 1075 argues that different considerations apply to selective repurchases in the course of internal rearrangements between existing participants and during external rearrangements involving third parties, but that the issue of substantive *versus* formal equality applies to both situations. See Luiz *Securities Regulation Code 725ff* for a discussion of equal treatment of shareholders in takeovers.

⁹³ See *The Purchase by A Company of its Own Shares, A Consultative Document* Cmd 7944 (June 1980) Part 2 par 12. See also Bourne “Purchase by a Company” 387 – 389 for a summary of this consultative document. Fox “Companies Purchasing” 274 is generally supportive, but notes the danger of fiduciary duties of directors and the temptation to use repurchases as a defensive device. See also Trichardt “Purchase of Own Shares” for a discussion of the differences between the English and American approaches.

⁹⁴ Cheffins *Company Law* 430 – 434 makes a clear distinction between benefits for companies with and without an active market for shares and those applicable to both. He discusses the disadvantages or objections at 434 – 435.

While there appears to be consensus on the advantages in private companies, the perceived advantages in public companies are more controversial.⁹⁵

As a consideration of the desirability of a repurchase power falls outside the scope of this thesis, the existence of this phenomenon is accepted as a given and the associated risks noted. As such, I make suggestions for the regulation of the distributional aspects of repurchases to the extent that they affect creditors and shareholders.

This short analysis of theoretical issues illustrates the interplay between the regulation of share capital structure, shareholder contributions and distributions to shareholders. While there are different solutions to several of the issues that have been identified, the regulation of distributions has developed along two clearly discernible approaches. Distributions is also the area in which the most drastic reforms have taken place. A short account of the main approaches to the regulation of distributions is thus necessary.

⁹⁵ Brudney “Equal Treatment” 1106 – 1107 distinguishes between neutral repurchases, made in the context of retiring shareholders, elimination of odd lots, corporate tax benefits or partial liquidations resulting from contracted operations, and repurchases made for purposes of good investment, price rectification, takeover defence, management entrenchment or to bail out insiders. He concludes (1113) that in public corporations with controlling shareholders most repurchases should be prohibited: only housekeeping exceptions should be allowed. However, if there are no controlling shareholders, repurchases should be allowed subject to approval by a court or regulatory body. Chirelstein “Optional Redemptions” 742 – 743 compares dividends and proportionate as well as selective repurchases and finds that they have the same economic effect. The purported ‘advantages’ of equity retraction to obtain a desirable debt-equity ratio and return of excess capital can be achieved in alternative ways and are thus not particular advantages of a repurchase power. Similarly, the employee stock option plans justification is also neutral between dividends and repurchases (744). He dismisses the ‘good investment’ justification, arguing that rather than being a real investment it is a return of capital exactly because no real investment opportunity exists (745). Chirelstein further argues that the objective of price rectification does not justify channelling the benefit of the correction to non-selling shareholders. Getz “Corporate Share Repurchases” 16 also highlights the differences and similarities between repurchases and other transactions, focusing on reorganisation of capital, unequal treatment, and a transactional element connected with the need for information and knowledge. He argues that in comparison to dividends, which avoid the dilution of both share values and voting rights, *pro rata* repurchases ensure substantial protection against financial dilution but not against dilution of voting power, unless every shareholder acts in an identical way. Getz illustrates that all the advantages of repurchases can be achieved by alternative means including exceptions under financial assistance or through management or controlling shareholders acquiring shares themselves (99), but supports repurchases because they can be cheaper than these other methods (117).

3 OVERVIEW OF THE REGULATION OF DISTRIBUTIONS

As early as the 18th century, it was common for companies voluntarily to restrict themselves to paying dividends out of profits only.⁹⁶ The report leading to the first generally enabling company legislation in England recorded the fact that some companies paid dividends out of capital, sometimes hidden by false accounts, and viewed this as an abuse of the corporate form.⁹⁷ Nevertheless, this first general legislation, the Joint Stock Companies Act of 1844,⁹⁸ did not contain an express prohibition on the payment of dividends out of capital. Instead, it included the power to declare dividends ‘out of the profits of the concern’ as one of the specific powers conferred on a company.⁹⁹

The Limited Liability Act of 1855,¹⁰⁰ imposed joint and several liability on directors who declared a dividend knowing that the company was insolvent or would thereby be rendered insolvent.¹⁰¹ The Joint Stock Companies Act of 1856¹⁰² also imposed this liability on directors. Although dividends in insolvent circumstances were not prohibited as such, the risk of personal liability would discourage them from declaring dividends in these circumstances.

However, the liability provision was not re-enacted in the Companies Act of 1862.¹⁰³ In the absence of statutory regulation of distributions, the courts had to resolve the conflicts of interest relating to share capital by formulating rules on an ad hoc basis.

⁹⁶ DuBois *English Business Company* 363.

⁹⁷ *Report of the Parliamentary Committee on Joint Stock Companies* BPP 1844 (119) VII 7 – 11.

⁹⁸ (7 & 8 Vict. C 110 & 111). This Act is regarded by Shannon “Coming of General Limited Liability” as introducing the era of modern company law. See also Cilliers *Limited Liability* 97 who refers to it as the first general Companies Act in England. The contents of this Act is discussed by Cilliers *Limited Liability* 101 – 108.

⁹⁹ Section 25 of the Joint Stock Companies Act of 1844.

¹⁰⁰ (18 & 19 Vict c 133). This Act made limited liability generally available to companies complying with certain requirements. See Cilliers *Limited Liability* 144 – 148 for a discussion of the share capital provisions of this Act. The Joint Stock Companies Act of 1856 (19 & 20 Vict c 47) abolished the additional share capital provisions introduced in the 1855 Act.

¹⁰¹ Section 9 of the Limited Liability Act of 1855 (18 & 19 Vict c 133).

¹⁰² Section 14 of the Joint Stock Companies Act of 1856. (19 & 20 Vict c 47)

¹⁰³ 25 & 26 Vict c 89. See Cilliers *Limited Liability* 166. It was only in 1980 that English company legislation introduced a statutory restriction on dividend distributions to shareholders, see *Gower & Davies’ Company Law* 7 ed 275.

3.1 The capital maintenance doctrine

The main principles established by the English courts during the last two decades of the nineteenth century,¹⁰⁴ were the following:

- Shares may not be issued at a discount to their par value.¹⁰⁵
- Dividends may not be paid out of share capital.¹⁰⁶
- A company may not purchase its own shares.¹⁰⁷

These principles were inferred from the existing legislation¹⁰⁸ and the ultra vires rule.¹⁰⁹ The legislation provided for disclosure of a company's authorised share capital and prescribed the procedure for the reduction of issued share capital, leading the courts to conclude that share capital could by implication not be returned to shareholders in other ways. The principle that the capital of a company should be devoted to the purpose for which the company was incorporated, confirmed that its return to shareholders would be ultra vires and void.

This reasoning forms the basis of the capital maintenance doctrine applicable to companies. Different theories advance justifications for the capital maintenance doctrine, for example that it gives effect to an implied contract between the company and the creditors or between the company and the state, on behalf of creditors,¹¹⁰ or that it is the price payable by shareholders for the benefit of limited liability,¹¹¹ and

¹⁰⁴ See Knight "Capital Maintenance" 52 – 54 for a discussion of the history of the capital maintenance doctrine. For a more detailed overview of the gradual development of these rules, see Brincker *Geldelike Bystand* 29 – 44.

¹⁰⁵ *Ooregum Gold Mining Co v Roper* [1892] AC 125 (HL).

¹⁰⁶ *Guinness v Land Corporation of Ireland* (1883) 22 ChD 349 CA (356); *Re Exchange Banking Co, Flitcroft's Case* (1882) 21 ChD 591.

¹⁰⁷ *Trevor v Whitworth* (1887) 12 App Cas 409 (HL).

¹⁰⁸ The Companies Act of 1862 (25 & 26 Vict c 89).

¹⁰⁹ See *Trevor v Whitworth* (1887) 12 AppCas 409 (HL) 420; *Guinness v Land Corporation of Ireland* (1882) 22 ChD 349 (CA) 375.

¹¹⁰ The statement of the company's capital in its constitution and the disclosure of issued capital are important in this regard.

¹¹¹ The fact that the liability of members used to be expressed with reference to the amount outstanding on their shares was regarded as significant in this regard, see *Re Exchange Banking Company, Flitcroft's Case* [1882] 21 Ch D 518. However, Cilliers *Limited Liability* 103 draws attention to the fact that the increased regulation of capital was introduced in the 1844 Act, which did not provide for limited liability. It would thus be more correct to argue that the capital requirements are related to the availability of general incorporation than to limited liability.

that the contributed capital is a 'trust fund' for creditors.¹¹² An evaluation of these theories falls outside the scope of this dissertation.¹¹³ I agree with McGee's assessment that the various capital maintenance rules were not designed in a coherent fashion, but that the following set of rational objectives can be inferred:¹¹⁴

- protecting existing shareholders from forced depletion of their interest in the company and by dilution of that interest by its devaluation
- protecting the company as an entity from being looted by unscrupulous shareholders or promoters
- protecting creditors from unjustified dilution of the value of company

In its most basic form, capital maintenance entails that share capital may not be returned to shareholders during the existence of the company, except as expressly allowed by legislation. Consequently, a company may not repurchase its shares and may not pay dividends out of share capital. By way of statutory exception, distributions can be made following a formal reduction of the share capital. Formulated as a financial restriction on distributions, the capital maintenance doctrine prohibits distributions to shareholders except out of an excess of the company's assets over the sum of its liabilities plus share capital.

Statutory and common-law rules have both extended and eroded this basic principle, complicating delineation of the doctrine.

The debate on the scope and content of the capital maintenance doctrine encompasses a number of issues. The ultra vires aspect is described either as a second leg of the capital maintenance doctrine¹¹⁵ or as a separate but related principle.¹¹⁶ Another issue is whether the doctrine is restricted to the maintenance of existing capital or includes aspects of the proper raising of capital, for example the

¹¹² This theory was formulated in *Wood v Dummer* 30 F Cas 435 (No 17,994) (CCD Me 1824). See Norton "Relationship of Shareholders to Corporate Creditors" 1062, who sketches the development and application of the trust fund doctrine and also discusses various criticisms against it. See also Westerbeck "Stated Capital" 826 – 828.

¹¹³ For a brief summary of the most important of these theories, including implied contract, see Manning *Legal Capital* 50 – 53.

¹¹⁴ See McGee *Share Capital* 139.

¹¹⁵ See Grantham & Rickett *Company and Securities Law* 851.

¹¹⁶ See Cilliers & Benade *Corporate Law* 322 and 345 where the two legs respectively are referred to as the capital maintenance doctrine and the wrongful application of share capital principle.

rule against issues at a discount.¹¹⁷ A wide view of the capital maintenance doctrine includes the rule denying shareholders a claim for damages arising from misrepresentation relating to shares.¹¹⁸

There are also diverging views as to whether statutory interventions such as the rule against crossholdings, the rules on share premiums and, in particular, the prohibition on financial assistance form part of the doctrine.¹¹⁹ The correct view is that it is a separate rule with a different purpose.¹²⁰ The giving of financial assistance is also not a distribution,¹²¹ although the regulation of financial assistance for the purchase or subscription of shares often relies on the same financial restrictions that apply to distributions. My thesis therefore does not deal with the prohibition against financial assistance.

The relationship between 'capital maintenance' and 'legal capital' merits brief attention. Like capital maintenance, legal capital also has different meanings, complicating comparison. In America and in Europe the term 'legal capital' is used to denote a body of rules which regulates share capital structure, shareholder pay-in obligations and shareholder pay-outs or distributions.¹²² Schön¹²³ identifies three separate elements of legal capital, namely minimum capital rules, mandatory disclosure of share capital, and distribution rules.¹²⁴ The concept 'legal capital' is

¹¹⁷ See Knight "Capital Maintenance" 50ff; Wishart *Company Law in Context* 61, 176; Manning *Legal Capital* 20ff; Jones "Raising and Maintenance" 155 – 157. In *Re Jarass Pty Ltd* (1988) 13 ACLR 728 SC (NSW) at 731 the rules on consideration were regarded as part of the capital maintenance doctrine. Kiggundu *Share Capital* 17 excludes the no discount rule.

¹¹⁸ Wishart *Company Law in Context* 176. This principle was formulated in *Houldsworth v Glasgow City Bank* (1880) App Cas 317. It was regarded as part of the capital maintenance doctrine in *Sons of Gwalia Ltd v Margaretic* [2007] HCA 1; (2007) 232 ALR 232. In *Sons of Gwalia* the High Court of Australia held that the shareholders, who acquired shares on the basis of misrepresentation by the company, could claim alongside creditors in the winding-up of the company, despite a statutory subordination of shareholder claims that applies in Australia.

¹¹⁹ Brincker *Geldelike Bystand* 51ff, 425; Kiggundu *Share Capital* 430; Knight "Capital Maintenance" 56 – 57; Cassim "Reform of Company Law and Capital Maintenance" 292; Dugan "Repurchase" 111 argue convincingly that it is not concerned with capital maintenance. However, Wishart *Company Law in Context* 176 – 177; Jones "Raising and Maintenance" 156 include the prohibition in their discussions of the capital maintenance doctrine.

¹²⁰ See Ferran *Corporate Finance* 373; Trichardt & Brincker "Capital in Company Law" 149 in addition to the references in footnote 119 above.

¹²¹ Although it can involve a distribution, see Knight "Capital Maintenance" 56 – 57.

¹²² See Manning *Legal Capital* 21, 44, 63.

¹²³ "Future of Legal Capital" 435 – 436.

¹²⁴ See also Hertig & Kanda "Creditor Protection" 83 who explain that legal capital regulates three aspects of corporate finance: the maximum permissible outflow of capital, the minimum initial investment, and the level of capital that must be maintained throughout corporate life. The first

thus potentially wider than the capital maintenance doctrine because it also encompasses the specific share capital structure on which a particular contribution and distribution regime is based. The operation of the capital maintenance doctrine depends on the existence of a basic framework that enables the amount of the share capital to be determined. In this regard, concepts such as authorised capital, issued capital, par value and no par value play a role and are subject to disclosure requirements. The regulation of shareholder contributions is also relevant, irrespective of whether they are viewed as part of or complimentary to the capital maintenance doctrine.¹²⁵

The common-law rule that dividends may not be paid out of capital¹²⁶ was supplemented by the rule that dividends could be paid out of profits only.¹²⁷ However, the interpretation of ‘profits’ gradually moved away from the net assets guarantee.¹²⁸ The first step was to recognise that a decline in the value of company assets was not relevant to the determination of profits.¹²⁹ Consequently, it was not necessary to make up past losses.¹³⁰ In *Verner v General Commercial Investment Trust*¹³¹ the court introduced a distinction between fixed and floating assets, and allowed distribution of a realised profit on fixed assets. Then in *Ammonia Soda Company v Chamberlain*¹³² it was accepted that dividends could be paid out of unrealised gains, a principle confirmed in *Dimbula Valley (Ceylon) Tea Co Ltd v*

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aspect relates to distributions, the second to minimum capital requirements and the third to reduction of capital and loss of capital.

¹²⁵ It is particularly interesting that the same justifications are used for share capital-based distribution rules and for the pay-in obligation of shareholders, see Mwenda “Obligation to Pay-Up” pars 4 – 16.

¹²⁶ See *Guinness v Land Corporation of Ireland* (1883) 22 ChD 349 CA (356); *Re Exchange Banking Co, Flitcroft’s Case* (1882) 21 ChD 591.

¹²⁷ See *Gower & Davies’ Company Law* 7 ed 275.

¹²⁸ Yamey ‘Dividends’ 275 notes that it was accepted until 1889 that any dividend which would reduce the remaining assets of a company to below its nominal paid-up capital would be illegal, see *In re Mercantile Trading Company (Stringer’s case)* 4 Ch App 475 (1869); *Davison v Gillies* (1880) 16 Ch D 347. Yamey traces the gradual watering down of the dividend restriction.

¹²⁹ *Lee v Neuchatel Asphalte Co* (1889) 41 Ch D 1. The court held that lost capital need not be replaced. *In re Kingston Cotton Mills Co, No 2* (1896) 1 Ch 331 confirmed that it was not necessary to deduct depreciation.

¹³⁰ *In re National Bank of Wales Ltd* (1899) 2 Ch 629

¹³¹ [1894] 2 Ch 239 (CA) at 265 – 266.

¹³² [1918] 1 Ch 266 (CA).

Laurie.¹³³

The rule against the repurchase of shares recognises the fact that a repurchase involves a reorganisation of the capital of the company. Even if the company has sufficient profits to cover the consideration given to the shareholder, a repurchase amounts to a return of capital to the extent that the amount of the share capital is required to be reduced.¹³⁴ The cushioning effect of the capital for subsequent distributions thus becomes less. However, if profits are used and the capital yardstick is not reduced, a repurchase will not violate the capital maintenance rule.¹³⁵ In fact, this is the basis upon which the redemption of shares could be allowed under the capital maintenance doctrine.¹³⁶

In addition to the possibility of a formal reduction of capital, which would reduce the size of the capital amount that had to be maintained, the doctrine was qualified by several exceptions.¹³⁷

In the last quarter of the twentieth century the capital maintenance doctrine was abolished in various jurisdictions.¹³⁸ South Africa followed suit in 1999.¹³⁹ Even in Europe, the current stronghold of capital maintenance, the wisdom of this traditional approach is under reconsideration.¹⁴⁰

¹³³ [1961] Ch 353. Yamey "Dividends" 284 – 286 shows that the courts did this contrary to accounting principles despite professing to leave the determination of profits to men of business. See Cilliers "Reserves Created by Revaluation" 400ff for a discussion of the impact of the *Dimbula Valley* case in commonwealth countries.

¹³⁴ See Blackman, Jooste & Everingham *Companies Act* 5-43 for a good explanation in this regard.

¹³⁵ Magner "Purchase" 80 states that there is no direct link between a repurchase prohibition and capital maintenance, as the effect of a repurchase on share capital will depend on the relevant financial limitations and the treatment of accounts.

¹³⁶ The returned capital was 'replaced' by the capital redemption reserve fund or by new share capital, see Gower "Companies Owning Their Own Shares" 313.

¹³⁷ See Chapter 5 paragraphs 3.1.1, 5.7 and 6.8 regarding South African exceptions.

¹³⁸ California was first in 1977, see Chapter 4 paragraph 3.1.

¹³⁹ See Chapter 5 paragraph 1.1.

¹⁴⁰ Proposals have been put forward by several influential groups. The proposals of the SLIM Group are set out in *Recommendation by the Company Law SLIM Working Group on the Simplification of the First and the Second Company Law Directives*; those of the High Level Group in *Report on a Modern Regulatory Framework for Company Law in Europe* (Brussels, 4 November 2002); those of the Rickford Group in "Report of the Inter-disciplinary Group on Capital Maintenance" April 2004 (15 *European Business Law Review* (2004) 919), and those of the Lutter group in "Stellungnahme der Group of German Experts on Corporate Law zum Konsultationsdokument der High Level Group of Experts on Corporate Law" 2002 ZIP 1310. See European Commission *Modernisation of Company Law and Enhancement of Corporate Governance in the European Union – A Plan to Move Forward* (21 May 2003). For a very useful summary of the views and recommendations of these different groups, see the feasibility study

3.1.1 Assessment of the capital maintenance approach

The capital maintenance doctrine is the subject of an active academic debate.¹⁴¹ McGee¹⁴² lists the three main criticisms against capital maintenance:

- The size of share capital can be negligible
- Creditors do not enquire into the size of share capital
- Share capital can be tied up in illiquid assets and thus not be available for payment of creditors

Both opponents and supporters of the capital maintenance doctrine raise the size issue.¹⁴³ Companies are often formed with very little share capital,¹⁴⁴ with the result that any perceived protection the capital could give creditors is illusory in practical terms. Prescribing certain ratios of debt to equity is a possible way of addressing the problem, but even here, the ratios would have to distinguish between different kinds of companies. Certain ex post remedies such as the reclassification of debt as equity, subordination of insider loans and piercing of the corporate veil for inadequate capitalisation can also contribute to construing an 'adequate' share capital.¹⁴⁵ However, the effectiveness of these measures will depend in each instance on the extent of extra funds that may become available in these ways.

Continued

on an alternative to capital maintenance that was commissioned by the EC: KPMG *Feasibility Study on Capital Maintenance – Main Report* (Contract ETD/2006/IM/F2/71) 269 – 310.

¹⁴¹ See, for example the debate between Enriques & Macey "Creditors Versus Capital Formation" and Mühlbert & Birke "Is there a Case?". See also Schön "Wer schützt den Kapitalschutz?"; Schön "Future of Legal Capital" and Kahan "Legal Capital Rules".

¹⁴² *Share Capital* 137

¹⁴³ Enriques & Macey "Creditors Versus Capital Formation" 1186 argue that the European legal capital rules are ineffective unless a company has a minimum capital relevant to its operations. Schön "Wer schützt den Kapitalschutz?" 4 – 5 admits that the deficiency in the way the share capital amount is determined means that it can never be of any serious help against the operational risks of an enterprise, but retorts that compared to restrictions based on the solvency of the company, the legal capital restrictions offer no worse protection to creditors, even if the size of the capital is negligible.

¹⁴⁴ Ferran *Corporate Finance* 46 notes that the total allotted capital of a private company can be a fraction of a cent, of which no part need to be paid up. According to a DTI Consultative Document of 1998 *The Euro: Redenomination of Share Capital*, 70% of UK companies have a share capital of under £100. See Prentice "Protection of Creditors" 102 for an argument that the market for credit might ensure that creditors are compensated for dealing with undercapitalised companies. However, this is not true of prepaying customers or suppliers who do not regard themselves as giving credit.

¹⁴⁵ See Prentice "Protection of Creditors" 103.

Opponents of capital maintenance tend to rely on the possibility of a trivial capital yardstick as justification of a solvency-based approach where no margin over solvency is required, although there is some support for requiring a minimum margin of safety even within a solvency-based approach.¹⁴⁶

The criticism that creditors regard share capital as irrelevant to their protection is an attack on one of the primary justifications of the capital maintenance doctrine: that creditors impliedly agree to rely on the amount held out by the company as its share capital. Empirical evidence confirms that creditors do not place much reliance on a company's share capital when considering whether to extend credit to it. Because they are concerned with the credit risk of the company, they consider aspects such as balance-sheet gearing, interest cover and minimum tangible net worth and rely on contractual restrictions and personal guarantees by directors or major shareholders.¹⁴⁷ Although critics of capital maintenance restrictions support the retention of a (realistic) contractual basis for the design of financial restrictions, they prefer to formulate these restrictions as default contract terms which can be changed by mutual agreement.

The observation that the share capital can be tied up in illiquid assets¹⁴⁸ is interesting, because it may be impossible to distinguish assets in which share capital has been invested from other assets. However, this criticism emphasises the importance of liquidity from the perspective of creditors. It is not unusual for capital maintenance or legal capital systems to also prohibit distributions while the company is unable to satisfy its obligations as they arise.¹⁴⁹

In addition to these conceptual criticisms against capital maintenance, there are a number of practical disadvantages. Complexity in identifying and managing the extent of the share capital is first on this list.¹⁵⁰ Another disadvantage is that the

¹⁴⁶ See paragraph 2.2.1 below.

¹⁴⁷ See Day & Taylor "Loan Contracting" 318ff; Eisenberg "Modernization" 200; Westerbeck "Stated Capital" 838. This was also confirmed by the results of a questionnaire sent out by the DTI in the UK, see *Company Formation and Capital Maintenance* URN 99/1144 (October 1999) par 3.5.

¹⁴⁸ See also Enrique & Macey "Creditors Versus Capital Formation" 1187.

¹⁴⁹ See Cox & Hazen *Corporations* 562.

¹⁵⁰ See also Gansen *Kapitalaufbringung* 188 who identifies the difference in the basic notions of protection through the raising as opposed to the maintenance of capital as one of the incisive differences between English and German law, explaining the more detailed regulation of non-cash consideration as well as the minimum capital amount applicable in Germany.

capital maintenance doctrine prevents companies from entering into certain potentially profitable transactions, even when doing so would neither impair their capital nor place their creditors at risk.¹⁵¹ Compliance with capital maintenance rules is also perceived to be difficult and costly to monitor and enforce.¹⁵² The ultimate effect of a legal capital system is to discourage equity investment.¹⁵³ There is growing consensus that, at least as a distribution restriction, the disadvantages associated with capital maintenance outweigh the advantages that this approach may have over alternative measures.

3.2 Solvency and Liquidity

The solvency and liquidity approach developed in response to the difficulties and artificiality associated with the capital maintenance idea.

The first element of this approach is the solvency test which entails that the assets of the company should exceed its liabilities after the distribution has been taken into account. Distributions may thus be made out of net assets only. The term balance-sheet test is also commonly used to describe this test.¹⁵⁴ The solvency test recognises the ultimate priority that creditors enjoy over shareholders upon dissolution of the company. It stands to reason that satisfaction of the capital maintenance test implies that the solvency test will also be satisfied.

Solvency in the sense of an excess of assets over liabilities is referred to as solvency in the bankruptcy sense and is determined through a balance sheet test. It

¹⁵¹ Mühlbert & Birke “Is there a Case?” 721 – 722 argue that legal capital places a greater burden on companies in the current economic environment than was the case a century ago. They point to various disadvantages that European companies have compared to their counterparts that are not subject to the legal capital regime, for example difficulties in effecting leveraged buy-outs.

¹⁵² See Enrique & Macey “Creditors Versus Capital Formation” 1186 – 1191. They argue that the result is that strong creditors devise alternative protection mechanisms (1188 – 1190) and weak creditors are unlikely to stop unlawful distributions or veto capital reductions (1190 – 1191). Further, the valuation requirements for non-cash consideration imposes unnecessary costs and acts as an incentive to prefer private above public companies (1187 – 1188). However, the KPMG *Feasibility Study on Capital Maintenance – Main Report* 6 found that the capital maintenance system did not impose excessive costs on companies compared to alternative systems.

¹⁵³ Enrique & Macey “Creditors Versus Capital Formation” argue that the European distribution rules encourage the retention of funds that cannot be effectively invested and so reduces the liquidity of European shares while it entrenches management (1202). The net effect is that wealth is transferred from equity claimants (shareholders) to fixed claimants (creditors), which discourages equity investment (1168).

is distinguished from equity solvency or the ability to satisfy one's debts as they become due, which is the second element.¹⁵⁵ The equity solvency test is generally termed a liquidity test in South Africa.¹⁵⁶ In contrast with the liquidity test, satisfaction of the capital maintenance test does not indicate that the company is able to pay its debts as they become due in the ordinary course of business.¹⁵⁷ Subjecting distributions to a liquidity requirement is not an innovation of systems that have abandoned the capital maintenance idea. It often applies in addition to capital maintenance.¹⁵⁸ The justification for a liquidity element is that it addresses the fundamental expectation of creditors to be paid on time. It also fits in well with the representation a company is said to make when it incurs debt, namely that it reasonably expects to be able to pay as and when the debt becomes due.¹⁵⁹ It would be unfair to allow a company which has made an implied representation of liquidity to subsequently compromise that liquidity by making distributions to shareholders.

The justifications for the solvency and liquidity test as a control on shareholder distributions echo those upon which the rules for the avoidance of pre-liquidation transactions are founded.¹⁶⁰ A distribution to a shareholder is a disposition without value, even where the distribution is in respect of the acquisition by the company of

Continued

¹⁵⁴ See Manning *Legal Capital* 65.

¹⁵⁵ See Manning *Legal Capital* 63. There are two main approaches to liquidity or the ability to service debt. The first entails a balance sheet test based on current assets and current liabilities, while the second involves a cash flow analysis. A reference to debts 'as they become due' or 'as they become payable in the ordinary course of business' indicates that a cash flow prediction should be used. This takes into account not only current assets but also future income of and credit given to the company. On the liabilities side not only existing current liabilities but also prospective liabilities are included. The choice between these two approaches may also have an impact on the valuation of contingent liabilities. For a discussion of these different approaches, see Murphy "Equity Insolvency" 847 – 850 and Grainger "Assessing Liabilities" 290 – 291. Murphy "Equity Insolvency" 856 – 864 also discusses various methods of analysing cash flow. KPMG *Feasibility Study on Capital Maintenance – Main Report* 11 lists four different approaches.

¹⁵⁶ See the South African Close Corporations Act 69 of 1984 s 51, s 70, s 85(4), 90(2).

¹⁵⁷ The company may experience cash-flow problems despite the fact that it has valuable fixed assets.

¹⁵⁸ See Cox & Hazen *Corporations* 562.

¹⁵⁹ See *Ex parte De Villiers NNO: In re Carbon Developments (Pty) Ltd (in liquidation)* 1993 (1) SA 493 (A) 504.

¹⁶⁰ Kahan "Legal Capital Rules" 146ff asserts that the fraudulent transfer rules of the USA achieve the same purpose as continental distribution rules.

its own shares from the shareholder.¹⁶¹ The possibility of regulatory bias if the consequences of unlawful distributions under the company law and insolvency law systems differ, also raises a more fundamental question of unnecessary duplication. However, despite certain common justifications, these sets of principles apply in different contexts. Distribution rules operate *ex ante* while the setting aside of impeachable dispositions is an *ex post* remedy.¹⁶² Because this thesis approaches the subject from the perspective of company law, I make only brief reference to the position under insolvency laws.¹⁶³

3.2.1 Assessment of the solvency and liquidity approach

Despite its relative simplicity compared to capital maintenance, it is still difficult to determine the solvency and liquidity of a company. If no margin over solvency is required, there is also no room for error. Correct valuation is thus crucial.¹⁶⁴ However, provision can be made for a margin over mere solvency.¹⁶⁵ Compliance and enforcement may not be much easier than in the case of capital maintenance. The regulation of share capital structure is still required for purposes of internal relations, although the constitutional law of companies can be simplified considerably.¹⁶⁶

The regulation of shareholder contributions can also be simpler, because creditors do not have a real interest in this aspect. Because it is unnecessary to distinguish between distributions that are returns of capital and those that are

¹⁶¹ The share is valueless in the hands of the company, see *CIR v Collins* 1923 AD 347; Doran “Transactions at an Undervalue” 169. Doran (170 – 173) distinguishes between gratuitous dispositions out of capital (like share repurchases), out of profits available for distribution (dividends in the narrow sense), and out of loan capital (any distribution by an already insolvent company).

¹⁶² See Schön “Future of Legal Capital” 446 – 447. Another advantage of pay-out restrictions in corporate law is that they address the interests of shareholders in addition to those of creditors (448).

¹⁶³ Insolvency measures are potentially wider than capital rules as they also enable recovery from non-shareholders, see Parkinson “Non-Commercial Transactions” 65. However, they are *ex post* remedies while distribution restrictions function *ex ante* as preventive measures.

¹⁶⁴ See Schön “Wer schützt der Kapitalschutz?” 5 who criticises the determination of solvency without regard to accurate accounts, which would leave scope for subjective interpretation and valuations.

¹⁶⁵ The High Level Group has recommended a solvency margin, see *Report on a Modern Regulatory Framework for Company Law in Europe* (Brussels, 4 November 2002) 88. California follows such an approach, see Chapter 4 paragraph 3.4.2.2.

¹⁶⁶ Wishart *Company Law in Context* 178.

returns on capital, the same rules can apply to both kinds, resulting in a further simplification of rules and the avoidance of regulatory bias.

Solvency and liquidity tests are not as sophisticated as creditor-imposed restrictions. Empirical evidence indicates that creditors regard aspects such as nett assets and interest cover as more important than cash-flow projections.¹⁶⁷ Consequently, the solvency and liquidity of the company may also be irrelevant to creditors, although probably not to the extent applicable to capital maintenance.

4 METHODOLOGY

This thesis is done by way of a comparative analysis of the regulation of share capital structure, shareholder contributions and distributions to shareholders in a number of countries. The aim of the comparative study is to identify strengths and weaknesses of the South African law in this field and to make recommendations for reform.

4.1 Need for this study

Subsequent to the introduction in South Africa of the new provisions regulating distributions to shareholders in 1999, various articles commenting on aspects of the new provisions have been published. Understandably, these have focused on specific topics of limited scope. Company law textbooks also deal with the relevant provisions of the Companies Act, but their emphasis is mostly on describing the existing position rather than to suggest legal reform. An extensive company law reform process is underway and a Companies Bill has been introduced to Parliament.¹⁶⁸

¹⁶⁷ Day & Taylor “Loan Contracting” 320 – 321 conclude that a dividend restriction is seldom used in financial covenants. Wishart *Company Law in Context* 177 – 178 argues that creditors are interested in future earnings and interest cover. See also *Company Formation and Capital Maintenance* URN 99/1144 (October 1999) par 3.5.

¹⁶⁸ [B 61—2008], tabled in Parliament on 27 June 2008, available at www.pmg.org.za/bill (2008-06-27). This Bill was approved by Cabinet on 14 May 2008 (Statement of Cabinet Meeting 14 May 2008 dated 15 May 2008). The Minister published an explanatory summary and notice of intention to introduce the Companies Bill into Parliament during June 2008, see GG 31104 of 30 May 2008 General Notice 677. The Department of Trade and Industry (DTI) first published a draft Companies Bill in February 2007 and invited public comments.

The purpose of this thesis is thus to analyse the existing capital rules in South African company law, to point out shortcomings, comment on proposed reforms, and make recommendations.

4.2 Scope and motivation of comparative study

I survey the laws of England,¹⁶⁹ New Zealand,¹⁷⁰ and the American states of Delaware and California. I also consider the provisions of the Revised Model Business Corporations Act which serves as the basis for the regulation of corporations more than half of the American states. I chose these systems not because they represent different legal families, but for the variety of approaches they have adopted in response to the issues investigated in this thesis.¹⁷¹ Although there is considerable variation in detail, the approaches can be divided into capital maintenance systems on the one hand,¹⁷² and solvency and liquidity systems on the other.¹⁷³ England and Delaware are capital maintenance systems, while New Zealand, California and the model provisions of the Revised Model Business Corporations Act represent the solvency and liquidity approach. South Africa can be classified as a hybrid system with elements of each category.

I survey England first.¹⁷⁴ Comparison is warranted on several grounds. First, the capital maintenance doctrine which represents one of the two main approaches to the regulation of distributions, originated in England.¹⁷⁵ Secondly, South African company law is based on English company law.¹⁷⁶ Although legislation in the two

¹⁶⁹ See Chapter 2.

¹⁷⁰ See Chapter 3.

¹⁷¹ In view of the harmonisation of capital and distribution rules through the implementation of the EU Second Company Law Directive EC 91/77, the position in the most important Germanic and Romance jurisdictions does not differ in material respects from that in the UK. Although the harmonisation of company law applies to public companies only, the basic approach to private companies in those jurisdictions tend to approximate that applicable to public companies. Moreover, a number of jurisdictions have adopted reforms in this area that differ radically from the principles they once embraced.

¹⁷² This includes 'legal capital' which is the preferred American and European term.

¹⁷³ Capital maintenance systems by necessary implication also require solvency and often impose liquidity as an additional requirement. My designation of a system as a solvency and liquidity system must be understood as indicating that the system relies exclusively or mainly on these restrictions.

¹⁷⁴ See Chapter 2.

¹⁷⁵ See paragraph 2.1 above.

¹⁷⁶ Cilliers & Benade *Corporate Law* 19.

systems have moved away from each other in the past couple of decades, most of the general principles of company law and many of the statutory provisions still correspond, making comparison valuable.¹⁷⁷ Thirdly, because of its implementation of the Second Company Law Directive of 1976,¹⁷⁸ which applies in respect of public companies, the regulation of important aspects of share capital and distributions is representative of the position in other member states of the European Union, thus adding a wider perspective. Finally, it is unique among the systems I survey in prescribing a minimum amount of issued and paid-up share capital¹⁷⁹ and prohibiting shares without par value.¹⁸⁰

New Zealand is next in line.¹⁸¹ While company law in New Zealand is based on English law, the new Companies Act that was adopted in 1993 decisively reformed the regulation of share capital, consideration for shares, and distributions. Notably, it abolished the concept of authorised capital.¹⁸² I chose New Zealand because it exemplifies a successful transition from an English-based system to a modern approach comparable with the most progressive jurisdictions internationally. The New Zealand reforms have been described as ‘the most radical appraisal of company law that has been put forward anywhere in the Commonwealth since limited liability was introduced in 1855’.¹⁸³ The New Zealand Act also served as the model for the new Companies Act in Botswana.¹⁸⁴ These two factors make New Zealand preferable over the more complex Australian example as a comparative jurisdiction for this thesis.

In the United States of America¹⁸⁵ the regulation of corporations falls within the powers of each state. Although a majority of American states have adopted legislation based on the Revised Model Business Corporation Act, the two states

¹⁷⁷ See Havenga *Corporate Opportunities* 5.

¹⁷⁸ Directive 77/91/EEC, 1997 OJ L26/1. See also Chapter 2 paragraph 1.

¹⁷⁹ For public companies, see Chapter 2 paragraph 2.2.

¹⁸⁰ See Chapter 2 paragraph 2.3.

¹⁸¹ See Chapter 3.

¹⁸² See Chapter 3 paragraph 22.

¹⁸³ See the report of the New Zealand Law Commission *Company Law Reform: Transition and Revision* R16 xiv, quoting a leading English commentator, Dr Len Sealy.

¹⁸⁴ See Havenga “Regulating Directors’ Duties” 621.

¹⁸⁵ The American position is considered in Chapter 4.

surveyed have not done so. The selection of three different approaches in the USA also shows that it is dangerous to generalise about 'American' company law.¹⁸⁶

Delaware¹⁸⁷ has a reputation as the most permissive, and consequently also the most popular, state for incorporations in America.¹⁸⁸ Curiously, it has not followed the trend of modernising its share capital and distribution rules and is thus still a legal capital system. Comparison with the law of Delaware law is useful as it illustrates a much more lenient approach to capital maintenance or legal capital. It is also the only other system surveyed that, like South Africa, allows a combination of par and no par value shares.

California¹⁸⁹ was the first American state to abolish the legal capital regime, thus making it an obvious choice for comparison. It replaced the legal capital system with economically equivalent, but legally different restrictions. The notion of retained earnings encompasses a higher standard than solvency. California is also unique in providing an alternative to the retained earnings measure in the form of a rather sophisticated debt to equity ratio test. The Californian innovations provided impetus for the revision of the financial provisions of the Model Business Corporations Act at the time which were subsequently taken over in the Revised Model Business Corporations Act of 1984.

The provisions of the Revised Model Business Corporations Act,¹⁹⁰ published by the American Bar Association,¹⁹¹ represent the law in many states and its provisions have been adopted by 29 states.¹⁹² It is a popular and easily accessible source of comparison that has influenced reforms in other jurisdictions such as New

¹⁸⁶ However, see Pound "Development of American Law" 50 – 52 for a discussion of unifying features of American Law.

¹⁸⁷ See Chapter 4 paragraphs 2 – 2.7.

¹⁸⁸ See Chapter 4 paragraph 2.1.

¹⁸⁹ See Chapter 4 paragraphs 3 – 3.7.

¹⁹⁰ See Chapter 4 paragraphs 4.1 – 4.7.

¹⁹¹ The Revised Model Business Corporations Act will be referred to as the MBCA or the RMBCA and any references to the previous version, which is still the basis of the corporate laws of a number of states, will be identified with reference to its year of publication, 1969.

¹⁹² See American Bar Association *Model Business Corporations Act Official Text with Official Comment* xxii.

Zealand¹⁹³ and appears to have been played a role in informing the company law review process in South Africa.¹⁹⁴

I conclude my study with an analysis of the share capital rules in South Africa.¹⁹⁵ Although distributions in the form of consideration for share repurchases and payments by reason of shareholding have been made subject to solvency and liquidity criteria, the rules regarding the share capital framework and shareholder contributions remain unchanged. I point out shortcomings of the current legislation and make recommendations for improvement based on my findings in the comparative survey. I also consider the proposals for reform that are made in the Companies Bill.¹⁹⁶

4.3 Specific issues considered

In order to facilitate comparison, I address issues as far as possible in the same order in my analysis of each jurisdiction.

A brief introduction sets out the kinds of companies having a share capital, the sources of applicable law and a concise historical overview of the capital regime adopted.

I then discuss the share capital structure with reference to authorised capital, considering also alternative measures that achieve a similar effect of protecting shareholders against uncontrolled dilution of their interests. Attention is also given to the minimum issued share capital, regardless of whether it involves a prescribed amount or is determined with reference to a number of shares. I consider the use of par value and no par value shares and the way in which the consideration for these should be reflected in a company's capital accounts and reserves. I also briefly address provisions regulating the variation of share capital because even apparently formalistic variations of share capital, like a consolidation of shares, may

¹⁹³ See New Zealand Law Commission *Company Law: Reform and Restatement* (NZLC R9).

¹⁹⁴ This will as far as possible be indicated in the discussion of the proposed reforms in South Africa, see Chapter 5.

¹⁹⁵ See Chapter 5.

¹⁹⁶ [B 61—2008], tabled in Parliament on 27 June 2008, available at www.pmg.org.za/bill (2008-06-27), hereafter 'Companies Bill'.

adversely affect the interests of certain shareholders.¹⁹⁷ Formal reduction of capital is discussed if provided for in the particular system.

The regulation of shareholder contributions is then analysed. I discuss the regulation of a minimum consideration, the kinds of acceptable consideration, formalities applicable to non-cash consideration, the time when consideration has to be given (including the regulation of partly paid shares) and circumstances under which shares may be issued at a discount, if applicable.

Turning to the regulation of distributions, the first aspect I consider is whether or not there is a comprehensive definition of distributions and a single set of financial restrictions to which all distributions are subjected.

The first category of distributions considered includes dividends and other payments to shareholders. I set out the kinds of payments that are regulated and the basic requirements for each, followed by an analysis of the procedural requirements.

Share repurchases are the second category. I identify the kinds of repurchases that are allowed, including redemption of shares, and discuss the requirements for each kind of repurchase. In focusing on the procedural requirements for repurchases, I distinguish between measures aimed at protecting creditors and shareholders. I also consider the effect of share repurchases on the share capital accounts and on the status of repurchased shares. The consequences of an unlawful repurchase, including personal liability of directors and shareholders for unlawful repurchases, are then analysed. The final issue I deal with under this section is the regulation of repurchases through subsidiaries.

My recommendations for reform are set out in the final chapter.

5 REFERENCE TECHNIQUES

For the sake of convenience I use the feminine form throughout this thesis to refer to persons. I use the terms 'company' and 'corporation' according to the practice in each system surveyed. In the discussion of general principles that transcend a particular jurisdiction, the term company is used.

¹⁹⁷ For example, the cancellation or redemption of fractional shares resulting from a consolidation of shares (a 'reverse stock split') can be used to expropriate minority shareholders. See Kaplan & Young "Corporate 'Eminent Domain'" 68.

When I refer to court judgments, the full citation appears in the footnote as well as in the table of cases. Other authorities are referred to in the footnotes by way of short titles while I supply the full title in the bibliography. In the case of authority sourced on the internet, the website and date it was last accessed is given in the footnote and in the bibliography, list or table, as the case may be.

The books, articles, cases and legislation referred to are those that were available to me as at February 2008, although I incorporate progress with the reform process up to the tabling of the Companies Bill on 27 June 2008.

CHAPTER 2

ENGLAND

1 INTRODUCTION

In England, company law is regulated mainly by the Companies Act 2006 (c 46),¹ the Companies Act 1985 (c 6),² and the common law. The Companies (Audit, Investigations and Community Enterprise) Act 2004 (c 27), the Criminal Justice Act 1993 (c 36), the Insolvency Act 1986 (c 45), the Company Directors (Disqualification) Act 1986 (c 46), the Financial Services and Markets Act 2000 (c 8) and the Business Names Act 1985 (c 7) also regulate aspects of company law.³ Parts V and VIII of CA 1985 regulate the areas of share capital, capital maintenance and distributions. Parts 17, 18 and 23 of CA 2006 regulate share capital, share repurchases and distributions respectively, but are not yet in force. As a member state of the EU, the United Kingdom has to comply with its directives and regulations. The Second Company Law Directive of 1976⁴ is directly relevant to the topic under consideration and applies in respect of public companies. The capital provisions required by this Directive were originally incorporated into the Companies

¹ This Act (hereafter CA 2006) received royal assent on 8 November 2006 and the commencement of its provisions is being staggered, see DTI, *Implementation of Companies Act 2006: A Consultative Document* (DTI, 2007). According to a revised timetable published by the Government by Written Statement on 13 December 2007, available at www.berr.gov.uk (2008-02-28), most of the provisions relevant to my thesis, including those dealing with share capital and repurchases, will come into force on 1 October 2009, when the Act will be fully in force. The sections dealing with distributions in the narrow sense (ss 829 – 853) commenced on 6 April 2008. CA 2006 is to replace the Companies Act of 1985, although certain parts of the latter Act will remain in force, notably those dealing with company investigations. Whenever possible, references will be made to both these Acts, indicating the relevant provision in each. For a succinct overview of CA 2006, see *Blackstone's Guide* 1 – 8.

² Companies Act 1985 (c 6), hereafter 'CA 1985'. Most of the provisions of this Act will be replaced by CA 2006, see note 1 above.

³ See *Gore-Browne on Companies* Vol 1 1-2 – 1-4; *Alcock Companies Act 2006* 14. On the sources of English company law in general, see *Gower & Davies' Company Law* 7 ed 45ff.

⁴ Directive 77/91/EEC, 1997 OJ L26/1. In the rest of this Chapter, this directive will be referred to as the 'Second Company Law Directive'. For an overview of the impact of European Commission regulation on company law in the UK, see *Gore-Browne on Companies* 1-10Aff; *Boyle & Birds' Company Law* 17 – 41; *Hannigan Company Law* 38 – 61.

Act 1981 (c 62), later consolidated in CA 1985, and are now reflected in CA 2006. An innovation of CA 2006 is that it applies to the whole of the United Kingdom.⁵ However, in this chapter reference will be made to the position in England. This is done because in addition to statute law, common-law principles developed in England are relevant.

The legislation distinguishes between limited and unlimited companies. Limited companies can be limited by shares⁶ or by guarantee.⁷ Companies limited by guarantee must be private companies, while companies limited by shares can be public or private. There are also unlimited companies, used mainly by professional firms. Since 2000, it has been possible to form limited partnerships.⁸ The Companies (Audit, Investigations and Community Enterprise) Act 2004 provides for the registration of a limited company as a community interest company, but a consideration of this type of company falls outside the scope of this thesis.⁹ Since

⁵ See CA 2006 s 1(1) s v 'company' in terms of which the 'Companies Acts' apply to the whole UK. The concept 'the Companies Acts' is defined in s 2 and comprises the company law provisions of CA 2006 (Parts 1 to 39 and Parts 45 to 47 so far as they apply for purposes of Parts 1 to 39), Part 2 of the Companies (Audit, Investigations and Community Enterprise) Act 2004 (c 27), as well as the provisions of CA 1985 and the Companies Consolidation (Consequential Provisions) Act 1985 (c 9) that in remain in force. See also CA 2006 s 1284 which implements the direct extension of the Companies Acts to Northern Ireland and repeals the separate enactments (which largely duplicated the Great Britain enactments) in force in Northern Ireland. CA 2006 ss 1285 – 1287 extend various other Great Britain enactments to Northern Ireland, for example those governing certain other forms of enterprise like limited liability partnerships and limited partnerships, and business names. See also *Gore-Browne on Companies* Vol 1 1 – 3; *Palmer's Annotated Guide* 56, 933; *Alcock Companies Act 2006* 14; *Mayson, French & Ryan on Company Law* 2.2.1.1.

⁶ CA 2006 s 3(2) defines a 'company limited by shares' as a company whose members' liability is limited to the amount unpaid on its shares.

⁷ CA 1985 s 1(2); CA 2006 s 3. Until 1981, when the amendments incorporating the Second Company Law Directive first came into force, it was possible to form guarantee companies that also had a share capital. These companies may continue to exist. See s 1(2) of the Companies Act 1980 (c 22); CA 2006 s 5; *Gower & Davies' Company Law* 7 ed 71. Guarantee companies with a share capital are a hybrid form of company and the rules pertaining to the share capital of limited companies usually apply to the share capital of a guarantee company, see also *Palmer's Company Law* Vol 1 2.101. Although reference will sometimes be made to provisions that apply also to such companies, a detailed consideration of these companies is beyond the scope of this thesis.

⁸ With the enactment of the Limited Liability Partnerships Act 2000 (c 12). See *Gower & Davies' Company Law* 7 ed 5 – 6 for a brief discussion of the features of this form of enterprise.

⁹ See *Mayson, French & Ryan on Company Law* 2.3.1 where this company form is discussed briefly.

only companies limited by shares are relevant to my thesis, I will consider public and private limited companies with share capital.

The private company is the default company form.¹⁰ The number of members a private company may have is not limited. A private company may not offer its shares to the public.¹¹ The constitution of a private company need not restrict the transfer of its shares, although such restrictions are common.¹² The minimum number of members is one.¹³ The common-law maintenance of capital doctrine has been relaxed for private companies in a number of respects.

A public limited company must state in its memorandum that it is a public company¹⁴ and it is currently required to have at least two members.¹⁵ The law relating to share capital of public companies must comply with the Second Company Law Directive. Public companies have a minimum prescribed authorised and paid-up capital, are subject to strict regulation pertaining to the valuation of non-cash consideration for shares, and may not make distributions out of share capital.¹⁶

Various provisions prevent abuse of the distinction between the private and public company rules by private companies that later convert to public companies.¹⁷

A comprehensive review of company law was launched in 1998.¹⁸ A Steering

¹⁰ CA 1985 s 1(3); CA 2006 s 4(1). See also *Gower & Davies' Company Law* 7 ed 12 – 14 for a discussion of the merits of regulating these two forms of company in a single Act.

¹¹ CA 1985 s 81; CA 2006 s 755.

¹² See *Palmer's Company Law* 2.110.

¹³ CA 1985 s 1(3A); CA 2006 s 7(1). Single member private companies became lawful under a special dispensation that was introduced in 1992 by the Companies (Single Member Private Companies) Regulations 1992 (SI 1992/1699) to give effect to the Twelfth Company Law Directive 89/667/EEC; 1989 OJ L395/40. See *Gore-Browne on Companies* Vol 1 2-16, 3-1; *Palmer's Company Law* 2.108.

¹⁴ CA 1985, s 3(1); CA 2006 s 4(2) – (3).

¹⁵ However, CA 2006 now makes provision for single-member public companies, s 7(1). This provision has been scheduled to come into operation in October 2009, see the revised timetable available at www.berr.gov.uk (2008-02-28).

¹⁶ See paragraphs 2.2, 3.2 and 5.2 below.

¹⁷ *Gower & Davies' Company Law* 7 ed 236 – 237. For an example, see the discussion of the regulation of non-cash consideration in paragraph 3.3 below.

¹⁸ *Modern Company Law for a Competitive Economy* is the launch consultative document issued by the DTI in March 1998. It sets out the purpose and terms of reference of the Review. For an

Group tasked with the review published its report in July 2001.¹⁹ The government reacted in a White Paper, accompanied by a Draft Companies Bill, in July 2002.²⁰ In 2004, a further consultation document was published by the DTI,²¹ which again set in motion the process that seemed to have stalled.²² The reform process eventually resulted in the Companies Act 2006, which is not fully in force yet. I include parallel references in the footnotes where both Acts regulate an aspect in the same way. I will also highlight differences where relevant.

The new Act reforms certain aspects of the law relating to share capital and distributions, but mainly for private companies. The Second Company Law Directive prevents the simultaneous relaxation of many provisions relating to public companies.²³ However, the Company Law Review reconsidered those instances where the requirements of the Second Company Law Directive had been voluntarily extended to private companies.²⁴

In the course of this chapter, I refer to a number of specific proposals of the Company Law Review, many of which have been incorporated in CA 2006. It is nevertheless sensible to give a brief overview of the proposals for reform in the areas covered by this thesis, as it will highlight specific concerns and expose

Continued

overview of the reform process, see *Gower & Davies' Company Law* 7 ed 53 – 54; *Alcock Companies Act 2006* 3 – 4; *Mayson, French & Ryan on Company Law* 1.5.1.3 – 1.5.1.6; *Palmer's Company Law* 1.134.

¹⁹ Several consultation documents and follow-up reports were issued in the mean time. There were four phases of consultation, and four major reports, viz *The Strategic Framework* URN 99/654 (February 1999), *Company Law Review: Developing the Framework* URN 00/656 (March 2000), *Company Law Review: Completing the Structure* URN 00/1335 (November 2000) and *Modern Company Law for a Competitive Economy - Final Report* (May 2001). The follow-up reports *Company Formation and Capital Maintenance* URN 99/1144 (October 1999) and *Modern Company Law for a Competitive Economy: Capital Maintenance: Other Issues* URN 00/880 (June 2000) are also of particular importance for the topic under consideration.

²⁰ White Paper *Modernising Company Law* Cm 5553-I and II (July 2002).

²¹ *DTI Company Law: Flexibility and Accessibility* (May 2004)

²² *Boyle & Birds' Company Law* 11 explain that the delay was caused by the need to devote urgent attention to the regulation of directors' remuneration and the improvement of accounting and auditing standards.

²³ The European Commission has its own reform initiative which includes the simplification of capital rules: see *Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward* par 3.2. See also Chapter 1 footnote 139.

²⁴ *Company Formation and Capital Maintenance* URN 99/1144 (October 1999) par 3.4.

general trends.

In formulating its proposals for reform of the share capital provisions of the Companies Act the Company Law Review Steering Group was influenced by two general considerations:

- the need to comply with the Second Company Law Directive in relation to public companies.²⁵
- the idea that in assessing a company's ability to repay credit, measures such as net assets, cash flow and interest cover were in most cases regarded as more important than the share capital of a company.²⁶

The Steering Group recommended abolition of the concept of authorised capital for both public and private companies.²⁷

As regards private companies, the first proposals included abolishing par value shares, doing away with the prohibition against issuing shares at a discount, and requiring the net consideration received for no par value shares to be reflected in a single subscribed capital account.²⁸ The share premium account provisions would thus no longer apply to private companies.²⁹

For public companies, a number of simplifications of existing provisions were proposed. For example, it was proposed that a right of creditors to object to court replace the requirement of court confirmation for capital reductions in certain circumstances. Another proposal was that the directors should issue a solvency declaration stating that the company will be able to pay its debts after the reduction and remain able to do so for the following 12 months or in the event of a winding up.³⁰

²⁵ *Company Formation and Capital Maintenance* URN 99/1144 (October 1999) par 3.4.

²⁶ *Company Formation and Capital Maintenance* URN 99/1144 (October 1999) par 3.5. This consideration resulted from responses to a question posed by the Steering Group during its consultation process.

²⁷ *Company Formation and Capital Maintenance* URN 99/1144 (October 1999) par 3.13.

²⁸ *Company Formation and Capital Maintenance* URN 99/1144 (October 1999) par 3.8.

²⁹ *Company Formation and Capital Maintenance* URN 99/1144 (October 1999) pars 3.19 – 3.21.

³⁰ *Company Formation and Capital Maintenance* URN 99/1144 (October 1999) pars 3.27 – 3.31.

The repurchase and redemption provisions did not elicit any proposals for substantial reform. It is interesting to note, though, that in relation to no par value shares, the amount of the issued capital account would not be reduced by the cancellation of the cancelled shares.³¹ Conversely, in the case where distributable profits were used, it would not be necessary to create a capital redemption reserve. This differs from the position in South Africa where the average issue price of no par value shares acquired by the company must be deducted from the stated capital account.³² This illustrates that the purpose of the South African repurchase provisions is to allow a reduction of capital upon a repurchase while that of the English provisions is to keep the total share capital and non-distributable reserves intact.³³

The Steering Group also recommended the withdrawal of the exception of CA 1985 allowing private companies to purchase or redeem their shares out of capital, because the simplified reduction of capital procedure it was proposing for private companies would achieve the same result.³⁴ The *quantum* of the issued share capital plays an important role in the determination of distributable profits. A private company wishing to reflect the reduction in its contributed capital would thus have to resort to a separate reduction of capital procedure.³⁵

The Steering Group proposed maintaining the substance of the provisions regulating distributions to shareholders, although it suggested certain improvements to the basic definition.³⁶ It also proposed that the statutory dispensation should completely replace the common law principles,³⁷ but this recommendation was not

³¹ *Company Formation and Capital Maintenance* URN 99/1144 (October 1999) par 3.60.

³² See Chapter 5 paragraph 6.3.3.

³³ Except, of course, in the case of private companies purchasing shares from capital, see paragraph 6.3.4 below.

³⁴ *Company Formation and Capital Maintenance* URN 99/1144 (October 1999) par 3.62.

³⁵ However, as will appear from paragraph 6.4.2 below, the repurchase out of capital was retained.

³⁶ *Company Law Review: Completing the Structure* URN 00/1335 (November 2000) par 7.21.

³⁷ *Company Formation and Capital Maintenance* URN 99/1144 (October 1999) par 3.66; *Company Law Review: Completing the Structure* URN 00/1335 (November 2000) par 7.21; *Modern Company Law for a Competitive Economy: Capital Maintenance: Other Issues* URN 00/880 (June 2000) Part II pars 37 – 39.

implemented.³⁸

2 STRUCTURE OF SHARE CAPITAL

2.1 Authorised capital

The memorandum of a company limited by shares must currently still state the number of shares it is authorised to issue and the division of its share capital into shares of a fixed amount.³⁹ In the case of a public company, the authorised capital must be at least equal to the minimum prescribed capital.⁴⁰ The only function of stating the authorised capital in the memorandum is to restrict the number of shares that directors may issue. However, the mentioning of an amount of authorised capital in other documents could cause confusion for investors.⁴¹ Any reference on the stationery and order forms of a company to its share capital is required to be to paid-up capital.⁴²

The Company Law Review proposed the abolition of the concept of authorised capital in the new legislation.⁴³ In its opinion, direct provisions that limit the authority of directors to issue shares,⁴⁴ as well as pre-emptive rights,⁴⁵ provide sufficient

³⁸ See paragraph 6.1 below.

³⁹ CA 1985 s 2(5). This will not be required under CA 2006. The provisions on company formation are scheduled to come into force on 1 October 2009, see the authority referred to in note 1 above.

⁴⁰ CA 1985 s 11.

⁴¹ See *Gower & Davies' Company Law* 7 ed 228.

⁴² CA 1985 s 351(2). This provision also addresses the problem of possible deception by referring to issued rather than paid-up capital. Although CA 2006 does not contain a similar provision, the First Directive on Company Law 68/151/EEC; 1968 OJ spec ed 41 – 45 dictates regulation in this regard. *Mayson, French & Ryan on Company Law* 6.1.2 explain that the requirement of the directive will be implemented by regulations issued under CA 2006 s 82.

⁴³ *Modernising Company Law* Cm 5553-I and II (July 2002) par 6.5.

⁴⁴ These restrictions are required in respect of public companies by art 25 of the Second Company Law Directive. CA 1985 s 80 subjects the power of directors to allot shares to authorisation by the general meeting or the articles of association. The maximum number of shares that may be allotted under the authorisation must be stated and the authorisation may not be given for a period exceeding 5 years. CA 1985 s 80A allows private companies to grant authorisations for longer than 5 years. See *Gower & Davies' Company Law* 7 ed 630ff.

⁴⁵ CA 1985 s 89ff. See *Gower & Davies' Company Law* 7 ed 631ff.

protection to shareholders. Consequently, under CA 2006 the only information about its share capital that needs to be contained in the memorandum of a company limited by shares is a statement by the subscribers that they agree to take up at least one share each.⁴⁶ However, the company must lodge a statement of capital and initial shareholdings, which sets out the issued capital and its division into shares, with the Registrar together with its memorandum.⁴⁷ This statement, or each further statement lodged when more shares are issued,⁴⁸ forms part of the current constitutive documents of the company.⁴⁹

The directors may allot and issue further shares, subject to authority in the articles of association or a resolution of the company.⁵⁰ Pre-emptive rights apply in respect of issues wholly for cash consideration.⁵¹ Existing shareholders of ordinary shares are entitled to subscribe for further shares in proportion to the nominal value of their shares, and may renounce their right to be allotted shares to anyone else. Exceptions apply in respect of employee share schemes and bonus shares.⁵² Pre-emptive rights are compulsory for public companies.⁵³ Private companies may exclude or limit pre-emptive rights in a number of ways.⁵⁴

⁴⁶ CA 2006 s 8(1)(b). According to the schedule this provision will come into force on 1 October 2009, see the revised implementation timetable available at www.berr.gov.uk (2008-02-28).

⁴⁷ CA 2006 s 9(4). The contents of the 'statement of capital and initial shareholdings' is prescribed in s 10(2)(a).

⁴⁸ CA 2006 s 555.

⁴⁹ CA 2006 s 32(1)(g). The annual return to be submitted by a company also has to reflect the composition of its issued share capital, s 856(1) – (2).

⁵⁰ CA 1985 ss 80 – 80A; CA 2006 s 551(1). Under CA 2006 s 550 a private company with only one class of shares need not subject the directors' power to allot and issue shares to restrictions in the articles. See *Mayson, French & Ryan on Company Law* 6.2.6.1; Paul Myners *Pre-emption Rights: Final Report* URN 05/679 (DTI, 2005).

⁵¹ CA 1985 s 89; CA 2006 s 561, s 565.

⁵² CA 1985 s 89(4) – (5); CA 2006 s 564, s 566.

⁵³ As required by article 29 of the Second Company Law Directive.

⁵⁴ CA 1985 s 95; CA 2006 ss 567 – 569. According to Weinbaum "Dilution" 4 companies usually grant the directors a general authority to issue shares and are likely to exclude pre-emptive rights as well.

2.2 Minimum share capital

A minimum allotted⁵⁵ share capital of £50 000 applies in respect of public companies.⁵⁶ No minimum amount of issued or allotted capital is prescribed for private companies, although such a company must have issued at least one issued share.⁵⁷

The amount of the minimum capital for public companies is substantially higher than the 25 000 euros prescribed in terms of the Second Company Law Directive. A public company may not do business or exercise its borrowing powers until it has obtained a certificate from the Registrar that it has complied with the requirements of the Act regarding allotment of the prescribed minimum capital.⁵⁸

When the minimum prescribed capital is increased, which can be done by the Secretary of State by statutory instrument,⁵⁹ public companies with an issued capital of less than the minimum may be required to increase their capital to an amount equal to the new minimum capital, or alternatively, to reregister as private companies.⁶⁰

It is important to note that shares are not required to be fully paid up when they are issued, so that the paid-up share capital of a company may be lower than its issued or allotted capital. I consider the requirement regarding the minimum paid-up

⁵⁵ A share is 'allotted' at the moment when a person acquired an unconditional right to be entered in the register in respect of that share and is regarded as 'issued' when it is registered in the name of the shareholder, see CA 2006 s 558. See also Marsden "The Issue" 144 – 145 on the difference between 'issued' and 'allotted'. The par value of allotted and issued shares is known as the allotted share capital and the issued share capital respectively. See also *Mayson, French & Ryan on Company Law* 6.1.10; *Palmer's Company Law* 4.004.

⁵⁶ CA 1985 s 117 and s 118; CA 2006 s 761(2) and s 763(1). The Secretary of State may also set an equivalent in euros. The amount of a company's capital need not be stated in pounds sterling and could include different currencies. The minimum capital must, however, be designated in pounds sterling, see *Re Scandinavian Bank Group plc* [1988] Ch 87; *Re Anglo-American Insurance Co Ltd* [1991] BCLC 564; *Gore-Browne on Companies* 6-19. See also Instone "Multi-currency Share Capital" 168 – 170 and Thornton "Lawfulness of Multi-currency Share Capital" 51 – 54 for discussions of *Re Scandinavian Bank Group plc* [1988] Ch 87. The minimum paid-up amount at incorporation is discussed in paragraph 3.4 below.

⁵⁷ *Gower & Davies' Company Law* 7 ed 229.

⁵⁸ CA 2005 s 117(8); CA 2006 s 761(2).

⁵⁹ CA 1985 s 118(1).

⁶⁰ CA 1985 s 118(2).

capital for public companies below.⁶¹

2.3 Kinds of shares

All shares are required to have a fixed amount or par value.⁶² England still does not allow shares without par value, despite the fact that both the Gedge Committee⁶³ in 1954 and the Jenkins Committee⁶⁴ in 1962 recommended the introduction of no par value shares.⁶⁵ The Company Law Review contemplated replacing par value shares with no par value shares for private companies,⁶⁶ but eventually abandoned the proposal.⁶⁷ The Second Company Law Directive prevents the abolition of par value in respect of public companies.⁶⁸ The potential problems different systems for public and private companies would create upon the conversion of companies motivated the ultimate recommendation to retain the par value system for private companies.⁶⁹

⁶¹ See paragraph 3.4 below.

⁶² CA 1985 s 2(5); CA 2006 s 542. The par value need not be an amount that could be paid in legal tender, need not be designated in sterling and could be stated in different currencies for different classes of shares, see *Re Scandinavian Bank Group plc* [1988] Ch 87 at 99 – 100. However, the minimum prescribed capital must be reflected in sterling, see paragraph 2.2 above.

⁶³ Board of Trade *Report of the Committee on Shares of No Par Value* (Cmd 9112 of 1954).

⁶⁴ *Report of the Company Law Committee* (Cmnd 1749 of 1962).

⁶⁵ See *Gower & Davies' Company Law 7* ed 230.

⁶⁶ See *The Strategic Framework* URN 99/654 (February 1999) pars 5.4.26 – 5.4.33; *Company Formation and Capital Maintenance* URN 99/1144 (October 1999) par 3.8; *Modern Company Law for a Competitive Economy: Capital Maintenance: Other Issues* URN 00/880 (June 2000) Part I pars 8 – 12, and see pars 13 – 23 for a discussion of the intended transitional provisions.

⁶⁷ See *Company Law Review: Completing the Structure* URN 00/1335 (November 2000) par 7.3.

⁶⁸ See *Company Formation and Capital Maintenance* URN 99/1144 (October 1999) par 3.4. It appears that McLennan "Abolition of Par-value" 42 may have lost sight of this fact when he thought it unusual that the possibility was being considered for private companies only.

⁶⁹ See *Company Law Review: Completing the Structure* URN 00/1335 (November 2000) par 7.3; *Gower & Davies' Company Law 7* ed 230. In England the most common method of forming a public company is to incorporate a private company and convert it into a public company, avoiding the necessity of obtaining a trading certificate under CA 1985 s 117; CA 2006 761(2), see *Palmer's Company Law* 2.206. Ease of conversion is commercially important. See also *Modern Company Law for a Competitive Economy: Capital Maintenance: Other Issues* URN 00/880 (June 2000) par 9. It is interesting that unlimited companies with share capital may indeed use no par value shares, see *Mayson, French & Ryan on Company Law* 6.1.14.

2.4 Share capital and reserve accounts

In addition to the share capital account, provision is made for non-distributable reserves which are treated like share capital, subject to certain exceptions. The share premium account and the capital redemption reserve are the most important statutory non-distributable reserves and serve to limit the amount of distributions to shareholders.⁷⁰

While the par value of a share is reflected in the share capital account of a company, any premium is shown in its share premium account.⁷¹ When a company resells treasury shares⁷² for more than the price it paid when repurchasing them, it has to transfer this excess to the share premium account.⁷³ The share premium account is also the appropriate account in which any other amounts of capital that unrelated to specific shares can be reflected.⁷⁴

The share premium account is treated as if it was paid-up share capital,⁷⁵ but provision is made for exceptions⁷⁶ and reliefs.⁷⁷ While an exception allows the reduction of the share premium account, the effect of a relief is that an amount that should otherwise have been transferred to the share premium account need not be

⁷⁰ In relation to distributions by public companies, additional reserves must be created; see CA 1985 s 264 and s 148(4); CA 2006 s 831 and s 669. See also the discussion in paragraph 5.2 below.

⁷¹ CA 1985 s 130; CA 2006 s 610(1). Prior to 1948 share premiums were regarded as paid in surplus which could be distributed to shareholders; see *Gower & Davies' Company Law* 7 ed 231. Also see Chapter 5 paragraph 2.4.3.1 for a brief account of the history of the regulation of share premiums.

⁷² Treasury shares are repurchased shares that have not been cancelled, but are held by the company. See paragraph 6.6 below for further detail as to how such shares are regulated.

⁷³ CA 1985 s 162F; CA 2006 s 731(3). This provision is also considered in paragraph 6.6 below.

⁷⁴ *Palmer's Company Law* 4.009. *Kellar v Williams* [2000] 2 BCLC 390 PC provides an example of share capital not related to specific shares. A shareholder had advanced money to the company, but it was not regarded as a loan. The amount was held to be share capital even though it could not be reflected in the share capital account.

⁷⁵ CA 1985 s 130(3); CA 2006 s 610(4).

⁷⁶ CA 1985 s 130(2); CA 2006 s 610(2) – (3). *Gower & Davies' Company Law* 7 ed 232 states that there are two exceptions, but although the provision contains paragraph numbers (a) and (b), it mentions at least three exceptions (if writing off preliminary expenses and providing for commissions or discount are regarded as a single exception).

⁷⁷ CA 1985 s 130(4) states that the reliefs are provided in ss 131 and 132; CA 2006 s 610(5) makes s 620 subject to the reliefs provided in ss 611, 612 and 614.

so transferred.

The exceptions allow use of the share premium account for:

- paying up bonus shares⁷⁸
- writing off preliminary expenses or commissions paid or discount allowed on an issue of shares or debentures⁷⁹
- the premium payable on the redemption of debentures.⁸⁰

Although these provisions dealing with the application of the share premium account do not refer to the application of the share premium account in respect of a premium payable on the redemption or repurchase of shares, this is provided for separately.⁸¹

In its regulation of how the share premium account may be applied, CA 2006 introduces a degree of correlation between the shares that contributed the premium and the transactions in respect of which the premium may be applied.⁸² Expenses or commissions may be written off out of share premium only to the extent that the shares in respect of which the expenses or commissions were incurred contributed to the share premium account.⁸³ Similarly, the extent to which the share premium account can be applied in respect of a redemption or repurchase at a premium is limited to the premium initially contributed in respect of those shares or the current amount of the share premium account, should the latter be lower.⁸⁴

The two reliefs pertain to the treatment of share premiums in mergers⁸⁵ and

⁷⁸ CA 1985 s 130(2); CA 2006 s 610(3).

⁷⁹ CA 1985 s 130(2)(a); CA 2006 s 610(2)(a) – (b).

⁸⁰ CA 1985 s 130(2)(b). However, CA 2006 s 610 does not provide for this use.

⁸¹ CA 1985 s 160; CA 2006 s 687(5) and s 692(4), see also paragraph 6.2.1 below.

⁸² Although s 133 of the 1989 Companies Act (c 40) also provides for such a link, it has not been put in force. See also *Mayson, French & Ryan on Company Law* 10.3.3 on the issue of linking up the contribution and distribution of share premiums. See also *Gower & Davies' Company Law* 7 ed 232 where draft clause 48 in the Bill accompanying the White Paper *Modernising Company Law* Cm 5553-I and II is commented on. See further Chapter 5 paragraph 2.4.3.3.2 on the position in South Africa.

⁸³ CA 2006 s 610(2)(a) – (b). CA 1985 did not limit the application in this way

⁸⁴ CA 2006 s 687(4) (redemptions) and s 692(3) (repurchases).

⁸⁵ CA 1985 s 131; CA 2006 s 611.

group reconstructions.⁸⁶ Where shares are issued in exchange for other shares in a merger or group reconstruction, the amount by which the value of the shares given in exchange for the issue of new shares exceed the par value of the new shares, need not be carried over to a share premium account.⁸⁷ A further opportunity for relief is introduced in CA 2006, in that the Secretary of State is given the power to provide further relief in respect of non-cash premiums or to restrict or modify the other reliefs by regulation.⁸⁸

When a redemption or repurchase is made out of distributable profits, an amount equal to the nominal value of the shares redeemed or purchased must be transferred to the capital redemption reserve.⁸⁹ An amount equal to the distributable profits used to fund the redemption or repurchase becomes undistributable, because the capital redemption reserve is treated as share capital.⁹⁰ The application of the capital redemption reserve is more limited than the share premium account, as it may only be capitalised as bonus shares. Premiums on debentures or preliminary expenses and commissions may not be paid from the capital redemption reserve.⁹¹

A public company that holds its own shares in treasury must, if it reflects the shares as an asset in its balance sheet, transfer an amount equal to their value into a statutory reserve fund out of its distributable profits.⁹² It may not distribute the amount of this reserve as dividend.⁹³ The same principle applies where a company has an interest in its own shares being held on its behalf by a nominee.⁹⁴

⁸⁶ CA 1985 s 132; CA 2006 s 612. See *Gower & Davies' Company Law* 7 ed 232.

⁸⁷ The excess value would otherwise have had to be reflected in the share premium account as was held in *Shearer v Bercaïn Ltd* [1980] 3 All ER 295. See also *Palmer's Company Law* 4.009.1. Similar relief for pooling of assets mergers introduced in the previous New Zealand Companies Act 1955 is criticised by Ross "Creditors' Protection" 368 as flying in the face of accounting convention and conflicting with the protection of creditors.

⁸⁸ CA 2006 s 614.

⁸⁹ CA 1985 s 170; CA 2006 s 733.

⁹⁰ CA 1985 s 170(4); CA 2006 s 733(6).

⁹¹ *Gower & Davies' Company Law* 7 ed 249; CA 1985 s 170 (4); CA 2006 s 733(5).

⁹² CA 1985 s 148(4); CA 2006 s 669(1).

⁹³ See paragraph 5.2 below.

⁹⁴ CA 1985 s 148(4); CA 2006 s 669(1).

2.5 The variation of share capital

The ways in which a company may alter its share capital are set out in the Act.⁹⁵ CA 2006 also contains a list of adjustments or reorganisations of share capital that are possible under other provisions of the Act and preserves the right of a company to use these.⁹⁶ In most cases, these require replacement of the share capital by some or other reserve or alternatively, court approval.

2.5.1 Increase and decrease

A company limited by shares may, if authorised by its articles, increase its share capital by new shares of such amount as it thinks expedient.⁹⁷ The increase must be authorised by the company in general meeting.⁹⁸ An ordinary resolution will suffice unless the articles prescribe a special or extraordinary resolution.⁹⁹ The Registrar must receive notification within fifteen days of the resolution authorising the increase.¹⁰⁰

A company authorised to do so in its articles may cancel shares that, at the time of passing of the resolution, have not been taken or agreed to be taken by any person.¹⁰¹ This is not a reduction of issued capital and is not subject to the restrictions applicable to the reduction of issued capital.¹⁰² CA 2006 does not

⁹⁵ CA 1985 s 121; CA 2006 s 617.

⁹⁶ CA 2006 s 617(5). These are a purchase of own shares, redemption of shares, forfeiture or surrender of shares, cancellation of shares under s 662 and an alteration under a compromise or arrangement sanctioned by the court.

⁹⁷ CA 1985 s 121; CA 2006 s 549 – 551 allows an increase through the allotment of further shares, but the notion of authorised capital is abolished. The formalities for allotment set out in CA 2006 ss 29 – 30 have to be complied with.

⁹⁸ CA 1985 s 121(4).

⁹⁹ *Gore-Browne on Companies* 26[2]. Regarding the position under CA 2006, see s 29.

¹⁰⁰ CA 1985 s 123(1); CA 2006 s 551(9) read with s 30.

¹⁰¹ CA 1985 s 121(5); CA 2006 s 641(4). See also CA 1985 s 121(2)(e). In *Re Swindon Town Football Company Ltd* [1990] BCLC 467 the court held that ‘agreed to be taken’ referred to a binding contract between the subscriber and the company. As a result, unissued shares could be cancelled despite the fact that someone had offered to subscribe for them. See also Fox “Right to Cancel” 73 – 74.

¹⁰² In order to distinguish it from a reduction of issued capital, *Palmer’s Company Law* 4.209 refers to such a cancellation of unissued shares as a diminution of capital.

provide for the cancellation of unissued shares, in view of the abolition of authorised capital.

2.5.2 Consolidation and subdivision

Under CA 1985 a company so authorised by its articles may consolidate and divide all or any of its share capital into shares of larger amounts than its existing shares, subdivide its shares, convert all or any of its paid-up shares into stock, and subsequently reconvert such stock into paid-up shares of any denomination.¹⁰³ The company in general meeting must exercise this power.¹⁰⁴ The memorandum must be amended accordingly.¹⁰⁵ The Registrar must be notified of any consolidation, conversion or reconversion.¹⁰⁶ Under CA 2006, it is no longer possible to convert shares into stock,¹⁰⁷ although the other kinds of variations, including the reconversion of existing stock into shares, remain possible.¹⁰⁸

Although these variations pertain to the issued capital of a company, they affect only the number of shares and their nominal value and do not amount to an increase or diminution of the amount of issued capital. It is expressly provided that the ratio of paid-up to unpaid amounts may not be changed by subdivision or consolidation.¹⁰⁹

A company may also redenominate its shares under CA 2006 by converting their nominal value into another currency.¹¹⁰

¹⁰³ CA 1985 s 121; CA 2006 s 617.

¹⁰⁴ CA 1985 s 121(4), or in the case of a private company, by written resolution under s 381A. CA 2006 s 618(3) requires a resolution of members.

¹⁰⁵ CA 1985 s 20. Under CA 2006 the memorandum cannot be amended but any change must be notified to the Registrar, see s 555, s 619, s 621, s 625.

¹⁰⁶ CA 1985 s 122. Apparently the Registrar need not be notified of subdivisions. This appears to be an oversight. Upon a subdivision the amount paid on the original shares must be equally apportioned to the shares of reduced amount, s 121(3). CA 2006 requires a statement of capital within 1 month of consolidation or subdivision (s 619) and of reconversion (s 621). See *Mayson, French & Ryan on Company Law* 6.1.12.3

¹⁰⁷ CA 2006 s 540(2), see also *Mayson, French & Ryan on Company Law* 6.1.12.3

¹⁰⁸ See CA 2006 s 617 and, with regard to stock, s 540(2) read with s 620.

¹⁰⁹ CA 1985 s 121 (3); CA 2006 s 618(2).

¹¹⁰ CA 2006 s 617(4) read with s 622(1). Limitations apply with regard to the exchange rate, see s 622(3). The articles could prohibit or restrict redenomination, s 622(7). Further formalities

Although South African legislation provides that a company may convert shares of one class into shares of another class,¹¹¹ the equivalent English provision does not expressly allow such a conversion.¹¹² However, this result can be achieved by a variation of class rights and, if necessary, a consolidation of classes of shares.¹¹³

2.6 Formal reduction of capital

Both CA 1985 and CA 2006 provide for a formal reduction of capital confirmed by the court.¹¹⁴ The procedure applies to companies limited by shares and to guarantee companies having a share capital. It applies to public as well as private companies. Under CA 2006, private companies can also reduce their share capital without court confirmation.¹¹⁵

A company can also reduce its issued capital by the redemption or repurchase of shares under separate provisions,¹¹⁶ but under the present heading I deal only with formal reductions of capital.

A reduction is subject to the articles of association¹¹⁷ and must be approved by special resolution.¹¹⁸ Although a reduction can be made 'in any way',¹¹⁹ CA 1985

Continued

include a resolution by the company (s 622(1)), recalculation of the par value of the shares (s 623) and disclosure in a statement of capital (s 627). The rights or obligations of members under the constitution are not affected (s 624). Provision is made for the reduction of capital to accommodate a suitable nominal value in the other currency, s 626. In such a case a redenomination reserve is required, s 628(3). In the case of a public company, public disclosure is required, s 1077 read with s 1078(3). See also *Mayson, French & Ryan on Company Law* 6.1.12.5.

¹¹¹ See s 75(1)(i) of the South African Companies Act and Chapter 5 paragraph 2.5.

¹¹² CA 1985 s 121 provides only for consolidation or subdivision, and for conversion and reconversion between shares and stock.

¹¹³ See *Palmer's Company Law* 6.029.

¹¹⁴ CA 1985 ss 135 – 141. CA 2006 s 641(1). See *Gower & Davies' Company Law* 7 ed 242ff. This is discussed in paragraph 2.6.1 below.

¹¹⁵ CA 2006 ss 642 – 644. This procedure is discussed in paragraph 2.6.2 below.

¹¹⁶ These are discussed in paragraphs 6 and 6.8 below. CA 1985 s 160(4); CA 2006 617(5) provide that redemptions and repurchases are not regarded as reductions of capital for purposes of the formal reduction of capital provisions.

¹¹⁷ CA 1985 s 135(1); CA 2006 s 641(6).

¹¹⁸ CA 1985 s 135(1); CA 2006 s 641(1)(b).

sets out three distinct examples, namely:

- reducing or extinguishing the amount of any uncalled liability on shares¹²⁰
- cancelling any paid up share capital which is lost or unrepresented by available assets,¹²¹ either with or without extinguishing or reducing liability on any of its shares¹²²
- paying off any paid up share capital in excess of the company's needs, either with or without extinguishing or reducing liability on any of its shares.

Under CA 1985 the memorandum may have to be amended to reduce the amount of authorised share capital and shares.¹²³ An amendment is not required where the share premium account or capital redemption reserve fund is reduced.¹²⁴ Companies often use the reduction procedure to reduce their share premium accounts.¹²⁵ Under CA 2006, a statement of capital must be filed in which the effect of the reduction on share capital is set out.¹²⁶

Where a reduction of capital will amount to a variation of class rights, the company must also comply with the procedure applicable to such variations.¹²⁷

Continued

¹¹⁹ CA 1985 s 135(1); CA 2006 s 641(3). See *Poole v National Bank of China Ltd* [1907] AC 229 HL. See also *Re Elders IXL Ltd* (1984) 9 ACLR 280 SC (SA) where shares held by subsidiaries were cancelled without compensation.

¹²⁰ CA 1985 s 135(2)(a). *Gower & Davies' Company Law* 7 ed 234 points out that partly paid shares are seldom used and consequently uncalled capital seldom exists. Even uncalled capital which can only be called up in the event of a liquidation, may be reduced. CA 2006 s 641(4)(a) refers to 'unpaid amounts'.

¹²¹ CA 1985 s 135(2)(b); CA 2006 s 641(4)(b)(i). Strictly speaking share capital cannot be 'lost' but the courts regard it as lost if the value of the company's net assets fall below the value of the share capital including statutory reserves, see *Gower & Davies' Company Law* 7 ed 242.

¹²² CA 1985 s 135(2)(c); CA 2006 s 641(4)(b)(ii).

¹²³ CA 1985 s 135(2). This is not required under CA 2006.

¹²⁴ See *Gower & Davies' Company Law* 7 ed 243.

¹²⁵ *Boyle & Birds' Company Law* 229 – 230. See *Re Ratners Group plc* (1988) 4 BCC 293; *Re Thorn EMI plc* (1988) 4 BCC 698. See also *Re Vavasour Pacific Ltd* [1977] 1 NSWLR 86 SC (NSW). As regards the limitations on the use of the share premium account, see paragraph 2.4 above.

¹²⁶ CA 2006 s 644(2). The statement of capital is registered together with the reduction order, s 649.

¹²⁷ CA 1985 s 125; CA 2006 s 630.

2.6.1 *Capital reduction subject to court confirmation*

Except in the case of the new reduction procedure available to private companies, application should be made for confirmation by the court once the special resolution has been passed.¹²⁸ The court has to take into account the interests of creditors and of shareholders. The rights of creditors are expressly set out in the statutory provisions and will be discussed first.¹²⁹ Shareholder protection is left to the discretion of the courts. I discuss creditor rights first.

Where existing creditors of the company are affected, all creditors have to be notified¹³⁰ and given the opportunity to object against the proposed reduction, unless a sum of money sufficient to pay all creditors has been set aside or guaranteed by a bank or insurance company.¹³¹ The court can also order the company to follow the notification and objection procedure in any case where any liability in respect of unpaid share capital is reduced or when any paid up capital will be paid to any shareholder.¹³²

The court can confirm the reduction if it is satisfied that every existing creditor has consented or that her debt has been discharged or secured. The court may also impose other terms and conditions.¹³³ The court has the power to dispense with the creditor protection provisions if it is proper to do so in the special circumstances of

¹²⁸ CA 1985 s 136; CA 2006 s 645. According to *Gower & Davies' Company Law* 7 ed 243 – 244 the purpose of requiring court confirmation is to ensure strict compliance with the formalities and fair treatment of shareholders. The court must take into account three principles: fair treatment of shareholders, proper disclosure and explanation to shareholders so that they could exercise an informed judgment on the proposals and lastly, safeguards to creditors.

¹²⁹ See also *Gore-Browne on Companies* 64[18] on the creditor protection measures.

¹³⁰ See CA 1985 s 136(4); CA 2006 s 646 regarding compilation of the list of creditors.

¹³¹ CA 1985 s136(3) – (5); CA 2006 s 646(1) – (2).

¹³² CA 1985 s 136; CA 2006 s 646.

¹³³ CA 1985 s 137(1); CA 2006 s 648(3). CA 1985 s 137(2) provides that the court may order the company to add the words “and reduced” at the end of its name, but *Gower & Davies' Company Law* 7 ed 243 note 12 explains that this is seldom resorted to in practice. However, CA 2006 retains this in s 648(4). In the event of a reduction based on an alleged ‘loss’ of capital, the conditions that may be imposed include the creation of a non-distributable reduction reserve, as was done in *Re Jupiter House Investments Ltd* [1985] 1 WLR 975 because the loss of capital was likely to be temporary. However, in *Re Grosvenor Press plc* [1985] 1 WLR 980 the court declined to order such a reserve in similar circumstances. See also *Gore-Browne on Companies* 26[9].

the case.¹³⁴

A creditor who was unaware of the reduction and who is subsequently not paid when the company goes into insolvent liquidation may apply to the court to hold liable members who benefited from the reduction.¹³⁵

The protection of shareholders in a capital reduction has enjoyed considerable attention by the courts. The basic points of departure are that the reduction must be fair and equitable between classes, must affect all shares of the same class in a similar manner, and that shareholders should be informed properly to enable them to make an informed decision.¹³⁶

In taking into account the rights of different classes of shareholders, their relative rights to a return of capital on winding-up are of prime importance.¹³⁷ The reduction should simulate a result that gives effect to these rights, which means that a return of excess capital should give preference to shares with a priority to the return of capital.¹³⁸ When capital has been lost, the reduction should usually affect the ordinary shares.¹³⁹

Shareholders of the same class are entitled to equitable treatment,¹⁴⁰ although disproportionate reductions are allowed in exceptional circumstances.¹⁴¹ Proper

¹³⁴ CA 1985 s 136(6); CA 2006 s 645(3). The Company Law Review proposed that it should be made clear that the court's power to dispense with the creditor protection provisions would depend on the availability of sufficient assets, see *The Strategic Framework* URN 99/654 (February 1999) par 5.4.5. The draft clause proposed by the Company Law Review states that the court can confirm the reduction even though creditors have not consented to it or had their claims secured where the court thinks these safeguards are 'unnecessary in view of the assets the company would have after the reduction', see draft clause 61(3)(c) in the draft Companies Bill accompanying the White Paper *Modernising Company Law* Cm 5553-I and II (July 2002). See *Gower & Davies' Company Law* 7 ed 244. However, CA 2006 s 645(3) is a simple re-enactment of CA 1985 s 136(6).

¹³⁵ CA 1985 s 140; CA 2006 s 653.

¹³⁶ See *Boyle & Birds' Company Law* 230.

¹³⁷ See *Bannatyne v Direct Spanish Telegraph Co* (1887) 34 Ch D 287 (CA) at 300.

¹³⁸ See *House of Fraser plc v ACGE Investments* [1987] AC 387 (HL).

¹³⁹ *Poole v National Bank of China Ltd* [1907] AC 229 (HL).

¹⁴⁰ *Re Jupiter House Investments Ltd* [1985] WLR 975 at 978; *Re Grosvenor Press plc* [1985] BCLC 286 at 290 – 291; *Re Ratners Group plc* (1988) 4 BCC 293 at 295; *Re Thorn EMI plc* (1988) 4 BCC 698 at 701.

¹⁴¹ *Re Robert Stephen Holdings Ltd* [1968] WLR 1 522; *Re Holders Investment Trust Ltd* [1971] 1 WLR 583. However, Telfer & Mitchell "Reductions of Capital" 249 argue that these judgments

disclosure is also extremely important, as the right to reduce capital is dependent on the approval of shareholders by special resolution.¹⁴²

The reduction becomes effective from the date of registration of the confirming order.¹⁴³ Notice of the capital reduction must be published in the prescribed manner.¹⁴⁴

When the share capital of a public company is reduced to an amount below the minimum allotted capital, the reduction order will not be registered until the company has reregistered as a private company, or unless the court has directed otherwise.¹⁴⁵

These provisions bear some similarity to the old capital reduction procedure in the South African Companies Act, which was abolished when the new capital rules came into force.¹⁴⁶ However, it is not possible to reduce share capital without court intervention, as was possible under the now repealed section 84 of the South African Companies Act.

2.6.2 Alternative reduction procedure for private companies

One of the points of criticism of the Company Law Review was that the requirement of court confirmation in all cases was too onerous and overprotected creditors to the disadvantage of the company. Upon a reduction, creditors can effectively force the company to settle or secure its debts, placing them in a better position than they

Continued

are based on an incorrect interpretation of earlier English cases and that a court cannot sanction a reduction of capital in violation of class consent provisions in the articles (257).

¹⁴² *Re Ransomes plc* [1999] 1 BCLC 775 and [1999] 2 BCLC 591 (CA) at 599 – 600.

¹⁴³ CA 1985 s 138; CA 2006 s 649(3)(b). The statement of capital is registered simultaneously.

¹⁴⁴ CA 1985 s 138; CA 2006 s 649(4).

¹⁴⁵ CA 1985 s 139; CA 2006 s 650. Section 651 of CA 2006 provides for an expedited re-registration as a private company which dispenses with the requirement of a special resolution and is incorporated in the court order. As to when the court would allow a reduction despite the fact that the capital of a public company will fall below the minimum, it appears that this would be possible if the deficiency is merely temporary. See *Re Anglo-American Insurance Co Ltd* [1989] BCLC 672; *Re Anglo-American Insurance Co Ltd* [1991] BCLC 564 where the capital was to be increased immediately afterwards.

¹⁴⁶ See Chapter 5 paragraph 2.6.1.

were before the reduction.¹⁴⁷

The Company Law Review proposed an alternative capital reduction procedure. While the existing reduction subject to confirmation by the court would be retained because of the certainty it provides to the company, the alternative procedure would require a special resolution and a solvency statement by the directors.¹⁴⁸ At the same time, the Company Law Review proposed that private companies should no longer be able to repurchase or redeem their shares out of capital, as they would instead be able to achieve a similar result by reducing their share capital under the new provision.¹⁴⁹ Section 642 of CA 2006 now provides for the 'reduction of share capital supported by solvency statement'. This procedure is available to private companies only.¹⁵⁰ However, CA 2006 has retained share repurchases out of capital.¹⁵¹

The solvency statement must state that the company will be able to pay its debts immediately after making payment, and will be able to continue carrying on business as a going concern in the year following payment.¹⁵²

The content, form and timing of the solvency statement must comply with minimum standards.¹⁵³ Each director must agree to the statement.¹⁵⁴ Directors commit an offence if they sign such a statement without having reasonable grounds

¹⁴⁷ *The Strategic Framework* URN 99/654 (February 1999) par 5.4.5.

¹⁴⁸ *The Strategic Framework* URN 99/654 (February 1999) par 5.4.5.

¹⁴⁹ They will reduce capital and return the money to shareholders and be able to repurchase further shares out of surplus (which will have been increased by the fact that the capital will have been reduced).

¹⁵⁰ CA2006 s 642(1) read with s 641(1)(a). The Company Law Review considered making this option available to public companies too, subject to notification of creditors and the preservation of their right, entrenched through the Second Company Law Directive, to object to the court, see draft clause 56. This idea did not materialise in CA 2006.

¹⁵¹ CA 2006 s 692 allows private companies to repurchase and redeem their shares out of capital in accordance with ss 709 – 723. See paragraph 6.2.2 below.

¹⁵² CA 2006 s 643(1).

¹⁵³ CA 2006 s 643. The content of the solvency statement is discussed in paragraph 6.2.2 below.

¹⁵⁴ CA 2006 s 643(1) introductory sentence. See also *Re In A Flap Envelope Co Ltd* [2004] 1 BCLC 64, dealing with the substantially similar requirement under CA 1985 s 155 for financial assistance. In this matter it was held that a statement did not comply with the requirements because one of the directors had formally resigned from office in order to avoid having to sign it.

for the opinion expressed in it.¹⁵⁵ As the reduction will be void if the requirements have not been met, the shareholders will have to return any payments they received.¹⁵⁶

It can be expected that the principles on fair treatment of shareholders as formulated by the courts will have to be adhered to.¹⁵⁷

In view of the similar effect of the two procedures, also evidenced by the Company Law Review's initial intention to replace the one with the other, this procedure must be compared to that pertaining to share repurchases out of capital. It is best to do this after the discussion of the repurchase of shares out of capital.¹⁵⁸

2.7 Serious loss of capital

In conformity with the Second Company Law Directive,¹⁵⁹ a public company must hold an extraordinary general meeting if its net assets are worth half or less than half of the amount of its called-up share capital.¹⁶⁰ The heading of the section refers to a 'serious loss of capital'. The directors must convene such a meeting within 28 days of any director having become aware of the situation.¹⁶¹ The meeting must take place within 56 days of the day on which a director first became aware of the situation.¹⁶² The purpose of the meeting is to consider which steps, if any, should be taken to deal with the state of affairs.¹⁶³ A director who knowingly and willfully authorises a failure to convene a meeting or the continuation of such a failure is

¹⁵⁵ CA 2006 s 643(4).

¹⁵⁶ See *Palmer's Annotated Guide* 507.

¹⁵⁷ See paragraph 2.6.1 above.

¹⁵⁸ See paragraph 6.3.1.5 below.

¹⁵⁹ Article 17.

¹⁶⁰ CA 1985 s 142; CA 2006 s 656.

¹⁶¹ CA 1985 s 142(1); CA 2006 s 656(2).

¹⁶² CA 1985 s 142(1); CA 2005 s 656(3).

¹⁶³ CA 1985 s 142(1); CA 2006 s 656(1). CA 1985 s 142(3) expressly states that only matters relating to the situation may be considered at the meeting. CA 2006 s 656(6) states that the provision does not allow the consideration at the meeting of matters that may not otherwise have been considered at the meeting.

liable to a fine.¹⁶⁴

The term 'called-up capital' used in this provision refers to all amounts paid up on shares, including amounts paid in advance of calls or instalments, as well as all amounts that have been called up, regardless of whether or not payment has been received, as well as all amounts that are payable under installments.¹⁶⁵ Called-up capital does not include amounts paid or payable in respect of premiums.

This provision confirms by implication that the share capital of a company need not be represented by assets and that it can be lost in the course of trade. It also shows that a company need not take any positive steps to end the situation, for example through a formal reduction of capital or a winding up. The insistence on a meeting rather than on any positive steps to correct the discrepancy between assets and capital has been criticised.¹⁶⁶ The provision is apparently not important in practice because other considerations will usually force the directors to take appropriate steps at an earlier stage.¹⁶⁷

However, the idea that the share capital of a public company must be represented by assets, or more accurately, that the net assets must equal or exceed the called-up share capital plus undistributable reserves finds expression in two other provisions of the Act. First, it is a prerequisite for the conversion of a private company into a public company that the value of its assets must be at least equal to its called-up capital plus reserves.¹⁶⁸ Secondly, it is part of the financial limitations on distributions by public companies.¹⁶⁹

¹⁶⁴ CA 1985 s 142(2); CA 2006 s 656 (4) – (5).

¹⁶⁵ See *Palmer's Company Law* 4.005; CA 2006 s 547.

¹⁶⁶ *Gower & Davies' Company Law* 7 ed 230.

¹⁶⁷ *Gower & Davies' Company Law* 7 ed 230.

¹⁶⁸ CA 1985 s 43(3)(b); CA 2006 s 92(1)(c). See *Palmer's Company Law* 2.208; *Mayson, French & Ryan on Company Law* 6.6.2.

¹⁶⁹ CA 1985 s 264(1)(a); CA 2006 s 831. The financial limitations for distributions are discussed in paragraph 5.2 below.

3 CAPITAL CONTRIBUTIONS

3.1 Size of the capital contribution

The minimum consideration must be at least equal to the par value of a share. The no discount rule was established in *Ooregum Gold Mining Co v Roper*¹⁷⁰ and is confirmed by legislation,¹⁷¹ which in addition expressly imposes liability on an allottee to pay the amount of any discount with interest.¹⁷² Subsequent holders of the shares issued at a discount are liable jointly and severally unless they acquired them for value and had no knowledge of the contravention.¹⁷³

The prohibition against discount on shares is fortified by a prohibition on the payment of any commission, discount or allowance out of share capital in consideration for subscribing or procuring subscriptions for shares.¹⁷⁴ Underwriters' commission is allowed, but limited to ten per cent of the issue price of the shares.¹⁷⁵ Underwriters' commission may be provided for out of the company's share premium account.¹⁷⁶

The position with regard to commissions is similar to the South African position.¹⁷⁷ However, although the South African provision allowing the issue of shares subject to court confirmation¹⁷⁸ is based on an English example,¹⁷⁹ the

¹⁷⁰ [1892] AC 125 HL.

¹⁷¹ CA 1985 s 100; CA 2006 s 580(1).

¹⁷² CA 1985 s 100; CA 2006 s 580(2). Directors are also liable for breach of their duty, see *Hirsche v Sims* [1894] AC 654 PC. See also *Gore-Browne on Companies* 24-3.

¹⁷³ CA 1985 s 112(1), (3); CA 2006 s 588(1) – (2). See CA 1985 s 113; CA 2006 s 589 for the power of the court to grant relief. See also *Gower & Davies' Company Law* 7 ed 233 and 288 – 289.

¹⁷⁴ CA 1985 s 98(1); CA 2006 s 552(1). CA 1985 s 98(2); CA 2005 s 552(2) extends the prohibition to disguised payments made by methods such as increasing a contract sum due by the company in respect of goods or services acquired by it.

¹⁷⁵ CA 1985 s 97; CA 2006 s 553. A company's articles can determine a lower percentage of commission. The articles of the company must allow the paying of such commission, see CA 1985 s 97(2); CA 2006 s 553(2).

¹⁷⁶ CA 1985 s 130(2)(b); CA 2006 s 610(2). See also paragraph 2.4 above.

¹⁷⁷ See Chapter 5 paragraph 3.6.

¹⁷⁸ See Chapter 5 paragraph 3.1.1.

English exception was repealed because of the implementation of the Second Company Law Directive.¹⁸⁰

Although the Company Law Review undertook to reconsider instances where the requirements of the Second Company Law Directive had been extended to private companies,¹⁸¹ it seems that no proposals were made in this regard.¹⁸² This could be due to the fact that consideration was given to abolishing par value shares for private companies,¹⁸³ which would have avoided the discount problem altogether.¹⁸⁴

3.2 Form of capital contribution

Consideration for shares of a private company can be paid up in money or money's worth, including goodwill and know-how.¹⁸⁵ However, a company may not agree in advance to accept non-cash consideration against future calls.¹⁸⁶ When a private company accepts non-cash consideration, a copy of the contract or particulars of it must accompany the return of allotments.¹⁸⁷ However, unless the inadequacy of the non-cash consideration appears *ex facie* the transaction, or the parties have acted in bad faith, the valuation placed upon the goods by the parties will be conclusive.¹⁸⁸

Continued

¹⁷⁹ A statutory exception to the no discount rule was first introduced as s 47 of the English Companies Act 1929 (19 & 20 Geo 5, c 23), see also the *Company Law Amendment Committee Report* Cmd 2567 (1925 – 1926) (Greene Committee) paragraph 19.

¹⁸⁰ See Schedule 4 of the Companies Act 1980 (c 22) which repealed s 57 of the Companies Act 1948 (11 & 12 Geo 6, c 38). Article 8(1) of the Second Company Law Directive provides that public companies may not issue shares at a discount.

¹⁸¹ *Company Formation and Capital Maintenance* URN 99/1144 (October 1999) par 3.4.

¹⁸² See *Company Law Review: Completing the Structure* URN 00/1335 (November 2000) par 7.4, where it is merely stated that the retention of par value shares implies that the current regulation of discounts and commissions should remain in place.

¹⁸³ See *The Strategic Framework* URN 99/654 (February 1999) pars 5.4.26 – 5.4.33

¹⁸⁴ An idea that was later abandoned, see *Company Law Review: Completing the Structure* URN 00/1335 (November 2000) par 7.3.

¹⁸⁵ CA 1985 s 99(1); CA 2006 s 582(1).

¹⁸⁶ *Re Wragg Ltd* [1897] 1 Ch 796 CA at 829. See also *Gore-Browne on Companies* 24-5.

¹⁸⁷ *Gower & Davies' Company Law* 7 ed 235.

The position is similar to that which applies to private and public companies in South Africa.¹⁸⁹

‘Cash’ includes not only cash or a cheque but also an undertaking to pay cash in the future and the release of a liability of the company for a liquidated sum.¹⁹⁰ Under CA 2006 payment by any other means giving rise to a present or future entitlement (of the company or a person acting on the company’s behalf) to a payment or credit equivalent to payment, in cash also qualifies as cash consideration.¹⁹¹ The payment of cash to any person other than the company, or an undertaking so to pay, is non-cash consideration.¹⁹²

As required by the Second Company Law Directive¹⁹³ public companies may not accept future services as consideration for shares in respect of either their nominal value or any premium.¹⁹⁴ Any sort of undertaking that need not be performed within five years from the date of allotment is also unacceptable.¹⁹⁵ However, should a company nevertheless accept as consideration future services or a long-term undertaking, the allotment will be valid, and the holder of the shares will be liable to pay to the company the nominal value or such part of it as is shown to be paid up, plus the premium.¹⁹⁶

Continued

¹⁸⁸ *Re Wragg* [1897] 1 Ch 796 CA; *Park Business Interiors Ltd v Park* [1992] BCLC 1034. See *Gower & Davies’ Company Law* 7 ed 234 – 235 and *Gore-Browne on Companies* 24-4 – 24-5 and cases referred to in note 8. See also Giugni “Consideration” 380 – 381 for a critical discussion of *Re Wragg* [1897] 1 Ch 796 CA.

¹⁸⁹ Except that in South Africa the full consideration has to be received by the company before issue of the shares. See Chapter 5 paragraph 3.4.

¹⁹⁰ CA 1985 s 738(2); CA 2006 s 583(3). According to *Gower & Davies’ Company Law* 7 ed 235 this facilitates debt for equity swaps. See *System Controls plc v Munro Corporate plc* [1990] BCLC 659 on the meaning of non-cash consideration and the consequences of non-compliance with the formalities.

¹⁹¹ CA 2006 s 583(3)(e).

¹⁹² CA 1985 s 738(3); CA 2006 s 583(5).

¹⁹³ Article 7.

¹⁹⁴ CA 1985 s 99(2); CA 2006 s 585(1).

¹⁹⁵ CA 1985 s 102(1); CA 2006, s 587(1). However, because an undertaking to pay cash in the future is still regarded as payment in cash, it is not subject to a similar time limit. *Gower & Davies’ Company Law* 7 ed 235 – 236 points out that this increases the risk posed by insolvency of the allottee. See also *Gore-Browne on Companies* 24-2.

¹⁹⁶ CA 1985 s 99(3) and s 102(2); CA 2006 s 585(2) and s 587(2). See paragraph 3.4 below for a discussion of the consequences should performance not be rendered within the five year period.

In a public company, a subscriber to the memorandum must pay in cash for shares taken up in pursuance of the undertaking in the memorandum.¹⁹⁷ However, this provision has little impact since in practice almost all public companies are formed through the conversion of private companies.¹⁹⁸

The paying up, from available funds of the company, of bonus shares or of amounts unpaid on shares, is expressly allowed as an exception to the rule that shares must be paid up.¹⁹⁹

3.3 The regulation of non-cash capital contributions

The regulation of non-cash consideration depends on whether the company is a private or a public company. 'Cash' is defined as including an undertaking to pay cash in the future or the release of a liability of the company for a liquidated sum.²⁰⁰ Stringent requirements apply to the valuation of non-cash consideration accepted by public companies, dictated by the Second Company Law Directive.²⁰¹ The integrity of the initial share capital of public companies is further protected by an anti-avoidance measure in terms of which certain non-cash transactions shortly after formation of the company are subjected to scrutiny.²⁰²

With regard to private companies accepting non-cash consideration for shares, CA 1985 requires that a copy of the contract or written particulars of it accompany the return of allotments.²⁰³ This disclosure requirement is similar to that which applies to allotment for non-cash consideration in South Africa.²⁰⁴ However,

¹⁹⁷ CA 1985 s 106; CA 2006 s 584.

¹⁹⁸ See *Gower & Davies' Company Law* 7 ed 236; *Buckley Companies Act* [106.6]. Even if a company is incorporated as a public company this requirement is easy to meet because the requirement will be satisfied provided the subscribers agree to take up one share each.

¹⁹⁹ CA 1985 s 99(4); CA 2006 s 582(2).

²⁰⁰ CA 1985 s 738(2); CA 2006 s 583(3).

²⁰¹ Article 10.

²⁰² CA 1985 s 104; CA 2006 s 598.

²⁰³ CA 1985 s 88(2). According to *Gower & Davies' Company Law* 7 ed 235 the provision is more for the benefit of the tax authorities than for shareholders and creditors.

²⁰⁴ See Chapter 5 paragraph 3.3.

CA 2006 does away with this requirement.²⁰⁵

In the case of a public company, valuation by an independent valuator is required in addition to disclosure of particulars of the contract.²⁰⁶ The valuation requirement applies regardless of whether the shares are fully or partly paid up. It does not matter whether the non-cash consideration is given in respect of the par value of the share or in respect of the premium. An independent valuator must be a person who qualifies to be the auditor of the company.²⁰⁷ The valuation must be made during the six months immediately preceding the allotment²⁰⁸ and a copy of the report must be sent to the proposed allottee.²⁰⁹ The valuator must confirm that the consideration is equal in value to the nominal value that will be reflected as paid up, plus the full amount of any premium.²¹⁰ A copy of the report must be lodged with the Registrar of Companies for registration.²¹¹ If the allottee has not received a copy of the valuation certificate or if there has been another contravention of the provisions that the allottee was or should have been aware of, she becomes liable to pay the consideration in cash, with interest.²¹² However, the court has the power to grant relief for non-compliance with these requirements.²¹³

²⁰⁵ CA 2006 s 555, which is the successor to CA 1985 s 88, requires a return of allotments but does not mention a copy of a contract for non-cash consideration.

²⁰⁶ CA 1985 s 103; CA 2006 s 593. See also *Gore-Browne on Companies* 24-3.

²⁰⁷ CA 1985 s 108(1); CA 2006 ss 1150 – 1153.

²⁰⁸ CA 1985 s 103(1)(b); CA 2006 s 593(1)(b). This provision applies to the initial allotment only. If at a later stage non-cash consideration is agreed on in respect of a call made, no valuation is apparently required.

²⁰⁹ CA 1985 s 103(1)(c); CA 2006 593(1)(c).

²¹⁰ CA 1985 s 108(6); CA 2006 596(3). The report must state the nominal value of the shares to be wholly or partly paid for by the non-cash consideration, the amount of the premium payable, the description of the consideration and of the part of it valued by the valuator personally, the extent to which the nominal value and any premium will be treated as paid up on allotment by the non-cash consideration and in cash. The report must also state that the method of valuation was reasonable in the circumstances, that there has been no material change in the value of the consideration since valuation and lastly that the non-cash consideration together with any cash consideration is equal in value to the nominal value and premium treated as paid up. It is not required that the value of the consideration should be stated, see *Mayson, French & Ryan on Company Law* 6.5.4.

²¹¹ CA 1985 s 111(1); CA 2006 s 597(1) – (2).

²¹² CA 1985 s 103(6); CA 593(3). See *Re Bradford Investments plc (No 2)* [1991] BCLC 688.

²¹³ CA 1985 s 113; CA 2006 s 606. See *Re Ossory Estates plc* [1988] BCLC 213 where the court granted relief under CA 113(3) for non-compliance with the valuation procedure on the basis

No valuation is required in respect of bonus issues.²¹⁴ Exceptions also apply in relation to takeovers, mergers and arrangements.²¹⁵

In public companies, creditors and shareholders also enjoy protection with regard to certain non-cash transactions during the 'initial period'.²¹⁶ The initial period is the two years from the date on which the company is first allowed to trade. The provision targets transactions that may adversely affect the financial position of the company, including the evasion of the valuation requirements for non-cash allotments through a splitting of transactions.²¹⁷ It applies when a company enters into a transaction in terms of which the subscriber (or member) will transfer to it a non-cash asset and the price payable by the company, in cash or kind, is equal to at least ten per cent of the company's nominal issued capital at the time of the transaction. An independent valuator must value the non-cash consideration to be received by the company as well as any non-cash consideration to be given by it.²¹⁸ The report must be made within the six months immediately preceding the agreement. The terms of the agreement also have to be approved by ordinary resolution.²¹⁹ All the members and the other party must receive a copy of the report.²²⁰ A copy of the resolution and the valuer's report must be lodged with the registrar.²²¹

Should these requirements not be met, the agreement will be void and the

Continued

that the company had indeed received money's worth. This judgment is noted by Birds "Valuation" 67 – 68.

²¹⁴ CA 1985 s 103(2); CA 2006 s 593(2). A bonus or capitalisation issue is a way of converting reserves into capital and the amount applied is not regarded as consideration.

²¹⁵ CA 1985 s 103(3) – (5); CA 2006 s 593(4).

²¹⁶ The term 'initial period' is defined in CA 1985 s 104(2); CA 2006 s 598(2).

²¹⁷ CA 1985 s 104; CA 2006 s 598. This provision is necessary in order to comply with article 11 of the Second Company Law Directive. In terms of CA 1985 s 104(3); CA 2006 s 603 this procedure is also applicable to transactions between private companies converted to public companies and their members as at date of conversion.

²¹⁸ CA 1985 s 109; CA 2006 s 599.

²¹⁹ CA 1985 s 104(4); CA 2006 s 601.

²²⁰ CA 1985 s 104(4)d); CA 2006 s 599(1)(c).

²²¹ CA 1985 s 111(2); CA 2006 s 602.

company will be able to recover any consideration given by it.²²² If shares were to be allotted under the agreement, the allotment will be valid but the allottee will be personally liable for the consideration plus interest.²²³

3.4 Timing of capital contribution

Shares issued by private companies need not be paid up to any extent at the time of allotment. The full consideration can be made payable in the future. A public company, however, may not allot a share until at least one-quarter of its nominal value as well as the whole of any premium has been paid up.²²⁴

I explained that a public company may accept as consideration undertakings to be performed within five years.²²⁵ If performance has not taken place within that time, payment in cash becomes due immediately.²²⁶

When shares are not fully paid upon being issued, the shareholder is liable to pay the outstanding consideration in accordance with the articles of association.²²⁷ The voting, dividend and other rights attaching to shares that are not fully paid will be in accordance with the articles of association.²²⁸ Should a call remain unpaid, the shares may be forfeited to the company if the articles so provide.²²⁹

It is possible under CA 1985 for a limited company to adopt a special resolution to the effect that it will not call up its uncalled capital except in a winding up.²³⁰ This

²²² CA 1985 s 105(2); CA 2006 s 604(2).

²²³ CA 1985 s 105(3); CA 2006 s 604(3).

²²⁴ CA 1985 s 101(1); CA 2006 s 586(1); (2). This rule is required by article 26 of the Second Company Law Directive. There is an exception with regard to employee share schemes, see CA 1985 s 101(2); CA 586(2). See also *Gore-Browne on Companies* 3-1.

²²⁵ See paragraph 3.2 above.

²²⁶ CA 1985 s 102(5) – (6); CA 2006 s 587(4).

²²⁷ See *Palmer's Company Law* 6.202 for a discussion of common provisions in company articles.

²²⁸ CA 1985 s 119; CA 2006 s 581(c). See *Palmer's Company Law* 6.207 for a discussion of the model articles and the usual practice in this regard.

²²⁹ The model articles under CA 1985 (Table A) articles 18 – 22 provide for the forfeiture of shares for non-payment of calls. Although the forfeiture of a shares is a reduction of capital, forfeiture for non-payment of calls is not regarded as an acquisition of own shares, CA 1985 s 143(3)(d); CA 2006 s 659(2)(c). See also *Palmer's Company Law* 6.901.

²³⁰ CA 1985 s 120. See also s 124 in respect of guarantee companies with share capital.

is referred to as long-term uncalled capital or reserve liability.²³¹ However, the Company Law Review proposed the deletion of this provision as such capital has become obsolete.²³² Accordingly, CA 2006 does not contain a similar provision, although it does provide for the extinguishing of liability in respect of shares, which constitutes a reduction of capital.²³³

4 DISTRIBUTIONS

The general principle in England is that share capital should be maintained unless the court confirms a reduction of capital. As a result, distributions may be made out of distributable profits only. However, various exceptions qualify this general principle. These exceptions were designed piecemeal and do not apply similarly to similar distributions. Moreover, public and private companies are subject to different regimes.

The term 'distribution' is defined in two separate provisions with different functions. However, under CA 2006 the second of these definitions will fall away, as I explain below.

The first use of the concept 'distribution' is to indicate which payments may be made only out of distributable profits. For purposes of the general regulation of distributions, it means 'every description of distribution of a company's assets to its members, whether in cash or otherwise'.²³⁴ However, the issue of bonus shares, the redemption and repurchase of shares, the reduction of share capital by extinguishing or reducing unpaid consideration or by paying off paid up capital, and any distribution on winding-up are excluded. The term 'distribution' includes both dividends and any other payments to shareholders.²³⁵ This is similar to the definition of 'payment' in section 90 of the South African Companies Act that also excludes

²³¹ *Palmer's Company Law* 4.005.

²³² *Company Formation and Capital Maintenance* URN 99/1144 (October 1999) par 3.16.

²³³ CA 2006 s 641, see also paragraph 2.6 above.

²³⁴ CA 1985 s 263(2); CA 2006 s 829.

²³⁵ See *Aveling Barford Ltd v Perion Ltd* [1989] BCLC 626 where the sale of a company asset to another company controlled by a shareholder was regarded as a distribution to that shareholder. Also see Calnan "Corporate Gifts" 91 for a discussion of this judgment.

repurchases and redemptions.²³⁶

The second use relates to the determination of the concept 'permissible capital payment'. This concept is relevant when a private company repurchases or redeems its shares out of capital. Here CA 1985 extends the meaning of distribution to include payments for repurchases and redemptions out of distributable profits,²³⁷ certain other payments pertaining to repurchase contracts,²³⁸ and financial assistance given out of distributable profits.²³⁹ Although this definition appears to cover every kind of distribution, it is not a general definition identifying transactions subject to specific financial limitations. Its function is to limit the extent to which a private company may acquire its own shares out of capital.²⁴⁰ CA 2006 achieves the same result of including these other payments but, instead of extending the meaning of 'distribution' it refers to 'other relevant payment lawfully made' and then lists the three instances.²⁴¹

The approach to distributions in the wider sense remains fragmented. However, all distributions still comply with the capital maintenance doctrine because they are made either out of distributable profits or, if out of capital, accompanied by appropriate adjustments to share capital which are similar to capital reductions.

5 DIVIDENDS AND OTHER PAYMENTS TO SHAREHOLDERS

The common-law rule that dividends may not be paid out of capital which gradually came to mean that dividends could be paid out of 'profits' as determined under permissive standards²⁴² has to a large degree been superseded by statutory

²³⁶ See Chapter 5 paragraph 5.1.

²³⁷ CA 1985 s 172(5)(b).

²³⁸ CA 1985 s 172(5)(c).

²³⁹ CA 1985 s 172(5)(a).

²⁴⁰ See paragraph 6.2.2 below for a discussion of such acquisitions out of capital.

²⁴¹ CA 2006 s 712(3) – (4).

²⁴² See *Guinness v Land Corporation of Ireland* (1883) 22 ChD 349 CA (356); *Re Exchange Banking Co, Flitcroft's Case* 918820 21 ChD 591. See Chapter 1 paragraph 2 for a brief overview of the gradual erosion of the rule, based on the courts' interpretation of 'profits'.

rules.²⁴³ The 1980 Companies Act (c 22), implementing the Second Company Law Directive, first introduced these rules in England. Whilst it was not mandatory to tighten the rules for private companies, this was done simultaneously.²⁴⁴ The statutory exposition of what constitutes permissible distributions has aligned the law with good commercial practice.²⁴⁵

However, the more restrictive common-law rules still guard against the unlawful reduction of capital, usually through transactions that are not in the nature of ordinary dividends.²⁴⁶ The common law is very relevant in the interpretation of the concept 'distribution', given that the statutory definition refers to every 'description of distribution'.²⁴⁷

The statutory dispensation prohibits the making of distributions otherwise than out of 'profits available for the purpose' as determined by the Act.²⁴⁸ Distributable profits represent the excess of net assets over the company's share capital and non-distributable reserves.

With regard to the determination of distributable profits, public companies are subject to stricter requirements than private companies. The main substantive difference is the net assets restriction applicable to public companies which in effect requires it to take into account unrealised losses.²⁴⁹

Special rules apply to investment companies, but I do not consider these in this thesis.²⁵⁰

²⁴³ These are set out in CA 1985 Part VII; CA 2006 Part 23. See *Gore-Browne on Companies* 25[1]. Section 281 clearly retains more restrictive common law rules. *Gower & Davies' Company Law* 7 ed 287 states that the Company Law Review has proposed to make the statutory rule exclusive, overriding the common law rule. However, CA 2006 s 851 expressly retains the common law (except in relation to the exceptions in s 845 and s 846 dealing with intra-group transactions).

²⁴⁴ See *Gower & Davies' Company Law* 7 ed 275.

²⁴⁵ *Gore-Browne on Companies* 25[2].

²⁴⁶ See *Gower & Davies' Company Law* 7 ed 279 – 280 and the discussion in paragraph 5.1 below.

²⁴⁷ The definition is discussed in paragraph 5.1 below.

²⁴⁸ CA 1985 s 263(1); CA 2006 s 830(1). See paragraph 5.2 below.

²⁴⁹ CA 1985 s 264; CA 2006 s 831, discussed in paragraph 5.2 below.

²⁵⁰ CA 1985 ss 265 – 266; CA 2006 ss 832 – 835, see *Gore-Browne on Companies* 25[2].

5.1 Kinds of payments regulated

A distribution is defined²⁵¹ as ‘every description of distribution of a company’s assets to its members whether in cash or otherwise’, but certain transactions are then excluded, either because they are not distributions in the normal sense of the word, or because they are regulated in other provisions.

The exceptions are:

- the issue of fully or partly paid bonus shares²⁵²
- the redemption or purchase of any of the company’s own shares out of capital (including the proceeds of any fresh issue of shares) or out of unrealised profits²⁵³
- the reduction of share capital by extinguishing or reducing the liability of any of the members on any of its shares in respect of share capital not paid up or by paying off paid up share capital²⁵⁴
- the distribution of assets to members of the company on its winding-up.²⁵⁵

There is a difference between CA 1985 and CA 2006 in the wording of the introductory part of the list of exceptions.²⁵⁶ CA 1985 terms the exceptions ‘distributions’, which may imply that they are regarded as distributions to begin with. Clearly, this is not the case with bonus shares, as shares are not assets in the hands of the company.²⁵⁷ CA 2006 is more accurate in this regard by merely providing that certain instances are not distributions for purposes of the relevant part of the Act.²⁵⁸

The notion of a distribution clearly includes, but is wider than, the regular

²⁵¹ CA 1985 s 263(2); CA 2006 s 829(1).

²⁵² CA 1985 s 263(2)(a); CA 2006 s 829(2)(a).

²⁵³ CA 1985 s 263(2)(b); CA 2006 s 829(2)(c).

²⁵⁴ CA 1982 s 263(2)(c); CA 2006 s 829(2)(b)(i) – (ii).

²⁵⁵ CA 1985 s 263(2); CA 2006 s 829 (2)(d).

²⁵⁶ CA 1985 s 263(2); CA 2006 s 829(2).

²⁵⁷ The issue of bonus shares is a capitalisation of profits.

²⁵⁸ Part 23, regulating distributions.

dividends declared and paid by the company.²⁵⁹ However, it is not clear to what degree a distribution is wider than a dividend. The courts are prepared to regard the disguised return of capital as a distribution. This is evidenced by the decision in *Aveling Barford Ltd v Perion Ltd*²⁶⁰ where a company that did not have distributable profits transferred an asset to another company, that was controlled by the same shareholder that controlled it, at an undervalue. The court held this to be an unlawful reduction of capital and had no problem ruling that a distribution was made to the controlling shareholder, despite the fact that the payment was not made directly to the shareholder, but to the other company.

In similar vein, the payment of remuneration to directors who were also shareholders of the company can be regarded as a disguised distribution in specific circumstances.²⁶¹

However, there is uncertainty about the payment of interest on advance payments by shareholders in respect of partly paid shares. These are not expressly excluded and while one authority argues that the payment of interest on payments made by a shareholder in advance of calls on partly paid shares would be regarded as a distribution,²⁶² another argues that such interest can be paid even out of capital.²⁶³ Although the payment of interest on payments made by shareholders in advance of calls can be regarded as payments to them in their capacity of creditors, and so is distinguishable from interest payments on certain shares under South African legislation, it is notable that there is similar uncertainty about the inclusion of interest payments under a comparable South African definition.²⁶⁴

²⁵⁹ *Gower & Davies' Company Law* 7 ed 279.

²⁶⁰ [1989] BCLC 626. See also the discussion of the implications of this judgment in Calnan "Corporate Gifts".

²⁶¹ See *MacPherson v European Strategic Bureau* [1999] 2 BCLC 203 (Ch D) and [2000] 2 BCLC 683 (CA) at 702. In this case, however, the remuneration was held to be *bona fide* remuneration. In *Re Halt Garage (1964) Ltd* [1982] 3 All ER 1016 remuneration was held to be a disguised distribution, as no services had in fact been rendered. See also *Barclays Bank plc v British and Commonwealth Holdings plc* [1996] 1 BCLC 1 (CA) on the indirect return of capital.

²⁶² *Gore-Browne on Companies* 25[3].

²⁶³ *Palmer's Company Law* 6.214.

²⁶⁴ The definition of 'payment' in s 90 of the South African Companies Act. This issue is discussed in Chapter 5 paragraphs 5.1.1 and 5.7.

The difficulty lies in the meaning of the phrase ‘to its members’. It is not clear whether, apart from disguised returns of capital, the distribution must be made to a member in the capacity of member or whether the mere fact that a payment is made to a member, albeit in another capacity, like director or creditor, would qualify it as a distribution for purposes of the definition.²⁶⁵ The words ‘every description of distribution’ support the second alternative.²⁶⁶

The Company Law Review recommended that the words ‘or to others at the direction of the members’ should be inserted in the definition to deal with the problem of payments to someone other than the shareholder.²⁶⁷ It also proposed clarification that only payment to members in their capacity as members is included.²⁶⁸ In addition, the Company Law Review recommended that the statutory rule should be exclusive, overriding the common law rule.²⁶⁹ However, CA 2006 expressly retains the common law.²⁷⁰

The South African provision that refers to a ‘direct or indirect’ payment made ‘by reason of shareholding’ addresses both the problems that arose in the *Aveling Barford* case.²⁷¹

While the exclusions to ‘distribution’ are similar to the South African definition of ‘payment’, the latter obviously does not exclude capital reductions, since these are no longer provided for in South Africa. However, liquidation distributions are not excluded under the South African provision and consideration should be given to the need for such exclusion.²⁷²

²⁶⁵ *Gower & Davies’ Company Law* 7 ed 279.

²⁶⁶ See *Gore-Browne on Companies* 25[3].

²⁶⁷ *Company Law Review: Completing the Structure* URN 00/1335 (November 2000) par 7.21.

²⁶⁸ *Company Formation and Capital Maintenance* URN 99/1144 (October 1999) par 3.66; *Modern Company Law for a Competitive Economy: Capital Maintenance: Other Issues* URN 00/880 (June 2000) Part II pars 35 – 36.

²⁶⁹ *Company Formation and Capital Maintenance* URN 99/1144 (October 1999) par 3.66; *Company Law Review: Completing the Structure* URN 00/1335 (November 2000) par 7.21; *Modern Company Law for a Competitive Economy: Capital Maintenance: Other Issues* URN 00/880 (June 2000) Part II pars 37 – 39.

²⁷⁰ Section 851.

²⁷¹ *Aveling Barford Ltd v Perion Ltd* [1989] BCLC 626. See Chapter 5 paragraphs 5.1.1 and 5.1.2.

²⁷² See Chapter 5 paragraphs 4.3, 4.4 and 5.1.3.

5.2 Financial Restrictions

Distributions may be made only out of 'profits available for the purpose'.²⁷³ This rule applies to all companies, but the determination of the available amount depends on whether the company making the distribution is a public or private company or an investment company.²⁷⁴ Public companies in addition have to satisfy a net assets test as a further restriction on the amount that may be distributed.²⁷⁵

5.2.1 Distributable profits

'Profits available for the purpose' are defined as a company's 'accumulated realised profits, so far as not previously utilised by distribution or capitalisation, less its accumulated, realised losses, so far as not previously written off in a reduction or reorganisation of capital duly made'.²⁷⁶ This means that distributions out of unrealised profits or out of current profits without making up losses incurred in previous years,²⁷⁷ possible under the common law, are no longer allowed.²⁷⁸ Capitalisation issues and bonus shares may still be funded from unrealised profits.²⁷⁹

The determination of profits available for distribution must be based on certain items reflected in the company's 'relevant accounts'.²⁸⁰ These items are:

- profits, losses, assets and liabilities
- certain provisions

²⁷³ CA 1985 s 263(1); CA 2006 s 830(1). See paragraph 5.2.1 below.

²⁷⁴ The rules pertaining to investment companies are not considered here. See *Gore-Browne on Companies* 25[12] for a discussion.

²⁷⁵ CA 1985 s 264; CA 2006 s 831. See paragraph 5.2.2 below.

²⁷⁶ CA 1985 s 263(3); CA 2006 s 830(2).

²⁷⁷ Dividends out of current profits are also known as 'nimble dividends', see Chapter 1 paragraph 2.

²⁷⁸ See *Gower & Davies' Company Law* 7 ed 277.

²⁷⁹ See *Gower & Davies' Company Law* 7 ed 288.

²⁸⁰ CA 1985 s 270(1) – (2); CA 2006 s 836(1).

- share capital and reserves, including undistributable reserves.²⁸¹

The 'relevant accounts' that must be used are in most instances the company's last annual accounts.²⁸² Exceptions exist in relation to companies that are in their first accounting period and in relation to companies that cannot validly make a distribution based on their last accounts.²⁸³

A distribution will be lawful if it is justified by the items referred to above and the accounts have been properly prepared in accordance with the Act, or have been properly prepared subject only to matters not material for determining whether the distribution would be lawful.²⁸⁴ In particular, the balance sheet and profit and loss account, must present a true and fair view.²⁸⁵ If the directors knew or should have known about a serious defect in the accounts, the accounts will not satisfy these requirements and distributions by the company will be unlawful.²⁸⁶ The accounts must be audited²⁸⁷ and if the auditors have issued a qualified report, the auditors must state in writing whether the respect in which the report was qualified is material in determining whether the distribution would be lawful.²⁸⁸ The auditors may make this statement irrespective of whether distributions have been proposed at the time they make the statement.²⁸⁹ The statement must be laid before the general meeting.

When a company wants to make successive distributions on the basis of the

²⁸¹ CA 1985 s 270(2); CA 2006 s 836(1). The reserves for public companies also differ from those required for private companies, see paragraph 2.4 above. See *Boyle & Birds' Company Law* 206 – 208.

²⁸² CA 1985 s 270(3); CA 2006 s 836(2). See *Gower & Davies' Company Law* 7 ed 281.

²⁸³ CA 1985 ss 272 and 273; CA 836(2)(a), (b). In these cases initial or interim accounts respectively, may be used. Such accounts also have to comply with certain prescribed standards. See *Gower & Davies' Company Law* 7 ed 282 – 283. It is important to bear in mind that interim accounts are not required in respect of all interim or provisional dividends, but only where a distribution cannot be made based on the last annual accounts.

²⁸⁴ CA 1985 s 271(1) – (2); CA 2006 s 836(1), (4) read with s 837.

²⁸⁵ CA 1985 s 271(2); CA 2006 ss 837 – 839.

²⁸⁶ *Re Cleveland Trust plc* [1991] BCLC 424.

²⁸⁷ CA 1985 s 271(3); CA 2006 ss 837(3) 839(5). This does not apply if the company is exempted from the audit requirement by s 249E(1)(c), (2)(c).

²⁸⁸ CA 1985 s 271(3) – (4); CA 2006 s 837(4), s 839(6).

²⁸⁹ CA 1985 s 271(5); CA 2006 s 837(5).

same relevant accounts,²⁹⁰ the distributions that have previously been made must be added back to the amount of the proposed distribution to determine whether it is permissible. Distributions have a wider meaning for this purpose. It includes payments made since the date of the accounts in respect of financial assistance for the acquisition of the company's shares, or in respect of the purchase price for the acquisition of its own shares. However, it is unnecessary to take into account payments made for acquisitions otherwise than out of distributable profits or assistance payments that do not reduce the company's net assets or increase its net liabilities.²⁹¹

The rules discussed above have replaced the rather lax common-law approach to the determination of profits and are generally regarded as an improvement on the common law.²⁹²

5.2.2 The net assets restriction

In order to give effect to article 15 of the Second Company Law Directive, public companies are subject an additional restriction on the distribution of their assets. A public company may make distributions only to the extent that the value of its net assets exceeds its share capital and undistributable reserves.²⁹³

The assets have to be accounted for as set out in the Act.²⁹⁴ Undistributable reserves are the share premium account, the capital redemption reserve, the excess of unrealised profits over unrealised losses and any other reserve the company is prohibited from distributing.²⁹⁵ The inclusion of the reserve in respect of net unrealised profits merits further consideration. Although the unrealised profits and unrealised losses are already accounted for in the determination of net assets,

²⁹⁰ For example, pay interim dividends without preparing interim accounts.

²⁹¹ CA 1985 s 274(2) – (3); CA 2006 s 840(2). *Gower & Davies' Company Law* 7 ed 283 – 284. This provision bears some similarity to s 172(4) which requires distributions lawfully made to be deducted from a company's distributable profits, see 4.2.2 above.

²⁹² See Leyte "Regime of Capital Maintenance" 87; Egginton "Distributable Profit" 3.

²⁹³ CA 1985 s 264; CA 2006 s 831.

²⁹⁴ CA 1985 s 275; CA 2006 s 836.

²⁹⁵ CA 1985 s 264(3); CA 2006 s 831(4).

net assets must cover the net unrealised profit (the excess of unrealised profits over unrealised losses) again. The effect of this requirement is that the company's profits must be sufficient to cover any unrealised losses.²⁹⁶

5.2.3 Distributions in kind

Distributions in kind are subject to relief in respect of unrealised profits. To the extent that the stated value of a non-cash asset²⁹⁷ being distributed represents or includes an unrealised profit in the relevant accounts, that profit will be treated as a realised profit for purposes of determining whether the distribution is lawful and whether that profit can be included in or transferred to the profit and loss account.²⁹⁸ This exception was inserted to facilitate de-mergers, but is not restricted to it.²⁹⁹

In CA 2006 the transfer of a non-cash asset by a company is regarded as a distribution to the extent only that the book value, as opposed to the real value, of the asset exceeds the consideration given. A transfer at consideration equal to the book value of the asset is valued at zero.³⁰⁰

5.3 Timing for the application of the financial restrictions

The Act refers to the 'making' of distributions,³⁰¹ which indicates that the financial restrictions apply at the time a distribution is executed rather than authorised.³⁰² Yet distributions are based on the relevant accounts, which will reflect an earlier

²⁹⁶ See *Gower & Davies' Company Law* 7 ed 278; *Buckley Companies Act* [264.3]; *Charlesworth's Company Law* 487.

²⁹⁷ Defined in CA 1985 s 739; CA 2006 s 1163.

²⁹⁸ CA 1985 s 276; CA 2006 s 846.

²⁹⁹ *Gower & Davies' Company Law* 7 ed 284.

³⁰⁰ CA 2006 s 845. This provision was inserted on the recommendation of the Company Law Review to address concerns of the business community that the decision in *Aveling Barford Ltd v Perion Ltd* [1989] BCLC 626 might affect innocent intra-group transfers because the residual common-law rules might operate in addition to the statutory rules on the determination of distributable profits, see *Modern Company Law for a Competitive Economy: Capital Maintenance: Other Issues* URN 00/880 (June 2000) Part II pars 24 – 36.

³⁰¹ CA 1985 ss 263, 264 and 265; CA 2006 ss 830, 831 and 832 – 833.

³⁰² *Gore-Browne on Companies* 25[2].

financial position.³⁰³ It appears that payments based on properly prepared accounts are valid under the Companies Act. However, if the company's financial situation has changed so that the conditions are no longer met, payment could constitute a breach of directors' fiduciary duties or an act of wrongful trading and could further amount to an unlawful return of capital at common law.³⁰⁴ The Company Law Review recommended a provision obliging the directors to deduct any subsequent losses they are aware of at the time of declaration of the dividend from the distributable profits as determined in the relevant accounts,³⁰⁵ but CA 2006 does not incorporate this proposal.

5.4 Status of claim in respect of authorised but unpaid distributions

In view of the prohibition on the making of a distribution in violation of the financial restrictions, it appears that a shareholder will not be able to insist on payment of a lawfully declared dividend when the company no longer has sufficient distributable profits.³⁰⁶ A shareholder will be able to obtain a prohibitory interdict against the payment of an unlawful distribution.³⁰⁷

5.5 Authorisation

As in South Africa, the power to declare dividends and the procedure to be followed depend on the articles of association. The usual provision of articles is that the directors recommend dividends and that the general meeting adopts an ordinary resolution confirming the recommendation. The general meeting may not declare a

³⁰³ *Gower & Davies' Company Law* 7 ed 285 explains that the accounts will usually be about 7 months old by the time the dividend is actually paid.

³⁰⁴ *Gower & Davies' Company Law* 7 ed 285.

³⁰⁵ *Gower & Davies' Company Law* 7 ed 286. *Modern Company Law for a Competitive Economy: Capital Maintenance: Other Issues* URN 00/880 (June 2000) par 38.

³⁰⁶ *Gore-Browne on Companies* 25[2] especially note 1. The authors state that the wording of the provision clearly intends actual payment.

³⁰⁷ *Gore-Browne on Companies* 25[14].

dividend exceeding that recommended by the directors.³⁰⁸ As in South Africa, it seems that the articles of companies tend to regulate dividends, but not other distributions.³⁰⁹

5.6 Liability for distributions made in contravention of the Act

No statutory criminal liability is imposed for non-compliance with the restrictions on distributions.³¹⁰ Instead, members who received certain distributions made in contravention of the provisions may incur statutory civil liability.³¹¹

When a distribution is made to a member who knew or had reasonable cause to believe that the distribution was made in contravention of the requirements of the Act, that member is liable to repay it or, if the distribution was otherwise than in cash, its value.³¹² The provision applies in respect of any distribution, other than financial assistance for the acquisition of a company's own shares given in contravention of the Act³¹³ or any payment made in respect of the redemption or purchase of shares in the company.³¹⁴ Since the definition of distribution in this part of the Act³¹⁵ already excludes financial assistance payments and payments for the redemption or purchase of shares, it is not clear why the liability provision also expressly mentions them as exceptions.

The payment received in contravention of the distribution provisions is not void or unlawful, but can be recovered from members who received it and who knew or should have known that it was made in contravention of the requirements.³¹⁶

The statutory remedy does not exclude liability that may exist under the

³⁰⁸ See article 102 of Table A. See also *Gower & Davies' Company Law 7* ed 285.

³⁰⁹ See Chapter 5 paragraph 5.5.

³¹⁰ See *Gower & Davies' Company Law 7* ed 286.

³¹¹ CA 1985 s 277; CA 2006 s 847.

³¹² CA 1985 s 277(1); CA 2006 s 847(2).

³¹³ CA 1985 s 151; CA 2006 ss 678 – 679.

³¹⁴ CA 1985 s 277(2); CA 2006 s 847(4).

³¹⁵ CA 1985 Part VIII; CA 2006 Part 23.

³¹⁶ *Gower & Davies' Company Law 7* ed 286.

common law.³¹⁷ At common law, shareholders who receive an unlawful distribution with actual knowledge of its unlawfulness are liable.³¹⁸ There is uncertainty as to whether shareholders who received an unlawful distribution in good faith are liable.³¹⁹ Although the statutory provision provides a wider basis of liability by covering constructive notice, the common law remedy is stronger, as the shareholders will be regarded as constructive trustees of the distribution.³²⁰

The South African position regarding liability of members, which does not require knowledge or imputed knowledge of the unlawfulness of the distribution, is stricter than the common law and the statutory liability in England.³²¹

The Act imposes no statutory liability on directors who make unlawful distributions. This is similar to the position in South Africa in respect of unlawful 'payments' by reason of shareholding.³²² Directors may be liable at common law.³²³ The common law liability of directors is not limited to the amount of the unlawful dividend, but is in respect of the loss suffered by the company because of the distribution.³²⁴ Directors are liable even if the company has remained solvent.³²⁵ It is

³¹⁷ CA 1985 s 277(2); CA 2006 s 847(3). See *Gore-Browne on Companies* 25[14].

³¹⁸ *Moxham v Grant* [1900] 1 QB 85 CA. See also *Precision Dippings Ltd v Precision Dippings Marketing Ltd* [1986] Ch 447; *Allied Carpets plc v Nethercott* [2001] BCC 81 and *Re Cleveland Trust plc* [1991] BCLC 424. In these cases the shareholders were either also officers of the company or other companies in the same group. It is unlikely that shareholders in a public company will have the requisite knowledge, see *Gower & Davies' Company Law* 7 ed 286. However, in *It's a Wrap (UK) Ltd v Gula* [2006] 2 BCLC 634 (EWCA Civ) the court indicated that members are liable if they knew or could be taken to know that the company has no distributable profits, despite the fact that they did not know the legal rules on distributions. See also *Gore-Browne on Companies* 25[14].

³¹⁹ See *Segenhoe Ltd v Atkins* (1990) 1 ACSR 691 SC (NSW) at 708 where the Australian court stated that this matter had not been authoritatively determined.

³²⁰ See *Gower & Davies' Company Law* 7 ed 286. An important benefit of the constructive trustee basis would be that the assets are protected from the recipient's creditors in insolvency. See *Precision Dippings Ltd v Precision Dippings Marketing Ltd* [1986] Ch 447; *Allied Carpets plc v Nethercott* [2001] BCC 81.

³²¹ See Chapter 5 paragraph 6.4.2.

³²² See Chapter 5 paragraph 5.6.

³²³ *Re Exchange Banking Co (Flitcroft's case)* (1882) 21 Ch D 519 CA.

³²⁴ *Re Exchange Banking Co (Flitcroft's case)* (1882) 21 Ch D 519 CA. Liability is also not limited to the unlawful part of the dividend either, see *Bairstow v Queen's Moat Houses plc* [2001] 2 BCLC 531 CA. See *Target Holdings v Redferns* [1996] AC 421 HL for authority that the loss should be measured at the time of the trial. In *Inn Spirit Ltd v Burns* [2002] 2 BCLC 780 Ch a dividend

possible that the directors could claim an equitable contribution from shareholders who received the improper dividend with knowledge of the facts.³²⁶

The directors may be relieved from liability by the court if they acted honestly and reasonably in paying the improper dividend.³²⁷

6 SHARE REPURCHASES

6.1 Power to acquire shares

The common-law prohibition against a company acquiring its own shares³²⁸ has been codified.³²⁹ This section provides that a company limited by shares may not acquire its own shares 'whether by way of purchase, subscription or otherwise', except in one of the instances set out in the section.³³⁰ A number of exceptions are then set out.³³¹ The first exception is that a company may acquire its fully paid up shares otherwise than for valuable consideration.³³² A second exception is the repurchase and redemption of shares in accordance with the specific provisions that regulate repurchases and redemptions.³³³ The remaining exceptions are the acquisition of shares in a capital reduction,³³⁴ purchase of shares under a court

Continued

which would have been lawful had the accounts been drawn up correctly, was nevertheless held to be unlawful: a clear indication of the importance of the statutory requirements on accounts.

³²⁵ *Baird v Queen's Moat Houses plc* [2001] 2 BCLC 531 CA at 545 – 548. See *Gower & Davies' Company Law* 7 ed 287 fn 91 regarding the so-called 'windfall' objection.

³²⁶ See *Gower & Davies' Company Law* 7 ed 287 note 91.

³²⁷ CA 1985 s 727; CA 2006 s 1157.

³²⁸ *Trevor v Whitworth* (1887) 12 App Cas 409.

³²⁹ CA 1985 s 143; CA 2006 s 658(1).

³³⁰ CA 1985 s 143(1); CA 2006 s 658(1).

³³¹ CA 1985 s 143(3); CA 2006 s 659.

³³² CA s 143(3); CA 2006 s 659(1).

³³³ CA 1985 s 143(3)(a); CA 2006 s 658(1).

³³⁴ CA 1985 s 143(3)(b); CA 2006 s 659(2)(a). See paragraph 2.6 above regarding the reduction of capital.

order,³³⁵ and the forfeiture or surrender of shares in terms of the articles for failure to pay any sum due on shares.³³⁶

The second exception, the redemption and repurchase of shares in accordance with the specific provisions in the Act, refers to share repurchases in the ordinary sense. Separate requirements apply to redemptions and repurchases that are made 'not out of capital'³³⁷ and those that are made 'out of share capital'.³³⁸

Redemptions and repurchases are subject to the same financial restrictions. As regards repurchases and redemptions not out of capital, the financial restrictions are those that previously applied to the redemption of shares.³³⁹ Private companies may repurchase and redeem shares out of capital.³⁴⁰ Companies have an express power to repurchase rather than redeem their redeemable shares.³⁴¹

6.2 Financial restrictions for repurchases

The redemption of redeemable preference shares has been possible in England since 1929.³⁴² The requirements were similar to the requirements still found in the South African Companies Act today.³⁴³ The capital yardstick was maintained either by the issue of new shares to replace the redeemed shares, or by the creation of a capital redemption reserve. It first became possible for English companies to repurchase their shares in 1981, but, at least in respect of public companies, this amounted to nothing more than an extension of the redemption provisions to shares

³³⁵ CA 1985 s 143(3)(c); CA 2006 s 659(2)(b). The court order may be given under CA 1985 s 5, s 54 or Part XVII; CA 2006 s 98, s 721(6), s 759 or Part 30. These instances all involve relief to dissenting minorities, see *Charlesworth's Company Law* 150.

³³⁶ CA 1985 s 143(3)(d); CA 2006 s 659(2)(c). See paragraph 3.4 above.

³³⁷ These are set out in CA 1985 ss 162 – 170; CA 2006 ss 687 (redemptions) and ss 692 – 708 (repurchases).

³³⁸ See CA 1985 ss 171 – 177; CA 2006 ss 709 – 723. Repurchases out of capital apply to private companies only.

³³⁹ These restrictions are similar to the South African requirements for the redemption of shares, see Chapter 5 paragraph 6.8.

³⁴⁰ See paragraph 6.2.2 below.

³⁴¹ CA 1985 s 162; CA 2006 s 690(1).

³⁴² *Gower & Davies' Company Law* 7 ed 248.

³⁴³ See Chapter 5 paragraph 6.8.

other than redeemable shares.³⁴⁴

Private companies may repurchase or redeem shares out of capital in certain instances.³⁴⁵ However, the amount of capital that may be applied is restricted to the 'permissible capital payment'.³⁴⁶ The effect of this is that share capital may be used only for the deficit between the purchase price and the available distributable profits. Repurchases out of capital are subject to strict creditor protection provisions. The reduction in issued share capital may not exceed the amount of the capital payment and, to the extent that distributable profits are used, a capital redemption reserve must be created.

These rules support the basic philosophy that creditors rely on the issued capital as stated in the memorandum of a company.

6.2.1 Repurchases otherwise than out of capital

The shares of public and private companies may be redeemed or repurchased out of distributable profits or out of the proceeds of a fresh issue of shares.³⁴⁷ Only fully paid shares may be repurchased or redeemed.³⁴⁸ A company may not repurchase shares if only redeemable shares will remain after the repurchase.³⁴⁹

Repurchases not out of capital may be financed from two possible sources: distributable profits³⁵⁰ or the proceeds of a fresh issue of shares made for the

³⁴⁴ *Gower & Davies' Company Law* 7 ed 250.

³⁴⁵ CA 1985 ss 171 – 177; CA 2006 ss 709 – 723.

³⁴⁶ Defined in CA 1985 s 172(5); CA 2006 s 710.

³⁴⁷ CA 1985 s 160, s 162(1); CA 2006 s 687(2), s 692(2). While CA 1985 made the requirements for redemptions applicable to share repurchases through cross referencing, CA 2006 sets out all the requirements for redemptions and repurchases respectively.

³⁴⁸ CA 1985 s 159(3); CA 2006 s 686(1), s 691(1).

³⁴⁹ CA 1985 s 162(3); CA 2006 s 690(2). It is interesting to note that the equivalent provision for redeemable shares, CA 1985 s 159(2); CA 2006 s 684(4), only prohibits the 'issue' of redeemable shares at a time when there are no unredeemable shares in issue. One would perhaps expect a similar restriction in respect of the actual redemption of redeemable shares. However, the combined effect of these two provisions is that a redemption cannot result in a situation where no unredeemable shares will be left. On the redemption of redeemable shares, see paragraph 6.8 below.

³⁵⁰ See CA 1985 s 181(a); CA 2006 s 736 for the meaning of distributable profits.

purpose of the repurchase.³⁵¹ To the extent that distributable profits are used, an amount equal to the nominal value of the repurchased shares must be transferred to a capital redemption reserve.³⁵²

Any premium payable on repurchase must generally be paid out of distributable profits.³⁵³ If the shares being purchased were issued at a premium, the premium payable on repurchase may be paid out of the proceeds of a fresh issue of shares.³⁵⁴ However, such proceeds may be used only up to an amount which is equal to the lesser of the amount that was transferred to the share premium account in respect of those shares or the current amount of the share premium account, including any premiums received on the new shares.³⁵⁵ When the premium on repurchase is paid out of the proceeds of a fresh issue of shares, the share premium account has to be reduced by the amount of such payments made out of the proceeds of the fresh issue.³⁵⁶ The practical effect of this provision is that the share premium account may be applied so that so much of the premium originally contributed by those shares as is still reflected in the share premium account, may be taken out to provide for the premium payable on repurchase. However, the share premium account may not be applied in this way, unless the proceeds of the new issue of shares are sufficient to cover the nominal value of the repurchased shares as well as any premium not covered by distributable profits.

A comparison of section 130(2), which deals with the application of the share premium account, and the equivalent South African provision, section 76(3), may lead one to think that their application in respect of a premium payable on redemption or repurchase is identical. However, the effect of section 160(2) is that the reduction of the share premium account applied will also have to be offset by the proceeds of the new shares. In contrast, the South African section 98(1)(c) and

³⁵¹ CA 1985 s 162(2); CA 2006 s 687(2) (redemptions), s 692(2) (repurchases).

³⁵² CA 1985 s 170; CA 2006 s 733(2)(b).

³⁵³ CA 1985 s 160(1)(b); CA 2006 s 687(3), s 692(2)(b).

³⁵⁴ CA 1985 s 160(2); CA 2006 s 687(4), s 692(3).

³⁵⁵ CA 1985 s 160(2); CA 2006 s 687(4), s 692(3).

³⁵⁶ CA 1985 s 160(2); CA 2006 s 687(5), s 692(4).

section 85(7) allow the share premium account to be reduced without a similar limitation.³⁵⁷

Any payment in addition to the purchase price made by the company in consideration of acquiring any right to repurchase shares under a contingent repurchase contract, or in consideration of the variation of an off-market contract or in consideration of the release of any of the company's obligations under any off-market contract, may only be made out of distributable profits.³⁵⁸

6.2.2 Repurchases out of capital

Private companies may redeem or repurchase their shares out of capital if certain requirements, aimed at protecting both creditors and shareholders, are met.³⁵⁹ The financial restrictions consist of a solvency test as well as a limit on the extent to which share capital may be applied, termed the 'permissible capital payment'.

The solvency test, which could be called a liquidity test in South Africa, involves asking:

- whether the company will, immediately after payment has been made, be able to pay its debts,³⁶⁰ and
- whether it will be able to continue carrying on business as a going concern in the year following payment.³⁶¹

The directors are required to issue a formal solvency statement that has to be

³⁵⁷ The application of the share premium account is also discussed in paragraph 2.4 above. For discussion of the position in South Africa, see Chapter 5 paragraph 2.4.3.3.2.

³⁵⁸ CA 1985 s 168; CA 2006 s 705. *Gower & Davies' Company Law* 7 ed 252 explains that such payments are not in the ordinary course of business of a company and really amount to distributions to a member or members. Should this provision not be complied with, the purchase or release would be void.

³⁵⁹ CA 1985 ss 171(1) CA 2006 s 709. The additional procedural requirements that apply to purchases and redemptions out of capital are identified in paragraph 6.3 and in particular in paragraph 6.3.1.4 below.

³⁶⁰ CA 1985 s 173(3)(a); CA 2006 s 714(3)(a).

³⁶¹ CA 1985 s 173(3)(b); CA 2006 s 714(3)(b).

reported on by the auditors of the company.³⁶² It is clear that both the directors and the auditors have an active duty to enquire into and report on the affairs of the company.³⁶³ The South African solvency and liquidity provision does not require any positive action from the directors and auditors.³⁶⁴

The ability of the company to pay its debts immediately after payment must be assessed taking into account the contingent and prospective liabilities of the company.³⁶⁵ The continued liquidity of the company is to be judged with reference to the way in which the directors intend managing the company's business during that year, and the amount and character of the financial resources the directors anticipate will available to the company during that year. The ability of the company to continue to carry on business as a going concern expressly includes the ability to pay its debts as they fall due.³⁶⁶ It is worth noting that South African legislation does not prescribe the manner of application of the liquidity test.³⁶⁷

The extent to which share capital may be applied is limited to the 'permissible capital payment'.³⁶⁸ The permissible capital payment is the amount by which the price payable by the company for its shares exceeds its available profits and the proceeds of any fresh issue made for purposes of the repurchase or redemption. The available profits and the permissible capital payment must be determined as set out in the Act.³⁶⁹

³⁶² The procedural aspects relating to the solvency declaration and auditors' report are dealt with in paragraphs 6.3.3.1 and 6.3.3.2 below.

³⁶³ The directors have to declare that they have made a full inquiry into the affairs and prospects of the company, CA 1985 s 173(3); CA 2006 s 714(3). The auditor has to report that she has inquired into the company's state of affairs, CA 1985 s 173(5); CA 2006 s 714(5). It is a criminal offence to make a false or misleading declaration, see paragraph 6.3.3.1 below.

³⁶⁴ See Chapter 5 paragraph 4.1.1.

³⁶⁵ CA 1985 s 173(4); CA 2006 s 714(4). See Grainger "Assessing Liabilities" 291 regarding the valuation of such liabilities.

³⁶⁶ CA 1985 s 173(3)(b); CA 2006 s 714(3)(b) reads that 'the company will be able to continue to carry on business as a going concern (and will 'accordingly' be able to pay its debts as they fall due)' (emphasis added). The question whether carrying on business as a going concern means more than the ability to pay debts is not discussed by the authorities consulted.

³⁶⁷ See Chapter 5 paragraph 4.1.2.

³⁶⁸ CA 1985 s 171(3); CA 2006 s 710.

³⁶⁹ CA 1985 s 172; CA 2006 ss 711 – 712.

The concept 'available profits' corresponds with 'profits available for distribution' in the provisions dealing with the distribution of profits and assets.³⁷⁰ The important difference is that the determination of available profits must be based on the 'relevant accounts' and not on the last annual accounts.³⁷¹ The relevant accounts are accounts that satisfy two requirements.³⁷² First, they must be prepared within the three months preceding the date of the statutory declaration of the directors.³⁷³ Secondly, they must enable a reasonable judgment to be made as to the amounts of the profits, losses, assets, liabilities, provisions, share capital and reserves.³⁷⁴

The permissible capital payment must be determined as at the date of the statutory declaration. This is implied by the requirement that distributions lawfully made between the date of the relevant accounts and the date of the declaration have to be deducted from the amount of available profits when calculating the permissible capital payment.³⁷⁵ 'Distributions lawfully made' are distributions out of distributable profits only and includes financial assistance, payments in respect of the purchase price of shares, and payments in consideration of the acquisition of a right, variation of a contract, or release of an obligation, to acquire own shares.³⁷⁶ The effect of the deduction of these distributions from available profits is to increase the amount of the permissible capital payment.³⁷⁷

The permissible capital payment rule is not a financial restriction in the true sense of the word. It does not limit the total amount that can be distributed by the company as consideration for the purchase of its shares. Its purpose is rather to limit

³⁷⁰ CA 1985 s 172(1); CA 2006 s 711. The available profits must be determined as set out in CA 1985 Part VIII; CA 2006 Part 23. This is discussed in paragraph 6 below.

³⁷¹ CA 1985 s 172(1); CA 2006 s 711(2). See also *Gower & Davies' Company Law* 7 ed 253 – 254, *Gore-Browne on Companies* 24[32].

³⁷² CA 1985 s 172(3); CA 2006 s 712(6).

³⁷³ CA 1985 s 172(3) read with s 172(6); CA 2006 s 712(6)(a) read with s 712(7).

³⁷⁴ CA 1985 s 172(3) read with s 172(2); CA 2006 s 712(6)(b) read with s 712(2).

³⁷⁵ CA 1985 s 173(4); CA 2006 s 712(3).

³⁷⁶ CA 1985 s 172(5); CA 2006 s 712(3) – (4).

³⁷⁷ There will be a larger difference between the purchase price and the available profits plus any proceeds of a fresh issue.

as far as possible the reduction of the company's share capital.

The adjustment of capital accounts following a repurchase out of capital is discussed elsewhere.³⁷⁸

6.2.3 The timing for the application of the financial restrictions

The Act provides that a company may repurchase or redeem shares out of distributable profits, the proceeds of a fresh issue of shares and, in the case of private companies, out of capital up to the amount of the permissible capital payment. However, since the distributable profits have to be determined by reference to the company's financial statements, the financial restrictions are practically applied in advance of the actual authorisation and payment.

When a repurchase is made out of distributable profits, the latest annual accounts of the company have to be used in determining the amount of the distributable profits.³⁷⁹ There is no statutory provision regarding changes in the company's financial position since the accounts were made up. However, as in the case of distributions, the common-law principles of directors' fiduciary duties may apply.³⁸⁰ It is also clear that a company cannot be compelled to make a payment in respect of the purchase or redemption of shares if the company can show that its distributable profits are not adequate.³⁸¹ This indicates that the financial position of the company at the time of payment remains relevant.

In the case of a repurchase or redemption out of capital by a private company, the accounts that must be used to determine the amount of the distributable reserves and indirectly also the permissible capital payment, have to be prepared within the three months preceding the date of the statutory declaration.³⁸² The permissible capital payment must be determined as at the date of the statutory

³⁷⁸ See paragraph 6.3.4 below.

³⁷⁹ CA 1985 s 181(a); CA 2006 s 736.

³⁸⁰ See paragraph 5.6 below.

³⁸¹ CA 1985 s 178(3); CA 2006 s 735(2) – (3). These provisions are discussed in paragraph 6.6 below.

³⁸² CA 1985 s 172(6); CA 2006 s 712(7).

declaration of directors. The permissible capital payment takes account of allowable distributions made since the date of the accounts and consequently reflects the situation on the date of the statutory declaration.³⁸³ The time limits imposed in respect of the period between the date of the declaration and the date of the authorisation (1 week)³⁸⁴ and in respect of the date of authorisation and the date of payment (not less than 5 weeks and not more than 7 weeks)³⁸⁵ ensure that payment is based on recent financial information.³⁸⁶

As in England, the intention in South Africa is that the company's position at the time of payment is relevant. However, the requirements prescribed by CA 1985 necessarily result in a delay between the enquiry into satisfaction of the financial requirements and payment. Although the English provisions could afford more certainty, require active involvement of directors and sometimes auditors, and possibly protect creditors better, the introduction of similar formal requirements in South Africa should be approached with caution in view of their complexity.³⁸⁷

6.3 Procedure and other requirements

The procedure for repurchases depends on whether the acquisition is to take place by way of an off-market³⁸⁸ or market purchase³⁸⁹ or contingent purchase contract.³⁹⁰ The procedural requirements for repurchases by private companies out of capital differ from those for other purchases. A market purchase is one in respect of shares listed or admitted on an investment exchange³⁹¹ if the purchase is made on that exchange.³⁹² Other purchases are off-market purchases.³⁹³

³⁸³ CA 1985 s 173(4); CA 2006 s 714(4).

³⁸⁴ CA 1985 s 174(1) ; CA 2006 s 716(2).

³⁸⁵ CA 1985 s 174(1) ; CA 2006 s 723(1).

³⁸⁶ The statements cannot be older than 5 months (3 months plus 8 weeks).

³⁸⁷ See Chapter 5 paragraph 4.4.

³⁸⁸ CA 1985 s 164 ; CA 2006 s 693(2).

³⁸⁹ CA 1985 s 166 ; CA 2006 s 701.

³⁹⁰ CA 1985 s 165 ; CA 2006 s 694.

³⁹¹ For the definition of recognised investment exchange, see CA 1985 s 163(4); CA 2006 s 693(5).

³⁹² CA 1985 s 163(3); CA 2006 s 693(4).

In general it can be said that the prescribed procedure is not as comprehensive as in the South African legislation, probably because purchases are not made out of capital.³⁹⁴ In the case of private companies the procedure for repurchases out of capital is indeed more detailed.³⁹⁵

There is no express reference to selective as apposed to *pro rata* acquisitions. The Act appears to be concerned only with the approval of the terms of the contract. There is no statutory *pro rata* offer procedure similar to that found in the South African Companies Act. The disclosure and authorisation requirements are the only elements of shareholder protection. It remains to be seen if the courts will adapt the shareholder protection principles applicable to capital reductions to share repurchases.

The FSA *Listing Rules* that apply to listings on the London Stock Exchange require equal treatment once more than 15 per cent of a company's equity shares is to be acquired. Such repurchases are referred to as substantial market purchases and must be carried out by way of a partial offer to all shareholders or by way of a tender offer.³⁹⁶

6.3.1 Authorisations

The articles of a company wishing to repurchase its shares must allow it do so.³⁹⁷ The requirements regarding authorisation depend on the kind of purchase involved.

6.3.1.1 Off-market repurchases

In an off-market purchase, the terms of the contract of repurchase must be

Continued

³⁹³ CA 1985 s 163(1).

³⁹⁴ Sealy *Company Law and Commercial Reality* 10 – 11 criticises the complexity of the repurchase provisions and suggests that general common-law and equitable principles dealing with misapplication of company funds are adequate protection against abuse of the repurchase power.

³⁹⁵ See paragraph 6.3.3 below.

³⁹⁶ *FSA Listing Rules* par 15.7 and par 15.8. Also see *Gower & Davies' Company Law* 7 ed 259.

³⁹⁷ CA 1985 s 162(1) requires an express authority while CA 2006 grants a power subject to any restrictions or prohibition in the articles. The model articles under CA 1985 contain such an authority, see Table A art 35.

authorised by a prior special resolution³⁹⁸ or, under CA 2006, approved by special resolution after conclusion of a contract that has been made conditional upon such subsequent approval.³⁹⁹ The authorisation can be varied, revoked or renewed by a similar special resolution.⁴⁰⁰ In the case of a public company, the resolution may remain valid for a maximum of 18 months and the expiration date must be specified.⁴⁰¹

Although English law rarely imposes voting restrictions on members,⁴⁰² the shareholder whose shares are being acquired may not vote in respect of the affected shares.⁴⁰³ This is a powerful measure against abuse by controlling shareholders and should be considered for South Africa too.⁴⁰⁴ Only the voting rights in respect of the shares that are to be acquired are neutralised. A majority shareholder from whom some shares are to be repurchased selectively can still exercise influence on the adoption of the special resolution, which may be a problem as her interests will not fully coincide with those of the other shareholders of the class.⁴⁰⁵ However, unless the legislation expressly draws a distinction between selective and *pro rata* repurchases, this is the only sensible voting restriction

³⁹⁸ CA 1985 s 164(1) – (2); CA 2006 s 693(1)(a) read with s 694(1) – (2). Fox “Companies Purchasing” 274 notes that the Bill preceding the 1981 Companies Act contained a clause preventing alteration of the articles to enable a coercive acquisition of existing issued shares. It was not enacted, see Fox “Companies Act 1981” 113.

³⁹⁹ CA 2006 s 694(2)(b). Although CA 1985 does not provide for ratification, it was held in *Western v Rigblast Holdings Ltd* 1989 GWD 23-950 (SC) that where the company and a shareholder had agreed on a repurchase, the contract would not become enforceable until approved under this provision. See also *Gore-Browne on Companies* 24[25] note 14 on 24-24.

⁴⁰⁰ CA 1985 s 164(3); CA 2006 s 694(4).

⁴⁰¹ CA 1985 s 164(4); CA 2006 s 694(5).

⁴⁰² *Gower & Davies’ Company Law* 7 ed 258.

⁴⁰³ CA 1985 s 164(5); CA 2006 s 694(6) read with s 695. This applies whether voting is by poll or by show of hands. Any member may request a poll, regardless of the provisions of the articles, see *Gower & Davies’ Company Law* 7 ed 258. If the resolution is by written resolution the member may not be regarded as a member for purposes of the resolution unless the written resolution cannot be agreed to without her agreement. See *Gore-Browne on Companies* 24[25] note 6 on 24-24; Schedule 15A paragraph 5(2).

⁴⁰⁴ See Chapter 5 paragraph 6.3.1.2.

⁴⁰⁵ See Kiggundu “Corporate Dealings” 22. Kiggundu points out that the intended protection can also be negated by splitting a repurchase programme from controlling shareholders into a number of individual repurchases, thereby allowing the controlling shareholders to vote in respect of each other’s shares.

because it allows shareholders to vote in a proportionate repurchase in respect of their shares that are not to be acquired.⁴⁰⁶

A copy of the contract or a memorandum of its terms, disclosing also the identity of the members from whom shares will be repurchased, must be available for inspection by members at the meeting and for at least 15 days before the meeting.⁴⁰⁷ Should the contract or memorandum not have been available as prescribed, the special resolution will not be effective.⁴⁰⁸ Any variation of the contract must also be approved by special resolution, subject to similar requirements.⁴⁰⁹ In view of these requirements, it is clear that off-market purchases under a general authority are not possible.⁴¹⁰

It is not clear what consequences non-compliance with this procedure will have, since no penalty or consequences are prescribed. *Gore-Browne on Companies* argues that the resultant contract will be void as an unlawful purchase of shares and that the penalties prescribed for a contravention of the restrictions on repurchases will apply.⁴¹¹

6.3.1.2 Contingent repurchase contracts

A contingent repurchase contract is a conditional contract in terms of which the company may become obliged or entitled to repurchase its shares. Contingent

⁴⁰⁶ If all the voting rights of vendor-shareholders were to be excluded, there would be no votes left to sanction proportionate repurchases.

⁴⁰⁷ CA 1985 s 164(6); CA 2006 s 696(1) – (4).

⁴⁰⁸ This requirement can be waived with the unanimous approval of all the shareholders, see *BDG Roof-Bond Ltd v Douglas* [2000] 1 BCLC 401 at 416 – 417. Also, in *Vision Express (UK) Ltd v Wilson (No 2)* [1998] BCC 173 the court was prepared to read in an implied term that the correct procedure for an off-market purchase would be followed. However, procedural requirements aimed at protecting creditors may not be waived. In this regard it was held in *Re R W Peak (Kings Lynn) Ltd* [1998] 1 BCLC 193 at 204 – 205 that the requirement of a special resolution could not be waived and in *BDG Roof-Bond Ltd v Douglas* [2000] 1 BCLC 401 that non-compliance with the requirements as to an auditor's statement rendered a distribution invalid.

⁴⁰⁹ CA 1985 s 164(7). A copy or memorandum of the original contract, previous variations and a copy or memorandum of the proposed varied contract must then be made available.

⁴¹⁰ There is no similar restriction in South Africa, see Chapter 5 paragraphs 6.3.1.3 and 6.3.2.1.

⁴¹¹ *Gore-Browne on Companies* 24[25].

repurchase contracts are regulated under a separate provision in CA 1985,⁴¹² but are subject to the same authorisation requirements as off-market repurchases.⁴¹³ The contingent repurchase contract is an alternative procedure for an off-market repurchase.⁴¹⁴ For this reason, CA 2006 no longer provides for these repurchases in a separate provision but treats them as a specific type of off-market repurchase.⁴¹⁵

Once the contingent repurchase contract has been approved, the company may proceed with an off-market repurchase when the condition is fulfilled, without the need for a further approval.⁴¹⁶ Put and call options over shares are contingent repurchase contracts.⁴¹⁷ Any payments in addition to the repurchase price that are made under a contingent repurchase contract must be made out of distributable profits.⁴¹⁸

6.3.1.3 Market repurchases

For market purchases, the company has to be authorised by an ordinary resolution of the general meeting to make such repurchases.⁴¹⁹ Although only an ordinary resolution is required, the resolution must be lodged with the Registrar in similar fashion as a special resolution.⁴²⁰ The reason why an ordinary resolution is required is to save time in view of the shorter notice period for ordinary resolutions.⁴²¹

⁴¹² CA 1985 s 165.

⁴¹³ The requirements of s 164(3)-(7) regarding procedural formalities apply, see paragraph 6.3.1.1 above.

⁴¹⁴ *Gore-Browne on Companies* 24[26].

⁴¹⁵ CA 2006 s 694(3).

⁴¹⁶ CA 1985 s 164(1) – (2). Variations will have to be approved in the same way as the original contract.

⁴¹⁷ *Gore-Browne on Companies* 25[26].

⁴¹⁸ CA 1985 s 168; CA 2006 s 705. See also paragraph 6.2.1 above.

⁴¹⁹ CA 1985 s 166(1); CA 2006 s 701(1). *Gower & Davies' Company Law* 7 ed 259 explains that the shorter notice period for ordinary resolutions is the reason why a special resolution is not required. See also Cheffins *Company Law* 448 – 450 for a discussion of additional regulation in the *FSA Listing Rules* and *The City Code on Takeovers and Mergers*.

⁴²⁰ CA 1985 s 166(7); CA s 701(8).

⁴²¹ *Gower & Davies' Company Law* 7 ed 259.

The authorisation must specify the maximum number of shares that may be acquired,⁴²² the maximum and minimum prices,⁴²³ and the date upon which the authority expires.⁴²⁴ The expiration date may not be later than 18 months after the passing of the resolution.⁴²⁵ The authority could be conditional or unconditional, and could either be general or refer to shares of a specific class or description.⁴²⁶ Once the market repurchase has been made, the exact terms of the contract including the maximum and minimum price that was paid must be disclosed in a return submitted to the Registrar.⁴²⁷

6.3.1.4 Repurchases out of capital

Should a private company wish to redeem or repurchase shares out of capital under CA 1985, its articles of association must expressly allow it to purchase or redeem shares otherwise than out of distributable profits or the proceeds of a fresh issue of shares.⁴²⁸ Under CA 2006, a private company will have this power subject to any restriction or prohibition in its articles.⁴²⁹

⁴²² CA 1985 s 166(3); CA 2006 s 701(3)(a). The *FSA Listing Rules* par 15.7 and par 15.8 provide that repurchases of more than 15% of the company's equity shares must either be made proportionately from all shareholders or through a tender offer. Such acquisitions are known as substantial market purchases. In South Africa, general market acquisitions can be used to acquire up to 20% of the shares of a class in a particular year, see Chapter 5 paragraph 6.3.2.2.

⁴²³ CA 1985 s 166(3)(b); CA 2006 s 701(3)(b). The price could be determined by specifying a particular sum or by providing a basis or formula for calculating the price without reference to any person's discretion or opinion, CA 1985 s 166(6); CA 2006 s 701(7).

⁴²⁴ CA 1985 s 166(3) – (4); CA 2006 s 701(5) – (6).

⁴²⁵ CA 1985 s 166(4); CA 2006 s 701(5). This accords with the off-market authorisation rule for public companies.

⁴²⁶ CA 1985 s 166(2); CA 2006 s 701(2).

⁴²⁷ CA 1985 s 169; CA 2006 s 707. It provides that detailed returns of acquisitions must be lodged with the Registrar within 28 days of delivery of the shares to the company. Contracts or memoranda of agreements must be retained by the company at its registered office for ten years. They may be inspected by any member or in the case of a public company, by any person, s 169(4) – (9); CA 2006 s 694, s 702(2) – (7). Public companies must submit a return that also indicates the maximum and minimum prices paid, CA 1985 s 169(2); CA 2006 s 707(4). This covers the situation of market purchases, but the subsection is not limited to market purchases.

⁴²⁸ CA 1985 s 171(1). A general power to purchase its shares will not suffice.

⁴²⁹ CA 2006 s 709.

A special resolution must authorise the payment out of capital.⁴³⁰ The special resolution will not be valid unless the statutory solvency declaration by the directors and the auditors' report are available for inspection by members at the meeting passing the resolution.⁴³¹ The resolution must be passed on or within a week of the date of the statutory declaration.⁴³² Members whose shares are being acquired may not vote in respect of those shares.⁴³³

6.3.1.5 Comparison of reduction procedures

The alternative reduction of capital procedure for private companies in CA 2006 was originally intended as a substitute for the rules allowing private companies to purchase or redeem their shares out of share capital. However, both procedures have been retained. It appears that CA 2006 may have introduced regulatory bias by prescribing different requirements for two procedures that can be used to achieve the same effect, for example the repayment of capital in excess of the wants of the company.⁴³⁴

I note various differences, although the basic financial restrictions are the same. First, the standards for compliance with the two procedures are different. In the case of a reduction there is no need for an auditor certificate in respect of the solvency statement, while such a certificate is required in respect of the solvency statement that has to be made for repurchases and redemptions out of capital.⁴³⁵ Secondly, each director has to be involved in the solvency statement for a reduction,⁴³⁶ while the solvency statement for repurchases has to be made by 'the directors'.⁴³⁷ Thirdly, public notice is required of an intended repurchase out of

⁴³⁰ CA 1985 s 173(2); CA 2006 s 716(1).

⁴³¹ CA 1985 s 174(4); CA 2006 s 718 read with s 716(3).

⁴³² CA 1985 s 174(1); CA 2006 s 716(2).

⁴³³ CA 1985 s 174(2); CA 2006 s 716(3) read with s 717. The voting restrictions are discussed in paragraph 6.3.1.1 above.

⁴³⁴ See CA 2006 s 641(4)(b)(ii).

⁴³⁵ Compare CA 2006 s 714(3) with s 643. See also *Palmer's Annotated Guide* 504.

⁴³⁶ CA 2006 s 643(1).

⁴³⁷ See CA 1985 s 173(3); CA 2006 s 714(1).

capital and members and creditors are given the right to object to court against a repurchase. The new reduction of capital procedure does not provide for notice or objection. Finally, while both provisions impose criminal liability for making an unsubstantiated statement, directors incur statutory civil liability under the Insolvency Act 1986 in respect of repurchases but not in respect of reductions. It is difficult to justify this divergence in the procedural requirements.

6.3.2 Assignment and release of right to repurchase shares

A company may not assign its rights under a contract to repurchase its own shares.⁴³⁸ This total prohibition applies to off-market, contingent, and market purchases and is aimed at preventing a company from speculating against its share price.⁴³⁹

A company can also not agree to release its rights under an off-market repurchase except with the prior approval of a special resolution.⁴⁴⁰ The purpose of this provision is to guard against undue influence that a prospective seller-shareholder may exert over the company should the transaction later appear to her to be unfavourable.⁴⁴¹ No comparable protection against abuse exists in South Africa and it may be useful to consider whether there is a need for it and whether this provision can serve as a starting point.⁴⁴²

6.3.3 Additional requirements for repurchases out of capital

I have shown that the authorisation requirements for repurchases out of capital differ from those for repurchases in general.⁴⁴³ The remaining requirements include strict timing provisions to ensure that the resolution is based on recent financial information and that the payment takes place when the situation is likely not to have

⁴³⁸ CA 1985 s 167(1); CA 2006 s 704.

⁴³⁹ See *Charlesworth's Company Law* 165.

⁴⁴⁰ CA 1985 s 167(2); CA 2006 s 700.

⁴⁴¹ See *Gower & Davies' Company Law* 7 ed 252.

⁴⁴² See Chapter 5 paragraph 6.10.5.

⁴⁴³ See paragraph 6.3.1.4 above.

changed. Creditors and shareholders are also given a right to object to the proposed repurchase out of capital. I now discuss these requirements in more detail.

6.3.3.1 Statutory declaration

The directors have to issue a statutory declaration, in the prescribed form, setting out the permissible capital payment.⁴⁴⁴ The declaration must also contain a solvency statement by the directors. They have to state that, having made full inquiry into the affairs and prospects of the company, and taking into account the contingent and prospective liabilities of the company⁴⁴⁵ they have formed the opinion:

- that as regards its initial situation immediately following the date on which the payment of capital is proposed to be made, there will be no ground on which the company could then be found unable to pay its debts
- that as regards its prospects for the year immediately following that date, having regard to their intentions with respect to the management of the company's business during that year, and to the amount and character of the financial resources which will, in their view, be available to the company during that year, the company will be able to continue to carry on business as a going concern (and will accordingly be able to pay its debts as they fall due) throughout that year.⁴⁴⁶

The declaration of the directors must be based on accounts prepared in the three months before the date of the declaration.⁴⁴⁷ It is a criminal offence for a director to make a declaration knowing it to be false or misleading, or without reasonable cause to believe in its truth.⁴⁴⁸

⁴⁴⁴ CA 1985 s 173(3); CA 2006 s 714(2).

⁴⁴⁵ CA 1985 s173(4); CA 2006 s 714(4).

⁴⁴⁶ CA 1985 s 173(3)(b); CA 2006 s 714(3)(b).

⁴⁴⁷ See paragraph 6.2.2 above.

⁴⁴⁸ CA 1985 s 173(6); CA 2006 s 715(1). The penalty is a maximum of two years imprisonment and an unlimited fine.

6.3.3.2 Auditors' report

A report by the company's auditor must be annexed to the statutory declaration.⁴⁴⁹

The report must be addressed to the directors. The auditor must state that:

- she has enquired into the company's state of affairs
- the amount specified in the statutory declaration as to the permissible capital payment is in her view properly determined
- she is not aware of anything to indicate that the opinion expressed by the directors in the declaration as to any of the matters required to be in it, is unreasonable in the circumstances.⁴⁵⁰

6.3.3.3 Publicity

Within one week of the special resolution authorising the purchase out of capital, the company has to give public notice of the intended payment out of capital. A notice must appear in the Gazette⁴⁵¹ and the company must either send a written notice to each of its creditors⁴⁵² or place a notice in an approved national newspaper.⁴⁵³ The notice must be in the prescribed form and must state:

- that the company has approved a payment out of capital for the purpose of acquiring its own shares by redemption or repurchase
- the amount of the permissible capital payment for the shares in question and the date of the resolution for payment out of capital
- that the statutory declaration of the directors and the report of the auditors are available for inspection at the company's registered office
- that any creditor of the company may within five weeks of the special resolution apply to the court for an order prohibiting the payment.

⁴⁴⁹ CA 1985 s 173(5); CA 2006 s 714(6).

⁴⁵⁰ CA 1985 s 173(5); CA 2006 s 714(6)(a) – (d).

⁴⁵¹ CA 1985 s 175(1); CA 2006 s 719(1).

⁴⁵² CA 1985 s 175(2); CA 2006 s 719(2)(b).

This is more onerous than the South African provisions where no notice is given to creditors and they are not afforded any right to object.⁴⁵⁴

6.3.3.4 Creditors' and members' right of objection

Any dissenting member and any creditor of the company may apply to court for the cancellation of the resolution.⁴⁵⁵ The application must be brought within five weeks of the date of the resolution.⁴⁵⁶ The company must notify the Registrar immediately of any such application and has to deliver an office copy of the court order to the Registrar within fifteen days of its being made.⁴⁵⁷

The court may order that the dissentient members be bought out by other members or by the company and may make any order for the protection of the dissentient creditors.⁴⁵⁸ The court may also make consequential orders, such as an amendment of the company's memorandum and articles.⁴⁵⁹

It is not stated what kind of order a creditor could ask for. Presumably, a creditor can obtain an order preventing the company from going ahead with the proposed purchase. The court can also order that the creditor be paid or that her debt be secured. When a company asks the court to confirm a formal reduction of capital, creditors have the right to insist on payment or security.⁴⁶⁰ Due to the similarity of the two procedures, it can be expected that creditors will be afforded similar remedies.

While a formal reduction of capital requires court confirmation, the purchase of shares out of capital can take place without court intervention if no objections from shareholders or creditors are lodged. Yet these transactions have a substantially

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⁴⁵³ CA 1985 s 175(2); CA 2006 s 719(2)(a). 'Approved national newspaper' is defined in CA 1985 s 175(3); CA 2006 s 719(3).

⁴⁵⁴ See Chapter 5 paragraph 6.3.2 for a discussion of the South African formalities.

⁴⁵⁵ CA 1985 s 176(3); CA 2006 s 721.

⁴⁵⁶ CA 1985 s 176(1)(b); CA 2006 s 721(2)(a).

⁴⁵⁷ CA 1985 s 176(3); CA 2006 s 722.

⁴⁵⁸ CA 1985 s 177(1); CA 2006 s 721(3).

⁴⁵⁹ These are set out in CA 1095 s 177(2) – (4); CA 2006 s 721(3) – (7).

⁴⁶⁰ See paragraph 2.6.1 above.

similar effect. This discrepancy was considered by the Company Law Review, which recommended introduction of an alternative formal reduction procedure in which the requirement for court confirmation would be replaced with a right of objection. Although it further recommended that the right of private companies to purchase or redeem their shares out of capital should be abolished, this was not done. The result is that similar transactions are still subject to different requirements.⁴⁶¹

6.3.3.5 Timing of payments

Payment may be made only during the period between five and seven weeks after the date of the resolution.⁴⁶² This provision ensures that payment is not made until the creditors have had the opportunity of applying to court,⁴⁶³ but that it is indeed made very soon thereafter.

The timing restriction makes the procedure rather different from that in South Africa where there is no similar restriction. This can be explained by the fact that in South Africa the solvency and liquidity test is applied at the time of payment with the result that these timing issues do not arise. However, if South Africa were to adopt rules that involve determining the financial position of the company on a specific date or that prescribe reliance on specific accounts of the company, specific rules limiting the time within which payment must be made may become necessary.⁴⁶⁴

6.3.4 Adjustment of capital accounts

Unless the repurchased shares are held in treasury,⁴⁶⁵ a repurchase of shares will have an effect on the company's share capital accounts. However, the size of the

⁴⁶¹ See paragraph 6.3.1.5 above.

⁴⁶² CA 1985 s 174(1); CA 2006 s 723(1). The period may be extended by court order, see CA 1985 s 177(2); CA 2006 s 721(5).

⁴⁶³ It appears that because the company can only pay until 7 weeks after date of the resolution the court has to dispose of the matter within two weeks. As this may be impossible, CA 1985 s 177(2); CA 2006 s 721(5) expressly authorises the court to alter or extend any date or period of time specified in the resolution or in any provision of the Act relating to the redemption or repurchase of shares to which the resolution applies.

⁴⁶⁴ See Chapter 5 paragraph 4.4.2.

⁴⁶⁵ This exception is discussed in paragraph 6.7 below.

company's total share capital, including the share premium account,⁴⁶⁶ will not be reduced. The repurchase of shares out of capital is an exception because it will lead to a reduction of share capital.

6.3.4.1 Repurchases not out of capital

Where a repurchase or redemption is funded wholly out of distributable profits, the amount by which the company's share capital is diminished on cancellation of the shares⁴⁶⁷ must be transferred to the capital redemption reserve.⁴⁶⁸ The capital redemption reserve is an undistributable reserve and, subject to some exceptions, is treated as if it was share capital of the company.⁴⁶⁹ The amount transferred to the capital redemption reserve will 'replace' the cancelled share capital.

Where the repurchase is made wholly or partly out of the proceeds of a fresh issue of shares and the aggregate amount of the proceeds is less than the aggregate nominal value of the shares redeemed or purchased, an amount equal to the difference must be transferred to the capital redemption reserve.⁴⁷⁰ The effect of this provision is that the capital redemption reserve will reflect that part of the nominal value of the redeemed or repurchased shares that is not replaced by the fresh capital. The cancelled capital will be replaced by the capital attributed to the new shares and the amount transferred to the capital redemption reserve. Where a private company has purchased or redeemed its shares partly out of capital and partly out of a fresh issue of shares, this latter provision does not apply.⁴⁷¹

⁴⁶⁶ As to which, see paragraph 2.4 above.

⁴⁶⁷ That is, the nominal value of the shares, see CA 1985 s 160(4); CA 2006 s 688(b) (redemptions), s 706(b)(ii) (repurchases) read with s 733(2).

⁴⁶⁸ CA 1985 s 170(1); CA 2006 s 733(1). Sealy "Views on Share Repurchase" 27 regards the capital redemption reserve requirement as an unnecessary safeguard.

⁴⁶⁹ See paragraph 2.4 above.

⁴⁷⁰ CA 1985 s 170(2); CA 2006 s 733(3). It stands to reason that if the redemption or repurchase is made wholly out of the proceeds of the fresh issue the nominal value of the redeemed or repurchased shares can only exceed the proceeds of the new shares if the old shares are redeemed or repurchased at a discount.

⁴⁷¹ CA 1985 s 170(3); CA 2006 s 733(3) proviso. The company will be reducing its capital by the amount of the permitted capital payment. If redemption or repurchase is funded partly out of

When a public company holds shares it repurchased in treasury, those shares will not be cancelled and the capital accounts will accordingly not be adjusted.⁴⁷² If the shares are later cancelled, the issued capital must be reduced by the nominal value of the cancelled shares.⁴⁷³

6.3.4.2 Purchases out of capital

In the case of a private company purchasing its shares out of capital, the accounts will be adjusted to reflect the cancellation of the shares and the total share capital will be reduced. However, the capital reduction is restricted to the amount of the 'permissible capital payment'.⁴⁷⁴

If the nominal value of the shares repurchased is higher than the permissible capital payment (and there is no fresh issue of shares), the difference must be transferred to the capital redemption reserve.⁴⁷⁵ This difference represents the distributable profits used in respect of the par value of the shares.

On the other hand, if the permissible capital payment exceeds the nominal value of the shares, the excess may be used to reduce the share premium account, capital redemption reserve, revaluation reserve or fully paid share capital of the company.⁴⁷⁶ So, apart from the reduction in the share capital account in respect of the cancellation of the acquired shares, the capital and reserve accounts of the company may be reduced up to the balance of the permissible capital payment.

The same principles apply to instances where the proceeds of a fresh issue of shares are used in conjunction with the permissible capital payment. The difference between these two amounts combined and the nominal value of the shares is

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distributable profits, the capital redemption reserve must reflect the distributable profits used, see paragraph 6.4.5.2 below.

⁴⁷² See s 162A, discussed in paragraph 6.7 below.

⁴⁷³ CA 1985 s 162D(4); CA 2006 s 724.

⁴⁷⁴ As defined in CA 1985 s 171(3); CA 2006 s 710, see paragraph 6.2.2 above.

⁴⁷⁵ CA 1985 s 171(4); CA 2006 s 734(2).

⁴⁷⁶ CA 1985 s 171(5); CA 2006 s 734(3).

treated either as a capital redemption reserve (where the nominal value is greater) or can be used to reduce the capital or reserves (where the nominal value is less).⁴⁷⁷

6.4 Liability for unlawful repurchases

6.4.1 Purchases otherwise than out of capital

If a company purports to repurchase its shares otherwise than in accordance with the Act, the company and any officer in default commits a criminal offence.⁴⁷⁸ The transaction will be void⁴⁷⁹ and consequently any consideration paid will have to be returned. There is no express provision to the effect that the directors will be liable to refund the consideration should it not otherwise be recoverable.

6.4.2 Purchases out of capital

Apart from imposing criminal sanctions on a director who makes a statutory declaration without having reasonable grounds for the opinion expressed in it, the Companies Act does not regulate liability for unlawful capital payments to acquire shares. The substantive protection is found in the Insolvency Act 1986 which provides for personal liability of directors and shareholders should the company be wound up within one year of making a payment out of capital for the purchase or redemption of shares.

Where a company has repurchased or redeemed its shares out of capital and is subsequently wound up within one year of the date of the payment, the person from whom the shares were acquired and the directors who signed the statutory declaration may be held liable to contribute to the assets of the company.⁴⁸⁰ No defence is available to the former shareholder.⁴⁸¹ However, a director can escape

⁴⁷⁷ CA 1985 s 171(6); CA 2006 s 734(4).

⁴⁷⁸ CA 1985 s 143(2); CA 2006 s 658(2)(a).

⁴⁷⁹ CA 1985 s 143(2); CA 2006 s 658(2)(b).

⁴⁸⁰ Section 76 of the Insolvency Act 1986.

⁴⁸¹ It would, for example, not help the shareholder to prove that the company was indeed solvent or able to pay its debts when the payment was made and that the eventual winding-up was caused

liability by proving she had reasonable grounds for forming the opinion set out in the declaration.⁴⁸² This means that some directors may be excused while others may be liable, depending on the exact information at their disposal. The grounds for relief are set out with more clarity than in the South African provisions.⁴⁸³

Any shareholder or director who has contributed an amount under the liability provision may apply to court for an order directing any other person jointly and severally liable in respect of that amount to pay her such amount as the court thinks just and equitable.⁴⁸⁴ This allows the court a discretion to allocate the blame between shareholders and directors and facilitates equitable contribution between shareholders.

The shareholders and directors will be liable for the 'deficiency'. This is the difference between, on the one hand, the aggregate of the company's assets and any contributions paid and, on the other hand, the total of its debts, liabilities and the costs of winding-up.⁴⁸⁵ It is interesting to note that the liability to contribute to the assets of the company is limited to the lesser of the amount of the unlawful payment and the amount required for meeting the company's liabilities at the time when liability is imposed.

A number of differences between the South African and English liability provisions are evident. In South Africa, liability is imposed regardless of whether or not the company is insolvent or unable to pay its debts at the time when the provision is invoked. The company's financial situation at the time of payment is relevant. The English provision does not depend on whether or not the company was able to pay its debts immediately after the payment nor on whether or not the payment caused the company to become unable to pay its debts in the ensuing year. The only question is whether the company was in fact wound up within one

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by unforeseen events. It is difficult to predict how the court might exercise its discretion in such a case.

⁴⁸² Section 76(1).

⁴⁸³ See Chapter 5 paragraph 6.4.1.1.

⁴⁸⁴ Section 76(4).

⁴⁸⁵ Insolvency Act 1986 s 76.

year of making a payment out of capital. The English provision may be easier to apply, as the liquidator will be certain of repayment, at least from shareholders.

The extent of liability is also different. In England, the liability is restricted to the deficiency or amount required to pay debts. Under the South African provision,⁴⁸⁶ the amount of the unlawful payment can be recovered, even if the company's assets exceed its liabilities at the time when the payment is recovered. The English approach is similar to the approach of the Close Corporations Act in South Africa in respect of the liability of former members.⁴⁸⁷

Another important difference between the two provisions is that in South Africa the directors are primarily liable for any amount of the unlawful payment not otherwise recovered by the company. Shareholders are liable only upon application of the directors or creditors. In England, however, the court can apportion liability and is not restricted to holding directors liable for amounts unrecovered from shareholders.

6.5 Enforceability of repurchase agreements

An agreement by a company to repurchase its shares, whether out of capital or not, is binding. However, the consequences of company's breach of such a contract are regulated.⁴⁸⁸ This provision changes the ordinary rules on breach of contract in important respects and further regulates the position should the company be wound up before the contract has been completed. The same principles apply to a company's failure to redeem redeemable shares.⁴⁸⁹

A company is not liable in damages for failing to redeem or purchase its own shares.⁴⁹⁰ An explanation for this deviation from ordinary principles of breach of

⁴⁸⁶ Companies Act 61 of 1973 (South Africa) s 86, see Chapter 5 paragraph 6.4.1.2.

⁴⁸⁷ Close Corporations Act 69 of 1984 (South Africa) s 70(3).

⁴⁸⁸ CA 1985 s 178; CA 2006 s 735.

⁴⁸⁹ CA 1985 s 178(1); CA 2006 s 735. The section applies where a company has on or after 15 June 1982 (the date when the 1981 Companies Act came into operation) issued redeemable shares or agreed to purchase any of its own shares.

⁴⁹⁰ CA 1985 s 178(2); CA 2006 s 735(2). In *Barclays Bank plc v British and Commonwealth Holdings plc* [1996] 1 BCLC 1 (CA) at 27 damages were awarded in respect of another

contract is that it will be inappropriate to pay damages to a shareholder who retained her shares, especially since damages may have to be paid out of capital.⁴⁹¹ Other remedies for breach, such as a prohibitory interdict, remain available.⁴⁹²

However, the court may not grant an order for specific performance if the company shows that it is unable to meet the cost of redeeming or repurchasing out of distributable profits.⁴⁹³ A literal interpretation of this provision means that a company will not be able to escape an order for specific performance if the repurchase or redemption was to be funded out of the proceeds of a fresh issue of shares and the company has been unable to obtain this fresh capital.⁴⁹⁴ Further, a company that undertook to fund a repurchase or redemption out of the proceeds of a fresh issue could technically avert an order for specific performance by proving insufficient distributable profits. However, I think an order should in fact be made against a company that has sufficient proceeds from a fresh issue of shares. This argument should also be extended to purchases out of capital where the distributable profits together with the permissible capital payment and any proceeds of a fresh issue are adequate.

One may have expected a further provision regulating the enforceability of a repurchase or redemption out of capital. Such a provision should refer to the company's solvency situation and should provide that an order for specific performance cannot be given against a company that shows that it is unable to pay its debts or that making the payment will affect its continued ability to pay its debts within the ensuing year. Perhaps such a provision was considered unnecessary in

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agreement that was connected with the company's obligation to redeem. See also *Gower & Davies' Company Law* 7 ed 256 note 11 and *Gore-Browne on Companies* 24[37] note 3.

⁴⁹¹ *Gower & Davies' Company Law* 7 ed 256.

⁴⁹² See *Re Holders Investment Trust Ltd* [1971] 1 WLR 583 at 590 for an example where the holder of redeemable shares prevented the payment of a dividend which would have left the company with insufficient assets to redeem her shares. See also *Gower & Davies' Company Law* 7 ed 257.

⁴⁹³ CA 1985 s 178(3); CA 2006 s 735(3).

⁴⁹⁴ *Gower & Davies' Company Law* 7 ed 256, especially note 13.

view of the strict time limits for payments out of capital.⁴⁹⁵

If a company is wound up while it has an outstanding liability⁴⁹⁶ in terms of a redemption or repurchase contract, the terms of the redemption or repurchase may be enforced by the shareholder⁴⁹⁷ provided that the company could, during the period between the due date for redemption or repurchase and the date of commencement of winding-up lawfully have made a distribution⁴⁹⁸ equal in value to the purchase or redemption price.⁴⁹⁹ If the shares were liable to be redeemed or repurchased at a date later than the date of commencement of the winding up, the terms of the redemption or contract may not be enforced against the company.⁵⁰⁰

Upon purchase or redemption the shares will be cancelled.⁵⁰¹ Any money owed to a shareholder in this respect ranks for payment:

- after all other debts and liabilities of the company, except debts due to members in their capacity as members
- after any amounts due in respect of shares having preference as to capital or income over the rights as to capital attaching to the shares in question
- before any other amounts due to members in satisfaction of their rights as members to capital or income.⁵⁰²

This is similar to the South African provision⁵⁰³ that affords claims for repurchase consideration the same ranking. However, it is significant that the South African

⁴⁹⁵ See paragraph 6.3.3.5 above. Payment has to be made within 7 weeks of the date of the statutory declaration.

⁴⁹⁶ In order to qualify as being outstanding, the terms of the redemption or repurchase must have provided for payment at a date not later than the commencement of the winding-up, see *Gower & Davies' Company Law* 7 ed 257.

⁴⁹⁷ CA 1985 s 178(4); CA 2006 s 735(4).

⁴⁹⁸ As defined in CA 1985 s 181 read with s 263(2); CA 2006 Part 23.

⁴⁹⁹ CA 1985 s 178(5)(b); CA 2006 s 735(5)(b).

⁵⁰⁰ CA 1985 s 178(5)(a); CA 2006 s 735(5)(a).

⁵⁰¹ CA 1985 s 178(4); CA 2006 s 735(4).

⁵⁰² CA 1985 s 178(6); CA 2006 s 735(6).

⁵⁰³ Companies Act 61 of 1973 (South Africa) s 88.

provision is restricted to repurchase agreements, leaving the position of shares that have become redeemable prior to liquidation to be determined under general principles.⁵⁰⁴ South Africa may benefit from providing for the enforceability of redemptions and the ranking of redemption claims along similar lines as for repurchases.⁵⁰⁵

6.6 The status of repurchased shares

In most instances, shares acquired by the company have to be cancelled.⁵⁰⁶ Under CA 1985 they are restored to the status of authorised but unissued shares. However, CA 2006 does away with authorised capital and merely requires cancellation of the shares.

Although the Second Company Law Directive has since its inception provided that companies could hold up to ten per cent of any class of their own shares in treasury,⁵⁰⁷ this option was introduced in England only fairly recently and to a limited extent.⁵⁰⁸ Since December 2003 companies with publicly traded shares may hold up to ten per cent of any class of their own shares in treasury.⁵⁰⁹

Publicly traded shares are shares that are included in the official list under Part 6 of the Financial Services and Markets Act; traded on the Alternative Investment Market; officially listed in an EU State; or traded on a regulated market established in an EU State that is a regulated market for the purposes of article 16 of the Investment Services Directive.⁵¹⁰ Shares that cease to be qualifying shares, may no

⁵⁰⁴ See Chapter 5 paragraph 6.5.

⁵⁰⁵ See Chapter 5 paragraph 6.8.

⁵⁰⁶ CA 1985 s 162(2), read with section 160(4) – (5); CA 2006 s 662 read with s 706(b).

⁵⁰⁷ Article 19.

⁵⁰⁸ See Morse “Treasury Shares” 305 – 308 for an overview of the reform process followed.

⁵⁰⁹ This possibility was introduced with effect from 1 December 2003 by the Companies (Acquisition of Own Shares) (Treasury Shares) Regulations 2003, SI 2003/1116, made under s 2(2) of the European Communities Act 1972. The regulations were supplemented by the Companies (Acquisition of Own Shares) (Treasury Shares) No 2 Regulations 2003, SI 2003/3031 which were made on 18 December 2003.

⁵¹⁰ CA 1985 s 162(4); CA 2006 s 724(2).

longer be held in treasury and have to be cancelled.⁵¹¹

Treasury shares must be acquired through a repurchase⁵¹² by the company out of distributable profits⁵¹³ and held by the company continuously since their repurchase.⁵¹⁴ The company must be entered in the register of members as the member holding the shares.⁵¹⁵

The maximum number of shares the company may hold is ten per cent by nominal value of the shares in any class or ten per cent of the nominal value of the issued share capital, should the company have only one class of shares.⁵¹⁶ Setting a limit with respect to any specific class of shares is more sophisticated than the South African provision that takes into account the total number of issued shares in the holding company.⁵¹⁷

Further, if the company holds more than the maximum limit of ten per cent, the excess has to be cancelled or disposed of before the expiration of twelve months from the date on which the limit was first exceeded.⁵¹⁸ This provision allows the company some leeway following a share repurchase or reduction of capital which has the effect of increasing the percentage of shares held by it. Although treasury shares are not allowed in South Africa, it is suggested that a cancellation provision may be useful in respect of shares held by subsidiaries in excess of the prescribed

⁵¹¹ CA 1985 s 162E; CA 2006 s 729(2). A mere suspension of listing or from trading on the relevant market does not mean that the shares cease to be qualifying shares, see *Gore-Browne on Companies* 24[39].

⁵¹² CA 1985 s 162(4); CA 2006 s 724(2) read with s 724(5)(a). Redeemable shares must be cancelled upon redemption; see paragraph 6.8 below.

⁵¹³ CA 1985 s 162A(1); CA 2006 s 724(1)(a). Morse "Treasury Shares" 310 explains that the reason for not allowing shares acquired out of the proceeds of a fresh issue of shares to be held in treasury is that it would lead to capital maintenance and accounting problems.

⁵¹⁴ CA 1985 s 162A(3); CA 2006 s 724(5)(b).

⁵¹⁵ CA 1985 s 162A(2); CA 2006 s 724(4).

⁵¹⁶ CA 1985 s 162B(1) – (2); CA 2006 s 725(1) – (2). Note the word 'hold' rather than acquire. The implications of the use of 'acquire' in the South African provisions allowing cross-holdings is considered in Chapter 5 paragraph 6.7.

⁵¹⁷ See Chapter 5 paragraph 6.7.

⁵¹⁸ CA 1985 s 162B(3); CA 2006 s 725(3). The cancellation or disposal must be done in accordance with CA 1985 s 162D; CA 2006 s 727 (disposal) and s 729 (cancellation).

limit, as this situation is currently not regulated.⁵¹⁹

Treasury shares do not confer on the company any rights that may be exercised by a shareholder, including the right to attend or vote at meetings and pre-emptive rights on further issues.⁵²⁰ Any attempt by the company to exercise these rights during their suspension is void.⁵²¹ Further, no dividend or other distribution, including a distribution on liquidation, may be paid in respect of treasury shares.⁵²²

Fully paid bonus shares may, however, be allotted in respect of treasury shares⁵²³ and will be treated as if they were repurchased in the same circumstances as the original treasury shares.⁵²⁴ As the bonus shares are issued proportionately to all shares in the class, the company will not exceed the ten per cent limit. However, if a cash alternative accompanies the bonus issue, the proportionality may indeed be disturbed. The company may then have to cancel or dispose of the excess shares.

A company may hold, cancel,⁵²⁵ sell for cash,⁵²⁶ or transfer for purposes of or

⁵¹⁹ See Chapter 5 paragraph 6.7.

⁵²⁰ CA 1985 s 162C(2); CA 2006 s 726(2). Morse "Treasury Shares" 313 explains that the general principle is that a company holding treasury shares should be in the same position as if it had cancelled the shares. Morse also outlines the implementation of this principle in relation to takeover regulation and tax consequences, see 318 – 324.

⁵²¹ CA 1985 s 162C(2); CA 2006 s 726(2)). See also *Gore-Browne on Companies* 24[39].

⁵²² CA 1985 s 162C(4); CA 2006 s 726(3).

⁵²³ CA 1985 s 162C(5)(a); CA 2006 s 726(4)(a).

⁵²⁴ CA 1985 s 162C(6); CA 2006 s 726(5). They will be regarded as having been purchased out of distributable profits and continuously held and will be subject to the same suspension of rights as other treasury shares.

⁵²⁵ CA 1985 s 162D(1)(c); CA 2006 s 729(1). It must then reduce its issued capital, CA 1985 s 162D(4); CA 2006 s 729(4). The requirements for a formal reduction of capital need not be complied with, CA 1985 s 162D(5); CA 2006 s 729(5).

⁵²⁶ CA 1985 s 162D(1)(b); CA 2006 s 727(1)(a). Cash means cash, including foreign currency received by the company; a cheque received in good faith which the directors have no reason to suspect will not be paid; a release of liability of the company for a specified sum; or an undertaking to pay cash on or before a date not more than 90 days after the date of which the company agrees to sell the shares, CA 1985 s 162D(2); CA 2006 s 727(2). This definition is similar to the definition of cash in CA 1985 s 738(2); CA 2006 s 583(3) that applies to the distinction between cash and non-cash consideration for the issuing of shares. However, under CA 1985 s 738(2) CA 2006 s 583(3) an undertaking to pay cash in the future is not subject to any time limit as is the case in CA 1985 s 162D(2); CA 2006 s 727(2).

pursuant to an employees' share scheme⁵²⁷ any treasury shares. However, it may not sell them if it has received notice of the exercise of minority buy-out rights,⁵²⁸ except to the person giving the notice.⁵²⁹ The company may redeem its redeemable treasury shares and pay (to itself) the amount payable on redemption.⁵³⁰ It is difficult to see how a company can pay an amount to itself. As the redemption must be funded out of distributable profits or a fresh issue of shares,⁵³¹ the payment to the company will not even involve an adjustment to its share capital account. It appears preferable for the company to cancel its treasury shares prior to redemption, in order to avoid the need of covering the redemption price payable to itself out of its distributable profits or the proceeds of a fresh issue of shares.

When treasury shares are sold, the proceeds of the sale, up to an amount equal to the purchase price paid by the company, have to be treated as realised profit of the company.⁵³² Any part of the resale price which exceeds the price paid by the company, must be transferred to the share premium account.⁵³³

As far as disclosure is concerned, a company has to distinguish between shares repurchased and cancelled upon acquisition⁵³⁴ and shares that will be held in treasury.⁵³⁵ When treasury shares are subsequently sold, transferred or cancelled, the number and nominal value of the shares so disposed of or cancelled,

⁵²⁷ CA 1985 s 162D(1)(b); CA 2006 s 727(1)(b). An employees' share scheme is defined in CA 1985 s 743; CA 2006 s 1166.

⁵²⁸ Minority buy-out rights are provided for in CA 1985 s 429; CA 2006 s 979. See *Gore-Browne on Companies* 24[39] and 46[32].

⁵²⁹ CA 1985 s 162D(3); CA 2006 s 727(4).

⁵³⁰ CA 1985 s 162C(5)(b); CA 2006 s 726(4)(b).

⁵³¹ Only public companies may have treasury shares so the option of using capital is not available.

⁵³² CA 1985 s 162F(2); CA 2006 s 731(2). The price paid by the company is calculated as the weighted average price, set out in CA 1985 s 162F(4); CA 2006 s 741(4)(a). No price is regarded as having been paid by the company in respect of shares allotted to it as fully paid bonus shares, CA 1985 s 162F(5); CA 2006 s 731(4)(b). This makes sense, because the company purchased them out of distributable profits (and created a capital redemption reserve) or out of a fresh issue of shares.

⁵³³ CA 1985 s 162F(3); CA 2006 s 731(3).

⁵³⁴ CA 1985 s 169(1A); CA 2006 s 707(1) – (2).

⁵³⁵ CA 1985 s 169(1B); CA 2006 s 707 (1) – (2).

and the date on which this happened, must also be disclosed within 28 days.⁵³⁶

The introduction of treasury shares in England at a time when other jurisdictions have abolished them can be explained by the retention of the share capital concept. One of the main advantages of treasury shares identified in England relates to the management by companies of their debt-equity ratios. Unless treasury shares are allowed, a repurchase will result in an increase of the ratio of debt to equity and the only way to counter this is to resort to an issue of new shares, which can be expensive.⁵³⁷ When treasury shares are resold, the company need not incur underwriting costs. Other advantages include having shares available for employee share schemes and share option demands.⁵³⁸

The risk of market manipulation and abuse is addressed by the FSA *Listing Rules*. The disposal of treasury shares are subject to the same limitations as a disposal of shares by a director, and when being disposed of at a discount of more than ten per cent to the middle price of the shares at the time of sale, all existing shareholders must be given the opportunity of acquiring them proportionately.⁵³⁹

6.7 Repurchases through subsidiaries

A subsidiary may not purchase shares in its holding company. This prohibition is inferred from the fact that a company may not directly or through a nominee be a member of its holding company.⁵⁴⁰ A subsidiary may continue to hold shares in its holding company that it acquired before becoming a subsidiary⁵⁴¹ or in

⁵³⁶ CA 1985 s 169A; CA 2006 s 728 (disposals) and s 730 (subsequent cancellations).

⁵³⁷ See Morse "Treasury Shares" 304, 306.

⁵³⁸ Morse "Treasury Shares" 306.

⁵³⁹ See Morse "Treasury Shares" 316 – 318. See also chapter XV of the *FSA Listing Rules*.

⁵⁴⁰ CA 1985 s 23(1); CA 2006 s 136(1)(a). Limited exceptions apply. A subsidiary may hold shares as a personal representative or as a trustee, provided the holding company or a subsidiary of it is not beneficially interested under the trust, CA 1985 s 23(2); CA 2006 s 138. A subsidiary who is an authorised dealer in securities may also hold shares in its holding company in the ordinary course of its business as intermediary, CA 1985 s 23(3); CA 2006 s 141. For an explanation of the extent of this exception, see *Gore-Browne on Companies* 24[45] – 24[49].

⁵⁴¹ CA 1985 s 23(5); CA 2006 s 137.

circumstances where it could lawfully acquire them,⁵⁴² but may not vote in respect of the shares while it remains a subsidiary.⁵⁴³ It may receive bonus shares allotted out of the capitalisation of reserves.⁵⁴⁴ Since the right to vote is expressly excluded, but not the right to receive a dividend, it can be inferred that subsidiaries may receive dividends. This is also in line with the position in South Africa.⁵⁴⁵

6.8 Redemption of shares

The redemption of redeemable preference shares has been possible in England since 1928.⁵⁴⁶ When the new share repurchase provisions were first introduced, it became possible for a company to issue shares of any class as redeemable shares,⁵⁴⁷ provided it also issues at least one class of shares that are not redeemable.⁵⁴⁸ Although CA 1985 subjected the power to issue redeemable shares to authorisation in the articles, CA 2006 requires this only in respect of public companies.⁵⁴⁹ Under CA 2006 private companies have the power to issue redeemable shares unless restricted or excluded by their articles.⁵⁵⁰ Relaxation of the formalities by CA 2006 also affects the terms and manner of the redemption. It is expressly provided that the directors can determine the terms, condition and manner of redemption either in terms of an authority in the articles or in terms of an ordinary resolution, despite the fact that the resolution may amend the articles.⁵⁵¹

⁵⁴² CA 1985 s 23(4); CA 2006 s 136(1)(b) – (c).

⁵⁴³ CA 1985 s 23(5); CA 2006 s 137(4). See *Acatos & Hutcheson plc v Watson* [1995] BCC 446.

⁵⁴⁴ CA 1985 s 23(6); CA 2006 s 137(3).

⁵⁴⁵ See Chapter 5 paragraph 6.7.

⁵⁴⁶ *Gore-Browne on Companies* 7 ed 248.

⁵⁴⁷ CA 1985 s 159; CA 2006 s 684(1) refers only to shares issued as redeemable shares and consequently does not allow for the conversion of other shares into redeemable shares, see *Re St James' Court Estate Ltd* [1944] Ch 6, see also *Forth Wines Ltd, Petitioners*, [1991] BCC 638, 1993 SLT 170 Ct of Session, Inner House. See *Gore-Browne on Companies* 24-22 note 6. par 24[23], 26[18] – 26[19]. The same effect as a subsequent conversion can presumably be achieved through a contingent repurchase contract.

⁵⁴⁸ CA 1985 s 159(2); CA 2006 s 684(4).

⁵⁴⁹ CA 2006 s 684(3).

⁵⁵⁰ CA 2006 s 684(2).

⁵⁵¹ CA 2006 s 685. This relaxation is particularly interesting in view of CA 1985 s 159A, which was inserted by the 1989 Companies Act, but which has not been put into force. This amendment

Redemption may take place out of the proceeds of a fresh issue of shares or out of distributable profits.⁵⁵² Details about the financial restrictions appear in the discussion of share repurchases and so are not repeated here.⁵⁵³

While CA 1985 requires payment of the full redemption price on the date of redemption,⁵⁵⁴ CA 2006 allows an exception whereby an agreement between the company and the shareholder may provide for payment on a later date.⁵⁵⁵

When redeemable shares were issued at a premium, any premium payable upon redemption may be paid out of a fresh issue of shares up to an amount equal to the lesser of:

- the aggregate of the premiums received by the company on the issue of the shares redeemed
- the current amount of the company's share premium account, including any sum transferred to the account in respect of premiums on the new shares.⁵⁵⁶

The share premium account must then be reduced by the amount of any payment made in respect of the premium out of the proceeds of the fresh issue of shares.⁵⁵⁷

Redeemed shares are to be treated as cancelled and the issued capital of the

Continued

took the opposite direction by requiring extensive terms and conditions for redemption in the articles, which would limit the discretion of directors. See *Gore-Browne on Companies* 24-21 24[23].

⁵⁵² CA 1985 s 160(1); CA 2006 s 687(2). CA 1985 s 180(2) provides that redeemable preference shares issued under section 59 of the 1948 Companies Act may also be redeemed out of the share premium account. CA 2006 does not provide for this.

⁵⁵³ See paragraph 6.2.1 above.

⁵⁵⁴ CA 1985 s 159(3); CA 2006 s 686(3). *Peña v Dale* [2004] 2 BCLC 508 at pars 107 – 114. See *Gore-Browne on Companies* 24[23] note 13 on 24-22.

⁵⁵⁵ CA 2006 s 686(2).

⁵⁵⁶ CA 1985 s 160(2); CA 2006 s 687(4). See also paragraph 2.4 above. It has been noted that these requirements are stricter than the comparable South African provision in that they limit application of the premium to the shares that contributed it, see further Chapter 5 paragraph 2.4.3.3.2.

⁵⁵⁷ CA 1985 s 160(2); CA 2006 s 687(5). The Standing Committee on Company Law of the Law Society was opposed to the application of the share premium account to provide for a premium on redemption, see Sealy "Views on Share Repurchase" 27.

company must be reduced by the nominal value of the redeemed shares.⁵⁵⁸ The authorised capital is not regarded as having been diminished and the company can issue fresh shares up to the value of redeemable shares that are about to be redeemed.⁵⁵⁹ The Registrar has to be notified within one month of any redemption.⁵⁶⁰

Private companies may redeem their shares out of capital, subject to the same requirements that apply to purchases out of capital.⁵⁶¹ I consider these requirements in relation to share repurchases⁵⁶² and do not repeat them here.

7 EVALUATION AND CONCLUSION

Despite the significance which other financial facts about the company may have for creditors, British law still regards a company's statement of the level of assets contributed by the shareholders to the company in exchange for shares as an important element in creditor protection.⁵⁶³

Although the above statement was made with reference to CA 1985, it remains true under CA 2006. Apart from the abolition of the concept 'authorised capital' by CA 2006,⁵⁶⁴ very little will have changed once all its provisions are in force.

In addition to submitting current statements pertaining to their issued capital,⁵⁶⁵ companies generally have to maintain their share capital and may make distributions only out of an excess of assets over liabilities and share capital.⁵⁶⁶

In respect of public companies, England has little freedom to reform its share capital and distribution rules and is dependent on EU initiatives that may allow it to

⁵⁵⁸ CA 1985 s 160(4); CA 2006 s 687(6).

⁵⁵⁹ CA 1985 s 160(4) – (5); CA 2006 s 688(a) – (b).

⁵⁶⁰ CA 1985 s 169; CA 2006 s 689. Failure to do so renders the company and every officer in default liable to a daily default fine. See *Gore-Browne on Companies* 24[23] at 24-22.

⁵⁶¹ CA 1985 s 160(1); CA 2006 s 687(1).

⁵⁶² See paragraph 6.2.2 above.

⁵⁶³ *Gower & Davies' Company Law* 7 ed 289 – 290.

⁵⁶⁴ See paragraph 2.1 above.

⁵⁶⁵ See paragraph 2.1 above.

⁵⁶⁶ See paragraph 5.2 above.

do so.⁵⁶⁷ Although it is theoretically possible to drastically reform the rules for private companies, an option that was indeed contemplated in the reform process, practical considerations militate against drastic divergence in the regulation of the capital structure of public and private companies.⁵⁶⁸ As a result, the recent reforms pertaining to private companies tend to affect procedure rather than substance.

The abolition of the concept of authorised capital has the effect of simplifying the variation of capital provisions.⁵⁶⁹ While authorised capital is a feature of CA 1985, the risk of confusion on the part of investors and creditors is reduced by the requirement that references on the stationery of the company must be to its paid-up capital. Such a provision has definite advantages, because it also avoids the risk of confusion between allotted or issued capital and paid-up capital, given the fact that partly paid shares are allowed in England. South Africa could benefit from such a provision.

Shareholders are protected against the dilution of their equity interests through pre-emptive rights that apply to all companies, unless expressly excluded in their articles of association.⁵⁷⁰ Any issue of shares wholly for cash consideration is subject to pre-emptive rights. In addition, the issue of shares must be approved by the shareholders or by a general authority in the articles. This existing protection of shareholders was regarded as adequate, so it was not necessary to introduce any further restrictions on the power of directors to issue shares in CA 2006.

Public companies have to have a minimum allotted share capital of £50 000, of which at least a quarter must be paid up when the company is incorporated.⁵⁷¹ As in South Africa, no specific amount of minimum share capital is prescribed for private companies and such companies may have shares that are not paid up to any extent upon being issued.

Shares have to have a par or nominal value and may not be issued at a

⁵⁶⁷ See paragraph 1 above.

⁵⁶⁸ See paragraph 2.3 above.

⁵⁶⁹ See paragraph 2.1 above.

⁵⁷⁰ See paragraph 2.1 above.

⁵⁷¹ See paragraph 2.2 above.

discount.⁵⁷² The consideration received by the company must be reflected in a share capital account and, if the shares are issued at a premium, in a share premium account. The capital structure of a company is closely regulated. A specific feature of the regulation of share premium accounts is the much greater degree of correlation between the contribution of a premium by a particular class of shares and the subsequent application of the share premium account.⁵⁷³ This reveals a much more sophisticated approach than the current South African position. Specific relief is also provided in the case of mergers and group reconstructions, with the result that the amount by which the value of shares received exceeds the par value of shares issued in exchange, need not be reflected in the share premium account.⁵⁷⁴

Provision is made for the variation and reduction of share capital, where the basic approach entails that share capital is substituted by a non-distributable reserve.⁵⁷⁵ Reductions of capital are also possible with the sanction of the court.⁵⁷⁶ However, CA 2006 introduces an alternative reduction of capital procedure for private companies.⁵⁷⁷ This procedure dispenses with the requirement of court approval and depends on the solvency and liquidity of the company.

Under the traditional reduction procedure subject to court approval, creditors enjoy particularly strong protection. They can object to the reduction and can in effect force the company either to pay them immediately or to provide security for the satisfaction of their claims.⁵⁷⁸ Under the new alternative reduction procedure applicable to private companies, creditors are protected by the solvency and liquidity requirements only.⁵⁷⁹

Shareholders are also protected in various ways when a company reduces its

⁵⁷² See paragraphs 2.3 and 3.1 above.

⁵⁷³ See paragraph 2.4.3 above.

⁵⁷⁴ See paragraph 2.4.3 above.

⁵⁷⁵ See paragraph 2.5 above.

⁵⁷⁶ See paragraph 2.6.1 above.

⁵⁷⁷ See paragraph 2.6.2 above.

⁵⁷⁸ See paragraph 2.6.1 above.

⁵⁷⁹ See paragraph 2.6.2 above.

capital.⁵⁸⁰ First, a special resolution is required for any reduction of capital. Secondly, where class rights are affected, the procedure for variation of class rights must be followed. Thirdly, the courts have formulated particular guidelines about the fair treatment of different classes of shares and of shares within a class.

Shareholder capital contributions are closely regulated, and shares may not be issued at a discount.⁵⁸¹ Specific provision is made for the issuing of capitalisation shares, to make it clear that such issues do not violate the requirements on consideration. The types of consideration that may be accepted by public companies are more limited than for private companies.⁵⁸² Further, in the case of public companies independent valuation of non-cash consideration is required, while proper disclosure of non-cash consideration is required in private companies.

⁵⁸³ Although shares need not be fully paid up upon issue, restrictions apply to public companies.⁵⁸⁴ At least a quarter of the par value must be paid up when the shares are issued and it is required that the consideration must be transferred within five years of the issue of the shares. These rules are aimed at protecting creditors and existing shareholders.

In line with the capital maintenance doctrine, the prescriptions on the formation of share capital are supplemented by distribution rules that rely on the concept of distributable profits. Distributable profits are net assets of the company in excess of its issued capital and prescribed reserves.⁵⁸⁵ Although there is a definition of 'distribution', this definition excludes share repurchases and redemptions, reductions of capital and capitalisation issues as these are provided for separately. Liquidation distributions are also excluded. Distributions include dividends as well as any other payments to shareholders. Although the definition of distribution does not expressly require the payment to be 'in respect of' or 'by reason of' shareholding,

⁵⁸⁰ See paragraph 2.6 above.

⁵⁸¹ See paragraph 3.1 above.

⁵⁸² See paragraph 3.2 above.

⁵⁸³ See paragraph 3.3 above.

⁵⁸⁴ See paragraph 3.4 above.

⁵⁸⁵ See paragraph 4 above.

the courts apply it in this way.

Distributable profits must be determined as prescribed in the legislation. This entails that specified items in the 'relevant accounts', usually the last annual accounts, properly audited, must be considered. Public companies also have to provide for unrealised losses. These rules are stricter than the common-law rules on the determination of 'profits'. Although the limitations theoretically apply at the moment of payment or making of the distribution, there is some confusion in this regard, given that the last annual accounts must be used to determine the amount of the distributable profits.

When a company has made a distribution in violation of the requirements, the recipient who knew or had reasonable cause to believe that the distribution was so made, is liable to repay to the company the amount of the distribution or its value.⁵⁸⁶ The statutory liability does not replace and common-law liability, but it is uncertain whether shareholders can be held liable despite receiving a distribution in good faith. Directors can be held liable at common law.⁵⁸⁷

A definite benefit of the English system is that the same financial restrictions are applicable to repurchases and redemptions, although the procedural aspects differ.⁵⁸⁸ This avoids the arbitrage of the current South African regulation of share repurchases and redemptions.

Repurchases and redemptions can be made out of distributable profits or alternatively out of the proceeds of a fresh issue of shares.⁵⁸⁹ When distributable profits are used, the nominal capital of the acquired shares must be reflected in a capital redemption reserve.

By way of exception, private companies may repurchase or redeem their shares out of share capital, although distributable profits and the proceeds of a fresh issue of shares must be exhausted first so that the resultant capital reduction is

⁵⁸⁶ See paragraph 5.6 above.

⁵⁸⁷ See paragraph 5.6 above.

⁵⁸⁸ See paragraph 6.1 above.

⁵⁸⁹ See paragraph 6.2 above.

limited to the 'permissible capital payment'.⁵⁹⁰ An equity solvency test applies and directors have to issue a formal declaration certified by the auditors.⁵⁹¹ Moreover, there must be public notice of the intended repurchase and members as well as creditors have the opportunity of objecting to court against the intended repurchase.⁵⁹²

Payment out of capital must take place within strict time limits that are designed to ensure on the one hand, that the financial position of the company will unlikely have changed since the date of the solvency statement and, on the other hand, that creditors and members are nevertheless given sufficient opportunity to object if they so wish.

There are a number of differences between this procedure and the new alternative reduction of capital procedure provided for in CA 2006. It is difficult to justify these differences given that the two procedures can achieve the same effect and that the simplified reduction procedure was intended to substitute the repurchase of shares out of capital.⁵⁹³

The procedure for share repurchases depends on the kind of repurchase that is involved. A distinction is made between off-market repurchases,⁵⁹⁴ market repurchases and repurchases out of capital.⁵⁹⁵ In all three instances, the articles of the company must authorise a repurchase.⁵⁹⁶ A special resolution is required, except in the case of a market repurchase where an ordinary resolution will suffice.⁵⁹⁷

Although no express provision is made for self-tender or proportionate offers, minority shareholders are protected by the voting exclusion applicable in respect of

⁵⁹⁰ See paragraph 6.2.2 above.

⁵⁹¹ See paragraph 6.3 above.

⁵⁹² See paragraph 6.3.3.4 above.

⁵⁹³ See paragraph 6.3.1.5 above.

⁵⁹⁴ Including contingent repurchase contracts.

⁵⁹⁵ See paragraph 6.3 above.

⁵⁹⁶ See paragraph 6.3.1 above.

⁵⁹⁷ See paragraph 6.3.1 above.

the shares that will be acquired in an off-market repurchase.⁵⁹⁸ The identity of the vendor-shareholder(s) and the terms of the repurchase must also be disclosed.⁵⁹⁹ A further safeguard is the requirement that any variation of the contract must be approved by special resolution.⁶⁰⁰

Although an ordinary rather than a special resolution is required for market purchases, the maximum number of shares as well as the maximum and minimum prices must be specified in the resolution. Provision is also made for full disclosure of the terms of the acquisition once implemented.⁶⁰¹

Finally, the *FSA Listing Rules* require that substantial market repurchases⁶⁰² should be implemented by way of an offer extended to all shareholders, either through a partial offer or as a self-tender offer.⁶⁰³

The repurchase of shares out of capital is subject to additional requirements pertaining to publicity and timing.⁶⁰⁴ No voting rights may be exercised in respect of the shares that are to be acquired. The right of members and creditors to object to an intended repurchase is a significant protection measure.⁶⁰⁵

It is clear that in England the main protection for shareholders against unfair repurchases lie in the requirements of authorisation, the exclusion of voting rights, and proper disclosure. Although companies are generally free to repurchase their shares proportionately from shareholders in an off-market repurchase, it is only in the case of substantial market repurchases that equal treatment is compulsory.⁶⁰⁶

The treatment of a share repurchase in the company's share capital accounts depends on the source from which the acquisition is funded. However, the underlying principle is that the cancelled share capital must be replaced either by

⁵⁹⁸ See paragraph 6.3.1.1 above.

⁵⁹⁹ See paragraph 6.3.1.1 above.

⁶⁰⁰ See paragraph 6.3.2 above.

⁶⁰¹ See paragraph 6.3.1.3 above.

⁶⁰² An acquisition of more than 15% of a company's equity shares.

⁶⁰³ See paragraph 6.3.1.3 above.

⁶⁰⁴ See paragraph 6.3.3 above.

⁶⁰⁵ See paragraph 6.3.3.4 above.

⁶⁰⁶ See paragraph 6.3.1.3 above.

fresh capital or by a capital redemption reserve.⁶⁰⁷ When shares are repurchased out of share capital, the accounts may be adjusted to reflect a reduction equal to the permissible capital payment.

A repurchase in violation of the statutory requirements is void, and gives rise to a claim for restitution. Directors will also have committed an offence. Where shares have been repurchased out of share capital and the company is subsequently wound up within one year of the payment, the directors and vendor-shareholders will be personally liable under the Insolvency Act 1986 to contribute to the assets of the company.⁶⁰⁸ Liability is for the lesser of the amount of the unlawful payment and the deficiency between assets and liabilities including the costs of winding-up. The court can apportion the liability between directors and shareholders. It is notable that no similar liability is imposed in respect of unauthorised reductions of capital under the new alternative capital reduction procedure. In addition, liability for repurchases from capital differs from the liability that can be imposed in respect of other unlawful distributions. Although South Africa may possibly benefit from a consideration of certain aspects of liability for unlawful distributions in England, such as the flexibility in apportioning liability between directors and shareholders in the case of repurchases out of capital, the English model is too fragmented and inconsistent to serve as an example for South Africa.

The English provisions on enforceability of unexecuted repurchase agreements rely on the same principle as the South African provision, namely that specific performance cannot be ordered if performance will contravene the financial restrictions.⁶⁰⁹ But the English provision is primarily designed for repurchases and redemptions otherwise than out of capital because it provides that specific performance is possible only if the company has sufficient distributable profits. However, the ranking of claims on winding-up applies to any outstanding liability for repurchase or redemption, regardless of the financial restrictions involved and so

⁶⁰⁷ See paragraph 6.3.4 above.

⁶⁰⁸ See paragraph 6.4.2 above.

⁶⁰⁹ See paragraph 6.5 above.

will apply to repurchases out of capital as well. The advantage of the English provision is that it also addresses the status of an obligation to redeem shares. South Africa could benefit by extending its rules regarding enforceability of repurchases to instances of redemption.

Shares repurchased or redeemed by a company must be cancelled. However, listed companies may hold up to ten per cent of their own shares in treasury.⁶¹⁰ The acquisition, holding and disposal of treasury shares are strictly regulated and the underlying objective is to ensure neutrality between holding and cancelling acquired shares. Nevertheless, several advantages remain, particularly flexibility and cost savings compared to subsequent fresh issues.

Under English Law, subsidiaries are not allowed to purchase shares in their holding companies.⁶¹¹ In view of the fact that in South Africa shares held by subsidiaries are analogous to treasury shares, some comparison of direct and 'indirect' treasury shares may be useful.⁶¹²

The temptation of dismissing English law as a useful source of comparison because it still adheres to the basic tenets of the outdated capital maintenance doctrine should be resisted. The basic objectives of creditor and shareholder protection play a central role in English company law and recently enjoyed the attention of policy-makers in the course of a very thorough and well-documented law reform process.

Despite the unavoidable rigidity of capital structure brought about by a par value system, the CA 2006 nevertheless managed to introduce some relief by abolishing authorised capital, with resultant simplification of capital variations, and simplification of the reduction of capital for private companies.

Even after these reforms, the English approach to creditor protection is somewhat out of step with that in other modern jurisdictions. Apart from the complexity caused by the co-existence of financial restrictions based on the ideas

⁶¹⁰ See paragraph 6.6 above.

⁶¹¹ See paragraph 6.7 above.

⁶¹² See Chapter 5 paragraph 6.10.7.

underlying the capital maintenance doctrine and the modern solvency and liquidity approach, the system is incongruous in a number of respects. This is evident from the haphazard availability of the creditor objection procedure⁶¹³ and the anomalous treatment of liability in respect of different unlawful distributions. Nevertheless, the rules on the determination of distributable profits in accordance with statutory guidelines represent a marked improvement on the vague common-law standards that applied to dividends. This in itself addresses many of the criticisms against the ineffectiveness of the eroded capital maintenance doctrine.

Shareholders enjoy considerable protection against the dilution of their equity interests and against unfair treatment. The Companies legislation provides some of this protection in the form of prescriptions regarding approval for the issuing of shares, pre-emptive rights, the regulation of non-cash consideration, the right to object against capital reductions, the authorisation of repurchases and the regulation of treasury shares. These rules are supplemented by the FSA *Listing Rules* in appropriate circumstances. Finally, English courts have developed specific principles regarding fair treatment of shareholders.

It will be interesting to monitor developments in England against the background of the reform of the principles embodied in the Second Company Law Directive. As the United Kingdom is increasing in popularity as a state of incorporation in the EU,⁶¹⁴ it can be expected to make maximum use of any opportunity to modernise its share capital and distribution rules.

⁶¹³ It is available for capital reductions subject to court confirmation and for share repurchases out of capital, but not for the alternative capital reduction procedure, although the last two procedures both involve private companies and depend on a solvency statement.

⁶¹⁴ See *Boyle & Birds' Company Law* 24.

CHAPTER 3

NEW ZEALAND

1 INTRODUCTION

The main statutory source of Company Law in New Zealand is the Companies Act 1993¹ that came into force on 1 July 1994.² It applies to all new companies incorporated or reregistered since that date and, from 1 July 1997, to all existing companies that failed to reregister.³ The Act is supplemented by various other statutes,⁴ the common law,⁵ and precedents. The distinction between public and private companies was abandoned under the Companies Act of 1993.⁶ Another innovation is that companies need not have a constitution, in which case the default provisions of the Act apply.⁷

Prior to the enactment of the 1993 Act, the capital maintenance doctrine applied in New Zealand.⁸ In addition to this, distributions to shareholders were subject to compliance with a common-law solvency and liquidity test.⁹ The 1993 Act

¹ No 105, hereafter in this chapter 'the Act'. All references to section numbers in this chapter are to sections in this Act, unless otherwise indicated.

² Section 1(2).

³ Companies Reregistration Act 1993, No 121, s 3, s 13. The Companies Act 1955, No 63 was repealed by the Companies Act Repeal Act 1993, No 126 which came into force on the close of day of 30 June 1997, s 1(2). For a discussion of the position during the 3 year transitional period, see Goodwin "New Zealand Companies Act 1993" 278 – 279.

⁴ Other applicable legislation includes the Takeovers Act 1993, No 107, the Financial Reporting Act 1993, No 106, the Receiverships Act 1993, No 122 and the Companies (Registration of Charges) Act 1993, No 125.

⁵ Which is based on English Law, see Grantham & Rickett *Company and Securities Law* 33. The Companies Act of 1955 No 63 mirrored the English Companies Act of 1948 (11&12 Geo, c 36), see Grantham & Rickett *Company and Securities Law* 38.

⁶ *Company Law: Reform and Restatement* (Report No 9, 1989). Certain other statutes, for example, the Financial Reporting Act 1993, No 106 do distinguish between companies on other grounds, such as turnover, number of shareholders etc. Generally all companies afford their members limited liability, but the constitution of a company may provide for personal liability of the members, see s 21.

⁷ Section 26. See also Grantham & Rickett *Company and Securities Law* 181 – 182.

⁸ Grantham & Rickett *Company and Securities Law* 851 – 852; *Morison's Company and Securities Law* 14.1.

⁹ *Morison's Company and Securities Law* 14.1. See *Hilton International Ltd v Hilton* (1988) NZCLC 64, 721 at 750 – 751; [1989] 1 NZLR 442 on the application and history of the common law principle of solvency, which included balance sheet and liquidity elements. For an outline of the reform process, see *Morison's Company and Securities Law* 1.5

moves away from capital maintenance and subjects distributions to the solvency and liquidity of the company, as certified by the directors.¹⁰

2 STRUCTURE OF SHARE CAPITAL

The Act does not use the concepts 'authorised capital' and 'share capital'.¹¹ For certain purposes reference is made to shareholders' funds as being the aggregate of amounts received by shareholders for the issue of their shares plus reserves.¹²

One of the essential requirements for the registration and existence of a company is that it must have at least one share.¹³ The liability of shareholders is expressed with reference to any amount unpaid on their shares.¹⁴

Although a company is obliged to issue the shares specified in its application for registration immediately upon incorporation,¹⁵ it need not receive any consideration for these initial shares.¹⁶ A company may be formed without any share capital.

Shares may not have a nominal or par value.¹⁷ The Act does not require the consideration received for the issue of shares to be reflected in any particular account of the company. However, a copy of the directors' certificate setting out the amount or the present cash value of the consideration for the issue of shares must be registered¹⁸ and may be inspected by shareholders.¹⁹ In a sense, these

¹⁰ *Morison's Company and Securities Law* 14.2.

¹¹ Grantham & Rickett *Company and Securities Law* 835.

¹² See s 80(1) which deals with certain instances of financial assistance.

¹³ Section 10. The remaining requirements are that it should have a name, one or more shareholders, and one or more directors.

¹⁴ Section 97(2)(a). The constitution of a company can also provide for unlimited liability, s 97(2), or for specific instances of liability, s 97(2)(b). Further, it is expressly stated that shareholders are liable to repay unlawful distributions, s 97(2)(d). Finally, shareholders can be liable as directors, s 97(2)(c), or because they exercised the functions usually exercised by directors, s 97(2)(e). See *Morison's Company and Securities Law* 3.1.

¹⁵ Section 41(a).

¹⁶ See *Morison's Company and Securities Law* 13.9. Initial shares are issued by the company under s 41 while subsequently issued shares are issued by the board of directors under s 42 or, if the company has a constitution that limits the rights of directors to issue shares, under s 44 following shareholder approval for the issue.

¹⁷ Section 38(1). Under the Companies Act 1955 all shares had to have a par value, see *Morison's Company and Securities Law* 13.3.

¹⁸ Section 43(1).

¹⁹ Section 216.

certificates will give an indication of the contributed share capital of the company. Such disclosure is not required in respect of initial shares of the company, though.²⁰

The board of directors may issue further shares at any time, to any person, and in any number it thinks fit.²¹ However, this right is subject to compliance with the Act and the constitution of a company.²² Compliance with the Act and the constitution of the company can be waived by unanimous assent of entitled persons.²³ The Act controls the power of directors to issue further shares in different ways.

First, pre-emptive rights apply unless excluded in the constitution of a company.²⁴ The default pre-emptive rights apply to any issue of shares by the company, regardless of the nature of the consideration for which the shares are issued.

A second measure controlling the power of directors to issue shares is the imposition of a positive duty on directors to consider the interests of the company and all the existing shareholders.²⁵ The common-law duties of directors when further shares are issued are partially codified and extended. The directors have to determine by resolution that not only the consideration, but also the terms of the issue, are fair and reasonable to the company and all the existing shareholders.²⁶ A determination by the directors is a precondition for the issuing of shares.²⁷ A purported issue is void if the relevant determination was not made.²⁸

Thirdly, shareholder approval is required in certain instances. The issue of further shares that rank equally with or in priority to existing shares is deemed to be an action affecting the rights attaching to existing shares.²⁹ This is so unless the

²⁰ Section 43(1) refers only to shares issued by the directors (s 42) and to shares issued following an amalgamation (s 41(b)).

²¹ Section 42.

²² Section 42.

²³ Section 107(2). 'Entitled person' is defined as a shareholder or any other person who in terms of the constitution of a company has any of the rights or powers of a shareholder, s 1.

²⁴ Section 45(1) read with s 45(3).

²⁵ Section 47. A similar duty applies in respect of the issue of options and convertible securities, see s 49.

²⁶ Section 47.

²⁷ The introductory words of s 47(1) read '**Before** the board of a company issues shares...' (emphasis added).

²⁸ *Waller v Paul* (1997) 8 NZCLC 261 (High Court of New Zealand).

²⁹ Section 117(3).

constitution expressly permits the issue of these further shares or the issue is subject to pre-emptive rights.³⁰ Since the issue of further shares is deemed to be an alteration of shareholder rights, it has to be approved by special resolution of each interest group.³¹ Dissenting shareholders can exercise appraisal rights.³²

The constitution of a company can also require that the issue of shares will be subject to shareholder approval.³³ In the event of non-compliance with this requirement, the issue will nevertheless be valid,³⁴ but the directors will incur criminal liability.³⁵

3 CAPITAL CONTRIBUTIONS

3.1 Size of capital contribution

Although consideration for the issuing of shares is regulated, the purpose is to protect the company and its existing shareholders rather than the creditors of the company.³⁶ The directors have to decide for which consideration and on which terms the shares will be issued.³⁷ Then they have to resolve that the consideration and terms they decided on are fair and reasonable to the company and to all its existing shareholders.³⁸ The directors who vote to adopt this resolution have to sign a certificate setting out the consideration, terms, and their assessment of the fairness and reasonableness of the issue.³⁹ A director who fails to comply with the requirements pertaining to the certificate commits a criminal offence.⁴⁰

³⁰ Section 117(3)(a), (b).

³¹ Section 117(1). An interest group is a group of shareholders with identical rights and whose rights are affected by an action or proposal in the same way, s 116. An issue in violation of this requirement will, however, not be void, s 119.

³² Section 118, read with s 111.

³³ Section 44(1).

³⁴ Section 44(5).

³⁵ Section 44(6).

³⁶ However, the reduction of a shareholder's liability in respect of a share is regarded as a distribution, see paragraph 4.1 below. This is indicative of a link between the liability to contribute and the interests of creditors.

³⁷ Section 47(1)(a).

³⁸ Section 47(1)(c).

³⁹ Section 47(2).

⁴⁰ Section 47(4).

The regulation of consideration for and terms of issue of shares is solely for the protection of the company and its shareholders. As a result, the shareholders can by unanimous written assent⁴¹ dispense with requirements as to authorisation of issues,⁴² determination and certification of consideration and terms,⁴³ pre-emptive rights,⁴⁴ any other restriction in the Act or the company's constitution.⁴⁵

The constitution of a company may provide that shares carry a liability to calls or may otherwise impose a liability on a shareholder.⁴⁶ Unlike the liability to pay the consideration for the issue of a share, which remains a liability of the person to whom the share was issued or who assumed liability for the consideration at the time of issue, the liability to pay calls always rests on the present holder of a share.⁴⁷

3.2 Form of capital contribution

Consideration for the issue of shares may be cash, promissory notes, contracts for future services, real or personal property, or other securities of the company.⁴⁸

It is not clear whether the issue of bonus shares is regarded as an issue for no consideration. When shares that are 'fully paid up from the reserves' of the company are issued proportionately to all shareholders in a class, the directors do not have to pass a resolution and sign a certificate regarding the consideration and terms of issue.⁴⁹ A leading commentary questions the justification for this exception by pointing out that such an issue can nevertheless disturb the overall equity interest in the company.⁵⁰ The exception leaves shareholders of the other classes unprotected by the requirements designed to protect all existing shareholders.

⁴¹ Section 107. See *Morison's Company and Securities Law* 13.14.

⁴² Section 44.

⁴³ Section 47.

⁴⁴ Section 45.

⁴⁵ Section 42.

⁴⁶ Section 100. The liability rests on the shareholder at the time the call is made, see *Morison's Company and Securities Law* 13.18.

⁴⁷ Section 100(1). This is so even if the liability became enforceable prior to the transfer of the share to its present holder.

⁴⁸ Section 46.

⁴⁹ Section 48(a). *Morison's Company and Securities Law* 13.14 criticises the reference to the shares being 'paid up' from reserves as these seem to be remnants of the previous Act.

⁵⁰ See *Morison's Company and Securities Law* 13.14

The directors' determination and certificate are also not required in the case of proportionate consolidations and subdivisions of shares.⁵¹ These actions clearly do not involve the reallocation of equity interests.⁵²

3.3 The regulation of non-cash capital contributions

Where non-cash consideration is accepted either when shares are to be issued or when they are subsequently credited as paid up, wholly or partly, other than in cash, the directors must determine the reasonable present cash value of the consideration.⁵³ They must also adopt a resolution declaring that the present cash value is not less than the amount to be credited for the issue of the shares.⁵⁴ Then they have to sign a certificate describing the consideration in sufficient detail to identify it, stating the present cash value and the basis for assessing it, and declaring that the present cash value is fair, reasonable, and at least equal to the amount to be credited in respect of the shares.⁵⁵ A copy of such a certificate has to be delivered to the Registrar for registration within 10 working days after it is given.⁵⁶

The reference to an amount that is to be credited for the issue of shares has been criticised as being anomalous, given the absence of a concept of nominal capital.⁵⁷ Presumably, this provision can only apply if the board of directors fixed an amount of money as consideration and then later accepts non-cash consideration from some shareholders. If the directors determine a non-cash consideration only, there is no 'amount' to be credited.⁵⁸

⁵¹ Section 48(b), (c).

⁵² See *Morison's Company and Securities Law* 13.14 who further asserts that a subdivision or consolidation does not really involve the issuing of shares.

⁵³ Section 47(1)(b).

⁵⁴ Section 47(1)(d) and 47(2)(e). *Morison's Company and Securities Law* 13.13 criticises this requirement because in the absence of par value and share capital accounts it is impossible to determine 'the amount to be credited for the issue of shares' if the shares are to be issued for specified property. However, the purpose seems to be that the consideration should not be overvalued in the books of the company. *Morison's Company and Securities Law* 13.19 regards this as an example of old concepts brought forward from the capital maintenance rule. A company need not reflect any amount as consideration.

⁵⁵ Section 47(2) and (4).

⁵⁶ Section 47(5).

⁵⁷ *Morison's Company and Securities Law* 13.13. It is said that it carries forward vestiges of the old share capital idea.

⁵⁸ But the present cash value will still have to be determined and certified as fair by the directors.

Shares are also regarded as paid up 'other than in cash' if they are credited as fully or partly paid up as part of an arrangement involving a transfer of property or the provision of services, even if the arrangement also involves an exchange of cash or cheques or other negotiable instruments.⁵⁹

When previously issued shares are later credited as fully or partly paid up other than for cash, the directors also have to determine the present cash value of the consideration and resolve and certify that it is fair and reasonable to the company and all its existing shareholders and that the present cash value is not less than the amount to be credited in respect of the shares.⁶⁰ This provision appears to be an important anti-avoidance measure and should be considered as a possible improvement on the proposed regulation in the South African Companies Bill.⁶¹

3.4 Timing of capital contribution

It is not a requirement that the company should actually receive the consideration before the shares are issued. The person to whom a share was issued, or another person who undertook the liability for the consideration at the time of issue will, however, remain liable to pay the consideration for the issue of the share, despite a subsequent transfer of the share.⁶² The directors may also have the power to refuse to register the transfer of a share while any liability attaching to it remains outstanding.⁶³

4 DISTRIBUTIONS

A company may make distributions to shareholders subject to requirements designed to protect creditors and ensure fair treatment of shareholders. Non-compliance with any of these requirements is deemed to constitute unfairly

⁵⁹ Section 47(6).

⁶⁰ Section 47(3). See *Morison's Company and Securities Law* 13.19 for criticism of this provision. *Morison's Company and Securities Law* argues that the provision of agreed services or non-cash consideration cannot strictly be regarded as 'paying up' a share and that s 47(3) thus possibly does not apply where the shares were initially agreed to be issued for non-cash consideration.

⁶¹ See Chapter 5 paragraphs 3.6.3 and 3.7.3.

⁶² Section 100(2).

⁶³ Section 84(5).

prejudicial conduct towards a shareholder for purposes of the minority oppression remedy.⁶⁴

Distributions are regulated in general by the inclusion of a definition of 'distribution' and by the requirements of the solvency test. However, the solvency test is modified for certain specific kinds of distributions and different procedures and other requirements are prescribed for different kinds of distributions.

4.1 Kinds of payments regulated

'Distribution' is defined as:

- in relation to a distribution by a company to a shareholder:
 - the direct or indirect transfer of money or property, other than the company's own shares, to or for the benefit of the shareholder; or
 - the incurring of a debt to or for the benefit of the shareholder –
- in relation to shares held by that shareholder, and whether by means of a purchase of property, the redemption or other acquisition of shares, a distribution of indebtedness, or by some other means.⁶⁵

The essence of this definition is that the company must make the distribution in relation to shares held by the shareholder. A distribution requires both an outflow of funds from the company and a corresponding benefit conferred on the shareholder.⁶⁶ This is comparable to the requirement in the definition of 'payment' in South Africa that the payment must be 'by reason of the shareholding' of the shareholder.⁶⁷ The use of the words 'direct or indirect' is another feature common to these two definitions. The current South African definition does not expressly include the incurring of a debt, although such an extension has been proposed.⁶⁸

Apart from this general definition, various other provisions specifically state that a particular transaction is a distribution.⁶⁹ The cancellation or reduction of a shareholder's liability in relation to a share will be regarded as a distribution to the

⁶⁴ Section 175. The minority oppression remedy is set out in s 174.

⁶⁵ Section 2(1) s v 'distribution'.

⁶⁶ *DML Resources Ltd (in liquidation)* [2004] 3 NZLR 490 (HL) 505. See also Blackman, Jooste & Everingham *Companies Act* 5-116 – 5-117.

⁶⁷ See Chapter 5 paragraph 5.1.2.

⁶⁸ See Chapter 5 paragraph 4.4.

⁶⁹ See s 55(5) and s 57.

shareholder of the amount by which the liability is reduced.⁷⁰ This will be the case regardless of whether the reduction or cancellation is achieved through an alteration of the company's constitution, the acquisition of own shares, or the redemption of shares.⁷¹ It is interesting to note that in addition to being a distribution, it will also be a dividend, necessitating equal treatment of shareholders.⁷² The same principle applies to amalgamations between companies resulting in the reduction of shareholder liability, but its ambit is there extended to include shareholders who do not become shareholders of the new company.⁷³

4.2 Financial restrictions

The solvency test is set out in section 4. It comprises two elements, namely an equity solvency or liquidity test which is satisfied if the company is able to pay its debts as they become due in the normal course of business,⁷⁴ and a balance sheet test, which requires the value of the company's assets to be equal or exceed the value of its liabilities, including contingent liabilities.⁷⁵

Section 4 contains various prescriptions regarding the application of the balance sheet test, but no further indication as to the interpretation of the liquidity test. In determining whether the balance sheet test is satisfied, the directors must have regard to the most recent financial statements of the company that comply with the Financial Reporting Act 1993, as well as to other circumstances they know of or ought to know of that affect or could affect the value of the assets or liabilities.⁷⁶ The valuation of contingent liabilities may be determined by having regard to the likelihood of the contingency occurring.⁷⁷ The directors may deduct the amount of any claim the company can make and which can reasonably be expected to be met,

⁷⁰ Section 57.

⁷¹ Section 57(1)(a), (2).

⁷² Section 57(1)(b). Section 53 provides for proportionality of distributions among the shareholders of the same class, see paragraph 6 below. On the common-law presumption of shareholder equality, see *Preston v Grant-Collier Dock Co* (1840) 11 Sim 327; *Galloway v Halle Concert Society* [1915] 2 Ch 233.

⁷³ Section 57(3).

⁷⁴ Section 4(1)(a).

⁷⁵ Section 4(1)(b).

⁷⁶ Section 4(2)(a).

⁷⁷ Section 4(4)(a).

that would reduce or extinguish the contingent liability.⁷⁸ A director may rely on valuations of assets or estimates of liabilities that are reasonable in the circumstances.⁷⁹

The solvency test is refined for purposes of section 52, which deals with the power to make distributions, and section 56, which governs the recovery of distributions made in breach of the solvency test.⁸⁰ Debts, which are to be taken into account in assessing the liquidity of the company, include fixed preferential returns on shares ranking ahead of the shares in respect of which a distribution is made.⁸¹ However, debts arising by reason of the authorisation must not be taken into account.⁸² It makes sense to disregard debts that arise by reason of the authorisation, as these cannot really be described as debts becoming due in the normal course of business.⁸³ This provision could provide clarity and a similar provision should be considered for South Africa.⁸⁴

Liabilities include the amount necessary to repay fixed preferential amounts payable on deregistration if the company were to be deregistered at the time of the distribution.⁸⁵ If the shares are liable to be redeemed before the date of the distribution, the redemption price must also be counted as a liability.⁸⁶

The interests of preference shareholders are protected. However, the constitution of the company can expressly provide that the fixed preferential amounts are subject to the power of the directors to make distributions.⁸⁷ This approach stands in contrast with the current position in South Africa, where the preferential claims of shareholders are not regarded as liabilities.⁸⁸

⁷⁸ Section 4(4)(b). See *Morison's Company and Securities Law* 14.5 – 14.8 for a discussion of the practical application of the solvency test.

⁷⁹ Section 4(2)(b).

⁸⁰ Section 52(4).

⁸¹ Section 52(4)(a). Where the company's constitution provides that the fixed preferential return is subject to the directors' power to make distributions, these preferential returns need not be taken into account.

⁸² Section 52(4)(a). See *Morison's Company and Securities Law* 14.5.

⁸³ Section 52(1), (2).

⁸⁴ See also Chapter 5 paragraph 4.2.

⁸⁵ Section 52(4)(b).

⁸⁶ Section 52(4)(b).

⁸⁷ Section 52(4)(b).

⁸⁸ See Chapter 5 paragraphs 4.3.1.2 and 4.4.1.3.

4.3 Timing for application of the financial restrictions

Before it authorises a distribution, the board has to consider the financial position of the company and be satisfied that it will be solvent and liquid immediately after making the distribution.⁸⁹ At this stage, the directors who support the distribution must sign a solvency certificate.⁹⁰ However, if the board subsequently ceases to be satisfied that the company will satisfy the test, the distribution is deemed not to have been authorised.⁹¹ Although an enquiry must be made at the time of authorisation, the board's view of the solvency and liquidity of the company at the time the distribution is actually made is decisive. The initial satisfaction of the board is relevant with respect to the question of authorisation only.

The recoverability of a distribution from shareholders and directors depends on the actual solvency and liquidity of the company at the time of the distribution, not when it is authorised.⁹²

The formulation of the solvency test facilitates this distinction between its application in determining whether a distribution has been authorised and in establishing the recoverability of a distribution. This perspective can be useful in reforming the position in South Africa.⁹³

4.4 Status of claim in respect of authorised but unpaid distributions

Although the Act expressly regulates the enforceability of repurchase contracts,⁹⁴ it does not address the status of a claim in respect of an authorised but unpaid distribution. The authors of *Morison's Company and Securities Law* argue that the authorisation of a distribution does not create a debt and that the common-law principle, that the declaration of a dividend created a debt recoverable by a shareholder, no longer applies.⁹⁵

⁸⁹ Section 52(1).

⁹⁰ Section 52(2).

⁹¹ Section 52(3).

⁹² Section 56(1). Liability for the return of distributions is discussed in paragraph 4.6 below.

⁹³ See Chapter 5 paragraph 4.4.1.1.

⁹⁴ In s 67, discussed in paragraph 6.5 below.

⁹⁵ *Morison's Company and Securities Law* 14.5.

4.5 Authorisation

Any distribution to shareholders must be authorised by the board of directors.⁹⁶ The board must authorise a distribution only if it is satisfied on reasonable grounds that immediately after the distribution, the company will satisfy the solvency test.⁹⁷ The directors voting in favour of a distribution have to sign a certificate stating that in their opinion the company will satisfy the solvency test and setting out the grounds for that opinion.⁹⁸

If after the authorisation of a distribution but before it is made, the board is no longer satisfied that the company will comply with the solvency test, the distribution is deemed not to have been authorised.⁹⁹

4.6 Liability for distributions made in contravention of the Act.

Section 56 provides for the recovery of distributions made in breach of the solvency test. If the company did not actually satisfy the test immediately after the distribution was made the distribution can, in principle, be recovered from the shareholder.¹⁰⁰ In order to retain the distribution, a shareholder must satisfy three conjunctive requirements.¹⁰¹ First, the shareholder must have received the distribution in good faith and without knowledge of the company's failure to satisfy the solvency test.¹⁰² Secondly, the shareholder must have altered her position in reliance on the validity of the distribution.¹⁰³ Thirdly, it must be unfair to require repayment in full or at all.¹⁰⁴

The authors of *Morison's Company and Securities Law* point out that these requirements are similar to those for resisting the repayment of voidable

⁹⁶ Section 52.

⁹⁷ Section 52(1).

⁹⁸ Section 52(2). A director who fails to comply with the certificate requirements commits an offence, see s 52(5).

⁹⁹ Section 52(3).

¹⁰⁰ Section 56(1).

¹⁰¹ *Morison's Company and Securities Law* 14.11.

¹⁰² Section 56(1)(a).

¹⁰³ Section 56(1)(b).

¹⁰⁴ Section 56(1)(c).

preferences and suggest that judgments dealing with voidable preferences may provide guidance on their interpretation.¹⁰⁵

Directors are liable for non-compliance with the solvency test¹⁰⁶ and for non-compliance with the procedural requirements.¹⁰⁷ They are, however, liable only to the extent that the distribution cannot be recovered from the shareholders.¹⁰⁸ A director can be liable on one of the following bases:

- failing to take reasonable steps to ensure that the proper procedure is followed¹⁰⁹
- signing of a solvency certificate when reasonable grounds for believing that the company would satisfy the test did not exist¹¹⁰
- failing to take reasonable steps to prevent a distribution after no longer being satisfied that the company would satisfy the solvency test.¹¹¹

5 DIVIDENDS AND OTHER PAYMENTS TO SHAREHOLDERS

The significance of regarding a distribution as a dividend is to provide for the proportionate treatment of shareholders.¹¹² Dividends paid to members of a specific class must be proportionate to their shareholding or alternatively, proportionate to the consideration paid to the company in satisfaction of the liability of the shareholder under the constitution of the company or under the terms of issue of the share.¹¹³ A shareholder may waive his or her entitlement to a dividend.¹¹⁴

A 'dividend' is defined as 'any distribution other than a distribution to which section 59 or section 76 applies'.¹¹⁵ Thus, it is any distribution except an acquisition

¹⁰⁵ *Morison's Company and Securities Law* 14.11.

¹⁰⁶ Section 52(2)(b).

¹⁰⁷ Section 56(2)(a).

¹⁰⁸ Section 56(2) – (4).

¹⁰⁹ Section 56(2)(c).

¹¹⁰ Section 52(2)d).

¹¹¹ Section 52(3).

¹¹² Section 53. Share repurchases and financial assistance are not regarded as dividends because otherwise it would have been difficult to make selective repurchases or give financial assistance in connection with a specific acquisition.

¹¹³ Section 53(2).

¹¹⁴ Section 53(3).

¹¹⁵ Section 53(1).

of shares and the provision of financial assistance for the acquisition of shares. Since redemptions are distributions under sections 69 to 75, the question arises whether redemptions are 'dividends'. It is expressly provided that the redemption of shares at the option of a shareholder or on a fixed date is not regarded as a distribution for purposes of section 52 or as a dividend for purposes of section 53.¹¹⁶ The position regarding redemption at the option of a company is not clear. Although it is expressly stated that in a redemption at the option of the company the solvency test of section 52 must be complied with,¹¹⁷ nothing is said about section 53. At first glance, it may appear that a redemption at the option of a company should be regarded as a dividend. However, since non-*pro rata* redemptions are expressly allowed, it is unlikely that redemptions qualify as dividends, which are by definition proportionate.

Shareholders of a company may agree to accept an issue of shares wholly or partly in lieu of a proposed dividend or proposed future dividends.¹¹⁸ All shareholders must be treated proportionately. Since shares will be issued, the requirements of section 47 regarding consideration must also be satisfied.

6 SHARE REPURCHASES

The acquisition by a company of its own shares is specifically regulated by sections 58 to 67 of the Act, while section 107 and sections 110 to 112 also apply to repurchases.

6.1 Power to acquire shares

Various provisions of the Act regulate the repurchase by a company of its own shares. Section 58 provides that a company may acquire its own shares in accordance with sections 59 to 66, section 107, and sections 110 to 112, 'but not otherwise'. A repurchase in compliance with a court order such as an order made

¹¹⁶ Section 74(2)(a), s 75(2)(a).

¹¹⁷ Section 70(1). While ss 74(2)(a) and 75(2)(a) state that a redemption is not a distribution for purposes of ss 52 or 53, s 70 does not state that a redemption at the option of a company is indeed a distribution under s 52 – it merely provides that the solvency test of s 52 must be satisfied.

¹¹⁸ Section 54.

under the minority oppression remedy¹¹⁹ is also possible, although not covered in s 58.¹²⁰

Sections 59 to 66 provide for four different types of share repurchases that can be initiated by a company, namely:

- a *pro rata* offer to all shareholders¹²¹
- a selective offer direct to some shareholders¹²²
- an on-market purchase with prior notice to shareholders¹²³
- an on-market purchase not subject to prior notice to shareholders.¹²⁴

The first three of these types of repurchase involve an offer made by the company to shareholders.¹²⁵ Regardless of the type of repurchase, compliance with section 52, which sets out the solvency test as it applies to distributions, is required. Sections 60, 63 and 65 set out the procedure for the different types of repurchase.¹²⁶

Section 107 provides for the repurchase of shares by a company with the agreement of all 'entitled persons'.¹²⁷ The authorisation and procedural requirements do not apply,¹²⁸ but the directors have to be satisfied on reasonable grounds and sign a certificate to the effect that the company will satisfy the solvency test.¹²⁹

¹¹⁹ Section 174(2)(a).

¹²⁰ Section 59(3) provides that repurchases in terms of a court order do not have to be authorised in the company's articles.

¹²¹ Section 60(1)(a). The procedure and requirements are set out in s 60(2) – (7), discussed on paragraph 6.3.1 below.

¹²² Section 60(1)(b). The procedure is set out in s 61, s 62 and s 60(3) – (7), see paragraph 6.3.2 below. This procedure need not be followed if approved by unanimous consent as envisaged in s 107.

¹²³ Sections 63 and 64, see paragraph 6.3.3 below. Section 63 expressly states that the company may make an offer on a stock exchange.

¹²⁴ Section 65, see paragraph 6.3.4 below. Note that this section does not say the company must make an offer but refers to the acquisition of shares.

¹²⁵ A company may only accept an offer made by a shareholder to sell her shares to the company with the unanimous assent of the shareholders, see *Morison's Company and Securities Law* 15.3 note 3.

¹²⁶ See paragraphs 4.3.1 to 4.3.4 above for a discussion of the procedure.

¹²⁷ Entitled persons are shareholders and persons on whom the constitution confers any of the rights and powers of a shareholder, s 1 s v 'entitled person'.

¹²⁸ Section 107(1)(c).

¹²⁹ Section 108.

A company may also acquire its own shares in compliance with a court order, such as an order under section 174 that the company must acquire the shares of a prejudiced shareholder. I do not consider this type of repurchase further.

In certain circumstances, dissenting shareholders may insist that the company buy them out. This appraisal remedy is set out in sections 110 to 112 and such acquisitions are not subject to sections 59 to 67.¹³⁰ Further discussion of the reasons and procedure for repurchases under the appraisal remedy falls outside the scope of this thesis.

I focus on repurchases initiated by the company.

6.2 Financial restrictions

Compliance with the solvency test is a basic prerequisite for a repurchase.¹³¹ However, section 59(3) expressly states that the requirements of section 59, which includes compliance with the solvency test as required by section 52, does not limit or affect court orders for purchase of shares or the acquisition of shares under the appraisal remedy. Therefore, although acquisitions under the appraisal remedy are not dependent on solvency and liquidity, the company must approach the court for an exemption if the purchase will result in its failure to satisfy the solvency test.¹³²

6.3 Procedure

I now consider the procedure for share repurchases by way of an offer to shareholders. Since the company has the power to make an 'offer' that can be accepted by shareholders, coercive repurchases are ruled out.

The constitution of the company must expressly permit it to purchase or otherwise acquire its own shares.¹³³ Companies without constitutions cannot acquire their own shares under section 59. However, they will be able to do a repurchase in terms of section 107, that is, with the unanimous assent of shareholders. Although a company can subsequently adopt a constitution or alter its

¹³⁰ Section 59(3)(b).

¹³¹ See paragraph 4.2 above for a discussion of this test.

¹³² Section 115. The company also has to prove that its reasonable efforts to arrange that someone else purchases the shares were unsuccessful.

¹³³ Section 59(1).

existing constitution by special resolution,¹³⁴ such a step will entitle dissenting shareholders to an appraisal remedy.¹³⁵

The board has to notify the Registrar of any purchase or acquisition within 10 working days of the purchase or acquisition.¹³⁶ In terms of section 66(2), shares are deemed to be acquired on the date on which the company would have become entitled to exercise the rights attached to the shares if they did not have to be cancelled. However, this date applies only for purposes of determining the moment of cancellation of the shares as envisaged in section 66(1). So it is not clear when the shares are 'acquired' for purposes of the notification period of 10 days.

There are various procedures which can be followed, namely a *pro rata* offer to all shareholders,¹³⁷ an offer to acquire shares from one or more shareholders,¹³⁸ a stock exchange acquisition subject to prior notice to shareholders,¹³⁹ or a stock exchange acquisition not subject to prior notice to shareholders.¹⁴⁰ Failure to comply with any aspect of the prescribed procedure will automatically constitute prejudicial conduct for purposes of the oppression remedy.¹⁴¹ In each instance, the board must declare that the acquisition is in the best interests of the company and the shareholders and that the terms of and consideration for the acquisition is fair and reasonable. It must also declare that it is not aware of any information which will not be disclosed to the shareholders¹⁴² or is not available to them¹⁴³ that is material to an assessment of the value of the shares and as a result of which the terms of and consideration for the acquisition of the shares are unfair to shareholders who accept the offer or from whom shares will be acquired.¹⁴⁴ Such a certificate by directors dealing with the solvency test and the effect of the repurchase on the company and

¹³⁴ Section 32(1), (2).

¹³⁵ See s 110 read with s 106(1)(a).

¹³⁶ Section 58(3).

¹³⁷ Section 60(1)(a).

¹³⁸ Section 60(1)(b).

¹³⁹ Section 63.

¹⁴⁰ Section 65. This type of acquisition is subject to a limit of 5% of the shares of that class that can be acquired in a twelve month period.

¹⁴¹ Section 174 read with s 175.

¹⁴² Section 60, s 63.

¹⁴³ Section 65,

¹⁴⁴ See McKenzie "Disclosure Requirements" 455ff for an analysis of the disclosure requirements, including the additional requirements of the *Stock Exchange Listing Rules*.

its shareholders is required, except for stock exchange acquisitions without prior notice.

It is interesting to note the way in which the requirement to heed the interests of shareholders is formulated in each type of acquisition.¹⁴⁵ In certain instances, the interests of the remaining shareholders are paramount, in others, the interests of the shareholders accepting an offer, or the shareholders from whom shares are acquired. This depends on whether it is a proportionate or selective offer and on whether the shares are acquired on the stock exchange or not.

6.3.1 Pro rata offer to all shareholders

A *pro rata* offer is described as an offer to all shareholders to acquire a proportion of their shares that would, if accepted, leave unaffected relative voting and distribution rights, and that affords a reasonable opportunity to accept the offer.¹⁴⁶ The offer may permit the company to acquire additional shares from a shareholder to the extent that another shareholder does not accept the offer or accepts it only in part.¹⁴⁷ This is known as a ‘top-up invitation’ because, although not expressly required by the provision, the company will have to invite all shareholders to tender more than their proportionate number of shares.¹⁴⁸ If the number of additional shares exceeds the number of shares the company wants to acquire, the number of additional shares must be reduced rateably.¹⁴⁹ This provision is unclear. It refers to the ‘number of additional shares’ rather than the number of additional shares offered to the company. This is confusing especially since section 60(2)(a) does not refer to any invitation to tender more shares – it merely states that the offer ‘may permit the company to acquire additional shares’. On the positive side, this provision makes it clear that the rateable reduction applies only in respect of additional shares and cannot affect the initial proportion in respect of which each shareholder may accept the offer. The intention appears to be that the reduction must be proportionate to the number of additional shares offered or tendered by each shareholder under the

¹⁴⁵ For a discussion of how the interests of shareholders and of the company could differ, see Gardner “Company Purchase” 170 – 171.

¹⁴⁶ Section 60(1)(a).

¹⁴⁷ Section 60(2)(a).

¹⁴⁸ See *Morison’s Company and Securities Law* 15.9.

¹⁴⁹ Section 60(2)(b).

top-up invitation.¹⁵⁰ This aspect may need reconsideration in South Africa where there is no proper distinction between the proportion of shares each shareholder may sell if all shareholders fully accept the company's offer and the total number of shares tendered by each shareholder.¹⁵¹

Before making the *pro rata* offer, the board has to resolve that the acquisition is in the best interests of the company,¹⁵² and that the terms of and consideration for the acquisition is fair and reasonable to the company.¹⁵³ It must also resolve that it is not aware of any information that will not be disclosed to the shareholders that is material to an assessment of the value of the shares and as a result of which the terms of the offer and the consideration offered for the shares are unfair to shareholders who accept the offer.¹⁵⁴ The resolution must set out the reasons for the board's conclusions.¹⁵⁵ The directors who vote in favour of the resolution must sign a certificate on the matters covered by the resolution.¹⁵⁶ If circumstances change after the passing of the resolution but before the making of the offer and the directors are no longer satisfied about the three aspects covered by the resolution, no offer may be made.¹⁵⁷ Unlike sections 63 and 65, which refer to the best interests of the company and its shareholders, section 60(3)(a) refers only to the best interests of the company. A similar distinction exists between section 60(3)(b) and sections 63 and 65 in respect of the fairness of the terms of the offer and the consideration. This indicates that the distinction was not unintended but is probably drawn because under section 60(3)(a) all the shareholders will be affected proportionately. When a selective offer is made directly to some shareholders, the resolution in section 60(3)(a) is required as well as a resolution in terms of s 61(1) dealing with the interests of the remaining shareholders.

¹⁵⁰ See *Morison's Company and Securities Law* 15.9 where it is explained that the top-up invitation must be accepted rateably.

¹⁵¹ See Chapter 6 paragraph 6.3.2.1.

¹⁵² Section 60(3)(a).

¹⁵³ Section 60(3)(b).

¹⁵⁴ Section 60(3)(c).

¹⁵⁵ Section 60(4).

¹⁵⁶ Section 60(5). The certificate may be combined with the solvency certificate required by section 52.

¹⁵⁷ Section 60(6).

6.3.2 Selective offer direct to some shareholders

Section 60(1)(b) refers to an offer to one or more shareholders to acquire shares and section 61 calls such an offer a 'special offer to acquire shares'. However, the term selective offer is commonly used.¹⁵⁸

A selective offer may be made with the written consent of all the shareholders¹⁵⁹ or under an express authorisation of non-*pro rata* offers in the constitution and in accordance with the procedure prescribed in section 61.¹⁶⁰

Protecting the interests of the remaining shareholders is an important consideration in the regulation of selective offers.¹⁶¹ In addition to resolving that the acquisition is in the best interests of the company and that the terms of the offer and the price are fair and reasonable to the company,¹⁶² the board must also resolve that the acquisition of the shares is of benefit to the remaining shareholders¹⁶³ and that the terms of the offer and the consideration offered for the shares are fair and reasonable to the remaining shareholders.¹⁶⁴ If circumstances change after the passing of the resolution so that the board ceases to be satisfied of the contents of the resolution, either in respect of the best interests of the company¹⁶⁵ or in respect of the benefit of the remaining shareholders,¹⁶⁶ the board may not make the offer.

Before making a selective offer, the company has to send to each shareholder a disclosure document.¹⁶⁷ This document has to set out the nature and terms of the offer, and if made to specified shareholders, to whom it will be made.¹⁶⁸ It has to

¹⁵⁸ See *Morison's Company and Securities Law* 15.13.

¹⁵⁹ Section 60(1)(b)(i). Written consent of all the shareholders in terms of this section must be distinguished from a share repurchase made in terms of s 107 with the unanimous assent of all entitled persons. As *Morison's Company and Securities Law* points out in 15.15, the consequences and requirements differ.

¹⁶⁰ Section 60(1)(b)(ii). Section 60(3) – (7) also apply to selective offers and relate to the interests of the company.

¹⁶¹ Section 61(1) – (4) and (9) mirrors s 60(3) – (7), except that the resolution in s 61 must be made with regard to the remaining shareholders while that in s 60 concerns the best interests of the company.

¹⁶² Section 60(3).

¹⁶³ Section 61(1)(a).

¹⁶⁴ Section 61(1)(b).

¹⁶⁵ Section 60(6).

¹⁶⁶ Section 61(4).

¹⁶⁷ Section 61(5). Failure to send out the disclosure document is an offence by the company and the directors, s 61(10).

¹⁶⁸ Section 62(a).

disclose the nature and extent of any relevant interest of any director in any shares that are the subject of the offer.¹⁶⁹ The text of the resolution required by section 61 must be set out¹⁷⁰ together with further information and explanations necessary to enable a reasonable shareholder to understand the nature and implications for the company and its shareholders of the proposed acquisition.¹⁷¹ A disclosure document is not required if a company listed on a registered stock exchange makes an offer to acquire less than the number of quoted shares that has been determined by the relevant exchange to be the minimum holding of shares in the company.¹⁷²

The selective offer must be made not less than 10 working days and not more than 12 months after the sending out of the disclosure document.¹⁷³ A shareholder or the company may apply for an order restraining the proposed acquisition on one of two grounds:

- it is not in the best interests of the company and of benefit to remaining shareholders
- the terms of the offer and the consideration offered are not fair and reasonable to the company and remaining shareholders.¹⁷⁴

This right to approach the court to restrain a repurchase is only available if the repurchase is a selective offer. Either the company or a shareholder can apply and there is no limitation requiring the objection to relate to the interest of the applicant only. It appears that the company can rely on unfairness towards remaining shareholders and *vice versa*. It is not clear whether both the terms and the consideration have to be unfair or whether it is sufficient to prove either aspect. The use of the conjunctive 'and' rather than the disjunctive 'or' may be a mistake. Because the resolution has to state that both the terms and the consideration are

¹⁶⁹ Section 62(b).

¹⁷⁰ This resolution relates to the interests of remaining shareholders only. It is not required that the resolution under s 60 regarding the interests of the company be disclosed.

¹⁷¹ Section 62(c). Although the further information and explanations must enable the shareholders to assess the impact of the acquisition also on the company itself, only the text of the s 61 resolution has to be disclosed.

¹⁷² Section 61(7).

¹⁷³ Section 61(6). This subsection does not apply to the acquisition of less than a marketable parcel of quoted shares.

¹⁷⁴ Section 61(8).

fair, the rebuttal of either aspect should be a sufficient ground for a restraining order. The practical utility of the restraining procedure in preventing unfair repurchases, including greenmail, can be criticised in view of the speed with which remaining shareholders will have to act.¹⁷⁵

6.3.3 Stock exchange acquisitions subject to prior notice to shareholders

A company may make an offer to acquire not more than a specified number of its shares on a stock exchange. The board must resolve that the acquisition is in the best interests of the company and its shareholders, and that the terms of the offer and the consideration offered for the shares are fair and reasonable to the company and its shareholders. The board must also state that it is not aware of any undisclosed information material to an assessment of the value of the shares and as a result of which the terms of the offer and consideration offered are unfair to shareholders accepting the offer.¹⁷⁶ This third leg of the resolution, dealing with undisclosed information, is concerned only with fairness to shareholders accepting the offer.

Prior to making the offer the company must send to each shareholder a disclosure document that complies with section 64 of the Act.¹⁷⁷ This document has to set out the nature and terms of the offer, the nature and extent of any relevant interest of any director in any shares that may be the subject of the offer, and the text of the resolution required by section 63. It must also contain further information and explanations necessary to enable a reasonable shareholder to understand the nature and implications for the company and its shareholders of the proposed acquisition. The offer must be made not less than 10 working days and not more than 12 months after the sending out of the disclosure document. A shareholder or the company may apply for an order restraining the proposed acquisition on one of two grounds:

- it is not in the best interests of the company or the shareholders

¹⁷⁵ See Gardner "Company Purchase" 169.

¹⁷⁶ Section 63(1).

¹⁷⁷ Section 63(6).

-
- the terms of the offer and, if it has been disclosed, the consideration offered are not fair and reasonable to the company or the shareholders.¹⁷⁸

The authors of *Morison's Company and Securities Law* explain that the procedure set out in section 63 envisages that the board will implement the acquisition by making offers on the stock exchange over a period until the required number of shares has been acquired.¹⁷⁹ It is important to note that disclosure of the consideration is not required. On the one hand, disclosure of an exact price can influence the market price of the company's shares. On the other hand, the price is the only variable term of a stock exchange acquisition and so the only term relevant to shareholders in assessing the fairness of the terms and consideration.¹⁸⁰ Presumably the board must disclose how the price will be determined, either by specifying a price range or by resolving to acquire the shares at the prevailing price.¹⁸¹

6.3.4 Stock exchange acquisitions not subject to prior notice

Section 65 provides for acquisitions on a stock exchange without prior disclosure to shareholders. A company can use the section 65 procedure to acquire a maximum of five per cent of the issued shares of any class during any 12-month period. Prior to making the acquisition the directors have to adopt the usual resolution regarding the fairness of the acquisition, in this instance to the company and the shareholders from whom shares are acquired.¹⁸² A notice disclosing particulars of the acquisition must be sent to each stock exchange on which the shares are listed within ten working days after an acquisition¹⁸³ and to each shareholder within three months of the acquisition.¹⁸⁴

¹⁷⁸ Section 63(8).

¹⁷⁹ *Morison's Company and Securities Law* 15.21.

¹⁸⁰ *Morison's Company and Securities Law* 15.20.

¹⁸¹ *Morison's Company and Securities Law* 15.20.

¹⁸² Section 65(1)(a).

¹⁸³ Section 65(2). The class of shares, the number of shares acquired, the consideration paid and the identity of the seller and, if applicable and known, of the beneficial owner must be disclosed.

6.4 Liability for unlawful repurchase

Shareholders and directors can be liable in respect of non-compliance with the requirements for a distribution,¹⁸⁵ or on various other grounds.¹⁸⁶ Failure to comply with the prescribed procedure for the particular type of repurchase will also amount to prejudicial conduct.¹⁸⁷

6.5 Enforceability of contracts for the acquisition of own shares

The enforceability of a contract for the acquisition of shares is regulated by section 67. The contract will not be enforceable if the company can prove that performance of the contract will result in it being unable to satisfy the solvency test as set out in section 52.¹⁸⁸ The claim for outstanding performance will remain and the seller can enforce payment as soon as the company is lawfully able to comply.¹⁸⁹ When the company is deregistered while the claim remains unpaid, the claim will rank subordinate to the rights of creditors, but in priority to the other shareholders.

6.6 The status of repurchased shares

Section 66 provides for the cancellation of shares immediately upon acquisition of shares, and applies to acquisitions pursuant to section 59, which includes all the offers to repurchase, and acquisitions under the appraisal remedy. Section 58(2), which also provides for the cancellation of shares immediately upon acquisition, applies where shares are acquired otherwise than in accordance with sections 59 to

Continued

¹⁸⁴ Section 65 (2A).

¹⁸⁵ See paragraph 4.6 above. See also *Morison's Company and Securities Law* 15.25.

¹⁸⁶ See *Morison's Company and Securities Law* 15.26. These include liability of directors for breach of fiduciary duties, and voidability of the contract for non-compliance with the company's constitution.

¹⁸⁷ See s 175(1)(d) – (g).

¹⁸⁸ Section 52 extends the solvency test so that preferential returns to preference shareholders are provided for, see paragraph 4.2 above.

¹⁸⁹ Section 67(3). This provision must be distinguished from s 52(3), which deems a distribution not to have been authorised if circumstances change after authorisation but before the distribution is made. *Morison's Company and Securities Law* 15.11 points out that s 52(3) does not render payment unauthorised if the test was satisfied when the debt was incurred, because the incurring of a debt qualifies as a distribution.

66 and sections 110 to 112, that is, when shares are acquired by unanimous assent¹⁹⁰ or in compliance with a court order.¹⁹¹

It is not clear why there are two separate provisions on the deemed cancellation of repurchased shares.¹⁹²

Section 66(2) contains a definition of 'acquisition' for purposes of section 66, that is, it explains exactly when the shares are deemed to be cancelled.¹⁹³ Section 58(2) does not contain a similar definition and it is uncertain exactly when the shares are regarded as having been acquired and thus deemed to be cancelled.

As an alternative to cancellation, a company may hold a maximum of five per cent of the shares of each class as treasury shares.¹⁹⁴ The constitution of the company must expressly provide for this, and the board of directors must resolve not to cancel the shares.¹⁹⁵ All rights and obligations attaching to shares are suspended while they are held in treasury,¹⁹⁶ and in particular, the shares may not be voted and may not share in any distribution.¹⁹⁷ Any transfer by the company of treasury shares are subject to the requirements for the issue of new shares, including the requirements on consideration.¹⁹⁸ A specific prohibition applies against the disposal of treasury shares to frustrate a takeover offer.¹⁹⁹

¹⁹⁰ See s 107.

¹⁹¹ Section 58(1) does not seem to envisage acquisitions in compliance with court orders. It states that shares may be acquired in accordance with ss 59 – 66, s 107, and ss 110 – 112, 'but not otherwise'. Section 58(2) then applies to shares acquired otherwise than in accordance with ss 59 – 66 and ss 110 – 112, thus leaving the impression that it applies only to s 107. The provisions in relation to acquisitions which can be overridden by s 107 (unanimous assent) are ss 58 to 65. However, s 66 does not seem to apply to s 107 acquisitions. Section 59(3)(a) does envisage acquisitions under a court order.

¹⁹² As will be seen in paragraph 5.8 below, there are also three separate provisions providing for the cancellation of redeemed shares.

¹⁹³ Perhaps this definition would also have been helpful for determining time of distribution.

¹⁹⁴ Section 67A(1)(c) read with s 67A(2).

¹⁹⁵ Section 67A(1)(a), (b).

¹⁹⁶ Section 67B(1).

¹⁹⁷ Section 67B(2).

¹⁹⁸ Section 67C. The certification of consideration required by s 47(2) is not required where the shares are transferred in terms of a system approved under the Securities Transfer Act 1991 No 119, s 67C(2).

¹⁹⁹ Section 67C(4).

6.7 Purchases through subsidiaries

A subsidiary may not acquire, either through issue or by transfer to it, shares in its holding company.²⁰⁰ Shares in the holding company that were held by the subsidiary prior to it becoming a subsidiary may be retained, but the voting rights in respect of those shares may not be exercised.²⁰¹

6.8 Redemption of shares

The constitution of a company can provide for redeemable shares that may be redeemable at the option of the company, at the option of the shareholder, or on a specified date.²⁰² Prior to 1993 only preference shares could be redeemable, but under the present Act there is no limit as to the kind of shares that may be redeemable. It is possible that all the shares of a company can be redeemable shares, although it will obviously not be possible to redeem all the issued shares of a company.²⁰³

An important feature of the regulation of the redemption of shares is the distinction made between shares that are redeemable at the option of the company and those that are redeemable at the option of the shareholder or on a fixed date. The equal or fair treatment of shareholders of the same class is regulated in each case. The incurring of a debt in favour of a shareholder in relation to the redemption of shares is regarded as a distribution.²⁰⁴ Although all redemptions qualify as distributions for purposes of section 56, which regulates the recovery of unlawful distributions, only redemptions at the option of the company are subject to the solvency test of section 52,²⁰⁵ which requires a prior solvency resolution and a certificate.

Because redemptions at the option of the company may be abused just like repurchases, the resolutions required by the board of directors relating to the

²⁰⁰ Section 82.

²⁰¹ Section 82(4).

²⁰² Section 68.

²⁰³ *Morison's Company and Securities Law* 15.27 points out that a company is liable to be wound up if it does not comply with the essential requirement of s 10 that it should have at least one share.

²⁰⁴ Section 2(1) s v 'distribution' paragraph (b) of the definition.

²⁰⁵ Section 70.

protection of the company and its shareholders resemble those required for repurchases. In the case of *pro rata* redemptions, the resolutions deal only with the best interests of the company. In the case of special or selective redemptions, additional resolutions are required dealing with the interests and position of the remaining shareholders. A disclosure document must then be sent to shareholders, change of circumstances rules apply, and shareholders and the company may apply for a restraining order.²⁰⁶

Redemption at the option of a shareholder is regulated by section 74 and redemption on a fixed date by section 75. In both instances the company is obliged to redeem the share, the share is deemed cancelled on the date of redemption and the former shareholder ranks as an unsecured creditor in respect of the redemption price.²⁰⁷

Redemption at the option of a shareholder or on a fixed date is not regarded as distributions for purposes of sections 52 and 53, but is deemed to be a distribution for purposes of section 56(1) and (5), which means that it or the 'unlawful' portion of it may be recovered from the shareholder.²⁰⁸ Directors are not liable for the redemption price paid to the shareholder in these cases.

It makes sense to provide separately for redeemable shares, especially if they are not redeemable at the option of the company. A similar distinction should be considered for South Africa.²⁰⁹

7 EVALUATION AND CONCLUSION

New Zealand has done away with the notion of nominal or authorised share capital and with the idea of protecting creditors by a company's issued share capital.²¹⁰ However, shareholders enjoy considerable protection against the dilution of their equity interests through pre-emptive rights and through the specific duty on directors to consider the fairness to shareholders when the company issues shares.²¹¹

²⁰⁶ Section 71.

²⁰⁷ Section 74(1) and s 75(1).

²⁰⁸ Section 74(2) and s 75(2).

²⁰⁹ See Chapter 6 paragraph 6.8.

²¹⁰ See paragraph 2 above.

²¹¹ See paragraph 2 above.

Maximum flexibility is retained as pre-emptive rights can be excluded or restrictions imposed on directors' power to issue shares.

Although consideration for the issue of shares is regulated, the purpose of this regulation is to protect the company and its shareholders.²¹² This makes sense, because the company is giving up an enforceable claim.

Creditors enjoy protection when a company makes distributions to its shareholders, although their protection does not depend on the contributed share capital. The company has to comply with a 'solvency test' comprising of a liquidity element and a balance sheet element.²¹³ The solvency test also takes into account the rights of shareholders with rights preferent to those of shareholders that will receive a distribution. Although designed to protect preferent shareholders, the creditors also benefit from this restriction. In comparison with the position in South Africa, positive action is required from directors to ensure compliance with the solvency test.²¹⁴ As in South Africa, the Act does not specify a time period during which the company should remain able to pay its debts.²¹⁵

The solvency test is applied with reference to the time when the company decides to make a distribution rather than the moment of payment.²¹⁶ However, when there has been a change in the position of the company and the directors are no longer satisfied that the company will meet the test, the making of a distribution is prohibited. The recovery of distributions depends on the actual financial position of the company immediately after the distribution.²¹⁷ Shareholders who received an unlawful distribution in good faith and who altered their position in reliance on it, can avoid having to return the distribution if it would be unfair to oblige them to return it.²¹⁸

²¹² See paragraph 3.1 above.

²¹³ See paragraph 4.2 above.

²¹⁴ The directors have to adopt a solvency resolution and issue a solvency certificate. Compare Chapter 5 paragraph 4.4.1 for the South African position.

²¹⁵ See Chapter 5 paragraph 4.1.2.

²¹⁶ See paragraph 4.3 above.

²¹⁷ See paragraph 4.6 above.

²¹⁸ See paragraph 4.6 above.

Another feature of New Zealand law is that it expressly defines the concept ‘dividend’ as encompassing all distributions except share repurchases.²¹⁹ Subject to certain exceptions, dividends must be made proportionately to all shareholders of the same class.

When a company repurchases its shares, the requirements for distributions apply.²²⁰ For purposes of shareholder protection, the Act distinguishes between different kinds of repurchases, namely *pro rata* offers, selective offers, and stock exchange acquisitions with or without prior notice to shareholders.²²¹ The procedure is prescribed in detail for each kind of repurchase and is designed to address the risks faced by shareholders in a particular type of repurchase.²²² Shareholders may apply to court for an order restraining the company from proceeding with a selective repurchase.²²³ In comparison with South Africa, shareholders in New Zealand are better protected against unfair repurchases.²²⁴ Shareholder activism is further encouraged by the recognition that non-compliance with procedures automatically amounts to unfairly prejudicial conduct.²²⁵

The regulation of the redemption of shares depends on whether the redemption is at the option of the company or at the option of a shareholder or at a specified time.²²⁶ If shares are redeemable at the option of the company, the redemption is regulated along lines similar to repurchases of shares. In all cases of redemption the company can potentially recover the redemption price if it appears that it was not in fact solvent when it redeemed the shares.

In conclusion, while creditors enjoy a level of protection that is comparable to that enjoyed by creditors in South Africa when distributions are made, the real difference between the approach in New Zealand and that in South Africa is found in

²¹⁹ See paragraph 5 above.

²²⁰ See paragraph 6.2 above.

²²¹ See paragraph 6.1 above.

²²² See paragraph 6.3 above.

²²³ See paragraph 6.3.2 above.

²²⁴ This is primarily as a result of the certification duties imposed on directors in respect of the effect of repurchases on selling and existing shareholders, see Gardner “Company Purchase” 191 who describes the statute as ‘pro-shareholder’, yet questions whether the institutional framework facilitates shareholder activism. See Chapter 5 paragraph 6.3 for a discussion of the position in South Africa.

²²⁵ Section 175, See paragraph 4 above.

²²⁶ See paragraph 6.8 above.

the regulation of shareholder interests. The effective shareholder protection is achieved through the coherent design of pre-emptive rights, the regulation of consideration, the financial restrictions that take into account preferential shareholder rights, the share repurchase procedures and the requirement that dividends in the extended sense should be proportionate. Despite this, companies retain a large measure of freedom to arrange their internal affairs in different ways that suit them.

CHAPTER 4

UNITED STATES OF AMERICA

1 INTRODUCTION

In the United States of America, laying down the legal principles governing the formation and regulation of corporations falls within the jurisdiction of the individual states.¹ Federal laws govern some aspects of corporation law, notably securities regulation.²

The main body of corporation law is found in state legislation. There is considerable variation in the way in which different states regulate corporations, also as regards capital contributions and distributions to shareholders.³ There have been efforts to harmonise the corporation laws in the different states.⁴ Many states adopted the 1969 Model Business Corporation Act⁵ and the 1984 (Revised) Model Business Corporation Act⁶ developed by the American Bar Association.⁷

¹ Henn & Alexander *Laws of Corporations* 7, 25. The constitution does not expressly confer on the federal government a power to grant incorporation. However, Henn & Alexander *Laws of Corporations* 25 explain that the federal government has an implied power of incorporation that it may exercise should it be necessary to advance one of its express powers, such as the regulation of interstate commerce.

² See Henn & Alexander *Laws of Corporations* 1, 7, 36 – 41; Luiz *Takeovers* 397. Securities regulation is the field in which the law of corporations has been most affected by federal legislation. For a brief historical overview of the interplay between state and federal regulation of corporations, see Henn & Alexander *Laws of Corporations* 24 – 36.

³ These differences may have an effect on the jurisdiction in which promoters choose to incorporate. Henn & Alexander *Laws of Corporations* devotes a whole chapter (chapter 4) on the selection of a jurisdiction of incorporation. Competition between states for incorporations has also been identified as an important driver of legal reform in individual states, see Henn & Alexander *Laws of Corporations* 31 – 32.

⁴ For an overview of these efforts, see xxi – xxii of the introduction to the American Bar Association *Model Business Corporation Act: Official Text with Official Comment and Statutory Cross-references* 2005 (MBCA Official Text).

⁵ Hereafter the '1969 MBCA'. Prior to the publication of the 1984 Revised Model Business Corporation Act, 27 states had adopted the 1969 MBCA, see Henn & Alexander *Laws of Corporations* 8. Manning *Legal Capital* 176 states that 'approximately' 35 states had based their statutes on the old version. By 2005 the corporation laws of only four states were based on this earlier version of the Model Act, see introduction to American Bar Association *Model Business Corporation Act: Official Text with Official Comment and Statutory Cross-references* 2005. The 1969 MBCA was amended from time to time and the capital provisions were substantially redrafted in 1979 – 1980 following the reforms in California in 1977.

⁶ In the rest of this thesis the 1984 Model Business Corporations Act, which is also sometimes referred to as the Revised Model Business Corporations Act or RMBCA to distinguish it from the 1969 version, will be referred to as the 'MBCA' or, when it is necessary to distinguish it from

The law of the state in which a corporation has been incorporated generally applies to that corporation.⁸ A corporation conducting business in a state other than the state of its incorporation may also be subject to the legislation of that state to the extent that its laws apply to foreign corporations doing business in its area of jurisdiction.⁹

The capital and distribution rules of the different states can be classified into a number of categories. The most important distinction is between 'traditional' statutes based on legal capital and 'modern' statutes that rely on the net worth of a corporation.¹⁰ The 1969 MBCA was initially based¹¹ on non-impairment of stated capital and is thus a good example of a 'traditional' statute. The 1984 MBCA is an example of a 'modern' or 'net worth' statute.

Each of these two main approaches has been implemented in various ways, thus allowing further categorisation. The basic premise of a traditional legal capital system is that distributions may be made to the extent only that the net assets of the corporation exceed the stated share capital. This means that the capital will not be 'impaired'. A related approach is to define the surplus from which distributions may legally be made in order to leave the capital intact. In its simplest form a surplus is

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the older version, the '1984 MBCA'.

⁷ More specifically, it was developed by the Committee on Corporate Laws of the Section of Business Law with support of the American Bar Foundation. The introduction to the 2005 edition of the official text of the MBCA mentions that 29 states had adopted all or substantially all of the MBCA as their general corporation statute, while several other states have adopted selected provisions.

⁸ For example, s 1.40(4) of the 1984 MBCA defines a 'corporation' or 'domestic corporation' as a corporation for profit that was incorporated in the particular state. Section 17.01 states that the Act will apply to such (domestic) corporations only.

⁹ The 1984 MBCA contains provisions relating to foreign corporations, see ss 15.01 – 15.05. Although the regulation of foreign corporations is usually limited to administrative issues such as maintaining a registered office and appointing a registered agent, some states regulate more substantive issues pertaining to foreign corporations. California makes its financial restrictions on distributions applicable to 'pseudo-foreign' corporations, California Corporations Code s 2115(b). A pseudo-foreign corporation is a corporation incorporated in another state but who does more than half its business in California and of which more than half the shareholders of record reside in California, see California Corporations Code s 2115(a). New York is another example of a State that subjects certain foreign corporations to its dividend restrictions, see the New York Business Corporation Law ss 1317, 1318, 1320. Although they state that it is not common for state legislation to apply to foreign corporations, Henn & Alexander *Laws of Corporations* 898 argue that the MBCA could have this effect. Their argument can also be applied to the revised MBCA, which is similarly worded (see s 15.05).

¹⁰ See Henn & Alexander *Laws of Corporations* 889 – 896; Clark *Corporate Law* 610 – 624; Hamilton *Corporations* 389 – 395.

¹¹ Prior to the 1980 amendments that substantially altered the contribution and distribution rules.

the excess of assets over liabilities and stated capital. However, different rules are used in different states to determine what would qualify as surplus available for distribution.

Because surplus is determined with reference to assets, liabilities and stated capital, a variation of each of these elements can affect the size of the surplus. Depending on the source, different kinds of surplus can be distinguished:¹²

- Paid-in surplus, also known as capital surplus, arises when shares are issued for more than their par value or stated value or when treasury shares are resold for more than the stated capital they represent.
- Capital reduction surplus arises when a corporation formally reduces its stated capital.
- Revaluation surplus arises when assets are revalued to reflect appreciation.
- Earned surplus is the undistributed net profits earned by the corporation since its formation. In an economic sense it is the equivalent of retained earnings.

Some states allow distributions out of any kind of surplus.¹³ This is called the balance sheet surplus approach.¹⁴ The 1969 MBCA allows dividend distributions only out of earned surplus.¹⁵ Nevertheless, special distributions may be made out of capital surplus or other unearned surplus in certain circumstances.¹⁶

Irrespective of whether they use surplus or earned surplus, some states nevertheless allow dividends out of current earnings in certain circumstances. These dividends are called 'nimble dividends'.¹⁷

¹² Henn & Alexander *Laws of Corporations* 894; Manning *Legal Capital* 74 – 78. See also Eisenberg "Modernization" 199.

¹³ Delaware is an example, although it also allows distributions out of current earnings, see paragraph 2.4.

¹⁴ See Kummert "State Statutory Restrictions" 211.

¹⁵ See Kummert "State Statutory Restrictions" 197.

¹⁶ Manning *Legal Capital* 80.

¹⁷ See Henn & Alexander *Laws of Corporations* 892 note 19 for a possible explanation of the origin of this term. Nimble dividends are sometimes subject to additional restrictions such as provision for liquidation preferences.

The modern approach considers the net worth of the corporation, without reference to its stated capital. A simple excess of assets over liabilities is thus sufficient, although provision for amounts that may become due to preference shareholders is sometimes required. The way in which surplus or net worth of a corporation is determined, is through a balance sheet test, that is, a comparison of the value of assets and liabilities on a specific date.¹⁸

In addition to a restriction based on the surplus or net worth of a corporation, every state imposes an equity solvency or liquidity test.¹⁹ This is also known as the 'insolvency limitation', referring to insolvency in the equity sense of inability to pay debts.²⁰

The modern approach was first adopted in California in 1977 when it eliminated the rules associated with stated capital and surplus and made all distributions subject to compliance with one of two alternative tests, namely retained earnings or maintaining a fixed financial ratio of equity to debt. The California approach is economically equivalent to the earned surplus test. In reaction to these innovations the financial provisions of the 1969 MBCA were substantially revised in 1979 to 1980 and the rules based on stated capital, surplus and par value were abolished. Instead, distributions became subject to a net assets test. The 1984 MBCA took over these capital and distribution provisions.²¹

For purposes of comparison with the position in South Africa, I will discuss the provisions of the 1984 MBCA and the laws of Delaware and California, two states that have not adopted the MBCA. I selected these two individual states not only because of their commercial significance,²² but also because they represent diverging approaches to the topic under consideration.

¹⁸ See Manning *Legal Capital* 68 – 69.

¹⁹ See Manning *Legal Capital* 64. Massachusetts, Minnesota and North Dakota have an equity solvency or liquidity test as the only financial restriction on distributions, see Cox & Hazen *Corporations* 562.

²⁰ See Cox & Hazen *Corporations* 562.

²¹ See Henn & Alexander *Laws of Corporations* 895 note 44.

²² Henn & Alexander *Laws of Corporations* 7 – 8 regard the corporate statutes of Delaware, California, New York and the jurisdictions following the MBCA (at that time still the pre-1984 version) as the most significant, based on the number of incorporations of major corporations and total incorporations of business corporations in those jurisdictions. Although New York is a significant jurisdiction, its regulation of distributions is largely similar to that of Delaware. New York is an example of a system based on legal capital that allows distributions out of earned surplus, the economic equivalent of retained earnings. Unlike California, it does not allow

Other researchers have alluded to various difficulties and dangers of drawing comparisons between American and South African law.²³ This phenomenon is also particularly relevant to the topics considered in this thesis. The central concepts 'stated capital' in the USA and 'issued share capital' in South Africa differ fundamentally in some respects. As a result, related concepts such as par value, no par value, surplus and reserves that may at first glance seem comparable, may have very different connotations and implications. The group concept is also more informal than in South Africa. There is no statutory definition and groups are largely ignored by legislation and the courts.²⁴

As regards the financial restrictions on dividends and other distributions, different states use different statutory formulations and provide various exceptions, allowing for a number of permutations in the application of the same original principle. The terminology used to describe these different formulations, for example, 'earned surplus' and 'net worth' are not well established in South African company law.²⁵ Some terms that appear to be used in both systems, have different meanings, for example, 'solvency' that is mostly used in America in the sense of what is understood as 'liquidity' in South Africa.²⁶

Continued

dividends out of current profits. It is also different from Delaware in that no provision is made for liquidation preferences, see Manning *Legal Capital* 78. The New York Business Corporation Law allows distributions to the extent that net assets exceed stated capital. Thus, revaluation and appreciation surplus can be distributed. Since it appears that the basic approach adopted in Delaware and New York is not the most suitable option for South Africa, a separate discussion of the position in New York will not further the purposes of this research. Since the 1984 MBCA has now been adopted by more states than the 1969 version, I discuss its provisions rather than those of the 1969 MBCA.

²³ Luiz *Takeovers* 396 – 398; Havenga *Corporate Opportunities* 125, Hurter *Statutêre Minderheidsbeskerming* 160 – 162.

²⁴ See Hertig & Kanda "Creditor Protection" 76. The regulation of financial statements of groups is an exception. See Cox & Hazen *Corporations* 111 for a discussion of different approaches to the definition of groups in American law.

²⁵ See, however, *Hahlo's Company Law* 141 – 142.

²⁶ In general, the following terms or concepts need brief explanation: a 'series' of shares is a subdivision in a class and may, for example, have the same liquidation priority as another series in the class, but different dividend or voting rights (Marsh *California Corporation Law* 4.25); to 'retire' shares involves cancelling them as issued shares and restoring them to the status of authorised shares, while to 'cancel' shares means cancelling them also as authorised shares (Cox & Hazen *Corporations* 585); a share that is 'outstanding' is a share that has been issued and that has not been reacquired by the corporation; a treasury share held by the corporation is thus a share that is 'issued but not outstanding', see Cox & Hazen *Corporations* 485.

Apart from the differences in the corporation or company laws of the two countries, other legal principles that may have an impact on capital and distributions, such as principles of creditors' rights laws and bankruptcy or insolvency laws do not correspond.

It is interesting to consider the effect of the Uniform Fraudulent Transfer Act,²⁷ which provides for the impeachment or recovery of 'conveyances' made in fraud of creditors. A conveyance is a transfer of money or property or the incurrence of an obligation. Both the distribution of a dividend and the repurchase of shares qualify as conveyances for which the corporation received no reasonably equivalent value.²⁸

Any conveyance made without receiving a reasonably equivalent value by a person who is or will thereby be rendered insolvent, is automatically regarded as a fraud on creditors and can be recovered from the transferee.²⁹ The intention of the transferor is irrelevant.

A conveyance made without receiving a reasonably equivalent value by a debtor-transferor who is left with unreasonably small capital after making the transfer, is also regarded as fraudulent.³⁰

An obligation incurred when the debtor intends or believes that she will incur debts beyond her capacity to pay as they mature, is also a fraudulent conveyance.³¹

Fraudulent conveyances may be set aside, either in the bankruptcy of the debtor or by individual creditors of a solvent debtor.

²⁷ Chapter 1 (commencing with section 3439) of Title 2 of Part 2 of Division 4 of the California Civil Code.

²⁸ *US v Gleneagles Investment Co* 803 F 2d 1288 (1986) (US CA 3rd Cir). The shares that the corporation reacquires in a repurchase transaction do not constitute value in the hands of the corporation. See also *Marsh California Corporation Law* 1180.

²⁹ Section 3439.05 of the Civil Code.

³⁰ Uniform Fraudulent Transfer Act s 5.

³¹ Uniform Fraudulent Transfer Act s 6.

2 DELAWARE

2.1 Introduction

Delaware is the most popular state of incorporation.³² It has been growing in popularity despite remaining a 'traditional' stated capital jurisdiction while many other states have abandoned this approach.³³

Immediately after the revision of its 1899 General Corporation Law in 1967, the Delaware corporation statute, the Delaware General Corporation Law³⁴ was more permissive than any other corporation statute of its time.³⁵ In 1969, Delaware amended its statute again to implement certain principles of the 1969 MBCA.³⁶

An analysis of how the stated capital doctrine finds expression in Delaware shows that it has been substantially eroded. This could explain why the continued use of a legal capital system, which is often described as rigid and outdated, does not deter incorporators.

2.2 Structure of share capital

2.2.1 Authorised capital

The authorised capital of a corporation must be set out in its certificate of incorporation. If a corporation is to have only one class of shares, the certificate of

³² Eisenberg *Corporations* 101. See also the 2007 Annual Report of the Delaware Department of State Division Corporations, available at www.corp.delaware.gov (2008-06-27). More than 90% of all US-based public offerings in 2007 were incorporated in Delaware. More than 50% of all publicly-traded corporations in the USA (60% of Fortune 500 companies) are incorporated in Delaware.

³³ Delaware's success in attracting incorporations has been described as the 'Delaware effect' and it has been criticised for leading a 'race to the bottom' through lenient regulation, see *Louis K Liggett Co v Lee* (1933) 288 US 517; Cary "Federalism" 663ff; Winter "State Law" 251ff. Other commentators justify the prominence of Delaware by identifying several positive aspects of this jurisdiction, such as its flexible legislative process and the fact that bar associations rather than politicians draft its laws (Alva "Delaware and the Market for Corporate Charters" 885), the fact that it has become a centre of corporate expertise (Bratton "Corporate Law's Race" 401), and its infrastructure (Kaouris "Is Delaware Still a Haven" 965; Romano "State Competition Debate" 721 – 722). See also Macey & Miller "Toward an Interest-Group Theory of Delaware Corporate Law"; Klausner "Networks of Contracts" 842 – 847 for a discussion of the debate.

³⁴ Delaware General Corporation Law, Title 8, hereafter 'Delaware General Corporation Law'.

³⁵ Henn & Alexander *Laws of Corporations* 31.

³⁶ Henn & Alexander *Laws of Corporations* 31.

incorporation has to state the total number of authorised shares, as well as the par value of the shares or the fact that the shares are no par value shares. If the corporation has more than one class of shares, the certificate of incorporation has to specify the total number of authorised shares, the number of shares in each class and whether they are no par value or par value shares and the par value of the shares of each class of par value shares.³⁷

The position regarding authorised capital is thus similar to the South African position, except that in Delaware the total amount of capital in respect of par value shares need not be stated separately.³⁸ This difference is insignificant, because a simple calculation will reveal the total par value share capital.

2.2.2 Minimum share capital

A corporation must have one or more shares of one or more classes or series which must have full voting powers.³⁹ No minimum amount of capital is prescribed.

2.2.3 Kinds of shares

Any class of stock⁴⁰ may consist of either par value or no par value shares. It is not required as in South Africa that all the ordinary or all the preference shares be of one kind.⁴¹ Although different series⁴² of shares in a class may apparently have different rights, it seems that all the shares in a class must be either par value or no par value shares.⁴³

The stock of any class or series may be made subject to redemption at the option of the corporation, the shareholders, or upon the happening of a specified event.⁴⁴ Immediately after redemption, the corporation must have one or more

³⁷ Delaware General Corporation Law s 102(a)(4).

³⁸ See Chapter 5 paragraph 2.1.

³⁹ Delaware General Corporation Law s 151(b).

⁴⁰ The term 'stock' rather than 'shares' is used, see s 151.

⁴¹ See Chapter 5 paragraph 2.3.

⁴² See note 26 above on the meaning of 'series'.

⁴³ Delaware General Corporation Law s 151(a). In the case of par value shares the par value of shares in different series in the class must be the same, see Folk *Delaware General Corporation Law* 102:10.

⁴⁴ Delaware General Corporation Law s 151(b).

shares of one or more classes or series in issue that must have full voting powers.⁴⁵ Unlike South Africa, Delaware thus allows ordinary redeemable shares.⁴⁶ If the redemption of ordinary shares were to be allowed in South Africa, a similar restriction regarding shares remaining following a redemption would be necessary. The Delaware requirement that one or more shares with full voting powers should remain in issue is preferable to the comparable South African requirement that shares that are not redeemable or convertible must remain in issue following a repurchase of shares.⁴⁷

2.2.4 Capital accounts

The treatment of share capital accounts in Delaware is not as complicated as in South Africa.⁴⁸ Although par and no par value shares are allowed, there is only one type of share capital account, namely a stated capital account.⁴⁹

There is very little correlation between the consideration for which shares are issued and the amount reflected in the stated capital account. The directors determine the total amount of stated capital of the corporation and in effect, the 'legal capital' can be much lower than the 'economic capital' contributed in respect of the shares.⁵⁰ Where the corporation has only par value shares, the amount of stated capital must be at least equal to the aggregate par value of the issued shares. Where there are also no par value shares, the total capital has to be in excess of the aggregate par value of the issued shares.⁵¹ The directors have to specify in dollars the part of the consideration for issued shares that will be capital.⁵² If the shares are issued for cash, and the directors have not determined the portion of the consideration that will be capital, the capital will be equal to the aggregate par value of all the issued par value shares and the full consideration received in respect of all

⁴⁵ Delaware General Corporation Law s 151(b).

⁴⁶ Ordinary redeemable shares have been allowed since 1990, see Folk *Delaware General Corporation Law* 151:12.

⁴⁷ See Chapter 5 paragraph 6.3.2.

⁴⁸ Compare Chapter 5 paragraph 2.4.

⁴⁹ See Delaware General Corporation Law s 154.

⁵⁰ Delaware General Corporation Law s 154. See also Eisenberg "Modernization" 199.

⁵¹ Delaware General Corporation Law s 154.

⁵² Delaware General Corporation Law s 154.

the no par value shares.⁵³ In the case of cash consideration, the determination has to be made at the time of issue of the shares and in the case of shares issued for property other than cash, within 60 days after the issue.⁵⁴

The way in which the amount of share capital is determined differs from the position in South Africa in two important respects. First, a premium received over the par value of par value shares, need not be allocated to a share premium account as is the case in South Africa. In Delaware, a premium is regarded as surplus.⁵⁵ Alternatively, the directors may decide to allocate a portion of such premium to the capital account.⁵⁶ The share capital can thus be higher than the par value of the issued shares if the directors determine a part of the 'premium' to be capital. Directors in South Africa do not have this option and a strict distinction exists between the share capital account and share premium account.⁵⁷

Secondly, there is no restriction as to the portion of consideration received for no par value shares that have to be regarded as share capital.⁵⁸ In South Africa, the full consideration for no par value shares is regarded as stated capital.⁵⁹ In Delaware, this will be the case only if the directors fail to make an allocation.

It is evident that in Delaware the capital yardstick is far more flexible than is the case in South Africa.⁶⁰

2.2.5 The variation of share capital

2.2.5.1 Increase, decrease and reclassification

A corporation may amend its certificate of incorporation to vary its capital in various ways. It may increase or decrease its authorised capital, reclassify its capital by

⁵³ Delaware General Corporation Law s 154.

⁵⁴ Delaware General Corporation Law s 154.

⁵⁵ It is called 'paid-in surplus', see Manning *Legal Capital* 41.

⁵⁶ Delaware General Corporation Law s 154. This determination must be made at the time of issue of shares for cash or, if shares are issued for consideration other than cash, within 60 days of the issue.

⁵⁷ See Chapter 5 paragraphs 2.4.1 and 2.4.3.

⁵⁸ Delaware General Corporation Law s 154.

⁵⁹ See Chapter 5 paragraph 2.4.2.

⁶⁰ Regard must also be had to the difference between paid-in surplus in Delaware and the share premium account in South Africa, see Chapter 5 paragraph 2.4.3.

changing the number, par value, designations, preferences or other rights of the shares, or by changing par value shares into no par value shares and *vice versa*, either with or without increasing or decreasing the number of shares. It may subdivide or combine shares or any class or series of shares into a greater or lesser number of outstanding shares.⁶¹ Such variations of the capital structure do not necessarily increase or decrease the stated capital of the corporation and thus may not affect the rights of creditors.⁶² Where par value shares are changed into no par value shares, the interests of creditors may be affected in that the requirement of a stated capital that is at least equal to the issued par value will fall away, allowing the corporation to reclassify existing capital as surplus.⁶³

2.2.5.2 Capitalisations

The directors may from time to time increase the stated capital of a corporation by transferring to its capital account a portion of the corporation's net assets that are in excess of the amount of its capital, in other words, out of its surplus.⁶⁴ The board may determine the allocation of the increased capital to classes or series of shares.⁶⁵

Shares that are 'issued but not outstanding', that is, shares held by the corporation⁶⁶ may be retired or cancelled.⁶⁷ When shares are retired, they resume the status of authorised and unissued shares of the class or series to which they belong, unless the certificate of incorporation provides otherwise.⁶⁸ Shares that are cancelled are no longer authorised shares.

If the certificate of incorporation prohibits the reissue of the shares altogether or prohibits their reissue as part of a specific series, a certificate stating that fact has to be executed, acknowledged and filed. The effect of this certificate is to amend the

⁶¹ Delaware General Corporation Law s 242(a)(3).

⁶² *Sapperstein v Wilson & Co, Inc* 21 Del Ch 139, 182 A 18. See Fletcher *Cyclopedia* 5151 note 1.

⁶³ See s 244(a)(3) – (4). This aspect is discussed in paragraph 2.2.5.3 below.

⁶⁴ Delaware General Corporation Law s 154.

⁶⁵ Delaware General Corporation Law s 154.

⁶⁶ See Fletcher *Cyclopedia* 5084. Outstanding shares are defined as shares in the hands of the public and excludes treasury shares, see *Nerken v Standard Oil Co* 810 F2d 1230 (CA DC 1987).

⁶⁷ Delaware General Corporation Law s 243(a). A resolution of the board of directors is required.

⁶⁸ Delaware General Corporation Law s 243(b).

certificate of incorporation so as to reduce the number of authorised shares of the class or series or, if all the shares of the class or series have been retired, to eliminate all references to the class or series from the certificate of incorporation.⁶⁹ If the corporation's capital will be reduced by the retirement of shares, the reduction of capital has to be effected in accordance with section 244.⁷⁰

2.2.6 Reduction of issued capital

A corporation may reduce its capital by unilateral resolution of the board of directors in four ways.⁷¹ First, the capital represented by shares that have been retired may be reduced or eliminated.⁷² Unlike the position in South Africa where the share capital of a company is automatically adjusted when shares are cancelled,⁷³ the amount of capital represented by specific shares is not automatically removed from the stated capital account when the shares are retired. This can be attributed to the fact that in Delaware there is no similar close correlation between the consideration received for issued shares and the stated capital account.

Secondly, some or all of the capital represented by shares being purchased or redeemed, or any capital that has not been allocated to any particular class of shares, may be applied to an otherwise authorised repurchase or redemption of such shares.⁷⁴ Once again, the position in South Africa is quite different. On the one hand, in a South African company the capital represented by the shares that are being purchased or redeemed will automatically be removed from the company's issued or stated capital.⁷⁵ On the other hand, the concept of stated capital not allocated to particular shares is foreign to South African law. A similar provision for reduction of capital is thus not necessary in South Africa.⁷⁶

⁶⁹ Delaware General Corporation Law s 243(b)

⁷⁰ Delaware General Corporation Law s 243(c).

⁷¹ Delaware General Corporation Law s 244.

⁷² Delaware General Corporation Law s 244(a)(1).

⁷³ The cancellation of shares in South Africa has the same effect as the retirement of shares in Delaware, which is to restore them to authorised but unissued shares, see paragraph 2.2.5.2 above and compare Chapter 5 paragraph 6.6.

⁷⁴ Delaware General Corporation Law s 244(a)(2).

⁷⁵ See Chapter 5 paragraph 6.3.3.

⁷⁶ The reduction of capital in South Africa is discussed in Chapter 5 paragraph 2.6.

Thirdly, some or all of the capital represented by shares that are being converted or exchanged, or any capital not allocated to a particular class of shares, may be applied to the authorised conversion or exchange of outstanding shares. This may be done to the extent that the capital in the aggregate exceeds the total aggregate par value or stated capital of any previously unissued shares that may be issued upon such conversion or exchange.⁷⁷ The remarks I made in the two preceding paragraphs on the position in South Africa, apply equally to this type of reduction.

Lastly, some or all of the capital not represented by any particular class of shares and some or all of the capital represented by par value shares which is in excess of the aggregate par value of those shares or some of the capital represented by issued shares of no par value, may be transferred to surplus.⁷⁸ There is no limitation on the portion of no par value stated capital that can be transferred out of stated capital to surplus. The word 'some' is rather vague, but in view of the directors' initial discretion in allocating consideration to capital,⁷⁹ not anomalous.

In all instances of the reduction of capital, a solvency test must be satisfied.⁸⁰ The assets of the corporation remaining after the reduction must be sufficient to pay any debts of the corporation for which payment has not otherwise been provided.⁸¹ It was held in *In re Bell Tone Records, Inc*⁸² that the right to reduce capital is by necessary implication conditioned upon the solvency of the corporation and the rights of creditors.⁸³

A reduction of capital does not release any shareholder from liability in respect of shares that have not been fully paid.⁸⁴ Existing creditors also have an interest in the consideration due on authorised but partly paid shares. In *State v Benson*⁸⁵ the

⁷⁷ Delaware General Corporation Law s 244(a)(3).

⁷⁸ Delaware General Corporation Law s 244(a)(4).

⁷⁹ See paragraph 2.2.3 above.

⁸⁰ Delaware General Corporation Law s 244(b)

⁸¹ Delaware General Corporation Law s 244(b). Secured debts will be regarded as debts otherwise provided for.

⁸² 86 FSupp 806.

⁸³ See also Fletcher *Cyclopedia* 5150 note 9.

⁸⁴ Delaware General Corporation Law s 244(b).

⁸⁵ 2 WW Harr (32 Del) 576, 128 A 107.

court decided that a corporation could retire shares and release the subscribers from liability for the amount unpaid on their shares, provided all unsecured debts are paid first.⁸⁶ However, this is not generally allowed in the USA.⁸⁷

It appears that a repurchase of shares, which has to be funded out of surplus,⁸⁸ will not reduce the share capital unless a reduction of capital is done simultaneously. The reduction is subject to compliance with a solvency test. In order to achieve the same effect as a repurchase in South Africa, which automatically reduces the issued share capital of a company, a Delaware corporation will have to have sufficient assets to pay its debts, in addition to funding the repurchase out of surplus.

When the board resolves to reduce the corporation's capital, it must lodge a certificate of reduction. This certificate is deemed to amend the certificate of incorporation.⁸⁹

2.3 Capital contributions

2.3.1 Size of capital contribution

The consideration for the issue of shares is determined by the board of directors or by the shareholders if the certificate of incorporation so provides.⁹⁰ In the case of par value shares the consideration may not be less than the par value thereof.⁹¹ Treasury shares may be disposed of for the consideration determined by the board or shareholders, regardless of any par value.⁹² The judgment of the directors as to the value of consideration is conclusive, unless actual fraud was present in the

⁸⁶ See Fletcher *Cyclopedia* 5150 note 11.

⁸⁷ *In re State Ins Co* 14 F 28.

⁸⁸ See paragraph 2.5.2 below.

⁸⁹ Delaware General Corporation Law s 243(b).

⁹⁰ Delaware General Corporation Law s 153(a) – (b). See also Folk *Delaware General Corporation Law* 153:1 – 153:3.

⁹¹ Delaware General Corporation Law s 153(a).

⁹² Delaware General Corporation Law s 153(c).

transaction.⁹³ The directors need not record the value of the consideration nor make any formal declaration regarding the adequacy of the consideration.⁹⁴

Shareholders may consent to the issuance of shares below par value,⁹⁵ but subject to the rights of creditors and dissenting shareholders. Such an issue below par will be binding between the corporation and the purchasers or subscribers, but creditors may require full payment based on equity.⁹⁶ This differs from the South African position where court sanction is required for the issue of par value shares at a discount and where creditors do not have a right to the difference between the consideration and the par value.⁹⁷ The South African solution seems to afford greater certainty to shareholders, but is arguably more cumbersome to follow due to the involvement of the court.

A corporation may issue stock in exchange for property worth less than par value, but an agreement that such shares are fully-paid and non-assessable is forbidden as against the corporation or its creditors.⁹⁸

When shares have been issued as fully paid while the consideration is in fact worth less than the par value of the shares, they are referred to as 'watered stock' or 'fictitiously paid up stock'.⁹⁹ Watered stock may be created when shares are issued for non-cash consideration or as a gratuity or bonus. Holders of such shares, as well as promoters, may be held liable for the difference between the par value of the shares and the value of the consideration in certain circumstances. The basis for liability is misrepresentation by the corporation and the potential injury to existing shareholders, investors and creditors.¹⁰⁰

⁹³ Delaware General Corporation Law s 152. This section corresponds with s 18 of the 1969 MBCA.

⁹⁴ See *Bowen v Imperial Theatres Inc* 13 Del Ch 120, 115 A 918; Fletcher *Cyclopedia* 5186; Folk *Delaware General Corporation Law* 152:4.

⁹⁵ See Fletcher *Cyclopedia* 5199 and the authority quoted at note 9.

⁹⁶ *Handley v Stutz* 139 US 417, 35 L Ed 227, 11 S Ct 530, *Scoville v Thayer* 105 US 143, 26 L Ed 968. See also Fletcher *Cyclopedia* 5199 note 10. In connection with the position regarding dissenting shareholders see *Kirkup v Anaconda Amusement Co* 59 Mont 469, 197 P 1005, 1011 (Montana); *Fisk v Chicago RI&P R Co* 53 Barb 513 (New York).

⁹⁷ See Chapter 5 paragraph 3.5.1.

⁹⁸ *Peters v United States Mortg Co* 13 Del Ch 11, 114 A 598. See also Fletcher *Cyclopedia* 5207.9 note 22.

⁹⁹ Fletcher *Cyclopedia* 5199.

¹⁰⁰ See Fletcher *Cyclopedia* 5199. See also Cook "Watered Stock" 585 – 588 regarding the common-law basis for liability and the different approaches to determining the extent of the liability as well as the gradual evolution of 'Blue-Sky Laws' protecting investors against

2.3.2 Form of capital contribution

The consideration for shares may be in the form of cash, services rendered,¹⁰¹ personal property, real property, leases of real property, or a combination thereof.¹⁰² Shares are fully paid and non-assessable once the corporation has received the full consideration or when at least the amount that will be represented as capital has been received and the corporation has received a binding obligation of the subscriber or purchaser to pay the balance of the subscription or purchase price.¹⁰³

2.3.3 The regulation of non-cash capital contributions

There are no additional requirements as to the acceptance or valuation of non-cash consideration. It is interesting to note, though, that the directors have 60 days after the issue of shares for non-cash consideration to determine which part of the consideration will become stated capital.¹⁰⁴ The function of this extended period is apparently to allow the directors time to value the consideration, which implies that they do not have to do so prior to the issue of the shares.

2.3.4 Timing of capital contribution

Some part of the consideration has to be given when the shares are issued, and the remainder of the consideration can be made payable subject to call.¹⁰⁵

A Delaware corporation may issue partly paid shares.¹⁰⁶ The amount paid on such shares as well as the total consideration payable should be stated on the

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securities fraud, at 590 – 591.

¹⁰¹ The phrase 'labor done' is used. Future services cannot be regarded as 'labor done', see *Catherines v Copytele Inc* 602 FSupp 1019 (ED NY 1985).

¹⁰² The nature of the consideration that is allowed corresponds with the Delaware constitutional provision regarding consideration, see Fletcher *Cyclopedia* 5181.95; Folk *Delaware General Corporation Law* 152:4. Property must have pecuniary value capable of ascertainment and not be something constructive or speculative and must be able to be delivered to the corporation, see *Scully v Automobile Finance Co* 11 Del Ch 355, 101 A 908. Promissory notes with collateral are regarded as personal property 'actually received', see *Sohland v Baker* 15 Del Ch 431, 141 A 277; Fletcher *Cyclopedia* 5194 note 12.

¹⁰³ Delaware General Corporation Law s 152. A promissory note is an example of a binding obligation that can be used as consideration for the paid-in surplus part of the issue price, see Fletcher *Cyclopedia* 5194.

¹⁰⁴ Delaware General Corporation Law s 154.

¹⁰⁵ Delaware General Corporation Law s 156.

share certificate or in the books or records relating to uncertificated shares.¹⁰⁷ When a dividend is declared on fully paid shares, a dividend must be declared on partly paid shares of the same class, proportionate to the percentage of consideration actually paid.¹⁰⁸ The directors may determine in which amounts and at which times the outstanding consideration of partly paid shares must be paid.¹⁰⁹ It is an express requirement that the directors must exercise this power in view of their judgment of the necessities of the business.¹¹⁰

The directors may institute action for the recovery of an unpaid instalment or call on shares. Alternatively, the part of the shares of the delinquent shareholder sufficient to meet the outstanding demands plus incidental expenses may be sold at a public sale. If no bidder can be found to pay the amount due on the stock or, if the amount is not collected by an action within one year after the bringing of such action, the shares and any amount previously paid on them are forfeited to the corporation.¹¹¹

The subscriber to or holder of shares in respect of which the full consideration has not been paid in, is liable for the unpaid balance if the corporation's assets are insufficient to satisfy the claims of its creditors.¹¹²

A person who became a transferee or assignee of shares or of a subscription of shares in good faith and without knowledge or notice that the full consideration has not been paid, is not personally liable for the outstanding consideration. The transferor will remain liable for the balance of the consideration.¹¹³ The liability for outstanding consideration must be asserted within six years of the issue of the stock or the date of subscription.¹¹⁴ Creditors may enforce a claim for outstanding

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¹⁰⁶ Delaware General Corporation Law s 156.

¹⁰⁷ Delaware General Corporation Law s 156.

¹⁰⁸ Delaware General Corporation Law s 156.

¹⁰⁹ Delaware General Corporation Law s 163.

¹¹⁰ Delaware General Corporation Law s 163.

¹¹¹ Delaware General Corporation Law s 164.

¹¹² Delaware General Corporation Law s 162(a).

¹¹³ Delaware General Corporation Law s 162(c).

¹¹⁴ Delaware General Corporation Law s 162(e).

consideration if a writ of execution against the corporation has been returned unsatisfied.¹¹⁵

2.4 Distributions

2.4.1 Kinds of payments regulated

The Delaware General Corporation Law contains separate provisions for different kinds of distributions. It does not contain a central definition of the concept 'distribution'. Repurchases and redemptions are regulated together in section 160 while dividends are regulated by section 170. Section 244 provides separately for the reduction of capital.¹¹⁶

2.4.2 Financial restrictions

The basic rule is that repurchases, redemptions and dividends may be made out of surplus, so that stated capital will not be impaired.¹¹⁷ However, the Delaware General Corporation Law uses different terminology in the two main sections dealing with distributions. Section 160 states that a corporation may not repurchase or redeem its shares when its capital is impaired or if the redemption or repurchase would cause the impairment of its capital. In contrast to this negative formulation, section 170(a) is couched in positive form and allows the payment of dividends out of surplus. In addition, dividends may be paid out of current profits if there is no surplus.¹¹⁸ This possibility of paying 'nimble dividends' means that the financial restrictions applicable to dividend payments are not as strict as those governing repurchases and redemptions.¹¹⁹

Despite the non-impairment principle, distributions can be made out of capital, provided a reduction of capital takes place simultaneously.¹²⁰ Reductions of capital are in turn subject to compliance with a liquidity test.¹²¹

¹¹⁵ Delaware General Corporation Law s 162(b) read with s 325.

¹¹⁶ See paragraph 2.2.4.3 above.

¹¹⁷ See paragraph 1 above.

¹¹⁸ Delaware General Corporation Law s 170(a).

¹¹⁹ 'Nimble dividends' are discussed below, see paragraph 2.5.2 below.

¹²⁰ Delaware General Corporation Law s 170 refers to the surplus as calculated in accordance with

A further exception applies in respect of dividends out of current net profits in the case of wasting assets corporations.¹²² A corporation that is engaged in the exploitation of wasting assets including natural resources and patents or that is engaged primarily in the liquidation of specific assets, need not take the depletion of those assets into account in determining the net profits derived from their exploitation.¹²³

2.4.3 Timing for application of financial restrictions

The Delaware General Corporation Law does not contain a general timing provision, but each of the two provisions regulating distributions sets out a timing rule for promissory notes, debentures or other obligations given by the corporation.¹²⁴ The time the corporation delivers the note, debenture or obligation is decisive. If the relevant test¹²⁵ is satisfied at that stage, subsequent payment cannot be attacked as an unlawful distribution. It appears that the general principle is that the financial requirements should be satisfied at the time when the obligation arises.¹²⁶ This principle is derived by analogy to the timing provision in the legislation. However, since the legislation refers to the 'delivery' of the note, debenture or obligation this is not altogether clear. This seems to imply that in the case of a post-dated cheque, for example, the test must be satisfied at a stage when the debt has not really been incurred. The regulation of timing issues in relation to promissory notes, debentures and other obligations in particular could be considered as an option in South Africa.¹²⁷

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ss 154 and 244, the latter being the reduction of capital provision. Such distributions out of capital are usually referred to as distributions out of capital surplus, see Clark *Corporate Law* 614 – 615.

¹²¹ See paragraph 2.6 above.

¹²² Delaware General Corporation Law s 170(b).

¹²³ Delaware General Corporation Law s 170(b).

¹²⁴ Delaware General Corporation Law s 160(a)(1); s 170(a).

¹²⁵ Non-impairment of capital as set out in Delaware General Corporation Law s 160 and the surplus test in s 170.

¹²⁶ *In re Reliable Mfg Corp* 703 F2d 996, 1002 (7th Cir 1983). See Folk *Delaware General Corporation Law* 160:3.

¹²⁷ See Chapter 5 paragraph 5.3.

2.4.4 Liability for distributions made in contravention of Act

Despite the existence of separate provisions regulating repurchases and dividends,¹²⁸ the liability of directors for unlawful distributions is regulated in a single section.¹²⁹ This approach could be a useful interim improvement to the current South African situation where directors can be held liable for unlawful repurchases, but not for unlawful dividends.¹³⁰

Directors under whose administration any wilful or negligent violation of the provisions on purchase or redemption of own shares or on the declaration of dividends take place, are jointly and severally liable to the corporation. In the event of the corporation's dissolution or insolvency, they are also directly liable to its creditors. Liability is for the full amount of the dividend unlawfully paid or for the full amount paid to purchase or redeem the shares, together with interest.¹³¹ Liability is imposed for any violation of the provisions relating to share repurchases or redemptions and dividends and not only, as is the case in South Africa, for non-compliance with the financial restrictions.¹³²

The liability extends for six years after the payment of the dividend or the purchase or redemption of the stock,¹³³ double the period applicable to liability for unlawful repurchases in South Africa.¹³⁴

A director, who was absent when the board resolution was taken, or who dissented from it, will be exonerated if she caused her dissent to be noted in the books containing the minutes.¹³⁵ The position of non-consenting directors in Delaware is thus more certain than in South Africa.¹³⁶

It is expressly provided that a director who in good faith relies on the records of the corporation or on information, opinions, reports or statements supplied by others in order to determine whether a dividend or repurchase or redemption of

¹²⁸ Delaware General Corporation Law s 160 and s 170 respectively.

¹²⁹ Delaware General Corporation Law s 174.

¹³⁰ See Chapter 5 paragraphs 6.4.1 and 5.6.

¹³¹ Delaware General Corporation Law s 174(a).

¹³² See Chapter 5 paragraph 6.4.1.

¹³³ Delaware General Corporation Law s 174(a).

¹³⁴ See Chapter 5 paragraph 6.4.2.

¹³⁵ Delaware General Corporation Law s 174(a). In case the director was absent, she must ensure that her dissent is noted immediately upon becoming aware of the resolution.

stock would comply with the financial restrictions, will be fully protected from liability.¹³⁷ The information must relate to the value and amount of assets and liabilities and/or the net profits or any other facts pertinent to the determination of surplus or other funds that may be distributed. Although the liability imposed on directors for unlawful distributions is not limited to instances where the unlawfulness resulted from non-compliance with the financial restrictions, it seems that the protection regarding reliance on information supplied by others, applies only in respect of the financial situation of the corporation.

A director who is liable under this provision is entitled to a contribution from her co-directors who voted for or concurred in the unlawful dividend, stock purchase or redemption.¹³⁸ When a director is liable under this section, she is also entitled, to the extent of the amount paid by her, to subrogation of the corporation's right against stockholders.¹³⁹ This differs from the position in South Africa where directors may recover certain distributions¹⁴⁰ from shareholders on behalf of the corporation through a derivative procedure.¹⁴¹

Only stockholders who received the dividend or payment for the sale or redemption of their stock with knowledge of facts indicating that the dividend, purchase, or redemption was unlawful are liable.¹⁴² In South Africa, by comparison, all shareholders are potentially liable to refund the director, but a court order is required.¹⁴³

In Delaware, creditors are not entitled to bring proceedings against stockholders who received an unlawful distribution, but they may proceed against the directors if the corporation is insolvent.¹⁴⁴ Apparently, only the corporation can enforce the liability of stockholders, although the directors may rely on the principles

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¹³⁶ See Chapter 5 paragraph 6.4.1.1.

¹³⁷ Delaware General Corporation Law s 172.

¹³⁸ Delaware General Corporation Law s 174(b).

¹³⁹ Delaware General Corporation Law s 174(c).

¹⁴⁰ Consideration for the repurchase of shares, see Chapter 5 paragraph 6.4.2.1. As to other 'payments' see Chapter 5 paragraph 5.6.

¹⁴¹ See Chapter 5 paragraphs 5.4.1.3 and 6.4.2.1.

¹⁴² Delaware General Corporation Law s 174(c).

¹⁴³ See Chapter 5 paragraph 6.4.2.

¹⁴⁴ Delaware General Corporation Law s 174(a).

of subrogation.¹⁴⁵ The relative merit of this approach, which differs from the South African provisions in several respects, is considered later.¹⁴⁶

2.5 Dividends

2.5.1 *Kinds of payments regulated*

Section 170 of the Delaware General Corporation Act regulates the payment by a corporation of 'dividends upon the shares of its capital stock'. The statute does not define the term 'dividend' and it bears its ordinary meaning of a distribution to stockholders of a share of the earnings of the corporation.¹⁴⁷ A stock dividend is not strictly speaking a dividend, as it does not involve the distribution of corporate assets to stockholders.¹⁴⁸ However, it is expressly stated that dividends may be paid in 'shares of the corporation's capital stock', thus apparently including the issuing of bonus shares in the meaning of 'dividend'.¹⁴⁹ It is interesting to note that the concept of 'payment to shareholders' in section 90(3) of the South African Companies Act does not include the issue of capitalisation shares.¹⁵⁰

2.5.2 *Financial restrictions*

Directors may declare dividends out of surplus¹⁵¹ or, if there is no surplus, out of its net profits in the fiscal year in which the dividend is declared and/or the preceding fiscal year.¹⁵² Dividends paid out of current profits are known as 'nimble dividends'.¹⁵³

If the corporation's capital has been diminished by a devaluation of assets or by losses or otherwise, to an amount less than the aggregate amount of capital

¹⁴⁵ Delaware General Corporation Law s 174(c).

¹⁴⁶ See Chapter 5 paragraph 6.10.4.

¹⁴⁷ See Folk *Delaware General Corporation Law* 170:5.

¹⁴⁸ Folk *Delaware General Corporation Law* 170:5.

¹⁴⁹ Delaware General Corporation Law s 173.

¹⁵⁰ See Chapter 5 paragraph 5.1.3.

¹⁵¹ Surplus must be calculated in accordance with s 154 and s 244.

¹⁵² Delaware General Corporation Law s 170. These are so-called 'nimble dividends'. For criticism against the payment of nimble dividends, see Eisenberg *Corporations* 1257.

¹⁵³ For criticism against the payment of nimble dividends, see Eisenberg *Corporations* 1257.

represented by the issued and outstanding stock of all classes having a preference upon the distribution of assets, the directors may not declare and pay dividends out of current profits without first making good the deficiency in the amount of capital represented by the preferred shares.¹⁵⁴ This rule protects the interests of preference shareholders by ensuring that the corporation cannot distribute dividends to its ordinary shareholders if its assets are insufficient cover the amount of its preferred share capital. The effect of this rule is also that the creditors enjoy the benefit of a margin above mere solvency equal to the extent of the corporation's preferred capital.

In the case of corporations that exploit 'wasting assets', including natural resources and patents, the protection of creditors is eroded by a further exception. In calculating net profits from which nimble dividends may be paid, the depletion of the assets can be ignored.¹⁵⁵

Directors and committee members are fully protected in relying in good faith on the corporation's records and on information, opinions and reports presented to the corporation as to the value and amount of the corporation's assets, liabilities and net profits, the existence of a surplus or other funds from which dividends may be declared and which may be used for the redemption or purchase of the corporation's shares.¹⁵⁶

Dividends may be paid in cash, property or shares of the corporation.¹⁵⁷ In the last instance, an amount must be designated as capital in respect of the shares being declared as dividend. In the case of par value shares this amount must be at least equal to the aggregate par value of the shares.¹⁵⁸

¹⁵⁴ Delaware General Corporation Law s 170(a).

¹⁵⁵ Delaware General Corporation Law s 170(b). This exception is criticised by Folk *Delaware General Corporation Law* 170:3 – 170:4 for being formulated too broadly in that it allows the disregarding of depletion that is not causally linked to the corporation's exploitation of the wasting assets.

¹⁵⁶ Delaware General Corporation Law s 172.

¹⁵⁷ Delaware General Corporation Law s 173.

¹⁵⁸ Delaware General Corporation Law s 173. Such designation is not required in the case of a stock split or division.

2.5.3 Timing for application of financial restrictions

The time when the financial restrictions have to be applied in general is discussed elsewhere.¹⁵⁹ However, it is provided that the directors may 'declare and pay' dividends out of surplus or current profits.¹⁶⁰ This seems to imply that there must be a surplus available both at the time of declaration and at the time of actual payment. The express regulation of dividends paid by way of certain debt instruments support this conclusion. Such a note, debenture or obligation¹⁶¹ will be valid and enforceable, provided the corporation could have lawfully paid the dividend at the time the note, debenture or obligation was given.¹⁶² Unless this exception applies, the corporation has to have the necessary surplus at the time of actual payment.

2.5.4 Status of claim in respect of authorised but unpaid dividends

It would seem that the shareholder will be entitled to enforce payment of a declared dividend only on condition that the corporation has the required surplus at the date of enforcement.

2.5.5 Authorisation

The declaration and payment of dividends is a matter for the discretion of the directors, subject to the provisions of the certificate of incorporation.¹⁶³

2.6 Share repurchases

2.6.1 Power to acquire shares

Corporations are given a general power to 'purchase, redeem, receive, take or otherwise acquire, own and hold, sell, lend, exchange, transfer or otherwise dispose of, pledge, use and otherwise deal in and with' their own shares.¹⁶⁴ Repurchases and redemptions are expressly recognised as separate ways of

¹⁵⁹ See paragraph 2.4.3 above.

¹⁶⁰ Delaware General Corporation Law s 170.

¹⁶¹ It is suggested that the word 'obligation' in this context refers to a debt instrument.

¹⁶² Delaware General Corporation Law s 170(a).

¹⁶³ Delaware General Corporation Law s 170(a).

¹⁶⁴ Delaware General Corporation Law s 160(a).

acquiring shares, although the same financial restrictions¹⁶⁵ apply to both procedures. The holding of treasury shares and the corporation's disposing of and dealing in them is also regulated.¹⁶⁶ Although the Delaware General Corporation Law does not define the term 'repurchase', it has a very wide meaning that includes any acquisition by the corporation for consideration, except redemptions.¹⁶⁷

Because the Delaware General Corporation Law does not regulate the procedure for repurchases,¹⁶⁸ it is also silent on different kinds of repurchases. The courts distinguish between selective repurchases or discriminatory tender offers and *pro rata* self-tender offers.¹⁶⁹ This distinction is relevant to directors' duties and is considered elsewhere.¹⁷⁰

2.6.2 Financial restrictions for repurchases

A corporation may not purchase or redeem its own shares for cash or other property when its capital is impaired or when such purchase or redemption would cause any impairment of its capital.¹⁷¹ The capital impairment test does not rely on a previously published balance sheet and a corporation is thus free to revalue its assets and liabilities in establishing whether a repurchase or redemption is possible.¹⁷² The only question is whether a surplus exists and the directors are thus not required to adopt a resolution setting out the surplus.¹⁷³ Moreover, directors may rely on the opinions of experts as to the value of assets and liabilities.¹⁷⁴

By way of exception, a repurchase or redemption out of capital is allowed in respect of preference shares or, if there are no preference shares, any shares,

¹⁶⁵ Set out in the first proviso to s 160(a) and discussed in paragraph 2.6.2 below.

¹⁶⁶ Delaware General Corporation Law s 160(b) – (c).

¹⁶⁷ See *Folk Delaware General Corporation Law* 160:7.

¹⁶⁸ See paragraph 2.6.3 below.

¹⁶⁹ See *Folk Delaware General Corporation Law* 160:12 – 160:14.

¹⁷⁰ See paragraph 2.6.3 below.

¹⁷¹ Delaware General Corporation Law s 160(a)(1). See also paragraph 2.4.2 above.

¹⁷² *Klang v Smith's Food & Drug Centers, Inc* Supreme Court of Delaware, 1997 702 A.2d 150 at 154 (confirming *Morris v Standard Gas & Electric Co Del Ch*, A.2d 577 (1949)). The court stated that unrealised appreciation reflected real economic value. See also *Folk Delaware General Corporation Law* 160:5 – 160:7; *Cox & Hazen Corporations* 577.

¹⁷³ *Eisenberg Corporations* 1255; *Folk Delaware General Corporation Law* 160:6.

¹⁷⁴ Delaware General Corporation Law s 172, see paragraph 2.4.4 above.

provided the shares are retired and the capital reduced simultaneously.¹⁷⁵ The shares are thus redeemed or repurchased out of a surplus created through the capital reduction.

Clearly, protection of the priority interests of preference shareholders lies at the heart of the hierarchy envisaged in this provision, namely that ordinary shares may be so repurchased only if there are no preference shareholders. This rule is similar in effect to the English common-law principles relating to formal reductions of share capital.¹⁷⁶

When shares are repurchased out of capital, creditors will be protected by the fact that a capital reduction is subject to compliance with a liquidity requirement.¹⁷⁷

The amount of the consideration a corporation may pay when repurchasing redeemable shares is restricted. A corporation may not purchase shares that are redeemable at the option of the corporation, for more than the price at which they can 'then' be redeemed.¹⁷⁸ This measure protects not only the creditors, but also the remaining shareholders of the corporation. A similar provision may be useful in South Africa.¹⁷⁹

2.6.3 Procedure and other requirements

The Delaware legislation contains no procedural requirements for repurchases. This is in contrast with South Africa where sections 85 and 87 of the Companies Act regulate various aspects of the procedure.¹⁸⁰ There is no requirement that shareholders should approve a repurchase of shares by their corporation or that repurchases should as far as possible be proportionate. In fact, it has been held that a corporation may purchase shares privately without making a *pro rata* offer to all stockholders of that class.¹⁸¹

¹⁷⁵ Delaware General Corporation Law s 160(a)(1) proviso. The share capital can be reduced under s 243 and s 244. See paragraph 2.2.6 above for a discussion of capital reductions.

¹⁷⁶ See Chapter 5 paragraph 2.6.1.

¹⁷⁷ See paragraph 2.2.6 above.

¹⁷⁸ Delaware General Corporation Law s 160(a)(2).

¹⁷⁹ See Chapter 5 paragraph 6.8.

¹⁸⁰ See Chapter 5 paragraph 6.3.

¹⁸¹ *Martin v American Potash & Chemical Corp* 33 Del Ch 234, 92 A2d 295. Even a purchase made with the purpose of eliminating a difficult shareholder is acceptable.

The courts have formulated a number of restrictions on the powers of directors of companies acquiring their own shares. These restrictions address some of the concerns of shareholder protection that South Africa addresses in legislation.

The most important non-financial restriction formulated by the courts is the proper purpose doctrine.¹⁸² According to this principle, the proper purpose for a repurchase must be to benefit the corporation. A repurchase made in order to benefit the directors in their position, power or profit is for an improper purpose.¹⁸³ However, the fact that a repurchase incidentally maintains the directors' control does not indicate an improper purpose.¹⁸⁴ Further, if directors believe on reasonable grounds that the threat to incumbent management is also a threat to the future of the corporation's policies or effectiveness, they will be protected by the business judgment rule.¹⁸⁵ This 'difference in policy' exception to the proper purpose doctrine is particularly relevant where shares are purchased from a single shareholder believed to be a threat to the corporation.¹⁸⁶ Directors who approve a repurchase in a sudden emergency to protect the corporation from serious injury may also be excused.¹⁸⁷

The proper purpose doctrine also addresses the potential abuse of selective or non-proportionate repurchases. These are allowed provided the directors are not acting out of a sole or primary purpose to maintain their position.¹⁸⁸

¹⁸² The courts also developed the financial restriction of capital impairment which was later taken up in the legislation, see *In re International Radiator Co* 92 A 255 (Del Ch 1914). See also *Folk Delaware General Corporation Law* 160:5.

¹⁸³ *Potter v Sanitary Co of America* 194 A 87 (Del Ch 1937).

¹⁸⁴ *Folk Delaware General Corporation Law* 160:8.

¹⁸⁵ This exception was formulated in *Kors v Carey* 158 A2d 136 (Del Ch 1960). It was also used in *Cheff v Mathes* 199 A2d 548 (Del 1964). These two decisions are discussed in Hartnett "Greenmail" 1281 – 1282, who criticises the application of the business judgment rule in this context and points out (1287ff) that there has been a shift in the application of the business judgment rule in Delaware, restricting its operation to protecting disinterested directors who have informed themselves of all material information about the decision. See also Kaplan & Young "Corporate Eminent Domain" 72 – 73 for a discussion of these and other cases.

¹⁸⁶ See *Folk Delaware General Corporation Law* 160:8 – 160:9; *Clark Corporate Law* 631.

¹⁸⁷ See *Bennett v Propp* 187 A 2d 405 (Del 1962), although in this case a director was held to have breached his fiduciary duties because the repurchase was made before there was a real threat to existing corporate policy. See also *Folk Delaware General Corporation Law* 160:10 – 160:11; Hartnett "Greenmail" 1283.

¹⁸⁸ *Unocal Corp v Mesa Petroleum Co* 493 A 2d 946 (Del 1985). See also *Folk Delaware General Corporation Law* 160:13 – 160:14. Sommer "Whom Should the Corporation Serve?" 49 argues that the court in *Unocal* equated the interests of the corporation with the interests of the shareholders in receiving an adequate price and did not consider corporate policy as such.

Contrary to the position in South Africa,¹⁸⁹ in Delaware an adjustment of capital accounts does not necessarily follow upon an acquisition of own shares. The capital can be reduced subject to compliance with additional requirements.¹⁹⁰

There is no requirement that voting shares should remain in issue after a repurchase, although such a requirement is laid down in respect of redeemable shares.¹⁹¹ The reason for this inconsistency is unclear.

2.6.4 Liability for unlawful repurchases

Liability for unlawful repurchases is regulated by a provision that applies to distributions in general. This is discussed elsewhere.¹⁹²

2.6.5 Enforceability of contracts for the acquisition of shares

The status of a claimant who sold shares to the corporation and has not been paid is not regulated in the legislation. While it appears that purchases and contracts made in contravention of the capital impairment restriction are void,¹⁹³ the timing rule for promissory notes, debentures and other obligations applies the restrictions at the time of delivery of the debt instrument. The Delaware law in this regard appears to be vague and uncertain. If the contract is void, it would appear that the seller, who may not even have been aware of the fact that she was contracting with the corporation, would have no claim for the purchase price, but would be treated exactly the same as the existing shareholders who did not purport to sell their shares to the corporation. In insolvency proceedings, the claim of a vendor-shareholder is subordinated to the claims of all other unsecured creditors.¹⁹⁴

¹⁸⁹ See Chapter 5 paragraph 6.3.3.

¹⁹⁰ See paragraph 2.2.6 above.

¹⁹¹ Delaware General Corporation Law s 151(b), discussed in paragraph 2.6.8 below.

¹⁹² See paragraph 2.4.4 above.

¹⁹³ See Folk *Delaware General Corporation Law* 160:7.

¹⁹⁴ See *Robinson v Wangeman* 75 F 2d 756 (5th Cir 1935).

2.6.6 The status of repurchased shares

Repurchased and redeemed shares are regarded as issued but not outstanding shares. The corporation in effect holds them as treasury shares.¹⁹⁵ The corporation may resell treasury shares redeemed or purchased out of surplus and not retired, at any price fixed by the directors, even below their par value.¹⁹⁶ Treasury shares held by a corporation shall not be entitled to vote and will not be counted for quorum purposes.¹⁹⁷

Rather than holding shares in treasury, a corporation can also decide to retire the shares or even to cancel them completely.¹⁹⁸

2.6.7 Repurchases through subsidiaries

The Delaware General Corporation Law does not regulate the acquisition of shares by a subsidiary in its parent corporation. However, the legislation does exclude voting rights in respect of shares held by another corporation of which the first corporation holds a majority of the shares entitled to vote in the election of directors of that other corporation.¹⁹⁹ This exclusion of voting rights in respect of cross-holdings indicates that a subsidiary may indeed acquire and hold shares in its parent corporation. In the absence of any specific regulation of the acquisition of shares by a subsidiary it seems that a subsidiary can acquire shares without complying with any financial or other restrictions.

2.6.8 The redemption of shares

Any class or series of shares may be redeemable at the option of the corporation or of the holders of such stock or on the happening of a specified event.²⁰⁰ Shares

¹⁹⁵ In *Wall v United States* 164 F2d 462 the court held that stock of a corporation purchased by it and kept in its treasury is redeemed in the sense that it no longer constitutes any liability of the corporation but represents nothing more than an opportunity to acquire new assets by a reissue. See also Fletcher *Cyclopedia* 5150 note 1.

¹⁹⁶ Delaware General Corporation Law s 160(b).

¹⁹⁷ Delaware General Corporation Law s 160(c).

¹⁹⁸ See footnote 26 above, where the difference between 'retire' and 'cancel' in relation to shares is explained.

¹⁹⁹ Delaware General Corporation Law s 160(c). Such shares also do not count for quorum purposes.

²⁰⁰ Delaware General Corporation Law s 151(b). It is possible to have ordinary redeemable shares.

may be redeemed for cash, property, or rights, including securities of the same or another corporation.²⁰¹ The capital impairment test applies,²⁰² but capital may in certain circumstances be used on condition that the capital is reduced simultaneously and on condition that the rights of preference shareholders are respected.²⁰³

A corporation may not redeem shares unless their redemption is authorised by section 151(b) of the Delaware General Corporation Law and unless it does so in accordance with that section and the certificate of incorporation.²⁰⁴ Section 151(b) provides that except in certain very limited instances,²⁰⁵ there should after the redemption be shares left in issue that have full voting powers. Strangely, there is no similar requirement regarding remaining shares that should be left in issue after a repurchase.²⁰⁶

Shares can be called for redemption by giving notice of their redemption and depositing or setting aside a sum sufficient to pay the redemption price. In such a case, the shares are deemed not to be outstanding shares and will not be taken into account for purposes of voting or determining the total number of shares entitled to vote.²⁰⁷

2.7 Evaluation and conclusions on Delaware

Delaware bases its contribution and distribution rules on the concept 'stated capital' while South Africa uses 'issued share capital' which could be reflected either in a share capital account or in a stated capital account.²⁰⁸ The term 'stated capital' is also used in South Africa, but in a narrower sense.²⁰⁹

²⁰¹ Delaware General Corporation Law s 151(b)(2).

²⁰² Delaware General Corporation Law s 160(a) proviso 1, see also paragraphs 2.4.2 and 2.5.2 above.

²⁰³ Delaware General Corporation Law s 160(c), see paragraph 2.5.2 above.

²⁰⁴ Delaware General Corporation Law s 160(a)(3).

²⁰⁵ These relate to regulated investment companies and to corporations holding licences or franchises from governmental agencies. A consideration of these exceptions falls outside the scope of this thesis.

²⁰⁶ See paragraph 2.6.3 above.

²⁰⁷ Delaware General Corporation Law s 160(d).

²⁰⁸ See Chapter 5 paragraph 2.4.

²⁰⁹ See Chapter 5 paragraph 2.4.2.

Delaware allows par value as well as no par value shares.²¹⁰ Corporations have to state their authorised capital in respect of par and no par value shares respectively.²¹¹ The minimum issued capital is one share with full voting powers.²¹² The legal capital system in Delaware is rather flexible since directors may determine the par value of shares and decide how much of the consideration for par value or no par value shares will be capital. This principle is subject only to the requirement that a figure at least equal to the par value and some amount in respect of no par value shares, must be stated as capital.²¹³ Premiums received on shares are not automatically allocated to reserve accounts, but are regarded as surplus available for distribution.²¹⁴ The directors may determine that any part of a share premium will be regarded as stated capital.²¹⁵ There is thus no strict correlation between consideration received and capital, unlike the position in South Africa where the composition of share capital accounts, share premium accounts and stated capital accounts is closely regulated.²¹⁶ The variation of capital is possible through increases, decreases and capitalisation.²¹⁷ Directors may also, subject to the par value limitation and the corporation's liquidity, transfer amounts from stated capital to surplus and *vice versa*, thus varying the share capital.²¹⁸ The directors may resolve to reduce the share capital, but this is subject to a solvency test.²¹⁹ An acquisition of own shares will not automatically result in a reduction of capital.²²⁰

The directors determine capital contributions, unless this power is reserved for the shareholders. In the case of par value shares, the consideration must be at least equal to the nominal value of the shares, although the shareholders can consent to issues below par value.²²¹ While shareholders are liable to the company for the

²¹⁰ See paragraph 2.2.3 above.

²¹¹ See paragraph 2.2.1 above.

²¹² See paragraph 2.2.2 above.

²¹³ See paragraph 2.2.4 above.

²¹⁴ See paragraph 2.2.4 above.

²¹⁵ See paragraph 2.2.4 above.

²¹⁶ See Chapter 5 paragraph 2.4.

²¹⁷ See paragraph 2.2.5.1 above.

²¹⁸ See paragraph 2.2.5.2 above.

²¹⁹ See paragraph 2.2.6 above.

²²⁰ See paragraph 2.2.6 above.

²²¹ See paragraph 2.3.1 above.

agreed consideration only, they may be liable to creditors for the difference between the par value and the value of the consideration given.²²² Delaware allows various forms of capital contributions, but corporations may not accept future services as consideration.²²³ There are no additional requirements for non-cash capital contributions.²²⁴ Partly paid shares are permitted and the liability for the outstanding amount is expressly regulated.²²⁵

Distributions, including redemptions and repurchases, may be made out of surplus.²²⁶ Dividends may also be paid out of 'current' profits, but the net assets of the corporation should then exceed the amount of the preferred capital.²²⁷ These dividends are known as 'nimble dividends'.

Shares may be redeemed or repurchased out of surplus. The Delaware legislation does not prescribe any authorisation requirements or other formalities.²²⁸ However, the courts have formulated certain guidelines for the protection of shareholders, particularly in the case of selective repurchases.²²⁹

Delaware also allows redemptions or repurchases out of capital, provided a capital reduction takes place.²³⁰ The reduction of capital is subject to compliance with a solvency test. The prior rights of preference shareholders are protected by the rule that only preferred shares may be repurchased or redeemed out of capital, unless there are no preferred shares, in which case ordinary shares may be repurchased or redeemed out of capital.²³¹ This rule accords with the English common-law principles on reductions of capital.²³²

Delaware does not distinguish between repurchases and redemptions in relation to the funds from they may take place.²³³ However, the price that may be

²²² See paragraph 2.3.1 above.

²²³ See paragraph 2.3.2 above.

²²⁴ See paragraph 2.3.3 above.

²²⁵ See paragraph 2.3.4 above.

²²⁶ See paragraph 2.4.2, paragraphs 2.5.2 and 2.6.2 above.

²²⁷ See paragraph 2.5.3 above.

²²⁸ See paragraph 2.6.3 above.

²²⁹ See paragraph 2.6.3 above.

²³⁰ See paragraph 2.6.2 above.

²³¹ See paragraph 2.6.2 above.

²³² See Chapter 2 paragraph 2.6.1.

²³³ See paragraph 2.6.8 above.

paid for a repurchase where the corporation has the option to redeem the shares is regulated.²³⁴ This protects not only the creditors, but also the remaining shareholders. South Africa could consider introducing a similar rule.

Delaware allows treasury shares and does not regulate the price or procedure for resale of these shares by the corporation.²³⁵ There is no regulation of the acquisition of shares in a parent company by its subsidiary, although the holding of such shares is addressed through a neutralisation of voting rights.²³⁶

It may at first glance appear as if Delaware applies stricter financial restrictions to corporate distributions than South Africa does, because it insists on the maintenance of stated capital. However, the way in which stated capital is determined, coupled with the ease with which the capital may be reduced subject to compliance with a solvency test, leads to a result that is not very different from the South African restrictions.

The stated capital system as implemented in Delaware illustrates the artificiality that is often attributed to the legal capital system. This is largely the result of inroads made into the assumption that the consideration received for shares should not be returned to shareholders. The discretion afforded to directors to decide what amount will be reflected as stated capital in respect of no par value shares, coupled with the absence of regulation of premiums received on par value shares, may mean that there is little practical difference between what would qualify as surplus and the amount that could have been distributed under the South African solvency test. When the Delaware system is compared to the way in which legal capital systems are implemented in member states of the European Union, it becomes obvious that many of the objections levelled at the maintenance of capital principle are criticisms of the way in which the system has been implemented in jurisdictions such as Delaware rather than criticisms of the theoretical basis of the doctrine.

From the perspective of creditor protection, Delaware's relatively slack distribution regime nevertheless offers creditors at least the same level of protection

²³⁴ See paragraph 2.6.2 above.

²³⁵ See paragraph 2.6.6 above.

²³⁶ See paragraph 2.6.7 above.

as solvency-based systems. This is because a net assets test applies to nimble dividends.

Shareholders in Delaware are protected by general principles of proportionality, by the fiduciary duties of directors and by the fact that at least a part of the capital they contributed will have to be maintained by the corporation. There are several statutory provisions to safeguard the rights of preference shareholders whenever the stated capital is to be impaired.

South Africa can possibly benefit from the implementation of three principles found in Delaware law. The first is the rule that a corporation may not purchase its own shares for more than the price at which it can redeem them at that stage. Although directors' fiduciary duties will probably prevent them from repurchasing shares for more than their redemption price, the procedural and financial differences between the two procedures in South Africa could influence the decision. In view of the uncertainties involved, it may be preferable to regulate this aspect. Secondly, the timing rule for distributions by way of promissory notes can also serve as an example for South Africa in formulating a timing provision.

Finally, the principle that preference shareholders should enjoy protection whenever capital is returned to ordinary shareholders, that finds expression in the restrictions on nimble dividends and on repurchases and redemptions out of capital, can serve as an example for South Africa.

3 CALIFORNIA

3.1 Introduction

California was the first state in the USA to move away from the legal capital regime.²³⁷ It is an important comparative jurisdiction in the USA not only because of this innovation, but also due to its size and commercial significance.²³⁸ The California General Corporation Law of 1977, also known as the California Corporations Code,²³⁹ employs economic concepts to protect creditors.²⁴⁰ Its

²³⁷ Manning *Legal Capital* 176; Eisenberg *Corporations* 1261; Marsh *California Corporation Law* 218.

²³⁸ Eisenberg *Corporations* 107.

²³⁹ Chapter 682 of the Statutes of 1975, hereinafter referred to as the 'California Corporations Code'.
Continued

approach greatly influenced the 1984 MBCA, although the financial restrictions under the MBCA are not as strict as those of California. California prescribes the economic equivalent of the earned surplus test while the MBCA allows distributions subject to the economic equivalent of the capital-impairment test.²⁴¹

When the legal capital doctrine still applied in California, share repurchases and dividends were regulated differently.²⁴² Shares could be repurchased only out of earned surplus²⁴³ while dividends could be declared out of any form of surplus.²⁴⁴ The dividend rule was further relaxed by the fact that nimble dividends, that is, dividends paid out of current profits, were allowed. In addition, a wasting asset exception allowed qualifying companies to pay dividends without making provision for the depreciation of certain assets.²⁴⁵

The idea behind the new approach was to restore to creditors the protection that had gradually been eroded, while at the same time allowing flexibility depending on the present financial position of the corporation.²⁴⁶

The California Corporations Code of 1977 introduced a single definition of 'distribution' encompassing repurchases and dividends.²⁴⁷ Distributions may be made out of retained earnings or alternatively when the corporation's assets exceed its liabilities by 25 per cent and its current assets are at least equal to its current liabilities.²⁴⁸

Continued
Code'.

²⁴⁰ Eisenberg *Corporations* 1261.

²⁴¹ See Kummert "State Statutory Restrictions" 282 – 284 for a brief comparison between the California Code and the MBCA.

²⁴² Marsh *California Corporation Law* 19.

²⁴³ A number of exceptions allowed repurchases out of paid-in surplus or even out of capital. These exceptions included repurchases from dissenting shareholders and the redemption of redeemable shares. See Marsh *California Corporation Law* 1123 – 1124.

²⁴⁴ If a corporation had issued preference shares, paid-in surplus could be used for dividends on the preference shares only. However, if there were only one class of ordinary shares, dividends could be paid out of paid-in surplus.

²⁴⁵ Marsh *California Corporation Law* 1122. A similar exception still applies in Delaware, see paragraph 2.5.2 above.

²⁴⁶ Marsh *California Corporation Law* 47; see also 1115 – 1118 for an overview of the development and gradual erosion of the financial restrictions in California.

²⁴⁷ See paragraph 3.4.1 below.

²⁴⁸ See paragraph 3.4.2 below.

The Code applies to all corporations, including close corporations, incorporated in California as well as to pseudo-foreign corporations.²⁴⁹

3.2 Structure of share capital

3.2.1 *Authorised capital*

The articles of incorporation must state the total number of shares a corporation is authorised to issue.²⁵⁰ The abolition of authorised capital was considered during the reform process, but eventually retained because of historical tradition.²⁵¹ If a corporation is authorised to issue more than one class of shares or if any class is to have more than one series, the total number of shares of each class and series must be stated in the articles of incorporation.²⁵² It is possible for a corporation to create blank or unclassified stock in respect of which the board of directors can determine the terms at a later stage.²⁵³

Pre-emptive rights apply only if expressly granted in the corporation's articles of incorporation.²⁵⁴

3.2.2 *Minimum capital*

It is not an express requirement of the California Corporations Code that a corporation should have one or more shares in issue. However, the requirement

²⁴⁹ California Corporations Code ss 500 – 505. See also Marsh *California Corporation Law* 18; Henn & Alexander *Laws of Corporations* 900 par 32. A pseudo-foreign corporation is a corporation doing business in California and with most of its business done and shareholders resident in California, see footnote 9 above.

²⁵⁰ California Corporations Code s 202(d) – (e).

²⁵¹ Marsh *California Corporation Law* 218. Whereas the prior law based the registration fee for corporations on their authorised capital a flat filing fee is now charged.

²⁵² California Corporations Code s 202(e). If a class is divided into more than one series, it is also permissible to state the total number of shares of the class and provide in the articles that the directors may fix the number of shares of any series in that class.

²⁵³ California Corporations Code s 202(e)(3). See also paragraph 3.2.5 below.

²⁵⁴ California Corporations Code s 204. Pre-emptive rights were developed by American courts in the 19th century, see *Gray v Portland Bank* 3 Mass 364 (1807) and were universally recognised in America as an 'inherent attribute' of stock ownership early in the 20th century, see *Miles v Safe Deposit & Trust Co* 259 US 247, 252, 42 A CT (1922). However, this principle has since been tempered so that pre-emptive rights will usually not apply automatically.

that a corporation cannot issue or redeem redeemable shares unless it has one or more common shares outstanding which is not redeemable, implies this.²⁵⁵

3.2.3 Kinds of shares

Shares do not have a par value.²⁵⁶ However, shares are deemed to have a par value of one dollar each for purposes of any statute or regulation levying a tax or fee based on the capitalisation of a corporation.²⁵⁷ If any other statute or regulation applying to a particular corporation requires its shares to have a par value, the board may determine a par value in order to satisfy the requirements of the statute or regulation.²⁵⁸

3.2.4 Share capital and reserve accounts

There is no reliance on share capital or reserve accounts in the formulation of the contribution or distribution rules.²⁵⁹

3.2.5 The variation of share capital

The number of authorised shares may be increased or reduced by amendment to the articles of incorporation.²⁶⁰ A corporation may also change, exchange, reclassify or cancel any shares.²⁶¹ Blank stock can be classified by the directors.²⁶²

A corporation has to make consequential changes to its articles when its authorised capital is reduced following a repurchase or redemption of shares.²⁶³

3.2.6 The reduction of issued capital

There is no provision for the formal reduction of issued capital.

²⁵⁵ California Corporations Code s 402(c).

²⁵⁶ Marsh *California Corporation Law* 215 points out that a par value is not prohibited, but the Act does not refer to par value.

²⁵⁷ California Corporations Code s 205.

²⁵⁸ California Corporations Code s 205.

²⁵⁹ Marsh *California Corporation Law* 217 – 218. See also California Corporations Code s 114.

²⁶⁰ California Corporations Code s 900.

²⁶¹ California Corporations Code s 900.

²⁶² California Corporations Code s 202(e)(3), see also Marsh *California Corporation Law* 215.

²⁶³ California Corporations Code s 510(b), see also paragraph 3.6.6 below.

3.3 Capital contribution

Shares may generally be issued for the consideration determined by the board,²⁶⁴ but the articles may confer on shareholders the right to determine the consideration for which shares may be issued.²⁶⁵

3.3.1 Size of capital contribution

The judgment of the directors as to the value of the consideration for shares is conclusive unless fraud is proved.²⁶⁶

Shares may be issued without consideration as a share dividend, upon a stock split, reverse stock split, reclassification of outstanding shares into shares of another class, exchange of outstanding shares for shares of another class or other change affecting outstanding shares.²⁶⁷

The articles of incorporation may also provide for the levying of assessments on shares.²⁶⁸ Such assessments are over and above the outstanding consideration on partly paid shares.²⁶⁹ The procedure is that the board levies an assessment and notifies the shareholders. It determines a date for payment and a date upon which shares on which the assessment remains unpaid become 'delinquent' as well as a date for the sale of delinquent shares. The assessment is regarded as a lien on the shares. If on the date of the sale no bidder offers to pay the amount due on the shares, they are forfeited to the corporation.²⁷⁰

3.3.2 Form of capital contribution

The consideration for the issue of shares may consist of money, labour done, services rendered to or for the benefit of the corporation or in its formation or reorganisation, debts or securities cancelled and tangible or intangible property

²⁶⁴ California Corporations Code s 409(a)(1).

²⁶⁵ California Corporations Code s 204(a)(8). If shareholders are to determine the consideration, the determination has to be done by approval of the outstanding shares, s 409(c).

²⁶⁶ California Corporations Code s 409(b).

²⁶⁷ California Corporations Code s 409(a)(2).

²⁶⁸ California Corporations Code s 204(a)(1) and s 423.

²⁶⁹ California Corporations Code s 423.

²⁷⁰ California Corporations Code s 423(i).

actually received by the corporation or its wholly owned subsidiary.²⁷¹ Promissory notes of the purchaser are not acceptable consideration, unless adequately secured by collateral other than the shares acquired.²⁷² Future services cannot constitute payment for shares.²⁷³

3.3.3 The regulation of non-cash capital contributions

When non-monetary consideration is accepted, the directors have to adopt a resolution stating their determination of the fair value to the corporation of such consideration.²⁷⁴

3.3.4 Timing of capital contributions

The full agreed consideration has to be paid prior to or concurrently with the issuance of shares, unless the shares are issued as partly paid, in which case the consideration has to be paid in accordance with the agreement of subscription or purchase.²⁷⁵ When shares are issued as partly paid,²⁷⁶ they will be subject to call for the remaining consideration.²⁷⁷ The share certificate or, for uncertificated shares, the initial transaction statement, must state both the amount paid and the outstanding amount. When a dividend is declared on fully paid shares, a dividend proportional to the consideration paid has to be declared on partly paid shares of the same class.²⁷⁸

²⁷¹ California Corporations Code s 409(a)(1). Payment in future instalments is allowed for employee stock purchase plans, s 408(a).

²⁷² California Corporations Code s 409(1)(a). An exception in s 408(a) makes promissory notes acceptable for employee stock option plans. The issue of shares for no or for unauthorised consideration will not necessarily be invalid or void, see Marsh *California Corporation Law* 396 and Division 8 of the Commercial Code.

²⁷³ California Corporations Code s 409(a)(1). Since corporations can have partly paid shares, services may be rendered and the payment due then subsequently used against further payments.

²⁷⁴ California Corporations Code s 409(e). See Marsh *California Corporation Law* 399 – 400 for a discussion of the correct approach to valuation of assets in this context.

²⁷⁵ California Corporations Code s 410(b).

²⁷⁶ Partly paid shares are, however, rarely used, see Marsh *California Corporation Law* 402.

²⁷⁷ California Corporations Code s 409(d).

²⁷⁸ California Corporations Code s 409(d).

The subscriber or person to whom shares are originally issued is liable to the corporation for the full consideration agreed on.²⁷⁹ Shares are usually issued as fully paid and the shareholder will then not be liable for any further payments.²⁸⁰

The California Corporations Code regulates the position of a transferee of partly paid shares extensively. A transferee of shares for which the full agreed consideration has not been paid and who acquired them in good faith and without knowledge that they were not paid in full or to the extent stated on the certificate or initial transaction statement, is liable only for the amount shown by the certificate or statement to be unpaid.²⁸¹ A transferee of partly paid shares, who acquired those shares with actual knowledge that the agreed consideration had not been paid to the extent stated on the certificate or statement, is personally liable to the corporation for the unpaid amount.²⁸² It appears anomalous that no liability is imposed on a transferee of shares issued as fully paid, but in respect of which the full consideration has, to the knowledge of the transferee, not been received. Only the original subscriber or holder will be liable for the unpaid amount.²⁸³

The claim in respect of outstanding consideration belongs to the corporation and a creditor of the corporation may generally not enforce this claim. However, if a creditor has obtained final judgment against the corporation and execution has been returned unsatisfied in whole or in part, the creditor may institute action to enforce the liability of the shareholder to the corporation to pay the amount due on the shares.²⁸⁴ Other creditors may intervene and join all shareholders with partly paid shares in the action.²⁸⁵ It is expressly provided that shareholders and creditors who have a right or remedy against any promoter, shareholder, director, officer or the corporation based on fraud or illegality in connection with the sale or issue of shares or securities, will retain such right or remedy. Likewise, the corporation retains any right of rescission, cancellation or otherwise because of fraud or

²⁷⁹ California Corporations Code s 410.

²⁸⁰ See Marsh *California Corporation Law* 401.

²⁸¹ California Corporations Code s 411.

²⁸² California Corporations Code s 412.

²⁸³ See California Corporations Code s 410.

²⁸⁴ California Corporations Code s 414(a).

²⁸⁵ California Corporations Code s 414(b). A receiver may be appointed for the benefit of the respective parties to the action.

illegality practiced on it in connection with the issue or sale of its shares or other securities.²⁸⁶

3.4 Distributions

3.4.1 *Kinds of payments regulated*

The phrase 'distribution to its shareholders' is defined as

'the transfer of cash or property by a corporation to its shareholders without consideration, whether by way of dividend or otherwise, except a dividend in shares of the corporation, or the purchase or redemption of its shares for cash or property, including the transfer, purchase or redemption by a subsidiary of the corporation',²⁸⁷

The definition also sets out what is not regarded as a distribution, namely:

- complying with a court order for the rescission of the issuance of shares
- the rescission by a corporation of the issuance of its shares, if the board determines that it is reasonably likely that the holders of the shares could legally enforce a claim for the rescission, that the rescission is in the best interests of the corporation and that the corporation is likely to be able to meet its liabilities (except those for which payment is otherwise adequately provided) as they mature
- the repurchase by a corporation of its shares issued in terms of section 408 if the board determines that the repurchase is in the best interests of the corporation and that the corporation is likely to be able to meet its liabilities (except those for which payment is otherwise adequately provided) as they mature.²⁸⁸

²⁸⁶ California Corporations Code s 415.

²⁸⁷ California Corporations Code s 166.

²⁸⁸ California Corporations Code s 166.

Although a rescission of the issuance of shares is not a distribution and the financial restrictions consequently do not apply to it, a claim for restitution is subordinated to the claims of general creditors.²⁸⁹

Shares issued in terms of section 408 are shares issued to directors or employees of a corporation pursuant to an employee stock option or stock purchase plan.²⁹⁰

It is notable that the acquisition of shares of dissenting shareholders under the appraisal remedy is subject to the financial restrictions applicable to share repurchases.²⁹¹ The rights of creditors enjoy priority over the rights of dissenting shareholders.²⁹²

3.4.2 Financial restrictions

The financial restrictions on distributions are set out in sections 500 to 503 of the Code. The first two of these provisions contain the restrictions aimed at the protection of creditors while the remaining two sections preserve the preferences of preferred classes of shareholders. Section 500 contains two alternative balance-sheet restrictions, namely the retained earnings test and the asset-liability ratios test. Section 501 contains an equity solvency or liquidity test. Section 502 and section 503 respectively entrench the liquidation preferences and dividend preferences of preferred classes of shareholders. A number of exceptions to all or some of these restrictions are set out in sections 503.1, 503.2 and 504.

3.4.2.1 The retained earnings test.

Section 500 prohibits the making of any distribution to shareholders unless one of two alternative balance-sheet tests is satisfied. The first alternative test may be termed the 'retained earnings test' and is set out in section 500(a). A distribution

²⁸⁹ 11 USC (Bankruptcy Code) s 510(b). See *Marsh California Corporation Law* 1163.

²⁹⁰ *Marsh California Corporation Law* 1164 states that although the purpose of this exclusion was to facilitate the reacquisition of shares issued to outgoing executives, the provision allows any reacquisition from employees or directors which is regarded to be in the best interests of the corporation.

²⁹¹ California Corporations Code s 1306.

²⁹² *Marsh California Corporation Law* 1174 explains that an exception was made under the earlier Californian legislation in respect of appraisal payments, but that the drafters of the present legislation made a policy decision against this approach.

may be made if the amount of the retained earnings of the corporation immediately prior to the distribution equals or exceeds the amount of the proposed distribution.²⁹³ The amount of retained earnings must be determined in accordance with generally accepted accounting principles.²⁹⁴ The retained earnings test achieves the same effect as an earned surplus test, in both instances the original investment of shareholders is left intact.

3.4.2.2 The asset-liability ratios test

As an alternative to the retained earnings test, the corporation can satisfy the asset-liability ratios tests which is set out in section 500(b)(1) and (2).

This balance-sheet test requires a comparison of the levels of a corporation's assets and liabilities. The two ratios apply cumulatively and must be satisfied immediately after the distribution.

The first ratio that must be satisfied is the ratio of total assets to total liabilities, which must be at least 1,25 to 1.²⁹⁵ This means that the total assets must exceed the total liabilities by 25 per cent or more. For this purpose, assets exclude goodwill, capitalised research and development expenses and deferred charges. The reason for the exclusion of these assets is that they are illiquid and, as their value depends on the continued existence of the corporation, would be worthless upon liquidation.²⁹⁶ On the liabilities side, deferred taxes, deferred income and other deferred credits are excluded.²⁹⁷

The second ratio that must be satisfied is that the current assets must be at least equal to current liabilities.²⁹⁸ The ratio is thus 1:1. However, if the average of the earnings of the two preceding fiscal years was less than the average of the

²⁹³ California Corporations Code s 500(a). The amount of a distribution payable in property is determined on the basis of the value at which the property is reflected in the corporation's financial statements in accordance with generally accepted accounting principles, s 500(d).

²⁹⁴ Marsh *California Corporation Law* 1132. The application of this test to repurchases paid for by way of promissory notes is discussed in paragraph 3.5.2 below.

²⁹⁵ California Corporations Code s 500(b)(1).

²⁹⁶ Marsh *California Corporation Law* 1136. The reason these are usually included in a balance sheet is to reflect the flow of income in an income statement.

²⁹⁷ Marsh *California Corporation Law* 1136 explains that although these items are included in a balance sheet to reflect the flow of income in the income statement accurately, they do not reflect actual liabilities to pay over money and are thus not considered for purposes of the asset-liability ratios test.

interest expense for those two years, the current assets have to be at least equal to 1,25 times the current liabilities.²⁹⁹ This higher ratio of current assets to current liabilities is intended to protect creditors against the increased risk of default by a corporation that could not cover its interest costs by its earnings.³⁰⁰

The meaning of current assets and current liabilities depends on classification according to generally accepted accounting principles. A corporation that does not classify its assets into current and fixed assets under generally accepted accounting principles is exempted from the current assets to current liabilities ratio test.³⁰¹

Profits derived from an exchange of assets may not be regarded as part of current assets unless the assets received are currently realisable in cash.³⁰² In certain instances, future income streams may be taken into account in determining current assets.³⁰³

The asset-liability ratios test is based on the assumption that the asset margin will cushion creditors against the risk of default. Financial ratios can be a useful tool in the prediction of corporate distress and failure.³⁰⁴ It is an innovative solution that simulates restrictions often imposed by sophisticated lenders such as banks.³⁰⁵ It is

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²⁹⁸ California Corporations Code s 500(b)(2).

²⁹⁹ California Corporations Code s 500(b)(2) proviso.

³⁰⁰ See Marsh *California Corporation Law* 1138.

³⁰¹ California Corporations Code s 500(b)(2).

³⁰² California Corporations Code s 500(b)(2) first proviso.

³⁰³ California Corporations Code s 500(b)(2) second proviso. This exception allows the inclusion of net amounts that the board of a corporation has determined in good faith may reasonably be expected to be received from customers during the 12-month period which is used to calculate current liabilities pursuant to existing contractual relationships that obligate those customers to make fixed or periodic payments. Future costs reasonably expected by the corporation to be incurred in performing those contracts have to be taken into account if they have not been included under current liabilities. The same rule applies to public utilities that will receive payments pursuant to service connections with customers, see Marsh *California Corporation Law* 1142.

³⁰⁴ See Ben-Dror "Distribution Rules" 376 and also the authority he refers to in note 62 on 387. Ben-Dror discusses the results of an empirical study showing that the two ratios in the California Corporations Code can be manipulated and do not adequately predict financial distress (390ff). The study also shows that satisfaction of the alternative test of retained earnings does not indicate continuing financial stability (407), leading Ben-Dror to recommend that the tests should be applied cumulatively rather than alternatively (413). The best protection, according to Ben-Dror, would be the application of a more sophisticated model of bankruptcy prediction, taking into account additional ratios and distinguishing between corporations operating in different industrial categories (413).

³⁰⁵ The same ratio of assets to liabilities was used in s 1907 of the previous California Corporations

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more difficult to evade this test than many of the restrictions traditionally imposed in legal capital regimes.³⁰⁶

3.4.2.3 The equity solvency test

A further test that has to be satisfied, in addition to one of the alternative tests of section 500, is set out in section 501. No distribution may be made if the corporation or subsidiary making the distribution is, or would as a result of it be, likely to be unable to meet its liabilities, except those whose payment is otherwise adequately provided for, as they mature.³⁰⁷ This test amounts to an equity solvency or liquidity test. It is difficult to think of circumstances where a corporation would satisfy the asset-liability ratios test, but not the liquidity test. However, this may happen if the current assets to current liabilities ratio is excluded due to the fact that the corporation does not distinguish between fixed and current assets.³⁰⁸ Clearly, when a distribution is made out of retained earnings, the liquidity test may effectively increase the protection offered to creditors.

Rather than relying on the frame of mind of the directors in assessing liquidity, the provision requires an objective assessment of the corporation's financial situation, namely whether or not it is 'likely to be unable to pay its debts'.³⁰⁹ Since not only directors, but also shareholders, may be held liable for unlawful distributions a more objective test is preferable.³¹⁰

3.4.2.4 Preferential dividend and liquidation distributions

Unlike the South African Companies Act, the California Corporations Code expressly protects the rights of preferred classes of shareholders when a

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Code to restrict the distribution of a surplus created by way of a reduction of capital, Marsh *California Corporation Law* 1137.

³⁰⁶ See Clark *Corporate Law* 623. Kummert "State Statutory Restrictions" 285 concludes that the asset-liability ratios test is more cost-effective to apply than the retained earnings test.

³⁰⁷ California Corporations Code s 501.

³⁰⁸ See paragraph 3.4.2.2 above.

³⁰⁹ An equity solvency or liquidity test also applied under s 1501 and s 1708 of the previous California Corporations Code, but these sections prohibited distributions where there was 'reasonable ground for believing' that the corporation would be unable to pay its debts. Marsh *California Corporation Law* 1152 observes that the change from a subjective to an objective test is unlikely to affect the outcome of the majority of cases.

³¹⁰ See Marsh *California Corporation Law* 1152.

distribution is made to classes enjoying a lower priority. Section 502 provides that, after giving effect to the distribution, the excess of assets over liabilities should be at least equal to the liquidation preference of all shares having a preference over the class of shares to which the distribution is made.³¹¹

In terms of section 503, no distribution may be made unless the retained earnings of the corporation immediately prior to the distribution equal or exceed not only the intended distribution, but also the amount of any arrear cumulative dividends of preferred classes of shares.³¹² It is interesting to note that section 502 relies on a certain level of assets while section 503 requires provision for arrear dividends out of retained earnings. These provisions apparently offer preference shareholders minimal protection compared to the type of restrictions commonly found in the terms of issue of preference shares.³¹³

3.4.2.5 Exceptions

Sections 503.1 and 503.2 contain exceptions where certain redemptions and repurchases may be made without complying with any of the financial restrictions. A corporation may, in order to carry out a prior agreement to that effect, purchase or redeem the shares of a deceased shareholder out of the net proceeds³¹⁴ of an insurance policy on the life of the shareholder.³¹⁵ Similarly, the financial restrictions do not apply to the purchase or redemption of the shares of a disabled shareholder out of the proceeds of disability insurance.³¹⁶ The inclusion of similar exceptions could be useful also for South Africa.³¹⁷

³¹¹ Eisenberg *Corporations* 1245 – 1247. The adjustment rule that applies in respect of the calculation of assets and liabilities where a distribution is made by way of repurchase, is discussed in paragraph 3.5.2 below.

³¹² California Corporations Code s 503. In cases of repurchase, the retained earnings must be calculated in accordance with the proviso discussed in paragraph 3.5.2 below.

³¹³ See Marsh *California Corporation Law* 1155 – 1157 who points out that usually the terms of issue of preference shares would prohibit the payment of dividends to lower ranking classes while the preference dividend is in arrears, thus ensuring better protection than the statutory requirement of merely having sufficient retained earnings.

³¹⁴ The provision requires that the total amount of all premiums paid by the corporation for the insurance must be deducted from the proceeds. The balance of the proceeds, including the part of it that represents the premium paid, will become part of the corporation's assets and could be available for purposes of other distributions, see Marsh *California Corporation Law* 1161.

³¹⁵ California Corporations Code s 503.1.

³¹⁶ California Corporations Code s 503.2.

³¹⁷ See Chapter 5 paragraph 6.10.2.

The exceptions provided for in section 504(a) are instances where section 500, the provision imposing the alternative tests of retained earnings and asset-liability ratios, do not apply. The other financial restrictions, namely the equity solvency test and the restrictions protecting preference shareholders, still apply. A dividend declared by a regulated investment company or by a real estate investment trust is exempt from section 500 to the extent that the dividend is necessary to maintain the status of the corporation as such an investment company or trust.³¹⁸

Under section 504(b) the purchase or redemption by an open-end investment company of shares that are redeemable at the option of the shareholder, qualifies as an exception to the financial restrictions and accompanying procedural and liability provisions for repurchases.³¹⁹

3.4.3 Timing for application of financial restrictions

The financial restrictions have to be satisfied at the time of the distribution. The time of a distribution is set out in the definition of distribution.³²⁰ In the case of a dividend, it is the date of its declaration and not the record date or payment date.³²¹

When a corporation repurchases or redeems its shares, the time of the distribution is the date the corporation, whether or not pursuant to a contract of an earlier date, transfers cash or property. If shares are repurchased on instalments, each instalment will be subject to the financial restrictions.

However, where a debt obligation that is a security is issued in exchange for shares being redeemed or repurchased, the date of distribution is the date when the corporation acquires the shares.³²² In the case of a sinking fund payment, the time

³¹⁸ California Corporations Code s 504(a). See Marsh *California Corporation Law* 1157 – 1160 for a discussion of these corporations. In order to retain their status under the Internal Revenue Code, they have to declare a prescribed percentage of their taxable income as dividends. These corporations are closely regulated by other legislation restricting the level of debt they may incur, and according to Marsh it will only be in unusual circumstances that they will not satisfy the restrictions imposed by California Corporations Code s 500.

³¹⁹ See Marsh *California Corporation Law* 1160. Once again, these corporations are strictly regulated by other legislation that adequately protects the rights of creditors and other classes of shareholders.

³²⁰ California Corporations Code s 166.

³²¹ Marsh *California Corporation Law* 1165 explains that there will usually be a maximum of two to three months between the date of declaration and the date of payment. In most cases, the corporation's financial position would thus not have changed much.

³²² California Corporations Code s 166.

of transfer of cash or property is when it is transferred to a trustee for the holders of preferred shares to be used for the redemption of the shares or when the corporation physically segregates the cash or property in trust for that purpose.³²³

The basic timing rule for repurchases corresponds with the South African provisions that require satisfaction of the solvency and liquidity test at the time payment is made.³²⁴ However, in California the date of declaration of a dividend rather than the date of actual payment is used. Although the South African provision provides stronger protection for creditors, the Californian provision is probably easier to work with and provides more certainty for directors and shareholders. South Africa could also consider inserting specific timing rules for distributions by way of debt instruments.³²⁵

3.4.4 Status of claim in respect of authorised but unpaid dividends

The position of the shareholder following the declaration of a dividend seems to depend on the terms of the declaration.³²⁶ Although the courts have viewed the declaration of a dividend as creating an enforceable debt,³²⁷ this may depend on whether or not a future record date is determined.³²⁸ In view of the fact that the financial restrictions have to be satisfied on the date of declaration³²⁹ it would seem that the right of a shareholder to enforce a dividend does not depend on the financial position of the corporation at the date of enforcement.³³⁰

3.4.5 Liability for unlawful distributions

Shareholders are liable in terms of section 506(a) for non-compliance with the restrictions on distributions.³³¹ It may appear that liability is imposed for

³²³ California Corporations Code s 166.

³²⁴ See Chapter 5 paragraph 4.2.

³²⁵ See Chapter 5 paragraph 4.4.2.

³²⁶ See *Marsh California Corporation Law* 1198.

³²⁷ *Meyers v El Tejon Oil and Refining Co* 29 Cal 2d 184 at 188.

³²⁸ *Smith v Taecker* 133 Cal App 351 at 352.

³²⁹ California Corporations Code s 166, see also paragraph 3.4.3 above.

³³⁰ This does not preclude the possibility that a dividend may be set aside as a fraudulent conveyance, see paragraph 1 above.

³³¹ This provision refers to non-compliance with any of the provisions of ss 500 – 511 of the California Corporations Code.

non-compliance with non-financial restrictions as well. However, section 506(b), which states when and by whom proceedings to enforce liability may be brought, refers to non-compliance with sections 500 to 503 only.³³² These sections contain the financial restrictions.

Similarly, directors are liable under the express statutory provision only for making distributions contrary to the financial restrictions.³³³

3.4.5.1 Directors

Directors who ‘approve’ the making of any distribution to shareholders to the extent that it is contrary to the financial restriction, are jointly and severally liable to the corporation for the benefit of creditors and shareholders.³³⁴ It is not only directors who vote in favour of a distribution who are taken to approve of it. A director who is present at a meeting where a distribution is approved and abstains from voting is also considered to have approved the making of the distribution.³³⁵ Directors who vote against the distribution, or are absent from the meeting, are thus not liable.

The liability of directors in respect of unlawful distributions is subject to section 309 of the California Corporations Code. The effect of this is that directors will only be liable if they did not act in good faith or with the required degree of care.³³⁶ A director may rely on information presented by others such as employees, independent accountants and board committees the director believes to be reliable.³³⁷ A director will be liable for unlawful distributions only if she acted at least negligently.

The amount recoverable from the director is the amount of the illegal distribution, but not exceeding the liabilities of the corporation owed to non-consenting creditors at the time of the violation and the injury suffered by non-consenting creditors. Non-consenting creditors are creditors who did not

³³² See further discussion in paragraph 3.4.5.1 below.

³³³ California Corporations Code s 316(a)(1).

³³⁴ California Corporations Code s 316(a)(1).

³³⁵ California Corporations Code s 316(b).

³³⁶ California Corporations Code s 309(a), (c).

³³⁷ California Corporations Code s 309(b).

consent to the distribution. If creditors consented to a distribution that could not lawfully be made under the financial restrictions, the directors will not be liable.³³⁸

Creditors whose claims arose before the making of the distribution and who have not consented to it may enforce liability in the name of the corporation where the unlawful distribution amounted to a contravention of the creditor protection restrictions set out in section 500 and section 501.³³⁹ The preferred shareholders who have not consented to the distribution may enforce liability where the distribution violated the preference shareholder protection restrictions of section 502 and section 503.³⁴⁰

A director sued for approving an unlawful distribution may join all the other directors who are liable and may compel contribution from them.³⁴¹ A director is also entitled to subrogation of the rights of the corporation and may thus recover the distribution from shareholders who received it.³⁴² Since the director's right depends on the right of the corporation, distributions can be recovered from shareholders only if they had knowledge of facts indicating the impropriety of the distribution.³⁴³ The director's right of recovery against shareholders is curtailed in view of the stricter test for imposing liability on shareholders. Compared to the South African recovery provision for repurchases, a director's right of recourse is thus more restricted on a practical level.³⁴⁴

It is also an offence for a director to concur in any vote or act of the board in making an illegal distribution if she acts 'knowingly and with dishonest or fraudulent purpose' and either with the design of defrauding creditors or shareholders or of giving a false appearance as to the value of stock, thereby defrauding subscribers or purchasers.³⁴⁵

³³⁸ See Marsh *California Corporation Law* 1183.

³³⁹ California Corporations Code s 316(c).

³⁴⁰ California Corporations Code s 316(c).

³⁴¹ California Corporations Code s 316(e).

³⁴² California Corporations Code s 316(f)(1).

³⁴³ See California Corporations Code s 506(a) and the discussion in paragraph 3.4.5.2 below.

³⁴⁴ See Chapter 5 paragraph 6.4.1.3.

³⁴⁵ California Corporations Code s 2253.

3.4.5.2 Shareholders

Any shareholder who receives a distribution made in violation of the financial restrictions ‘with knowledge of facts indicating the impropriety thereof’ is liable to the corporation. Liability is for the amount received by her or the fair market value of property received by her, together with interest and certain costs, up to the amount of the corporation’s liabilities to non-consenting creditors at the time of the violation and the injury suffered by non-consenting shareholders.³⁴⁶

A shareholder will be regarded as having knowledge of the ‘impropriety’ of a distribution if she knows of facts indicating that the distribution is unlawful.³⁴⁷

Action to enforce liability of shareholders may be instituted in the name of the corporation.³⁴⁸ A shareholder who is sued may compel contribution from other shareholders who are liable.³⁴⁹ If section 500 or section 501 has been violated, any one or more creditors whose debts or claims arose prior to the time of the distribution and who did not consent to the distribution may bring the action. Where section 502 or section 503 has been violated, action may be instituted by one or more holders of preferred shares outstanding at the time of the distribution and who have not consented to it.

Creditors need not obtain judgment against the corporation prior to instituting action against a shareholder or director and preferent shareholders need not rely on the derivative action procedure provided elsewhere in the California Corporations Code³⁵⁰ in order to institute the action in the name of the corporation.³⁵¹

³⁴⁶ California Corporations Code s 506(a).

³⁴⁷ See *England v Christensen* 243 Cal App 2d 413; 52 Cal Rptr 402 (1966) where it was held that the shareholder need not have known that the distribution was unlawful but only what the corporation’s financial situation was.

³⁴⁸ California Corporations Code s 506(b). According to Marsh *California Corporation Law* 1179 this reference to non-consenting creditors and shareholders implies that the obtaining of consent could be used as a mechanism to limit or exclude the liability of shareholders.

³⁴⁹ California Corporations Code s 506(c).

³⁵⁰ California Corporations Code s 7710.

³⁵¹ California Corporations Code s 506(b). It is possible that persons other than those mentioned in s 506(b) could institute proceedings based on the illegality of a distribution in violation of the limitations. *Tiedje v Aluminum Taper Milling Co Inc* 46 Cal 2d 450; 296 P 2d 554 (1956), which, according to Marsh *California Corporation Law* 1189 should still apply under the new statute, granted a former shareholder who had sold her shares to the corporation in ignorance of the fact that the contract violated the financial restrictions on distributions an order for the rescission of the contract and for restitution.

The possible liability of a shareholder under the Uniform Fraudulent Transfer Act³⁵² is expressly retained.³⁵³

The Californian provision thus distinguishes between non-compliance with the creditor-protection restrictions of sections 500 and 501 and the preference shareholder-protection restrictions of sections 502 and 503. Creditors and shareholders may either sue to enforce the liability of shareholders who received the distribution or of directors who approved it. Any recovery made in such an action will be for the benefit of the corporation and not for the specific creditors or shareholders who instituted the action.³⁵⁴

3.5 Dividends

3.5.1 *Kinds of payments regulated*

Included in the definition of distribution is 'the transfer of cash or property by a corporation to its shareholders without consideration, whether by way of dividend or otherwise, except a dividend in shares of the corporation'.

Rather than relying on the link between the shareholding and the payment,³⁵⁵ this provision depends on the feature that the transfer to a shareholder is 'without consideration'.³⁵⁶ Dividends and any other payments, including disguised dividends in the form of salary payments to shareholders who have not rendered services, will be regarded as distributions.³⁵⁷ A transfer of assets without consideration and an informal liquidation coupled with a distribution of assets will also qualify.³⁵⁸

³⁵² Chapter 1 (commencing with section 3439) of Title 2 of Part 2 of Division 4 of the Civil Code.

³⁵³ California Corporations Code s 506(d). See paragraph 1 above for a discussion of the Uniform Fraudulent Transfer Act.

³⁵⁴ This is because s 506(b) allows the proceedings to be instituted 'in the name of the corporation'.

³⁵⁵ As for example the South African provision which requires the payment to be made 'by reason of' the shareholder's shareholding, see Chapter 5 paragraph 5.1.2.

³⁵⁶ Marsh *California Corporation Law* 1126.

³⁵⁷ *De Martini v Scavenger's Protective Association* 3 Cal App 2d 691; 40 P 2d 317 (1935); *Kohn v Kohn* 95 Cal App 2d 708; 214 P 2d 71 (1950), see Marsh *California Corporation Law* 1126.

³⁵⁸ *Oilwell Chemical and Materials Co v Petroleum Supply Co* 64 Cal App 2d 367; 148 P 2d 720 (1944).

A transfer of cash or property by a subsidiary of the corporation is also regarded as a distribution.³⁵⁹ The wording of the definition seems to imply that it will be regarded as a distribution by the parent corporation rather than by the subsidiary.³⁶⁰ There is no further reference to a subsidiary in the provisions imposing the financial and other restrictions.

3.5.2 Financial restrictions

A corporation or its subsidiary may not make any distribution, including dividends and other payments, to the corporation's shareholders unless it complies with the financial restrictions set out in sections 500 to 503.³⁶¹

3.5.3 Authorisation

The power to declare dividends rests with the board of directors. Declaration of a dividend is usually done through a resolution of the directors at a board meeting.³⁶² The board may delegate the final authority to declare dividends to the executive committee or any other committee of the board, but then subject to the restriction that the rate or periodic amount must have been set forth in the articles or determined by the board.³⁶³

When a dividend is not chargeable to retained earnings, shareholders have to be notified of this fact.³⁶⁴ The notice has to explain the accounting treatment of the dividend. Either the notice has to accompany the dividend or it should be given within three months after the end of the fiscal year in which the dividend is paid.³⁶⁵ Shareholders need this information in order to determine their liability for tax.³⁶⁶

³⁵⁹ California Corporations Code s 166.

³⁶⁰ The definition of 'distribution' is quoted in paragraph 4.1 above.

³⁶¹ See paragraph 3.4.2 above.

³⁶² California Corporations Code s 311.

³⁶³ California Corporations Code s 311(f).

³⁶⁴ California Corporations Code s 507.

³⁶⁵ California Corporations Code s 507. It will not always be clear whether a dividend paid during a fiscal year will ultimately be covered by retained earnings or whether it will constitute or include a return of capital, see Marsh *California Corporation Law* 1200.

³⁶⁶ See Marsh *California Corporation Law* 1200. A similar provision existed in the previous California Code where it had the function of identifying dividends paid out of a capital reduction surplus.

3.6 Share repurchases

3.6.1 *Power to acquire shares*

Corporations are given the express power to 'issue, purchase, redeem, receive, take or otherwise acquire, own, hold, sell, lend, exchange, transfer or otherwise dispose of, pledge, use and otherwise deal in and with' their own shares and other securities.³⁶⁷ This power is subject to section 510, which regulates the status of reacquired shares.³⁶⁸ 'Reacquires' means for purposes of section 510 that a corporation purchases, redeems, acquires by way of conversion to another class or series or otherwise acquires its own shares, or that issued and outstanding shares cease to be outstanding.³⁶⁹

Not all reacquisitions of shares amount to distributions. It is only the purchase or redemption of shares for cash or property that is regarded as a distribution. Furthermore, a purchase of shares issued pursuant to section 408 is not regarded as a distribution if the board has determined that the repurchase is in the best interests of the corporation and that the corporation is likely to be able to meet its liabilities as they mature.³⁷⁰ This exception relates to stock purchase and option plans for employees or directors of the corporation.

The California Corporations Code distinguishes between redemptions and purchases, although the same financial restrictions apply to them. No distinction is made in the code between selective and proportionate repurchases.³⁷¹

3.6.2 *Financial restrictions*

The financial restrictions applicable to distributions in general are discussed above.³⁷²

³⁶⁷ California Corporations Code s 207(d).

³⁶⁸ This provision is further discussed in 3.6.6 below.

³⁶⁹ California Corporations Code s 510(d).

³⁷⁰ California Corporations Code s 166(c). Any director who is or would be party to the transaction may not vote.

³⁷¹ As in Delaware, the courts apply general principles, primarily fiduciary obligations of directors and majority shareholders. See, for example *Heckmann v Ahmanson* 168 Cal App 3d 119, 214 Cal Rptr 177 (1985) where directors had to account for a greenmail payment. See also paragraph 2.6.3 above.

³⁷² See paragraph 3.4.2 above.

However, when the restrictions are being applied to a repurchase or a redemption, adjustments have to be made so that amounts outstanding on other repurchases or redemptions can be disregarded.

The first such adjustment applies when the retained earnings test is applied. The amount of the retained earnings must be increased by all amounts previously deducted from it with respect to obligations incurred in connection with repurchases and that are reflected on the balance sheet, to the extent that they remain unpaid immediately before the distribution.³⁷³ Conversely, the liabilities must be reduced by all amounts that had previously been added to it in respect of obligations incurred in connection with repurchases and reflected on the balance sheet, to the extent that they will remain unpaid after the distribution.³⁷⁴ The purpose of this provision is to ensure that assets and liabilities are not duplicated.³⁷⁵

Similar adjustments for distributions by way of repurchases or redemptions are prescribed for the determination of assets and liabilities when applying the preference shareholder restrictions of section 502 and section 503.³⁷⁶

3.6.3 Procedure and other requirements

The power to authorise the repurchase of shares rests with the board of directors.³⁷⁷ The board may delegate the final authority to authorise a repurchase to the executive committee or any other committee of the board, but then subject to the restriction of a price range that has been set out in the articles or determined by the board.³⁷⁸

³⁷³ California Corporations Code s 500(d).

³⁷⁴ California Corporations Code s 500(d).

³⁷⁵ This rule, which became necessary as a result of an accounting treatment of promissory notes, is explained in Marsh *California Corporation Law* 1133, based on an earlier version of s 500(d) while the amendment thereof in 1994 is explained in detail at 1134ff.

³⁷⁶ See California Corporations Code s 502 proviso and s 503 proviso.

³⁷⁷ California Corporations Code s 311.

³⁷⁸ California Corporations Code s 311(f).

3.6.4 Liability for unlawful repurchases

The California Corporations Code does not provide separately for liability in respect of unlawful repurchases. The liability provisions for distributions in general thus apply.³⁷⁹

3.6.5 Enforceability of contracts for the acquisition of own shares

The enforceability of share repurchase contracts depends on satisfaction of the financial restrictions at the time of actual payment or transfer. The shareholder will not become a creditor of the corporation unless the purchase is permitted in terms of the financial restrictions.³⁸⁰

The position of a shareholder who exercised her appraisal right and who has not been paid is expressly regulated.³⁸¹ Should the corporation be unable to pay without violating the financial restrictions on distributions, the shareholder will be regarded as a creditor entitled to payment subject to compliance with the financial restrictions. If the corporation is liquidated the claim is subordinated to the claims of all the other creditors of the corporation.

3.6.6 The status of repurchased shares

When a corporation reacquires its own shares, those shares are restored to the status of authorised but unissued shares, unless the articles prohibit their reissue.³⁸² The term 'reacquires' means that a corporation acquires its own shares whether through a repurchase, redemption, acquisition through conversion to another class or series, or otherwise, or because issued and outstanding shares cease to be outstanding.³⁸³

Where the articles prohibit the reissue of acquired shares, the articles have to be amended upon acquisition to reflect the fact that the shares cannot be issued again. If all the authorised shares of a class or series are reacquired, that class or

³⁷⁹ See paragraph 3.4.4 above.

³⁸⁰ California Corporations Code s 402(d).

³⁸¹ California Corporations Code s 1306.

³⁸² California Corporations Code s 510(a).

³⁸³ California Corporations Code s 510(d).

series is automatically eliminated.³⁸⁴ If all the issued shares of a class or series are reacquired, the directors may either reduce the number of authorised shares by the number of acquired shares or may decide to eliminate the class or series by also cancelling the authorised but unissued shares of that class or series.³⁸⁵ If only some of the issued and outstanding shares of a class or series are reacquired, the number of authorised shares must be reduced by the number of reacquired shares.³⁸⁶

If the articles only prohibit the reissue of reacquired shares as shares of the same series, the directors may either cancel the reacquired shares³⁸⁷ or restore them to the status of authorised but undesignated shares of the class to which they belong.³⁸⁸ If all the authorised shares of a series are reacquired, the series is eliminated.³⁸⁹ If all the issued and outstanding shares of a series, but not all the authorised shares of the series are reacquired, the board may either eliminate the series or reduce the number of authorised shares of that series by the number of reacquired shares.³⁹⁰

The provisions of section 510 are subject to any contrary or inconsistent provision in the articles and can be avoided by making a different arrangement in the articles.³⁹¹

California previously recognised treasury shares, that is, shares that were issued by the corporation, but were reacquired and thus no longer outstanding. The requirement that reacquired shares be restored to the status of authorised and unissued shares, or eliminated as authorised shares,³⁹² abolished the concept of

³⁸⁴ California Corporations Code s 510(b)(1).

³⁸⁵ California Corporations Code s 510(b)(2).

³⁸⁶ California Corporations Code s 510(b)(3).

³⁸⁷ California Corporations Code s 510(c)(1)B.

³⁸⁸ California Corporations Code s 510(c)(1)A.

³⁸⁹ California Corporations Code s 510(c)(1).

³⁹⁰ California Corporations Code s 510(c)(2).

³⁹¹ California Corporations Code s 510(e).

³⁹² California Corporations Code s 510(b).

treasury shares.³⁹³ It is not clear why corporations are still given the power to own or hold their own shares.³⁹⁴

3.6.7 Repurchase through subsidiaries

The basic distribution rule covers distributions made by a corporation or its subsidiary.³⁹⁵ There are no further indications in the California Corporations Code regarding application of the financial and other restrictions to this situation. However, a subsidiary may not vote shares it holds in its parent corporation.³⁹⁶

3.6.8 The redemption of shares

A corporation may provide in its articles for one or more classes or series of shares that are redeemable, in whole or in part, at the option of the corporation or upon the happening of a specified event or events.³⁹⁷ Section 402(b) allows the articles to provide how a selection should be made in the event of a partial redemption. This opens the door for discrimination between shareholders of the same class or series.

Redeemable preference shares could also be redeemable at the option of the holder of the shares or upon the vote of at least a majority of the outstanding shares of the class or series to be redeemed.³⁹⁸ However, ordinary or common redeemable shares are not allowed to be redeemable at the option of the shareholder.³⁹⁹

Any redemption is subject to the provisions governing distributions.⁴⁰⁰ A corporation may create a sinking fund or similar provision or enter into an

³⁹³ See Marsh *California Corporation Law* 1202 for a brief overview of the problems associated with treasury shares. See also Ballantine "Treasury Shares" 538 – 541.

³⁹⁴ California Corporations Code s 207(d), referred to in paragraph 3.6.1 above. Since this power is subject to California Corporations Code s 510 which can in turn be varied by the articles as provided for in s 510(e), it can possibly be argued that corporations may hold treasury shares. However, s 510(a) provides for mandatory cancellation as issued shares, leaving to the articles only the question of whether the shares will be able to be reissued or not.

³⁹⁵ California Corporations Code s 166. See 3.4.1 above.

³⁹⁶ California Corporations Code s 703(b).

³⁹⁷ California Corporations Code s 402. Common shares will usually be redeemable only if there are more than one class or series of them. In exceptional circumstances where there is only one class of common shares, these could also be redeemable, s 402(c).

³⁹⁸ California Corporations Code s 402(a).

³⁹⁹ California Corporations Code s 402(a).

⁴⁰⁰ California Corporations Code s 402(d), read with ss 500 – 511.

agreement for the redemption or purchase of its shares, but unless the redemption is permitted by the financial restrictions, the holder of shares to be redeemed shall not become a creditor of the corporation.⁴⁰¹

The procedure for redemption is set out in section 509 and the articles of incorporation. It is possible for a corporation to deposit funds for the redemption of shares with a bank or trust company, upon which date the shares shall be regarded as redeemed and no longer outstanding. The timing provision states that the distribution will be deemed to have been made when the cash or property is transferred to the trustee or segregated in trust.⁴⁰²

3.7 Evaluation and conclusions on California

The California Corporations Code uses economic concepts to protect creditors against distributions.⁴⁰³

The articles of incorporation must state the number of authorised shares, but do not mention an amount of capital.⁴⁰⁴ Shares, which do not have a par value,⁴⁰⁵ may be issued at any consideration determined by the directors, unless the articles give this power to the shareholders.⁴⁰⁶ Future services and promissory notes of the purchaser are not acceptable forms of consideration.⁴⁰⁷ Where non-monetary consideration is accepted, the directors have to declare its fair value in a resolution.⁴⁰⁸ Partly paid shares are allowed, but are not popular.⁴⁰⁹

The California Corporations Code contains a single definition of distribution that encompasses repurchases, redemptions and dividends.⁴¹⁰ A corporation may make distributions out of earned surplus or alternatively, on condition that assets will exceed liabilities by a prescribed ratio once the distribution has been made.⁴¹¹

⁴⁰¹ California Corporations Code s 402(d). See also paragraph 3.6.5 above.

⁴⁰² California Corporations Code s 166.

⁴⁰³ See paragraph 3.1 above.

⁴⁰⁴ See paragraph 3.2.1 above.

⁴⁰⁵ See paragraph 3.2.3 above.

⁴⁰⁶ See paragraphs 3.3 and 3.3.1 above.

⁴⁰⁷ See paragraph 3.3.2 above.

⁴⁰⁸ See paragraph 3.3.3 above.

⁴⁰⁹ See paragraph 3.3.4 above.

⁴¹⁰ See paragraph 3.4.1 above.

⁴¹¹ See paragraphs 3.4.2, 3.4.2.1 and 3.4.2.2 above.

In addition to this, a liquidity or equity solvency test applies.⁴¹² It is significant that this test is based on an objective standard. The rights of preferred classes of shareholders are also protected.⁴¹³

The timing rule for distributions differs from the South African position in various respects, the most important being that separate principles apply to dividends and repurchases.⁴¹⁴ In relation to dividends, it provides more certainty than the South African approach, but offers less protection to creditors. In accordance with the timing rule, a shareholder obtains an enforceable claim when a dividend is authorised.⁴¹⁵ Nevertheless, there is some uncertainty as to whether the shareholder will indeed be able to enforce this right if the financial restrictions are not satisfied at the time of payment.⁴¹⁶

There are important differences between the liability provisions in the California Corporations Code and those in South Africa. First, California imposes the same liability on shareholders and directors regardless of whether a distribution takes the form of a dividend or an acquisition of shares⁴¹⁷ whereas in South Africa there is a difference in the liability of directors depending on whether a repurchase or a dividend is involved.⁴¹⁸ Secondly, shareholders in California are liable only if they knew of facts indicating that the distribution was unlawful.⁴¹⁹ Shareholders must be alerted to the fact that a proposed dividend is to be paid otherwise than out of retained earnings.⁴²⁰ Thirdly, shareholders and directors in California are also liable to preference shareholders,⁴²¹ but this is because the rights of preference shareholders are taken into account for purposes of the stricter financial restrictions in California.⁴²² South Africa could benefit from streamlining its provisions on

⁴¹² See paragraph 3.4.2.3 above.

⁴¹³ See paragraph 3.4.2.4 above.

⁴¹⁴ See paragraph 3.4.3 above.

⁴¹⁵ See paragraph 3.4.4 above.

⁴¹⁶ See paragraph 3.4.4 above.

⁴¹⁷ See paragraph 3.4.5 above.

⁴¹⁸ See Chapter 5 paragraphs 5.6 and 6.4.

⁴¹⁹ See paragraph 3.4.5.2 above.

⁴²⁰ See paragraph 3.5.3 above.

⁴²¹ See paragraphs 3.4.5.1 and 3.4.5.2 above.

⁴²² See paragraph 3.4.2.4 above.

liability for unlawful distributions to achieve consistency for different types of distributions.⁴²³

Despite the existence of separate procedures for redemptions and repurchases,⁴²⁴ both are subject to the same financial restrictions.⁴²⁵ This avoids the kind of anomalies present in the South African legislation. The financial restrictions apply also to payments under the appraisal remedy, thus favouring the interests of creditors over those of shareholders.⁴²⁶

The California Corporations Code does not set out the procedure for repurchases.⁴²⁷ Repurchased shares generally have to be restored to the status of authorised but unissued shares.⁴²⁸

Although the definition includes a distribution by a subsidiary, there is no further statutory regulation of such distributions, except a prohibition on the exercise of voting rights in respect of shares held in the parent company.⁴²⁹

To conclude, the Californian Corporations Code can serve as an example for South Africa in a number of respects. Apart from the introduction of a single definition of distribution and the consistent treatment of redemptions and repurchases, its provisions regulating the liability of shareholders and directors for unlawful distributions can be singled out. Its sophisticated financial restrictions, including the asset-liability ratio tests, are stricter than the present South African solvency and liquidity test.

4 THE MODEL BUSINESS CORPORATION ACT

4.1 Introduction

The American Bar Association first published a Model Business Corporation Act in 1950.⁴³⁰ The Model Business Corporation Act was amended from time to time⁴³¹

⁴²³ See Chapter 5 paragraph 6.10.4.

⁴²⁴ See paragraphs 3.6.3 and 3.6.8 above.

⁴²⁵ See paragraphs 3.4.1 and 3.6.1 above.

⁴²⁶ See paragraph 3.4.1 above.

⁴²⁷ See paragraph 3.6.3 above.

⁴²⁸ See paragraph 3.6.6 above.

⁴²⁹ See paragraph 3.6.7 above.

⁴³⁰ *Model Business Corporation Act Official Text with Official Comment* xxii. An earlier effort was
Continued

and a complete revision was published in 1984. The 1984 MBCA is characterised by the elimination of legal capital concepts such as par value, stated capital and treasury shares. It contains relatively little regulation of consideration for shares and a single definition of distribution. Distributions are subject to liquidity, solvency, and the protection of liquidation preferences.⁴³²

By 2005, 29 states had adopted all or substantially all of the provisions of the 1984 MBCA while four states still based their legislation on the 1969 MBCA.⁴³³ Delaware, New York and California are the most important states, from a corporate law perspective, that do not base their statutes on the MBCA.⁴³⁴

4.2 Share Capital Structure

4.2.1 *Authorised capital*

The MBCA requires the articles of incorporation to state the classes of shares and the number of shares of each class that a corporation is authorised to issue.⁴³⁵ Although shares are not required to have a par value, and no amount of share capital is mentioned, the concept of authorised capital remains a feature of the MBCA. This can be contrasted with the position in New Zealand⁴³⁶ and in England⁴³⁷ where the concept of authorised capital has been removed altogether.

It is expressly required that a corporation must authorise at least one class of shares with unlimited voting rights and at least one class entitling its holders to

Continued

the promulgation by the commissioners on uniform state laws of a Uniform Business Corporation Act (1928) but this model was never widely accepted. It was renamed the Model Business Corporation Act in 1943 and was eventually withdrawn in 1958.

⁴³¹ The financial provisions were amended substantially in 1979 to 1980. (Kummert "State Statutory Restrictions" 242 note 274 gives 8 December 1979 as the date on which the Committee adopted these amendments.) These new provisions, which did away with the legal capital system, were taken over and developed further in the complete revision of the MBCA in 1984, see Manning *Legal Capital* 177; Cox & Hazen *Corporations* 565.

⁴³² MBCA s 6.40, discussed in paragraph 4.4.2 below.

⁴³³ See MBCA *Official text with Official Comment* xix notes 1 and 2 for lists of these states.

⁴³⁴ Cox & Hazen *Corporations* 35.

⁴³⁵ MBCA s 6.01(a).

⁴³⁶ See Chapter 3 paragraph 2.1.

⁴³⁷ See Chapter 2 paragraph 2.1.

receive the net assets of the corporation upon dissolution.⁴³⁸ The same class of shares can satisfy both these requirements.⁴³⁹

The MBCA abolished the distinction between common and preferred shares.⁴⁴⁰ Instead, it refers to shareholders whose 'preferential rights are superior' to those of the shareholders receiving a distribution.⁴⁴¹

The preferences, limitations and relative rights of each class of shares have to be described in the articles of incorporation prior to the issuance of shares of that class.⁴⁴² It is not compulsory to set out the terms of each class of shares in the original articles of incorporation. A corporation can thus issue 'blank stock'.⁴⁴³ The power to determine the terms of an unissued class or series of shares may be delegated to the board of directors.⁴⁴⁴ However, before shares of any such class may be issued, the terms of issue of those shares have to be set out in an amendment to the articles of incorporation.⁴⁴⁵

Pre-emptive rights do not generally apply under the MBCA, but are reflected as an optional provision that a corporation may include in its articles of incorporation.⁴⁴⁶ If a corporation elects to have pre-emptive rights and does not expressly set out the extent of these rights, the default rules of MBCA s 6.30 apply.⁴⁴⁷ These rules entitle the shareholders to a proportionate pre-emptive right, on uniform terms and conditions, in respect of further shares to be issued.⁴⁴⁸ These rights apply only to shares issued for cash consideration.⁴⁴⁹

⁴³⁸ MBCA s 6.01

⁴³⁹ MBCA s 6.01. One or more of these shares must also be issued and outstanding, see s 6.03 and paragraph 2.2 below.

⁴⁴⁰ The Official Comment explains that there is no longer a significant distinction between the two kinds of shares, in view of the many permutations possible among classes of shares. The terminology was abolished to reflect this flexibility.

⁴⁴¹ See, for example, MBCA s 6.40(c)(2). For the sake of convenience, however, I will refer to preferred and unpreferred or common shares.

⁴⁴² MBCA s 6.01(b).

⁴⁴³ See *Cox & Hazen Corporations* 486.

⁴⁴⁴ MBCA s 6.02(a).

⁴⁴⁵ MBCA s 6.01(b).

⁴⁴⁶ MBCA s 6.30(a) read with s 2.02. See also Rock, Kanda & Kraakman "Significant Corporate Actions" 148 where it is explained that in lieu of pre-emptive rights, shareholders are protected by onerous fiduciary duties.

⁴⁴⁷ MBCA s 6.30(b)(1).

⁴⁴⁸ MBCA s 6.30(b)(1).

⁴⁴⁹ MBCA s 6.30(b)(3)(iv).

Pre-emptive rights also do not apply in respect of shares issued as compensation to the corporation's directors, officers or employees, or to satisfy their conversion or option rights.⁴⁵⁰ Also excluded are shares authorised in the articles of incorporation that are issued within six months of incorporation.⁴⁵¹ A shareholder may waive her pre-emptive right.⁴⁵² Non-voting preferential shares do not have pre-emptive rights.⁴⁵³ Shares with general voting rights but with no preferential distribution rights do not have pre-emptive rights in respect of shares with preferential distribution rights, except if the preferential shares are convertible into or have a right to acquire shares without preferential rights.⁴⁵⁴

If shares that are subject to pre-emptive rights are not acquired by the shareholders, they may be issued to anyone within a period of twelve months, but not at a consideration lower than that set for the pre-emptive rights.⁴⁵⁵ Offers after expiry of twelve months or at a lower price are once again subject to pre-emptive rights.⁴⁵⁶

In conjunction with the regulation of substantial non-cash issues, which I discuss in relation to non-cash consideration,⁴⁵⁷ pre-emptive rights play a significant role in preserving the relative equity interests of shareholders.

4.2.2 Minimum capital

Section 6.03 requires that a corporation must have 'outstanding'⁴⁵⁸ at all times one or more shares that together have unlimited voting rights and one or more shares entitled to receive the net assets of the corporation upon dissolution.⁴⁵⁹ The Official Comment to section 6.03 of the MBCA explains that these shares will have the residual equity financial interests in the corporation.

⁴⁵⁰ MBCA s 6.30(b)(3)(i) – (ii).

⁴⁵¹ MBCA s 6.30(b)(3)(iii).

⁴⁵² MBCA s 6.30(b)(2).

⁴⁵³ MBCA s 6.30(b)(4).

⁴⁵⁴ MBCA s 6.30(b)(5).

⁴⁵⁵ MBCA s 6.30(b)(6).

⁴⁵⁶ MBCA s 6.30(b)(6).

⁴⁵⁷ See paragraph 4.3.3 below.

⁴⁵⁸ That is, the share must have been issued and not reacquired by the corporation, see MBCA s 6.03(a).

⁴⁵⁹ MBCA s 6.03(c).

4.2.3 *Kinds of shares*

Shares are not required to have a par value,⁴⁶⁰ but the articles may set forth a par value for authorised shares or classes of shares.⁴⁶¹ Should a par value be stated in the articles, this value might be relevant with regard to the contractual relationships arising from the articles, but will have no legal significance beyond that.⁴⁶²

A corporation may issue redeemable or convertible shares that are redeemable or convertible at the option of the corporation,⁴⁶³ the shareholder, or upon the occurrence of a designated event.⁴⁶⁴ Any kind of share may be made redeemable or convertible, including shares in the class having unlimited voting and distribution rights.⁴⁶⁵

Shares may be redeemable or convertible for shares, debt instruments, other property or cash.⁴⁶⁶ Upstream conversions, that is, conversions for classes of shares that have priority over the converted class, as well as conversions for debt securities, are allowed. This is regarded as a logical consequence of allowing the redemption of shares at the option of shareholders, because conversion into preferred classes or debts is less risky for the remaining shareholders than a redemption.⁴⁶⁷ Shares that are redeemable for debt and shares convertible into debt securities have the same practical effect.⁴⁶⁸ Redemptions and conversions are distributions and are subject to the financial restrictions set out in section 6.40 of the MBCA.⁴⁶⁹

Issued shares remain 'outstanding' until they are reacquired, redeemed, converted, or cancelled.⁴⁷⁰ The reacquisition, redemption or conversion of

⁴⁶⁰ See the Official Comment to s 6.21 of the MBCA.

⁴⁶¹ MBCA s 2.02(b)(2)(iv).

⁴⁶² See the Official Comment to s 2.02.

⁴⁶³ Also known as 'callable shares', see Official Comment to s 6.01(c).

⁴⁶⁴ MBCA s 6.01(c)(2)(i).

⁴⁶⁵ See the Official Comment to s 6.01(c). However, the minimum outstanding shares rule of MBCA s 6.03(c) applies.

⁴⁶⁶ MBCA s 6.01(c)(2)(ii). The practical effect of a conversion for cash and a redemption appear to be the same.

⁴⁶⁷ See the paragraph 3(d) of the Official Comment to s 6.01(c).

⁴⁶⁸ See paragraph 3(d) of the Official Comment to s 6.01(c).

⁴⁶⁹ See paragraph 4.4.2 below.

⁴⁷⁰ MBCA s 6.03(a)

outstanding shares is subject to the requirement that at least one share that has unlimited voting rights and that is entitled to receive the net assets upon dissolution, remains outstanding.⁴⁷¹

4.2.4 Share capital and reserve accounts

Apart from the disclosure of the authorised capital in the articles of incorporation, there is no mention of share capital accounts, surplus accounts or reserves. The consideration received for shares need not be valued in money and need not be reflected in separate accounts.⁴⁷² A corporation could have such accounts for accounting purposes, but their existence is irrelevant for the distribution rules.⁴⁷³

4.2.5 The variation of share capital

4.2.5.1 Variations without shareholder approval

The board of directors may amend the articles without shareholder approval in certain circumstances.⁴⁷⁴ These include increasing the issued and authorised shares of its single class of shares into a greater number of whole shares of that class.⁴⁷⁵ The board may likewise increase the number of authorised shares of its single class of shares to allow the issuance of shares as a share dividend.⁴⁷⁶ However, if there is more than one class of shares outstanding, the subdivision must be approved by shareholder vote.⁴⁷⁷

The incorporators or board of directors can also amend the articles of association, including the statement of authorised shares, before any shares have been issued.⁴⁷⁸

⁴⁷¹ MBCA s 6.03(c).

⁴⁷² The Official Comment to MBCA s 6.21 explains: 'bookkeeping details are not the statutory responsibility of the board of directors'.

⁴⁷³ See Manning *Legal Capital* 185.

⁴⁷⁴ MBCA s 10.02.

⁴⁷⁵ MBCA s 10.02(4). This is a subdivision of shares.

⁴⁷⁶ MBCA s 10.02(4).

⁴⁷⁷ MBCA s 10.04(a)(1).

⁴⁷⁸ MBCA s 10.05.

The board may further effect consequential changes to the total authorised capital following a reacquisition of shares and may delete a class of shares following a repurchase when the corporation's articles prohibit its reissue.⁴⁷⁹

Where blank stock has been authorised, the directors may also amend the articles in order to determine the preferences, limitation and rights of the shares.⁴⁸⁰

4.2.5.2 Variations subject to shareholder approval

Shareholder approval is required for variations of authorised and issued shares that have the potential of affecting their relative rights.⁴⁸¹ Where class rights are varied, voting must take place in separate voting groups.⁴⁸²

A corporation may reclassify its shares into shares of another class,⁴⁸³ change the rights attaching to shares,⁴⁸⁴ or change shares into a different number of shares in the same class through subdivision or consolidation.⁴⁸⁵ It may also create new classes of shares with distribution or liquidation rights prior to or superior to existing classes,⁴⁸⁶ increase the rights of existing classes so that they will have preference over other existing shares,⁴⁸⁷ limit or deny existing pre-emptive rights,⁴⁸⁸ or cancel or vary rights to accumulated but undeclared distributions.⁴⁸⁹

4.2.6 The reduction of issued capital

The MBCA does not provide for a formal reduction of capital. However, after a distribution certain adjustments to a corporation's articles of incorporation may be required.⁴⁹⁰

⁴⁷⁹ MBCA s 10.02(6) – (7).

⁴⁸⁰ MBCA s 6.02, read with s 10.02(6).

⁴⁸¹ MBCA s 10.04 requires prior approval, because shareholders are entitled to vote on a 'proposed' amendment. No special majority is prescribed.

⁴⁸² MBCA s 10.04. A voting group comprises a class or classes of shares that are similarly affected.

⁴⁸³ MBCA s 10.04(a)(1) – (2).

⁴⁸⁴ MBCA s 10.04(3).

⁴⁸⁵ MBCA s 10.04(a)(4).

⁴⁸⁶ MBCA s 10.04(5).

⁴⁸⁷ MBCA s 10.04(6).

⁴⁸⁸ MBCA s 10.04(7).

⁴⁸⁹ MBCA s 10.04(8).

⁴⁹⁰ See paragraph 4.2.5.1 below.

4.3 Capital contributions

4.3.1 Size of capital contribution

The directors have to determine that the consideration received or to be received in respect of the issue of shares is adequate.⁴⁹¹ However, a formal adequacy resolution is not necessary, and it can be inferred from a board decision to issue shares for a particular consideration that the board has determined that consideration to be adequate. The board is further not required to determine the specific value of non-cash consideration.⁴⁹² Upon receipt of the authorised consideration, the shares become fully paid and non-assessable.⁴⁹³ Directors who abuse their power in making an adequacy determination may be liable for breach of the prescribed standard of conduct.⁴⁹⁴

A shareholder is not liable to the corporation or its creditors with respect to the shares, except to pay the consideration for which the shares were authorised to be issued (in the case of subscriptions after incorporation) or specified in the subscription agreement (in the case of pre-incorporation subscriptions).⁴⁹⁵ A shareholder is not personally liable for the acts or debts of the corporation, except that she may become liable because of her own acts or conduct or if the articles provide otherwise.⁴⁹⁶ Limited liability of shareholders is thus the point of departure.

Shares may also be issued for no consideration, in the form of share dividends.⁴⁹⁷ Share dividends have to be issued *pro rata* to holders of a class or

⁴⁹¹ MBCA s 6.21(c).

⁴⁹² See the Official Comment to s 6.21.

⁴⁹³ MBCA s 6.21(d). This means that shareholders will have no further liability in respect of those shares and cannot be held liable under the 'watered stock' principles that apply in legal capital jurisdictions, see the Official Comment to s 6.21.

⁴⁹⁴ MBCA s 8.30. This is a general provision on directors' liability and, in addition to the general formulation of directors' duties, contains a number of rules detailing issues such as the effect of reliance on the opinions of others.

⁴⁹⁵ MBCA s 6.22(a). Manning *Legal Capital* 180 note 4 points out that technically s 6.21(c) requires the board to make a determination of adequacy prior to the issuance of shares, which determination will conclude any enquiry as to the liability of the purchaser to pay more. It could thus be argued that a shareholder who purchased shares in the absence of such a timely determination would thus not, in terms of s 6.22(a), have paid the consideration for which the shares were 'authorised' to be issued.

⁴⁹⁶ MBCA s 6.22(b).

⁴⁹⁷ MBCA s 6.23(a).

series. Shares of one class or series may not be issued as a share dividend to holders of another class or series, unless the articles allow this or it is approved by a majority of the votes entitled to be cast by holders of the class to be issued, or if the class to be issued has no shares outstanding.⁴⁹⁸ The purpose of these restrictions is to protect existing holders of the class to be issued against a dilution of the value of their shares. Share dividends are not regarded as distributions, as they do not involve a transfer of property by the corporation to its shareholders.⁴⁹⁹

4.3.2 Form of capital contributions

The MBCA distinguishes between the subscription for shares before and after incorporation. The purpose is to regulate the legal nature and enforceability of agreements for subscription entered into before incorporation at a time when there is not yet a board of directors or corporation with which to contract.⁵⁰⁰ In a pre-incorporation subscription, the shares will be fully paid once the corporation receives the consideration specified in the subscription agreement. If the agreement does not specify the terms of payment, the directors may determine these terms. A call by the directors must generally be uniform as far as practicable as to all shares of the same class or series.⁵⁰¹ Unlike section 6.21 of the MBCA, which deals with subscriptions after incorporation, section 6.20 does not contain a list of acceptable forms of consideration. However, it is expressly provided that the corporation can enforce an obligation to pay money or property like any other debt, or that the corporation may rescind the agreement and sell the shares.⁵⁰² It appears from the Official Comment to section 6.20 that if the consideration is not money or property, then it cannot be enforced like any other debt and the corporation has to resort to the second alternative, namely to rescind the contract. The implication is thus that consideration other than money or property, such as services, will also be acceptable in respect of pre-incorporation subscriptions.

⁴⁹⁸ MBCA s 6.23(b).

⁴⁹⁹ MBCA s 1.40(6).

⁵⁰⁰ See the Official Comment to MBCA s 6.20.

⁵⁰¹ MBCA s 6.20(b). The agreement may provide for unequal treatment.

⁵⁰² MBCA s 6.20(d).

Section 6.21 of the MBCA regulates subscriptions for shares after incorporation. The board may authorise the issue of shares at the consideration it determines, unless the articles have reserved this power for the shareholders.⁵⁰³ The consideration may consist of any tangible or intangible property or benefit to the corporation, including cash, promissory notes, services performed, contracts for services to be performed, or other securities of the corporation.⁵⁰⁴ The nature of acceptable consideration is not restricted.

The MBCA also expressly authorises corporations to issue rights, options or warrants for the purchase of shares of the corporation upon the terms determined by the board.⁵⁰⁵

Interestingly, it is expressly provided that the expense of selling or underwriting an issue of shares and of organising or reorganising the corporation may be paid out of the consideration received for shares.⁵⁰⁶ The Official Comment admits that this is a remnant of the old concepts of par value and stated capital, but that it was nevertheless retained to show that original capitalisation could be used to pay the expenses of formation and of raising capital.⁵⁰⁷

4.3.3 The regulation of non-cash capital contributions

Before shares are issued, the board of directors must determine that the consideration is adequate. This requirement applies in general, not only when non-cash consideration is involved. The board need not determine the cash value of non-cash consideration.⁵⁰⁸

In order to protect shareholders against a significant dilution of the value of their shares, shareholder approval is required for certain non-cash issues. Advance shareholder approval is required if a corporation is issuing new shares or securities convertible into shares or into rights exercisable for shares for a consideration other

⁵⁰³ MBCA s 6.21(a).

⁵⁰⁴ MBCA s 6.21(b).

⁵⁰⁵ MBCA s 6.24. The Official Comment to s 6.24 explains that corporations have the inherent power to do so, but that in view of the economic importance of such instruments, it was desirable to include specific authorisation. A second objective is to establish the supremacy of the board of directors in determining the terms and consideration.

⁵⁰⁶ MBCA s 6.28.

⁵⁰⁷ Official Comment to s 6.28.

⁵⁰⁸ See paragraph 4.3.1 above.

than cash or 'cash equivalents'⁵⁰⁹ and the voting power of the shares will comprise more than 20 per cent of the voting power of the outstanding shares immediately before the transaction.⁵¹⁰ In applying this provision, the total number of shares to be issued in a transaction or series of integrated transactions is relevant.⁵¹¹ Approval must be given by majority vote at a meeting with a quorum of at least a majority of the votes entitled to be cast on the matter.⁵¹²

A similar rule has been proposed for South Africa in the Companies Bill, although its scope will be different from the MBCA provision.⁵¹³

4.3.4 Timing of capital contribution

Shares need not be fully paid when they are issued. They will, however, only be regarded as fully paid and non-assessable when the corporation receives the consideration.⁵¹⁴ The MBCA does not regulate the rights and obligations of transferees of unpaid shares.⁵¹⁵

Shares issued for future services or benefits or for promissory notes may be placed in 'escrow' or the corporation could make other arrangements to restrict their transfer.⁵¹⁶ Distributions to shareholders may be credited against the outstanding purchase price until the services are performed, the benefit is received or the note is paid. The application of this provision seems problematic if services or benefits are involved and no specific monetary value has been determined as consideration. The Official Comment to this provision does not address this problem. If the

⁵⁰⁹ Cash equivalents are liquid short-term investments like certain Treasury Bills, investment grade commercial paper and money-market funds, see paragraph 3 of the Official Comment to s 6.21.

⁵¹⁰ MBCA s 6.21(f).

⁵¹¹ This is defined as a series of transactions where one is conditional upon one or more of the others, MBCA s 6.21(2)(ii).

⁵¹² MBCA s 6.21(f)(1).

⁵¹³ See Chapter 5 paragraph 2.8.1.

⁵¹⁴ MBCA s 6.21(d); s 6.20(c).

⁵¹⁵ It is left to s 8-202 and s 8-301 of the Uniform Commercial Code, which protects the position of a good faith purchaser for value.

⁵¹⁶ According to the Official Comment to s 6.21 the corporation is not obliged to do this. If no restriction is placed on such shares they will be regarded as validly issued as far as the adequacy of consideration is concerned.

shareholder defaults, the corporation may cancel the shares as well as the distributions that have been credited in whole or in part.⁵¹⁷

4.4 Distributions

4.4.1 *Kinds of payments regulated*

The definition of a distribution is set out in section 1.40(6) of the MBCA. A distribution is a direct or indirect transfer of money or other property (except its own shares) or incurrence of indebtedness by a corporation to or for the benefit of its shareholders in respect of any of its shares.⁵¹⁸ The definition further states that a distribution may be in the form of a declaration or payment of a dividend; a purchase, redemption, or other acquisition of shares; a distribution of indebtedness;⁵¹⁹ or otherwise.⁵²⁰ In addition to the reacquisition and redemption of shares, a conversion of shares is regarded as a distribution.⁵²¹ Payments under the appraisal remedy are also not excluded from the definition and will be subject to the financial restrictions.

Share dividends or bonus issues are regulated separately⁵²² and are not regarded as distributions.

The Official Comment explains that the intention of the inclusion of 'indirect' transfers is to cover transactions such as a purchase by a subsidiary of shares in its parent corporation.⁵²³ The MBCA does not have a separate provision for repurchases in a group. The reference to indirect transfers will also cover any other transaction that has the effect of a distribution, such as a hidden dividend or repurchase.

⁵¹⁷ MBCA s 6.21(e).

⁵¹⁸ MBCA s 1.40(6).

⁵¹⁹ Such as a promissory note or debenture, see paragraph 3 of the Official Comment to s 1.40. It is the creation of the indebtedness which constitutes the distribution, not the date of payment under the debt instrument.

⁵²⁰ Liquidation distributions are also included.

⁵²¹ MBCA s 6.03(b). In view of the fact that the liquidation preferences of preferent classes of shares have to be taken into account as part of the financial restrictions, it makes sense to subject conversions to the requirements for distributions, see paragraph 4.4.2 below.

⁵²² MBCA s 6.23.

⁵²³ See paragraph 3 of the Official Comment to s 1.40.

4.4.2 Financial restrictions

Although the financial restrictions applicable to distributions have been termed a ‘single unitary’ or ‘single uniform’ test,⁵²⁴ the test comprises two separate elements that must both be satisfied. These phrases allude to the fact that the same restrictions apply to all kinds of distribution.

The first element is an equity solvency test or, as such a test is known in South Africa, a liquidity test. No distribution may be made if, after giving it effect the corporation would not be able to pay its debts as they become due in the usual course of business.⁵²⁵ This test is a codification of the principle set out in *Wood v Dummer*⁵²⁶ and it is a feature of the distribution rules of most states, regardless of whether or not they have adopted a legal capital system.⁵²⁷ No period is prescribed during which the corporation should remain able to satisfy its debts. The test has an objective format independent of any particular individual’s opinion or belief. Although in another subparagraph reference is made to a determination by the board of directors,⁵²⁸ the test itself does not rely on the board’s view. It is clear, however, that the test requires a prediction based on facts and circumstances prevailing at the time when the distribution is made. The test cannot be applied with the benefit of hindsight. The equivalent South African provisions⁵²⁹ ask if there is ‘reason to believe’ that a company will not be able to pay its debts. Despite the different wording of the MBCA and the South African provisions, I submit that they have the same effect.⁵³⁰

The Official Comment expands on the equity solvency test.⁵³¹ It explains that a going concern will usually satisfy this test and that no particular enquiry will be necessary. However, when the corporation is in financial distress specific attention should be given to the issue of liquidity. Reasonable assumptions may then be

⁵²⁴ Official Comment to s 1.40, paragraph 3 and Official Comment to s 6.40, paragraph 1.

⁵²⁵ MBCA s 6.40(c)(1).

⁵²⁶ 30 Fed Cas 435 (CCD Me 1824) (No 17944).

⁵²⁷ See Manning *Legal Capital* 63 – 65, Cox & Hazen *Corporations* 562.

⁵²⁸ MBCA s 6.40(d).

⁵²⁹ South African Companies Act s 85(4)(a) and s 90(2)(a).

⁵³⁰ See Chapter 5 paragraph 4.1.1.

⁵³¹ Official Comment on MBCA s 6.40 paragraph 2. See also Murphy “Equity Insolvency” 850ff for a discussion of the test as introduced by the 1980 revisions to the 1969 MBCA.

made about the likely future course of business, including that the demand for the corporation's products or services will continue or increase and that long-term debt will be refinanced. A cash flow analysis may be useful in certain instances.

The second element of the financial restrictions is an 'adjusted net worth test'. The word 'adjusted' refers to the fact that preferential dissolution rights of preferred classes of shareholders are added to the corporation's ordinary liabilities.⁵³² The test is based on the corporation's balance sheet and concerns solvency in the bankruptcy sense. A corporation may not make a distribution if after giving it effect the corporation's total assets would be less than the sum of its total liabilities plus the amount that would be needed, if the corporation were to be dissolved at the time of the distribution, to satisfy the preferential rights upon dissolution of shareholders whose preferential rights are superior to those receiving the distribution.⁵³³ The articles of a corporation can exclude liquidation preferences from the test.⁵³⁴

Certain debts are ignored when determining the liabilities of a corporation for purposes of the solvency (adjusted net worth) and liquidity (equity solvency) test in section 6.40(c).⁵³⁵ Where a corporation has issued an indebtedness, including one issued as a distribution, and the principal sum and interest has been made payable only if and to the extent that the corporation could then make a distribution to shareholders, it is not regarded as a liability.⁵³⁶ This arrangement gives effect to the agreed subordination. The relative priority of the 'subordinated' indebtedness and the distribution being contemplated is not altogether clear. If there are sufficient funds to pay the existing indebtedness, the amount would actually be due and payable. Nevertheless, it appears that the corporation can opt to make a new distribution rather than repay the indebtedness.⁵³⁷ In South Africa, an indebtedness that is subject to a similar subordination arrangement could be regarded as a

⁵³² If upon dissolution the preferred classes are also entitled to arrear dividends, such dividends will form part of the liquidation preference, see the Official Comment to s 6.40 par 5.

⁵³³ MBCA s 6.40(c)(2).

⁵³⁴ MBCA s 6.40(c)(2).

⁵³⁵ MBCA s 6.40(g), first part.

⁵³⁶ MBCA s 6.40(g).

⁵³⁷ This issue will have to be determined according to the exact terms of the agreement between the corporation and the shareholder/creditors. As explained in paragraph 4.4.4 below the shareholder is in the position of an ordinary creditor with respect to the amount of the distribution due to her.

contingent liability, but its validity and valuation are uncertain and it may be a good idea to regulate the effect of such agreements by statute.⁵³⁸

The directors may base a determination that a distribution is not prohibited either on financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances or on a fair valuation or other method that is reasonable in the circumstances.⁵³⁹ This provision applies with respect to both elements of the financial restriction, but it is particularly relevant to the net worth test, which necessarily involves a valuation of assets and liabilities. It is not required that an accounting system based on generally accepted accounting principles should be followed, although it will always be regarded as a reasonable valuation method.⁵⁴⁰ Any system that is reasonable in the circumstances is acceptable.⁵⁴¹

The MBCA provides expressly that in the course of discharging their duties, directors may rely in good faith on information and opinions provided by third parties such as officers or employees, professional advisers and board committees.⁵⁴² Financial statements and other financial data prepared or presented by such other persons are expressly included as information the directors may rely on. However, this provision deals with director liability only, and does not determine whether a distribution is lawful or unlawful.⁵⁴³

4.4.3 Timing for the application of the financial restrictions

No distribution may be made unless the corporation will satisfy the financial restrictions of solvency and liquidity 'after giving it effect'.⁵⁴⁴ Section 6.40(e), read with section 6.40(g), of the MBCA sets out when the effect of a distribution has to be measured, identifying the date on which the financial restrictions must be satisfied. The factors that influence the time of measurement include the nature of the distribution involved, the manner and time of payment and the priority or ranking of

⁵³⁸ See Chapter 5 paragraph 4.3.1.2.

⁵³⁹ MBCA s 6.40(d).

⁵⁴⁰ Official Comment on s 6.40, paragraph 4.

⁵⁴¹ See paragraph 4 of the Official Comment on s 6.40. See also Manning *Legal Capital* 186.

⁵⁴² MBCA s 8.30(d) – (e).

⁵⁴³ The liability of directors for unlawful distributions is discussed below in paragraph 4.4.6.

⁵⁴⁴ MBCA s 6.40(c).

a debt incurred by reason of a distribution. The MBCA employs a so-called 'one-time' test, that is, a test that is applied to a distribution only once, either on the date of payment or on another date, but not at more than one stage of the same distribution.⁵⁴⁵

Section 6.40(e) sets out separate timing provisions for distributions by way of the reacquisition of shares,⁵⁴⁶ distributions of indebtedness,⁵⁴⁷ and other distributions.⁵⁴⁸ By way of exception, section 6.40(g)⁵⁴⁹ creates a further timing rule for certain distributions. Since the exception could apply to all the instances set out in section 6.40(e), it is convenient to discuss it first.

Any indebtedness of a corporation, including indebtedness issued as a distribution, is not regarded as a liability in applying the financial restrictions if it is stipulated that payments in respect of the indebtedness will be made only if and to the extent that the corporation could then make a distribution.⁵⁵⁰ If the indebtedness is in respect of a distribution, the financial restrictions apply to each payment in respect of the principal sum and interest, on the date of actual payment.⁵⁵¹ The prerequisite to applying this timing rule is the consensual subordination of the shareholder's claim in respect of the distribution to the claims of ordinary trade creditors with which the claim would otherwise have ranked equally.⁵⁵² Because the shareholder-creditor is willing to be ranked as a shareholder, this exception has the effect that the solvency test need not be satisfied when the distribution is authorised, but only once payment is to take place. This provision enables corporations to make distributions they would not otherwise have been able to make. It is particularly useful for reacquisitions with a deferred purchase price in a corporation with a low net worth, but good projections.⁵⁵³

⁵⁴⁵ See also Clark *Corporate Law* 638 on the distinction between 'one-time' and 'two-time' tests.

⁵⁴⁶ MBCA s 6.40(e)(1).

⁵⁴⁷ MBCA s 6.40(e)(2). In the case of a distribution of indebtedness in respect of a reacquisition of shares, subparagraph (1) applies.

⁵⁴⁸ MBCA s 6.40(e)(3).

⁵⁴⁹ MBCA s 6.40(g), second paragraph. The first part of s 6.40(g) is discussed in paragraph 4.4.2 above.

⁵⁵⁰ MBCA s 6.40(g).

⁵⁵¹ MBCA s 6.40(g).

⁵⁵² The ranking of an indebtedness distributed as a distribution is governed by s 6.40(f). See also paragraph 4.4.4 below.

⁵⁵³ Official Comment to s 6.40 par 8(d).

The exclusion from liabilities applies to any subordinated debt, not only to debt incurred as a distribution.⁵⁵⁴

The timing rule set out in this exception achieves the same effect as the South African timing principle for repurchases, namely measurement of each payment and statutory subordination of outstanding payments.⁵⁵⁵ I nevertheless note some important differences. The subordination in the MBCA is voluntary, allowing more flexibility. More importantly, under the MBCA these subordinated claims may be disregarded as liabilities when other distributions are being considered.⁵⁵⁶ In South Africa such claims may not be disregarded, but could possibly be valued at lower than their face value.⁵⁵⁷

Distributions by way of purchase, redemption or other acquisition of the corporation's shares must be measured at the earlier of:

- the date money or other property is transferred or debt incurred by the corporation
- the date the shareholder ceases to be a shareholder with respect to the acquired shares.⁵⁵⁸

The effect of this rule is that the test must be satisfied on the purchase date, regardless of whether payment is made or the corporation remains indebted to the vendor in respect of the purchase price.⁵⁵⁹ It is not easy to think of circumstances when the second option, ceasing to be a shareholder, will occur before the first option, the date a debt is incurred or payment made.⁵⁶⁰

⁵⁵⁴ See the introductory words of MBCA s 6.40(g).

⁵⁵⁵ See Chapter 5 paragraph 4.2.

⁵⁵⁶ See also paragraph 4.4.2 above. This arrangement is criticised by Schulman & Lesser "Installment Repurchases" 1540 for not addressing the problem of overdue instalments that satisfied the test on the maturity date and in addition because the corporation can continue to make other distributions without taking into account the subordinated distribution.

⁵⁵⁷ See Chapter 5 paragraph 4.4.1.4.

⁵⁵⁸ MBCA s 6.40(e)(1). The application of this requirement to specific instances of reacquisitions is explained further in the Official Comment.

⁵⁵⁹ See Schulman & Lesser "Installment Repurchases" 1531.

⁵⁶⁰ It may refer to instances where redeemable shares are to be redeemed out of a sinking fund kept in trust on behalf of the shareholders, see paragraph 3.4.3 above.

In the case of any other distribution of an indebtedness,⁵⁶¹ the effect must be measured on the date the indebtedness is distributed.⁵⁶² It is interesting to note that the timing rule for reacquisitions refers to the date the debt is incurred while this rule speaks of the distribution of the indebtedness. The difference between these two phrases is not clear. The distribution of an indebtedness seems to be a more appropriate term for this kind of distribution, which is not 'incurred' in the ordinary sense of word, as opposed to a reacquisition where there is a *causa* for a debt. In the absence of a *causa*, the debt arises out of the document such as a promissory note.

Although it can be argued that creditors are not properly protected by this rule, which allows payments at a later stage when the corporation is insolvent or unable to pay its debts,⁵⁶³ the Official Comment to section 6.40 explains that creditors are not worse off. This is because the company satisfied the test and could thus have actually paid the debt on the date it was incurred.⁵⁶⁴ Further, the Official Comment states that the purpose of the MBCA is to regulate the validity of distributions from the perspective of corporate law, leaving it to the federal Bankruptcy Code⁵⁶⁵ and state fraudulent conveyance law to protect creditors by impeaching distributions made in certain circumstances.⁵⁶⁶

In all other cases, the effect of a distribution must be measured on:

- the date of authorisation of the distribution, if payment occurs within 120 days after the date of authorisation, or
- the date payment is made if it occurs more than 120 days after date of authorisation.⁵⁶⁷

This rule applies to distributions that involve neither a reacquisition of shares nor the issuing of an indebtedness. It introduces a rather practical measure by imposing a time limit of 120 days after authorisation within which a payment may be made

⁵⁶¹ That is, other than in respect of an acquisition of shares.

⁵⁶² MBCA s 6.40(e)(2).

⁵⁶³ See Clark *Corporate Law* 638.

⁵⁶⁴ This view is supported by Schulman & Lesser "Installment Repurchases" 1532 – 1535.

⁵⁶⁵ 11 USCA. See s 548 regarding dispositions without value.

⁵⁶⁶ See paragraph 3 of the Official Comment on the MBCA s 6.40.

without the need to reassess the corporation's financial situation at the time of payment. The rule is based on the premise that the financial situation of the corporation would in most instances be relatively stable for such a short period and creditors are thus unlikely to suffer prejudice. The corporation has the advantage of certainty.

Payments after the 120 day limit will have to be subjected to the solvency test again. The provision refers to the actual date of payment and not to the time when a distribution becomes due or payable. In order to understand this provision a distinction must be drawn between a distribution that has been authorised but not paid and the distribution of an 'indebtedness' by the corporation.

A 120-day rule is being proposed for South Africa under the Companies Bill. However, the ambit of this proposed rule differs from the rule in the MBCA in important respects.⁵⁶⁸

4.4.4 Status of claim in respect of authorised but unpaid distributions

Unless payment of the distribution is subordinated subject to satisfactions of the financial restrictions, the shareholder acquires a status equal to that of general unsecured creditors at the time when the corporation incurs an indebtedness to that shareholder.⁵⁶⁹

4.4.5 Authorisation

Distributions are authorised by the board of directors, subject to any restrictions in the articles of incorporation and, of course, the financial restrictions.⁵⁷⁰

4.4.6 Liability for unlawful distributions

The MBCA imposes liability for unlawful distributions on directors.⁵⁷¹ This liability is the only specific instance of liability imposed on directors in addition liability for

Continued

⁵⁶⁷ MBCA s 6.40(e)(3).

⁵⁶⁸ See Chapter 5 paragraph 4.3.1.6.

⁵⁶⁹ MBCA s 6.40(f).

⁵⁷⁰ MBCA s 6.40(a).

⁵⁷¹ MBCA s 8.33.

breaching the general standards for director conduct set out in section 8.30.⁵⁷² The focus on director liability as the primary consequence of unlawful distributions has historical reasons.⁵⁷³ The Official Comment also makes it clear that the possible liability of shareholders is best determined under fraudulent conveyance or bankruptcy laws.⁵⁷⁴ The right of a corporation to the return of an unlawful distribution from shareholders is not regulated in the MBCA, but will depend on the general principles in the specific state.⁵⁷⁵ The clear trend among states is that shareholder liability to the corporation will also depend on the knowledge of the shareholder.⁵⁷⁶

A director who votes for or assents to a distribution made in violation of section 6.40 of the MBCA or the corporation's articles of incorporation may be held personally liable to the corporation for the amount of the unlawful distribution.⁵⁷⁷ It will have to be proved that the director did not comply with the general standards of conduct for directors set out in section 8.30.⁵⁷⁸ After having stated that directors owe their corporations a duty of good faith and of reasonable care, the provision expressly entitles directors to rely on information, opinions, report or statements, including financial statements and other financial data, prepared or presented by officers or employees, professional advisers and committees of the board. The director may so rely provided she reasonably believes that person to be competent and provided she does not have knowledge making such reliance unwarranted.⁵⁷⁹ In determining whether distributions may be made, directors will very often have to rely on financial information presented or prepared by others. This provision thus limits the liability of directors in respect of unlawful distributions to a reasonable level.

⁵⁷² MBCA s 8.30 covers the duty of good faith, duty of reasonable care and allows reasonable reliance on others. It is often described as the business judgment rule.

⁵⁷³ Manning *Legal Capital* 187.

⁵⁷⁴ See Official Comment to MBCA s 6.40, paragraph 3.

⁵⁷⁵ Cox & Hazen *Corporations* 571.

⁵⁷⁶ Cox & Hazen *Corporations* 571.

⁵⁷⁷ MBCA s 8.33(a).

⁵⁷⁸ MBCA s 8.33(a).

⁵⁷⁹ The Official Comment to s 8.33 refers to this as 'warranted reliance'.

Proceedings to enforce directors' liability must be instituted within two years of the date on which the effect of the distribution was measured or, in case of a violation of the articles of incorporation, within two years of such violation.⁵⁸⁰

A director who is held liable is entitled to a contribution from every other director who could be held liable for the unlawful distribution.⁵⁸¹ The *pro rata* portion of the amount of an unlawful distribution may be recouped from each shareholder who received it knowing that it was unlawful.⁵⁸² Proceedings by a director to enforce a contribution from co-directors or a recoupment from shareholders must be instituted within a year after the final adjudication of the directors' liability.⁵⁸³

In addition to the possible liability of shareholders in respect of a recoupment by a director, shareholders could be liable under the Uniform Fraudulent Transfer Act and the Bankruptcy Act for unlawful distributions received. I briefly discuss this aspect elsewhere.⁵⁸⁴

Unlike the position in South Africa,⁵⁸⁵ the MBCA regulates the liability of directors for all kinds of unlawful distributions in a coherent manner. Directors can be held liable only if they allowed a distribution to be made while they did not comply with the standard of conduct expected of them. A prerequisite for the recovery by directors from shareholders is the shareholders' knowledge of the unlawfulness of the distribution. In this sense, the liability thus appears to be narrower than in South Africa.⁵⁸⁶ A consideration of these differences could guide the review of the South African provisions in this regard.

4.5 Dividends

The definition of a distribution includes any 'transfer of money or other property or incurrence of indebtedness by a corporation to or for the benefit of its shareholders in respect of any of its shares'.⁵⁸⁷ A dividend is expressly mentioned as an example

⁵⁸⁰ MBCA s 8.33(c)(1).

⁵⁸¹ MBCA s 8.33(b)(1).

⁵⁸² MBCA s 8.33(b)(2).

⁵⁸³ MBCA s 8.33(c)(2).

⁵⁸⁴ See paragraph 1 above.

⁵⁸⁵ See Chapter 5 paragraphs 5.6 and 6.4.2.

⁵⁸⁶ See Chapter 5 paragraph 6.4.1.3.

⁵⁸⁷ See s 1.40(6). See paragraph 4.4.1 above.

of a distribution. A share dividend is not a distribution.⁵⁸⁸ The term 'dividend' in its narrow sense refers to a distribution of earnings and profits, but in its wider sense it includes distributions in partial liquidation.⁵⁸⁹

I have analysed the financial restrictions and other principles applicable to dividends as distributions in relation to distributions in general and will not repeat them here.⁵⁹⁰

4.6 Share repurchases

4.6.1 Power to acquire shares

A corporation has a general power to acquire its own shares.⁵⁹¹ The provision does not distinguish between different kinds of acquisitions, but it is wide enough to encompass acquisitions by way of repurchase, redemption or any other method. There is no separate provision that regulates the redemption of shares.⁵⁹²

4.6.2 Financial restrictions

It is expressly provided that the reacquisition, redemption or conversion of shares is subject to the financial restrictions of section 6.40.⁵⁹³ The definition of 'distribution' also makes specific reference to the 'purchase, redemption, or other acquisition of shares'.⁵⁹⁴

The right to reacquire shares is subject to the qualification that one or more shares should remain outstanding that together have unlimited voting rights and entitlement to receive the net assets on dissolution.⁵⁹⁵

It is not required that the articles of incorporation authorise the acquisition or that shareholders should approve of it. The general position is thus that the board of directors has the power to authorise the reacquisition of shares.

⁵⁸⁸ The definition in s 1.40(6) excludes a transfer of the corporation's own shares.

⁵⁸⁹ See *Hamilton Corporations* 870.

⁵⁹⁰ See paragraph 4.4.2 above.

⁵⁹¹ MBCA s 6.31.

⁵⁹² The creation of redeemable shares is provided for in s 6.01(c)(2). See paragraph 4.6.6 below.

⁵⁹³ MBCA s 6.03(b). The financial restrictions are discussed in paragraph 4.4.2 above.

⁵⁹⁴ Section 1.40(6). Also see paragraph 4.4.1 above.

4.6.3 Procedure and other requirements

The MBCA does not prescribe the procedure when a corporation wants to acquire its shares.

Securities exchanges usually prescribe requirements for the reacquisition of shares listed on that exchange.⁵⁹⁶ These requirements include notification and equal treatment of shareholders.⁵⁹⁷ The federal Securities Exchange Act of 1934, as amended⁵⁹⁸ regulates tender offers by a corporation for the purchase of its own shares in the context of defensive tactics including greenmail.⁵⁹⁹

For unlisted corporations the procedure and further requirements are governed by the applicable state law and would usually depend on whether the corporation involved is a closely held or a public corporation.⁶⁰⁰

It is generally accepted that a corporation can selectively repurchase or redeem its shares. This can give rise to conflicts of interest, abuse of power by management or controlling shareholders, and unequal treatment of different classes of shares.⁶⁰¹ The courts have formulated several specific fiduciary limitations on share repurchases.⁶⁰²

In public corporations the fiduciary duties of the management are relevant in addressing the problem of repurchases motivated by improper considerations (such as to avoid a takeover). The courts in most states apply the ‘primary purpose test’ formulated by the Delaware Supreme Court in *Cheff v Mathes*.⁶⁰³ This test enquires whether the primary purpose of the directors was to further what they honestly believed to be in the interest of the corporation. When the interests of

Continued

⁵⁹⁵ MBCA s 6.03(b) – (c). See paragraph 4.2.2 above.

⁵⁹⁶ See Henn & Alexander *Laws of Corporations* 943.

⁵⁹⁷ See, for example the Securities and Exchange Commission’s going-private rules, rule 13e-3 and Schedule 13E-3. For a discussion of federal protection measures in going private transactions, see Kofele-Kale “Unfinished Business” 625.

⁵⁹⁸ 15 USCA s 78a et seq. The provisions under consideration were introduced by the Williams Act of 1968.

⁵⁹⁹ See Securities Exchange Act 1934, s 13(d), (f), s 14(d) – (e). Hartnett “Greenmail” 1301 argues that the federal regulation is ineffective as a result of restrictive interpretation by the courts. See also s 13(e) which deals with proper disclosure to shareholders in a repurchase.

⁶⁰⁰ Clark *Corporate Law* 633.

⁶⁰¹ Cox & Hazen *Corporations* 582; Clark *Corporate Law* 633.

⁶⁰² Cox & Hazen *Corporations* 582 – 583; Rock, Kanda & Kraakman “Significant Corporate Actions” 150.

different classes of shares are involved, the directors have to act primarily in the interest of the ordinary shareholders.⁶⁰⁴ Takeover legislation in several states address the issue of greenmail, although this approach has been criticised for fragmenting markets.⁶⁰⁵

In closely held corporations,⁶⁰⁶ many states recognise the existence of a fiduciary duty of utmost good faith owed by the controlling shareholders to the minority shareholders.⁶⁰⁷ The existence of such a duty and the rule that shareholders should all have an equal opportunity to have their shares repurchased or redeemed, was formulated by the Supreme Judicial Court of Massachusetts in *Donahue v Rodd Electrottype Co.*⁶⁰⁸ Selective repurchases or redemptions require the consent of the other (non-controlling) shareholders. The equal opportunity rule in close corporations does not apply in Delaware, though.⁶⁰⁹

4.6.4 The status of repurchased shares

Shares reacquired by the corporation constitute authorised but unissued shares.⁶¹⁰ The articles of incorporation may prohibit the reissue of such acquired shares, and then the shares must be cancelled and the number of authorised shares must be reduced by the number of shares acquired.⁶¹¹

Continued

⁶⁰³ 199 A 2d 548 (Del 1964).

⁶⁰⁴ *Zahn v Transamerica Corp* 162 F2d 36 (3d Cir 1947).

⁶⁰⁵ See Hartnett "Greenmail" 1292 – 1294.

⁶⁰⁶ In *Donahue v Rodd Electrottype Co* 367 Mass 578, 328 N E 2d 505 the court identified three characteristics of a close corporation, namely a small number of shareholders, no ready market for its stock, and substantial majority shareholder participation in its management, direction and operations.

⁶⁰⁷ *Pepper v Litton* 308 US 295 (1939); *Zahn v Transamerica Corp* 162 F2d 36 (3d Cir 1947). According to Hamilton *Corporations* 447 more than 25 states recognise the existence of such a duty in the context of selective repurchases. See also Hertig & Kanda "Related Party Transactions" 126; Kaplan & Young "Corporate Eminent Domain" 67.

⁶⁰⁸ 367 Mass 578, 328 N E 2d 505.

⁶⁰⁹ *Nixon v Blackwell* 626 A 2d 1366, 1380 (Del 1993). See also Hamilton *Corporations* 451 – 452 where the possible development of the 'entire fairness' test as a protection measure for minorities in closely held corporations is alluded to. 'Entire fairness' is used where the controlling shareholder is involved in self-dealing transactions, see *Sinclair Oil Corporation v Levien* 280 A 2d 717 (Del SC 1971). See also Hertig & Kanda "Related Party Transactions" 126.

⁶¹⁰ MBCA s 6.31(a).

⁶¹¹ MBCA s 6.31(b). See paragraph 4.2.5.1 above.

4.6.5 Repurchases through subsidiaries

The MBCA does not contain specific provisions regulating the acquisition by a subsidiary of shares in its parent corporation. It appears that a subsidiary may acquire any number of shares in its parent corporation.

A wholly owned or majority owned subsidiary⁶¹² may generally not vote shares held in its parent.⁶¹³

4.6.6 The redemption of shares

The redemption of shares is a distribution and is treated in the same way as repurchases and other acquisitions.⁶¹⁴

4.7 Evaluation and conclusions on the MBCA

Following the lead of California, the revised MBCA of 1984 abolished the concept of stated capital and introduced economic concepts to regulate distributions to shareholders.⁶¹⁵

The articles of incorporation must set out the classes and numbers of authorised shares, and it is possible to have unclassified shares or blank stock.⁶¹⁶ Pre-emptive rights apply only to companies that elect to have them.⁶¹⁷ The concept of authorised shares has been retained,⁶¹⁸ and although directors may have the power to make certain alterations to the articles without shareholder approval, it is clear that whenever the interests of existing shares are affected shareholder approval is required. This includes an increase in authorised shares once any shares have been issued. Another example of this is that directors may subdivide

⁶¹² In determining whether a corporation is a parent company for this purpose, regard is had to the shares entitled to vote for directors, s 7.21(b). A corporation can be a subsidiary of another corporation because of other circumstances, see *Cox & Hazen Corporations* 111 for a discussion of definitions.

⁶¹³ MBCA s 7.21(b). This provision recognises that there could be special circumstances when such a subsidiary could indeed vote the shares in its parent corporation. See *Cox & Hazen Corporations* 348 for a discussion voting rights in respect of treasury shares and shares held by a subsidiary.

⁶¹⁴ See paragraph 4.5.1 above.

⁶¹⁵ See paragraph 4.1 above.

⁶¹⁶ See paragraph 4.2.1 above.

⁶¹⁷ See paragraph 4.2.1 above.

⁶¹⁸ See paragraph 4.2.1 above.

shares when there is only one class of shares, but need shareholder approval when it has more than one class of shares.⁶¹⁹

The kind of consideration a corporation may accept for its shares is not limited,⁶²⁰ but the directors have to determine that the consideration is adequate.⁶²¹ Certain non-cash issues that have the potential of disturbing the relative equity interests in the corporation are subject to shareholder approval.⁶²²

There is a comprehensive definition of the term 'distribution'. It includes repurchases, redemptions, dividends as well as conversions of shares into preferred classes of shares or debt securities.⁶²³ All distributions are subject to an equity solvency test and a balance sheet test.⁶²⁴ The equity solvency test is comparable to the South African liquidity test while the balance sheet test is similar to the South African solvency test. In addition to these tests designed to protect creditors, it is required that sufficient assets should remain to cover the preferential rights of classes of shareholders preferred to the class to which a distribution is being made.⁶²⁵

The MBCA contains a detailed provision setting out the time of measurement of various distributions.⁶²⁶ The general rule is that the financial restrictions apply when a distribution is made or a debt in respect of it is incurred, even though actual payment is deferred.⁶²⁷

It is interesting to note the interaction between the time of measurement and the status of the shareholder's claim for payment in respect of a distribution. If the financial restrictions are satisfied when the distribution is authorised, the claim of the shareholder will rank equal with claims of ordinary unsecured creditors.⁶²⁸ The philosophy behind this approach is that, since the amount due could have been distributed and paid at that stage, the creditors will not be worse off if the

⁶¹⁹ See paragraphs 4.2.5.1 and 4.2.5.2 above.

⁶²⁰ See paragraph 4.3.1 above.

⁶²¹ See paragraph 4.3.2 above.

⁶²² See paragraph 4.3.3 above.

⁶²³ See paragraph 4.4.1 above.

⁶²⁴ See paragraph 4.4.2 above.

⁶²⁵ See paragraph 4.4.2 above.

⁶²⁶ See paragraph 4.4.3 above.

⁶²⁷ See paragraph 4.4.3 above.

corporation does not pay immediately, but holds on to the money until a later stage. The position is the same as if the shareholder had received payment and then advanced the money back to the corporation on loan as an ordinary creditor.⁶²⁹ On the other hand, if the shareholder is prepared to have each payment subjected to the financial restrictions, effectively subordinating her claim to those of ordinary creditors, the test need not be satisfied when the distribution is authorised.

South Africa can perhaps learn from the timing provision in the MBCA, especially in view of the uncertainty about the possible dual imposition of the test.⁶³⁰

The MBCA addresses the ranking of claims in respect of all distributions⁶³¹ and this could provide an example for regulation in South Africa where claims in respect of reacquisitions are automatically subordinated to the claims of other creditors and the position in respect of dividends is uncertain.⁶³²

Directors who allow the making of an unlawful distribution in violation of the standards of conduct expected of them, are liable.⁶³³ The MBCA does not impose direct liability on shareholders, but directors can recoup unlawful distributions from shareholders who received them with knowledge of their impropriety.⁶³⁴

With the introduction of the new distribution rules, treasury shares were abolished. Reacquired shares have to be restored to the status of authorised but unissued shares, unless the articles of incorporation require them to be cancelled completely.⁶³⁵

The financial restrictions imposed by the MBCA are very similar to the South African restrictions. An important difference is that the MBCA requires provision to be made for the preferential rights of preferred classes of shareholders. Similar protection for holders of preference shares should be considered for South Africa.

The MBCA rules on distributions have several other advantages over the fragmented South African provisions. Apart from the comprehensive definition of

Continued

⁶²⁸ MBCA s 6.40(f).

⁶²⁹ Official Comment to s 6.40, par 8 (c).

⁶³⁰ See Chapter 5 paragraph 4.4.2.

⁶³¹ See paragraph 4.4.4 above.

⁶³² See Chapter 5 paragraph 5.4.

⁶³³ See paragraph 4.4.6 above.

⁶³⁴ See paragraph 4.4.6 above.

⁶³⁵ See paragraph 4.6.4 above.

'distribution' and the single set of financial restrictions, it contains a timing provision and a single liability rule.

5 EVALUATION AND CONCLUSION

In the United States of America, the regulation of corporations falls within the jurisdiction of individual states.⁶³⁶ I chose to analyse the share capital, contribution and distribution rules in two individual states generally regarded as important jurisdictions for corporate law, namely Delaware and California.⁶³⁷ I also considered the provisions of the MBCA, which serves as the basis for corporate law in many states.⁶³⁸

In the state of Delaware, the traditional legal capital doctrine still applies. The concept of stated capital, which at first glance resembles the South African concept 'issued capital', forms the basis of the regulation of distributions.⁶³⁹

I illustrated that there is very little correlation between the consideration paid for shares and the amount of the stated capital.⁶⁴⁰ Although an amount equal to the par value of a share must be regarded as stated capital, share premiums received by a corporation are not automatically regarded as part of its share capital or non-distributable reserves. In the case of no par value shares, the directors decide how much of the consideration will be share capital.⁶⁴¹ A corporation may reduce its capital provided that it is able to pay its debts as they mature.⁶⁴² Shares may also be repurchased or redeemed out of capital if the stated capital is reduced simultaneously.⁶⁴³

The Delaware General Corporation Law does not contain a definition of 'distribution'. Repurchases and redemptions may be made provided the stated capital is not impaired, while dividends may be paid out of surplus.⁶⁴⁴ Despite the

⁶³⁶ See paragraph 1 above.

⁶³⁷ See paragraphs 2 and 3 above.

⁶³⁸ See paragraph 4 above.

⁶³⁹ See paragraph 2.2.1 above.

⁶⁴⁰ See paragraphs 2.2.4 and 2.7 above.

⁶⁴¹ See paragraph 2.2.4 above.

⁶⁴² See paragraph 2.2.6 above.

⁶⁴³ See paragraph 2.6.2 above.

⁶⁴⁴ See paragraph 2.4.1 above.

difference in wording, this means that a corporation may make distributions out of the excess of assets over stated capital. In addition, 'nimble dividends' are allowed.⁶⁴⁵ These are dividends paid out of 'current' profits rather than out of surplus.

I argued that the practical effect of the Delaware legislation is similar to that of the South African solvency and liquidity restrictions, although two steps may be required to achieve that effect in Delaware. When a corporation wants to make a distribution that would impair its stated capital, it may reduce its stated capital subject to compliance with a liquidity test and then proceed to make the distribution.⁶⁴⁶ This principle gives effect to the creditors' purported reliance on the stated capital.

Although I do not regard the Delaware approach in general as suitable for South Africa, I think that two provisions of its Code could be considered for implementation in South Africa. The first is the rule that a corporation may not repurchase its own shares for a higher price than that at which it can redeem those shares at that stage.⁶⁴⁷ This provision protects the interests of remaining shareholders. It also prevents a misapplication of company funds and thus works to the advantage of creditors too. Secondly, I identified the timing rule for distributions by way of promissory notes, debentures or other obligations as a possible addition to the South African distribution provisions.⁶⁴⁸ However, there are more comprehensive timing provisions in the Californian legislation⁶⁴⁹ and in the MBCA⁶⁵⁰ and these should also be considered.

The second jurisdiction I considered in this chapter is California. The California Corporations Code regulates distributions based on two alternative economic concepts, namely earned surplus and the ratio of debt to equity.⁶⁵¹

Although the concept of stated capital is not used, the California Corporations Code nevertheless limits the types of acceptable consideration and prescribes the

⁶⁴⁵ See paragraph 2.5.2 above.

⁶⁴⁶ See paragraph 2.5.2 above.

⁶⁴⁷ See paragraph 2.6.2 above.

⁶⁴⁸ See paragraph 2.4.3 above.

⁶⁴⁹ See paragraph 3.4.3 above.

⁶⁵⁰ See paragraph 4.4.3 above.

⁶⁵¹ See paragraph 3.1 above.

valuation of non-cash consideration.⁶⁵² The purpose of these measures is to protect shareholders rather than creditors.

California uses a single definition of 'distribution' that includes repurchases and dividends.⁶⁵³ All distributions are subject to the same financial restrictions. First, all distributions are subject to compliance with an equity solvency test.⁶⁵⁴ Secondly, one of two alternative balance sheet tests must be satisfied. The first is the retained earnings test, which is similar in effect to an earned surplus test in that the original contributions of shareholders may not be distributed. As an alternative to the retained earnings test, distributions may be made if the assets of the corporation exceed its liabilities by a prescribed ratio once the distribution has been made.⁶⁵⁵ The debt/equity ratios offer better protection to creditors than the South African solvency requirement, because they require an additional cushion of assets from which creditors can be paid. Two ratios are involved: that of total assets to total liabilities (certain illiquid assets are disregarded), and that of current assets to current liabilities.⁶⁵⁶

Like its South African counterpart, the Californian equity solvency test is an objective test. The Californian formulation, which considers whether the corporation is 'likely to be unable' to pay its debts may be preferable than the South African reference to a reasonable belief.

The timing rule for distributions in California differs from the South African position in various respects.⁶⁵⁷ South Africa should consider a timing provision along the lines of the Californian provision, which distinguishes between dividends and other distributions and also expressly regulates debt instruments and sinking fund payments.⁶⁵⁸

A feature of the Californian distribution rules is that the rights of preferred classes of shareholders are protected when a distribution is made to lower ranking classes. The retained earnings of the corporation, even if the distribution is to be

⁶⁵² See paragraph 3.3.1 to paragraph 3.3.3 above.

⁶⁵³ See paragraph 3.4.1 above.

⁶⁵⁴ See paragraph 3.4.2 above.

⁶⁵⁵ See paragraph 3.4.2 above.

⁶⁵⁶ See paragraph 3.4.2 above for a discussion of the different ratios.

⁶⁵⁷ See paragraph 3.4.3 above.

⁶⁵⁸ See paragraph 3.4.3 above.

made under the alternative debt/equity ratio test, must be sufficient to cover both the dividend and liquidation preferences of the preferred shareholders.⁶⁵⁹ The South African legislation contains no similar principle and the possibility of introducing statutory protection for shareholders with rights preferent to those of the shareholders to whom a distribution is to be made should be considered.

California provides a good example of a sophisticated approach to liability for unlawful distributions. It clearly delineates the respective liability of directors and of shareholders and differentiates between non-compliance with creditor protection measures and rules protecting shareholders.⁶⁶⁰ The South African provision can be improved by employing similar distinctions.

Despite the existence of separate procedures for share redemptions and share repurchases, both are subject to the same financial restrictions.⁶⁶¹ This avoids the kind of anomalies present in the South African legislation.

To conclude, the Californian Corporations Code can serve as an example for South Africa in a number of respects. Apart from the introduction of a single definition of distribution and the consistent treatment of redemptions and repurchases, its provisions regulating the liability of shareholders and directors for unlawful distributions can be singled out. Its sophisticated financial restrictions, including the asset-liability ratio tests, are stricter than the present South African solvency and liquidity tests.⁶⁶²

Although it does not represent a specific jurisdiction, I analysed the provisions of the MBCA of 1984. Its provisions have been adopted in the corporation laws of the majority of states, making it fairly representative of American law.

Like the California Corporations Code, the MBCA replaced the legal capital approach with one relying on economic concepts.⁶⁶³

As a logical result of the abolition of stated capital and par value, shares may be issued for any kind of consideration.⁶⁶⁴ Non-cash consideration should be

⁶⁵⁹ See paragraph 3.4.2.4 above.

⁶⁶⁰ See paragraph 3.4.5 above.

⁶⁶¹ See paragraph 3.6.1 above.

⁶⁶² See paragraph 3.7 above.

⁶⁶³ See paragraph 4.1 above.

⁶⁶⁴ See paragraph 4.3.1 above.

declared adequate by the directors, although it need not be valued.⁶⁶⁵ Shareholders cannot generally rely on pre-emptive rights, as these are available only when expressly included in a corporation's articles. However, the concept of authorised capital has been retained.⁶⁶⁶ Shareholders must generally approve amendments to the articles in respect of authorised capital.⁶⁶⁷ Shareholders also enjoy protection against unfair non-cash issues through the requirement of advance shareholder approval for substantial non-cash issues.⁶⁶⁸

I explained that the MBCA subjects all distributions to uniform financial restrictions. Any transfer of money, property or an obligation is regarded as a distribution if it is made in respect of a share.⁶⁶⁹ Repurchases, redemptions, dividends and conversions of shares into preferred classes of shares or into debt securities are treated similarly.⁶⁷⁰ The financial restrictions comprise an equity solvency test, a balance sheet test, and the requirement that assets equal to the dividend and liquidation preferences of preferred classes of shareholders should remain.⁶⁷¹ Although South Africa also subjects some distributions to the equivalent of an equity solvency and a balance sheet test, it does not impose a requirement of providing for dividend or liquidation preferences. Many of the anomalies arising from the separate regulation of different types of distributions in South Africa⁶⁷² will be solved by the adoption of a uniform standard for all distributions.

I considered the time when the effect of a distribution is measured under the MBCA.⁶⁷³ The time of payment is used in certain circumstances, while the time of authorisation or creation of an indebtedness is used in other instances. It is also possible to manipulate the time of measurement through a subordination

⁶⁶⁵ See paragraph 4.3.2 above.

⁶⁶⁶ See paragraph 4.2.1 above.

⁶⁶⁷ See paragraph 4.2.5 above. However, directors may increase the authorised capital if no shares have been issued.

⁶⁶⁸ See paragraph 4.3.3 above.

⁶⁶⁹ See paragraph 4.4.1 above.

⁶⁷⁰ See paragraph 4.4.1 above.

⁶⁷¹ See paragraph 4.4.2 above.

⁶⁷² See Chapter 5 paragraph 4.

⁶⁷³ See paragraph 4.4.3 above.

agreement, thus allowing flexibility. I observed that the status of claims in respect of outstanding distributions determine the time of measurement.⁶⁷⁴

I considered liability of directors and shareholders for unlawful distributions. The grounds for director liability under the MBCA are wider than in South Africa, but the prerequisites for imposing liability, which are set out with more clarity than in South Africa, are stricter.⁶⁷⁵ The MBCA requires knowledge on the part of a shareholder who receives an unlawful distribution before that shareholder will be liable to return the distribution.⁶⁷⁶

I conclude with general observations on the differences between the South African and American regulation. In each of the American systems, all distributions are subject to the same basic financial restrictions. The inclusion of a restriction to safeguard the preferential dividend and liquidation rights of preferred classes of shareholders is a feature common to all three systems.

The financial restrictions achieve creditor protection in a consistent or neutral way in relation to different distributions. Creditors also benefit from the protection of the prior rights of preferred shareholders because it has the effect of ensuring a margin over solvency. In all these systems an equity solvency or liquidity test apply to distributions, which recognises the creditor's right to receive payment when due.

Except for the statutory protection of preferred shareholders through the financial restrictions, shareholder interests in repurchases are not regulated in any detail. The legislation does not prescribe rules for *pro rata* and selective acquisitions respectively, but the courts have developed fiduciary limitations in this regard. The acquisition of shares by a subsidiary corporation in its parent is not regulated by the legislation, although voting restrictions are imposed on shares held by certain subsidiaries. Federal regulation provides protection against selective repurchases on markets while several states have also enacted takeover legislation addressing defensive repurchases.

Shareholders also do not enjoy strong statutory protection when further shares are issued, although certain protection mechanisms apply to non-cash capital contributions. The protection of shareholders against a dilution of their

⁶⁷⁴ See paragraph 4.4.4 above.

⁶⁷⁵ See paragraph 4.4.6 above and compare Chapter 5 paragraph 6.4.

⁶⁷⁶ See paragraph 4.4.6 above.

interests when further shares are issued relies on the concept of authorised capital but is weaker than in South Africa, because authorised capital can generally be increased by an ordinary majority vote. As in South Africa, shareholders have pre-emptive rights only if the articles expressly include them.

An assessment of the overall level of protection enjoyed by creditors and shareholders in America is difficult. While different state systems have been investigated, the effect of federal legislation relating to securities and bankruptcy and the provisions of other uniform legislation such as the Uniform Fraudulent Transfer Act and the Uniform Commercial Code should also be taken into account, as should court-imposed equitable subordination.⁶⁷⁷

It appears that the level of creditor protection is higher than in South Africa because creditors benefit by the greater margin required satisfying rights of preferential shareholders. In Delaware this margin is further increased by the amount of the stated capital and in California by the asset-liability ratio test or alternatively by the retained earnings test.

Shareholder interests are better protected as far as the financial implications of distributions are concerned, because of the provision for liquidation preferences. However, shareholders seem to enjoy less protection than South African shareholders when further shares are authorised and issued. Similarly, shareholder interests are not clearly protected by state legislation against disproportionate distributions. Although proportionality or fair treatment is not required by statute, the courts have developed general principles over many years.

⁶⁷⁷ See Gelb "Undercapitalization Factor" 1; Dye "Inadequate Capitalization" 823, 843.

CHAPTER 5

SOUTH AFRICA

1 INTRODUCTION

This chapter on South Africa analyses the regulation of share capital and of distributions to shareholders under the Companies Act of 1973¹ and the common law. The purpose is to evaluate the role of the share capital rules in the protection of shareholders and creditors respectively, and to assess the effectiveness of the distribution rules in safeguarding the interests of these two groups.

Attention is given to the implications of the grafting of modern distribution rules, based on solvency and liquidity, onto an Act designed to facilitate the operation of the common-law capital maintenance doctrine. These modern distribution rules were introduced in 1999.² The resultant anomalies and uncertainties are discussed in detail.

The continued need for comprehensive regulation of the share capital structure of a company is evaluated. This involves an enquiry as to whether the burden of complying with these complex provisions is offset by a concomitant benefit to either shareholders or creditors, or both. The availability of alternative protective measures is an important factor in this equation. However, I focus on measures that relate specifically to the share capital or share capital structure of companies. An assessment of the impact of contractual undertakings exacted by creditors, or of minority shareholder remedies, for example, falls outside the scope of this thesis.

Apart from the tension between the reformed distribution rules and the pre-existing rules governing share capital structure, there are internal inconsistencies in the regulation of distributions. These arise because certain kinds of distributions to shareholders, notably the redemption of shares, are subject to restrictions based on the capital maintenance doctrine while others are subject to solvency and liquidity only. Moreover, the procedures for and consequences of different

¹ Act 61 of 1973, hereafter the 'Act'. Unless the contrary is indicated, all references to sections in this Chapter are to sections of this Act.

² By the Companies Amendment Act 37 of 1999.

kinds of distributions vary. An answer is sought as to whether there are any substantive differences in the effect various kinds of distributions may have on shareholders or creditors that could justify these disparate approaches.

The extent to which these issues will either be solved or aggravated under the Companies Bill 2008,³ resulting from the comprehensive company law review process,⁴ is considered.⁵ Reference will also be made to the draft Companies Bill published by the Department of Trade and Industry in February 2007 in certain instances.⁶

The structure of this chapter follows that of the earlier chapters in the comparative study. However, in relation to each of the five main sections, namely share capital structure, capital contributions, distributions, dividends and other payments, and share repurchases, the current legal position is outlined, followed by a consideration of the Companies Bill. Specific criticisms against the provisions of the Act or the Companies Bill are addressed when the particular provision is considered. Each main section culminates in an evaluation and conclusion which takes into account the comparative perspectives. Overall conclusions and recommendations are reserved for the final chapter.

Although consideration was given to discussing the Companies Bill either in a separate chapter or in a separate section at the end of this chapter, the proposals it embodies often address criticisms against the current position. It thus makes sense to evaluate the present provisions in the light of these proposals rather than *in vacuo*. While the provisions of the Companies Bill are still open to changes in the course of the legislative process, it is unlikely that there will be a major shift in the basic approach that has thus far emerged from the *Policy Framework* and the two versions of the draft legislation. I hope that my criticism against specific draft clauses will contribute to the improvement of the proposed legislation.

Integrating the discussion of the Companies Bill into the main body of this chapter poses definite challenges, particularly as a result of diverging approaches.

³ [B 61—2008], tabled in Parliament on 27 June 2008, available at www.pmg.org.za/bill (2008-06-27), hereafter 'Companies Bill'.

⁴ See *South African Company Law for the 21st Century – Guidelines for Corporate Reform* GN 1183 in GG 26493 of 23 June 2004.

⁵ Whenever reference is made in this chapter to a 'clause', it is to a clause in this Companies Bill 2008, unless indicated otherwise.

⁶ For a discussion of the share capital and distribution rules in this draft Bill, see Jooste
Continued

While the Act regulates the share capital structure in considerable detail, the Companies Bill devotes little attention to this topic. The first discussion of provisions of the Companies Bill is thus encountered only after a very lengthy discussion of present problems caused by, among others, the dual system of par value and no par value shares, the regulation of share premium accounts, and references to the reduction of share capital. Further, the Companies Bill regulates distributions in a uniform way while the Act provides separate procedures and requirements. To facilitate comparison, yet eliminate repetition, certain provisions of the Companies Bill that apply to distributions in general are discussed in sections dealing with specific kinds of distributions rather than under more general headings. For example, liability for unlawful distributions is discussed in relation to share repurchases because that is where the focus of the current regulation of liability lies. Where necessary, further cross references and explanations will indicate where specific issues are discussed in the course of this chapter.

1.1 Overview of the development of share capital and distribution rules

South African company law is found in both the Act and the common law. The Act applies to all companies registered under it or under its predecessor,⁷ as well as to external companies with a place of business in the Republic.⁸ The 1926 and 1973 Companies Acts were based on English legislation and the English common law rules applicable to companies have been accepted into South African company law in as far as they do not conflict with South African law.⁹

The main distinction between different types of companies incorporated under the Companies Act is between a company 'having a share capital'¹⁰ and a company 'not having a share capital and having the liability of its members limited by the memorandum of association'.¹¹ A company having a share capital may be

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"Companies Bill 2007" 710ff.

⁷ Act 46 of 1926.

⁸ Section 2(2).

⁹ Cilliers & Benade *Corporate Law* 19. The 1973 Companies Act contained a number of innovations compared to the English legislation, see Cilliers & Benade *Corporate Law* 24 for an outline.

¹⁰ Section 19(1)(a).

¹¹ Section 19(1)(b). This kind of company is referred to in the Act as a company limited by guarantee.

either a public or a private company and may have shares of par value or shares of no par value.¹² It is clear from the negative formulation of the description of a company limited by guarantee that the point of departure of the Companies Act is a company having a share capital. It is also true that the vast majority of companies incorporated under the Act are indeed companies having a share capital.¹³ Companies limited by guarantee will not be considered further, because they do not have a share capital. All further references to companies in this chapter will thus be to companies having a share capital, unless otherwise indicated.

The capital maintenance doctrine which was developed by English courts in the nineteenth century was accepted as part of South African company law. The idea that the paid-up share capital of a company served as a guarantee fund to which creditors looked for payment was confirmed by the then Appellate Division in *Lewis v Oneanate (Pty) Ltd & Another*.¹⁴ However, in 1999 the Companies Amendment Act 37 of 1999 introduced amendments which 'changed dramatically the capital maintenance rule and the perceived protection it afforded [creditors]'.¹⁵ Although these amendments brought about significant changes in the regulation of distributions to shareholders, the provisions underpinning the concepts of authorised and issued capital and the capital maintenance principle were not amended. This has given rise to certain anomalies and the amendments have been described as 'unsystematic efforts to eliminate the capital maintenance principle'.¹⁶

It is thus not surprising that the reform of the share capital provisions is a theme of the company law reform project which is currently under way. Unfortunately neither the policy document, *South African Company Law for the*

¹² Section 19(2). A company limited by guarantee is deemed to be a public company, s 19(3). The difference between par value shares and no par value shares is considered in paragraph 2.3 below.

¹³ As at 24 November 2003 there were 415 990 active companies having a share capital (public and private companies together) and 16 570 active companies limited by guarantee. Only 85 of the companies limited by guarantee were not s 21 companies. See www.cipro.co.za/about_us/registration_stats.asp (2008-01-28).

¹⁴ 1992 (4) SA 811 (A) at 818.

¹⁵ *Capitex Bank Ltd v Qorus Holdings Ltd & Others* 2003 (3) SA 302 (W) at 306.

¹⁶ Blackman, Jooste & Everingham *Companies Act* 4-58; 5-113; 5-274. For further criticism of the lack of cohesion between the old and new provisions, see Cassim "Reform of Company Law and Capital Maintenance" 284, Cilliers & Benade *Corporate Law* 323.

21st Century – Guidelines for Corporate Reform,¹⁷ nor the *Explanatory Memorandum to the Companies Bill 2008*¹⁸ articulate in any detail the considerations that informed the proposals regarding share capital and distributions.¹⁹

2 STRUCTURE OF SHARE CAPITAL

Many provisions in the Companies Act deal directly or indirectly with the share capital of a company having a share capital. Chapter V of the Act carries the heading 'Share Capital, Acquisition by Companies of Own Shares, Shares, Allotment and Issue of Shares, Members and Register of Members, Debentures, Transfers, and Restrictions on Offering Shares for Sale'.²⁰ The sub-heading for sections 74 to 82 is 'Share Capital'. These sections set out the basic structure of the share capital accounts of a company depending on whether it has par value or no par value shares or both these types of shares. They deal with the variation of capital and with conversions of par value shares into no par value shares and vice versa. They also regulate aspects of the minimum consideration for which shares may be issued. Most of these provisions relate to the contribution or raising of share capital.²¹ Distributions to shareholders are regulated both by sections 85 to 90 and certain other provisions.²² Some provisions dealing with or referring to share capital can be found elsewhere in the Act.²³

2.1 Authorised capital

The Companies Act employs the concept of authorised capital in relation to companies having a share capital. Section 52(2) requires the memorandum of a company to state the amount of the share capital with which it is proposed to be

¹⁷ GN 1183 in GG 26493 of 23 June 2004, hereafter '*Policy Framework*'.

¹⁸ This appears at the end of the Companies Bill 2008.

¹⁹ This lack of explanation of the policy issues in the *Policy Framework* is also noted by Cassim "Reform of Company Law and Capital Maintenance" 283.

²⁰ The heading was amended by s 5 of Act 37 of 1999. Previously it read: 'Share Capital, Reduction of Capital, Shares, Allotment and Issue of Shares, Members and Register of Members, Debentures, Transfers, and Restrictions on Offering Shares for Sale'.

²¹ However, s 76(3) and s 79 regulate specific kinds of distributions.

²² See s 76(3) and s 79.

²³ See, for example, s 52(2), considered in paragraph 2.1 below.

registered and the division thereof into shares of a fixed amount,²⁴ or the number of shares if the company is to have shares of no par value.²⁵ This amount of share capital or number of shares is known as the authorised share capital of a company.²⁶ Although the concept 'authorised capital' is not used in section 52(2), section 75(1)(h) contains a reference to a reduction of authorised capital.²⁷ In the case of par value shares, the authorised capital is expressed as an amount of money, divided into shares with a particular par or nominal value. When no par value shares are used, the authorised capital is a specific number of shares without any reference to a total amount of capital or a value per share.²⁸ Since a company may have both par and no par value shares,²⁹ the authorised capital can also be a combination of an amount of money and a number of shares. The fact that allowance has to be made for the two different concepts of par value and no par value shares also affects further provisions dealing with authorised and issued share capital, and leads to anomalies, some of which will be considered below in the context of the different kinds of shares.³⁰

The function of the authorised capital is firstly to determine the maximum number of shares that the company may issue without altering its share capital as provided for in section 75.³¹ The statement of authorised capital thus protects the interests of existing shareholders, because it limits the potential disturbance of the proportionate interests of shareholders which could result from the issue of further shares. Creditors have no interest in the statement of authorised capital, because the company is under no obligation to issue all its authorised shares.

A second function of the statement of authorised capital is to determine the prescribed fee that is payable to the Registrar upon registration of the company.³² The fee, which is payable in addition to the general prescribed fee of section 63(1), is R5 for each R1000 or part thereof of the nominal capital and R5 for each 1000

²⁴ Section 52(2)(a)(i), in relation to par value shares.

²⁵ Section 52(2)(a)(ii).

²⁶ See Blackman, Jooste & Everingham *Companies Act* 5-1.

²⁷ This provision is discussed in paragraph 2.6.1 below.

²⁸ See Blackman, Jooste & Everingham *Companies Act* 5-1.

²⁹ Section 74. See paragraph 2.3 below for a discussion of these types of shares.

³⁰ See paragraph 2.3 below.

³¹ A purported allotment of shares beyond the number of authorised shares will be void, *Moosa v Lalloo & Another* 1957 (4) SA 207 (N).

no par value shares or part thereof.³³

While authorised capital constitutes an upper limit on the number of shares that directors may issue, the power of directors to allot and issue shares is in any event curtailed by the requirement of shareholder approval.³⁴ Any issue of shares must be approved by an ordinary resolution. The approval may either be a specific authority or a general authority. The latter is only valid until the next annual general meeting, but may be revoked at any time.³⁵

Until the amendments brought about by the Corporate Laws Amendment Act 24 of 2006, the Act did not provide for pre-emptive rights when shares are issued. The model articles in Table B of Schedule 1 provides for pre-emptive rights in the case of a sale of shares by a shareholder in a private company.³⁶ Directors were thus free to issue the further shares to anyone, provided they were acting in terms of the shareholder approval. The fiduciary duties imposed on directors oblige them to exercise their powers for a proper purpose. This principle is particularly relevant to share issues.³⁷

The Corporate Laws Amendment Act 24 of 2006 appears to have introduced pre-emptive rights on share issues through a back door. It inserted definitions of 'widely held' and 'limited interest' companies into the Act.³⁸ One of the alternative characteristics of a widely held company is the unrestricted transferability of its shares,³⁹ which in turn depends on the absence of an 'effective right of pre-

Continued

³² Section 63(2).

³³ See paragraph 2.3 below for further discussion of the effect of the nature of shares on the fee payable in respect of authorised capital.

³⁴ Section 221.

³⁵ Allotments to directors are subject to the additional requirements of s 222. The basic effect of s 222 is that each particular allotment or issue has to be approved in advance, so that a general power cannot be used to issue shares to directors, see s 222(1)(a). This additional precaution does not apply when shares are issued to directors in proportion to their existing shareholdings or on the same terms and conditions as have been offered to members of the public or in terms of an underwriting contract, see s 222(1)(b) – (d).

³⁶ See articles 21 – 24 of Table B in Schedule 1 to the Act.

³⁷ See Kiggundu *Share Capital* 31 – 48.

³⁸ See s 1(6)(a) and (d), inserted by s 1(h) of the Corporate Laws Amendment Act 24 of 2006. The purpose of this distinction is the imposition of different governance and financial disclosure standards on these two kinds of companies, see the amendments to various sections in Chapters X and XI of the Act, brought about by ss 24 to 47 of the Corporate Laws Amendment Act 24 of 2006.

³⁹ See s 1(6)(a)(i). The others are that it is permitted to offer shares to the public, that it has decided by special resolution to be a widely held company or that it is a subsidiary of a widely held company, s 1(6)(a)(ii) – (iv).

emption'.⁴⁰ Companies lacking all the alternative characteristics of a widely held company are limited interest companies. This means that one of the prerequisites to being a limited interest company is the existence of an effective right of pre-emption in respect of the transfer of shares. For some reason, which is not immediately clear, section 1(6)(e) deems an effective right of pre-emption contained in the articles of a limited interest company also to operate when the company offers shares created in terms of section 75(1) to any non-shareholder. This deeming provision is not required for purposes of the definition, as the definition refers to unrestricted 'transfer' only. It is an independent provision introducing a substantive rule that an issue of newly created shares will be subject to the company's existing pre-emptive rights on share transfers, 'with the necessary changes'.

Although there is merit in providing pre-emptive rights in respect of the issue of shares,⁴¹ the way in which this has been done must be questioned, especially in view of the interim nature of the Corporate Laws Amendment Act and the incisive reform process that was underway. There are also a number of substantive criticisms.

First, the deeming provision is limited to shares created through a variation of share capital as envisaged in section 75(1) and does not cover an issue of shares that were originally authorised in the articles or of shares that were acquired by the company and restored to the status of authorised but unissued shares. Secondly, it applies only when the shares are offered to non-shareholders, leaving the company free to issue and allot all the shares to one or more selected shareholders.

Thirdly, it makes the deemed pre-emptive rights dependent on the level of protection afforded by the particular company in respect of transfers by shareholders, provided the existing pre-emptive rights meet the minimum standard of effectiveness. Article 22 of the model articles for private companies in Table B of Schedule 1 which gives each shareholder an equal right to acquire shares being sold by a shareholder qualifies as 'effective'. Articles 21 to 24 apply whenever a shareholder proposes to sell any of her shares and are thus more effective than

⁴⁰ See s 1(6)(c).

⁴¹ See paragraph 2.9.1 below.

the minimum requirement in section 1(6)(c) (ii) which applies only to sales to non-shareholders.⁴² On the one hand, companies that have 'over-effective' pre-emptive rights for transfers will now be subject to similarly stringent pre-emptive rights when they issue shares created under section 75(1), regardless of whether their articles provide for pre-emptive rights to issues⁴³ or contain pre-emptive rights to issues that conform to the minimum standard of effectiveness outlined in the Act. On the other hand, the provision makes no allowance for more comprehensive pre-emptive rights in respect of further issues that may already be contained in the articles of companies. The implication seems to be that the deeming provision replaces any existing pre-emptive rights with respect to further issues.

Fourthly, it is not clear whether the 'necessary changes'⁴⁴ that must be made in order to apply the rules on 'sales' by shareholders to 'offers' by the company would include reading in a qualification that the offer must be for cash consideration. I think that this deeming provision undermines the contractual underpinnings of internal relationships in companies. Private companies should have been given the opportunity to provide for minimum standards of pre-emptive rights in respect of further issues and, if they indeed have stronger pre-emptive rights for further issues, these should have been respected.⁴⁵

The level of protection afforded by an 'effective right of pre-emption' and consequently also of the deemed pre-emptive rights on new issues needs further consideration. It is clear that the primary purpose is to discourage external shareholders rather than to encourage preservation of the relative interests of existing shareholders. This is why selective issues to existing shareholders will not trigger the pre-emptive rights. It is also evident from the fact that the provision does not afford pre-emptive rights in proportion to the relative shareholding or voting power of the shareholders.

Public listed companies are subject to pre-emptive rights under the *JSE*

⁴² However, even if existing pre-emptive rights apply regardless of whether the shares are being sold to shareholders or non-shareholders, only offers to non-shareholders will be subject to the deeming provision.

⁴³ As is the case with the model articles in Table B.

⁴⁴ See s 1(6)(e).

⁴⁵ Criticism can also be expressed against the exclusive focus on pre-emptive rights as a restriction on the transferability of shares. Section 20(1)(a) permits any form of restriction. Private companies with alternative restrictions may have to amend their articles in order to avoid being classified as widely held companies.

Limited Listings Requirements when further shares are issued for cash.⁴⁶ Such issues have to be implemented by way of rights offers to existing shareholders in proportion to their existing holdings.⁴⁷ The Registrar may, with the prior approval of the JSE Limited, permit a company to dispense with this requirement in certain limited instances.⁴⁸ The shareholders may also waive pre-emptive rights.⁴⁹

2.2 Minimum share capital

The Act does not prescribe a minimum authorised or issued capital expressed in monetary terms. There is a minimum capital in the sense that each subscriber to a company has to take up at least 1 share, but the minimum consideration is not prescribed.⁵⁰ The memorandum has to state the number of shares to be taken up by each subscriber.⁵¹ The subscribers to the memorandum have to take up their shares at incorporation.⁵²

Although the existence of a share capital is used to determine the nature of a company,⁵³ the size of this share capital can be negligible.⁵⁴ Many companies are incorporated with a nominal share capital which is insignificant as a form of actual finance and are financed through loans.⁵⁵ The Companies Act impliedly sanctions this practice. An example is found in section 172 which regulates the issue of a certificate to commence business. One of the requirements for such a certificate in

⁴⁶ *JSE Limited Listings Requirements* par 3.30.

⁴⁷ *JSE Limited Listings Requirements* par 3.30.

⁴⁸ *JSE Limited Listings Requirements* par 3.31.

⁴⁹ *JSE Limited Listings Requirements* par 3.32.

⁵⁰ See Delport "Capital Rules" 408. Although the minimum legal tender is 1 cent (see s 15 of the Reserve Bank Act 90 of 1998), each share need not be taken up separately and the consideration need not even consist of money. The share capital of a company could arguably be a fraction of a cent. See *Re Australia and Pacific Technology Ltd* (1994) 13 ACSR 478; *Re Scandinavian Bank plc* [1988] Ch 87 and *Re Cultus Gold NL* (1987) 12 ACLR 433 on nominal values comprising or including fractions of minimum legal tender. In the case of a company limited by guarantee it is required that each subscriber undertake to contribute at least R1, s 52(3)(b). The minimum guarantee fund will thus be R7, see s 32 read with s 19(3).

⁵¹ Section 52(2)(b).

⁵² Section 103(1).

⁵³ See s 19(1)(a), referred to in paragraph 1.1 above.

⁵⁴ See *Re Australia and Pacific Technology Ltd* (1994) 13 ACSR 478 at 480 – 481 where the Supreme Court of Victoria raised the possibility that the par value could be so minimal that the shares could actually be described as having no par value. See also Baxt "Par Value Shares" 515 – 516.

⁵⁵ *Ex parte De Villiers & Another NNO: In re Carbon Developments (Pty) Ltd (in Liquidation)* 1993 (1) SA 493 (A) at 503; *Ex parte Strydom NO: In re Central Plumbing Works (Natal) (Pty)*

the case of a company with a share capital is a statement by each director that in her opinion the capital of the company is adequate for the purposes of the company and its business or, if she thinks it is not adequate, the reasons for this and the manner in which and sources from which the company is to be financed and the extent thereof.⁵⁶ The fact that the procedure is only required in the case of a company with a share capital is significant - it indicates that the reference to 'capital' is to share capital. This clearly recognises that although a company must have a share capital, it need not rely on this share capital and could instead be financed by debt. The Registrar is not given a power to refuse to issue such a certificate on the basis of inadequate share capital. It is not clear to what extent the Registrar scrutinises these statements before granting a certificate to commence business. There is also no express sanction for directors who make false or unsubstantiated statements.⁵⁷

The model articles of association provided in Schedule 1 of the Act limit the borrowing powers of a company to half of its share capital except with the permission of the general meeting.⁵⁸ Companies that have adopted these articles will thus generally have to maintain a certain debt-equity ratio. However, although a limitation on borrowing powers will provide protection to creditors and shareholders,⁵⁹ the primary focus of protection in the model articles is the shareholders, who are free to authorise a higher level of debt.

2.3 Kinds of shares

The share capital of a company can be divided into par value and no par value shares.⁶⁰ However, all the ordinary shares or all the preference shares must

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Ltd 1988 (1) SA 616 (D) at 623.

⁵⁶ Section 172(3)(a). The company will not be able to exercise borrowing powers until the certificate has been issued. It may, however, issue debentures.

⁵⁷ Delport "Capital Rules" 409 suggests that a remedy can be based on common-law fraud.

⁵⁸ Table A art 60, Table B art 61. The *JSE Limited Listings Requirements* oblige listed companies to disclose their borrowing powers and to provide an explanation if it exceeded the limits of its borrowing powers within the past three years, see paragraphs 7.A.12 and 7.A.13.

⁵⁹ Delport *Verkryging* 58.

⁶⁰ Section 74. Banks may not have no par value shares, see s 79(1)(a) of the Banks Act 94 of 1990. This regime is likely to continue under the new Companies Act, see item 6(1) of Schedule 7.

consist of either the one or the other.⁶¹ This dual system is implemented through a number of other provisions dealing with different aspects of share capital and membership rights associated with each of these types of share.

The option of having shares without par value was first introduced in South Africa in the 1973 Companies Act.⁶² The Van Wyk de Vries Commission was specifically instructed to investigate the desirability of allowing no par value shares.⁶³ The Commission referred to the Gedge Report⁶⁴ and the Jenkins Report⁶⁵ in England.⁶⁶ It concluded that in most respects there was not much practical difference between the two systems. The only difference was that a no par value share would not have the label of a fixed amount attached to it. Such a label or indication of value was thought to be misleading since there need not be any relationship between the par value and the inherent value of a share⁶⁷ and also because it could be misleading to express dividends as a percentage of par value rather than of capital invested.⁶⁸

Despite its conviction that no par value shares could do no harm and should be introduced as an alternative, the Van Wyk de Vries Commission nevertheless thought it wise to impose certain restrictions 'at least until the new system was known in practice'.⁶⁹ These restrictions did not enjoy the further attention of the legislature.⁷⁰ This may be because the new system never really became widely used in practice.⁷¹

The first restriction was that all ordinary shares must be of one kind and all

⁶¹ Section 74 proviso.

⁶² See Louw "Aandele Sonder Pari-waarde" 53 – 55 for an overview of the history of no par value shares.

⁶³ *Main Report of the Commission of Enquiry into the Companies Act* (RP 45 of 1970), hereafter 'Van Wyk de Vries *Main Report*', 34.01.

⁶⁴ *Report of the Committee on Shares of No Par Value* (Cmnd 9112) of 1954, hereafter 'Gedge Report', see 34.05 and 34.14

⁶⁵ *Report of the Company Law Committee* (Cmnd 1749) of 1962, hereafter 'Jenkins Report'. Although the Jenkins Committee recommended the introduction of no par value shares, they were never introduced in England. See Chapter 2 paragraph 2.3.

⁶⁶ See Van Wyk de Vries *Main Report* 34.05, 34.06 and 34.15.

⁶⁷ Van Wyk de Vries *Main Report* 34.10.

⁶⁸ Van Wyk de Vries *Main Report* 34.11.

⁶⁹ See Van Wyk de Vries *Main Report* 34.13.

⁷⁰ Van der Linde "Par-value or No-par-value" 477

⁷¹ See Delpont *Verkryging* 20 – 21 note 32 where reference is made to a press release by the Standing Advisory Committee on Company Law in 1985 in which the success and usefulness of no par value shares was said to be debatable.

preference shares of one kind.⁷² The explanation given for this rule was that confusion could arise if part of the capital consisted of par value shares and part of no par value shares.⁷³ The Commission probably had in mind the establishing of relative voting rights of shareholders. The second restriction that was recommended in view of the Commission's self-admitted cautious approach to the introduction of no par value shares was the regulation of the minimum issue price of subsequent issues of no par value shares.⁷⁴

Although the Commission was not asked to report on the desirability of retaining par value shares, it referred to several disadvantages of par value shares and indicated that some of these disadvantages required further investigation at a later stage.⁷⁵ The report mentioned the fact that the no discount rule did not offer shareholders any protection against the subsequent issue of shares at a lower premium than they had paid, or at a price lower than the current value of the shares.

An analysis of the Van Wyk de Vries Report reveals that the Commission considered only the type of no par value share that was recommended by the Gedge Commission, namely shares where the full consideration or issue price had to be transferred to the stated capital account, thus leaving the company no room to allocate any part of the consideration to surplus or reserves. The Gedge Commission considered no par value systems in various jurisdictions, including America where a number of different systems were used.⁷⁶ In some systems corporations were free to allocate any portion of the consideration to stated capital and reserves;⁷⁷ in others they could allocate a prescribed maximum percentage of the consideration to a paid-in surplus account.⁷⁸ However, these alternatives were not considered by the Van Wyk de Vries Commission.

Shares without par value are rarely used in South Africa.⁷⁹ Although the par

⁷² Section 74 proviso.

⁷³ See Van Wyk de Vries *Main Report* 34.13.

⁷⁴ See s 82, discussed in paragraph 3.1.2 below.

⁷⁵ Van Wyk de Vries *Main Report* 34.16 – 34.18.

⁷⁶ See paragraph 13 of the Gedge Report.

⁷⁷ See s 154 of the Delaware General Corporation Law of 1967, discussed in Chapter 4 paragraph 2.2.4. Amounts allocated to reserves constitute paid-in surplus and can be distributed freely to shareholders.

⁷⁸ See also Manning *Legal Capital* 41.

⁷⁹ Cilliers & Benade *Corporate Law* 223 note 1. See also McLennan "Abolition of Par-value" 43.

value concept has been criticised as potentially misleading,⁸⁰ this has not deterred companies from using par value shares to the almost complete exclusion of no par value shares.⁸¹

The reason for the unpopularity of no par value shares in South Africa has not been established empirically.⁸² Perhaps some deductions can be made by comparing the provisions regulating the various aspects of par and no par value shares.⁸³

2.3.1 Comparison of par and no par value shares

Despite an attempt to ensure neutrality between these two types of shares - which probably also removed most of the advantages of no par value shares - various differences remain. The one essential difference between par and no par value shares, namely the presence or absence of an indicator of value, translates into a number of consequential differences. As will appear from the discussion below, the South African dual system does not succeed in achieving neutrality between par value and no par value shares. In many respects the current no par value share is more restrictive than a par value share.

2.3.1.1 Statement of authorised capital

In the case of par value shares the authorised capital is expressed as an amount, divided into shares of a specific amount.⁸⁴ Authorised capital thus reflects the par value of the shares.

When no par value shares are used, the authorised capital will not be reflected as an amount.⁸⁵ However, once the shares are issued the full

⁸⁰ McLennan "Abolition of Par-value" 43 note 3; *Policy Framework* 2.2.3.

⁸¹ The unpopularity of no par value shares is noted by Cilliers & Benade *Corporate Law* 223; Delpont *Verkryging* 20 – 21; McLennan "Abolition of Par-value" 43.

⁸² McLennan reports that he asked a couple of practitioners, but to no avail, see McLennan "Abolition of Par-value" 43.

⁸³ This analysis of the differences between par value and no par value shares is largely based on an earlier article by this writer, see Van der Linde "Par-value or No-par-value" 477 – 484.

⁸⁴ Section 52(2).

⁸⁵ As regards the statement of authorised capital, it seems as if there was some confusion as to exactly how the authorised capital of a company having no par value shares should be stated. In paragraph 34.08 of the Van Wyk de Vries *Main Report* it is said that in a case where the capital is divided into no par value shares, the company would declare its capital to be "R1 000, divided into 100 shares". In as much as the impression could be created that the total authorised capital of a company having no par value shares would also be stated, this is

consideration or issue price will be reflected in the stated capital account.⁸⁶ The requirement that the consideration for no par value shares should be reflected in a stated capital account has been described as a remnant of the par value system,⁸⁷ but this is not entirely accurate. The stated capital account is rather the equivalent of the aggregate of issued share capital, made up of the aggregate par value, and the share premium account in order to reflect the total issue price. This is clearly illustrated by the conversion provisions, discussed below.

2.3.1.2 Conversions

When par value shares are converted into no par value shares, the full issue price of the par value shares (the par value plus the premium) must be transferred to the stated capital account.⁸⁸ Upon a conversion of all ordinary or preference (or both) par value shares into no par value shares the whole of the ordinary or preference share capital, as well as the whole of the share premium account or part thereof contributed to it by the shares being converted, must be transferred to the stated capital account.⁸⁹ The requirement that the part of the share premium account that was contributed by the shares being converted should be transferred to the stated capital account will apply when the company had both ordinary and preference par value shares and only one type is being converted or where only some shares of a class were issued at a premium.⁹⁰ It is not clear how it should be determined which part of the share premium account was 'contributed' by the shares being converted if the share premium account has previously been 'applied' as provided for in section 76(3).⁹¹

If no par value shares are converted into par value shares, the whole of the stated capital account or the part thereof contributed by the shares so converted

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wrong and not borne out by section 52(2)(a)(ii) as proposed by the Commission in the same report. This proposed provision required only the number of shares to be stated. The conflicting explanation in the report may have resulted from earlier thoughts on the implementation of the new system.

⁸⁶ Section 77(1).

⁸⁷ Louw "Aandele Sonder Pari-waarde" 58.

⁸⁸ Section 78.

⁸⁹ Section 78(1). Fractions may be rounded off, but material reductions have to be carried over to a non-distributable reserve, see s 78(3) which is discussed in paragraph 2.4.5 below.

⁹⁰ The proviso to s 74 makes it impossible to convert only some classes of ordinary or preference shares.

must be transferred to the share capital account.⁹² If the stated capital account has been applied as provided for in section 77(3), the determination of the part of that account that can be said to have been contributed by the shares being converted may be problematic. The par value of the converted shares will be determined by dividing the stated capital contributed by each class of converted shares into the number of shares in that class. A company converting its no par value shares into par value shares is not allowed the flexibility of determining a lower par value for the new par value shares and allocating the balance of the stated capital account to the share premium account. The reason for this rigidity is not clear.

2.3.1.3 Stated capital and share premium account

Since the stated capital account is to some extent the equivalent of the share capital account plus the share premium account,⁹³ it is important to compare the purposes for which a share premium account can be applied with the possible applications of the stated capital account. Both can be used to defray preliminary expenses. The fact that the stated capital account can be so used, while the share capital account cannot, reflects the fact that stated capital could have a 'premium' element because it reflects the total consideration received for no par shares. If par value shares are issued at par, preliminary expenses may not be covered out of the share capital account. This could be regarded as a disadvantage of par value shares that are issued at par.

2.3.1.4 Minimum issue price

Another important difference between par and no par value shares is the way in which the minimum issue price payable to the company is regulated. Par value shares may not be issued for a consideration lower than their par value,⁹⁴ unless a

Continued

⁹¹ This provision is discussed in paragraph 2.4.3.3.2 below.

⁹² Section 78(2). Fractions may be rounded off in terms of s 78(3), and any material reductions have to be placed in a non-distributable reserve. The implications of this reserve are dealt with in paragraph 2.4.5 below.

⁹³ See Van der Linde "Par-value or No-par value" 480. The full consideration for no par value shares is reflected in the stated capital account while the full consideration for par value shares is reflected in the share capital account plus, if the shares were issued at a premium, the share premium account.

⁹⁴ *Ooregum Gold Mining Co of India Ltd v Roper* [1892] AC 125 (HL). See also *Etkind & Others v Hicor Trading Ltd & Another* 1999 (1) SA 111 (W).

discount has been approved by the court in terms of section 81. No par value shares may be issued at any price, but section 82 requires an issue at a price below the average issue price of the class to be sanctioned by special resolution. At first glance these two rules may appear similar in nature. However, their objectives differ substantially.⁹⁵ The rule for no par value shares offers more protection to existing shareholders because the total consideration payable by the new shareholders is regulated. The company's freedom to determine an issue price, which is traditionally regarded as an advantage of no par value shares, is thus restricted considerably by section 82. A company that issues shares with a very low par value at a premium thus has far more freedom in determining an issue price than a company issuing no par value shares. Shareholders of par value shares enjoy only limited protection in this regard because share premiums they may have paid are not required to be taken into account when the company determines the issue price of further shares of that class. Although these differences and the resultant anomalies were considered by the Van Wyk de Vries Commission and identified as an issue that required further attention,⁹⁶ the improvement of the rule in respect of par value shares was left for future review.

2.3.1.5 Apportionment of shareholding

The allocation of membership participation rights such as the right to vote or to call a meeting could differ depending on whether the members hold par value or no par value shares. Voting rights of par value shareholders in public companies are determined according to the nominal value of their shares, while holders of no par value shares have one vote in respect of each share.⁹⁷ Since only the nominal value is taken into account in determining the voting rights of par value shareholders, shareholders who subscribed for shares at a premium may have voting rights that are disproportionately small in relation to their actual investment in the company. A public company could thus manipulate the relative voting rights of different classes of shares by the ratios between nominal values and share premiums. This could be unfair to shareholders who paid large premiums. The

⁹⁵ See paragraph 3.7.1 below.

⁹⁶ Van Wyk de Vries *Main Report* 34.16 – 34.18.

⁹⁷ Section 195(1).

situation for no par value shares is also that there is no correlation between the capital actually contributed (by the shareholder or by the class in the aggregate) and voting rights.

Where a company has par value as well as no par value shares, the apportionment issues are further complicated. It is probably this concern which lay behind the requirement that all the ordinary shares or all the preference shares must be of one kind. There would be no problem if a company has only one class of ordinary shares and one class of non-voting preference shares. However, when preference shares have voting rights either because such rights have not been excluded by the articles or because of the operation of section 194, problems arise regardless of whether the preference shares or the ordinary shares are the no par value shares. The Act does not make provision for establishing the relative weighting of voting rights attaching to par and no par value shares in the same company.⁹⁸ Section 195(1)(a) states that a member will have a certain proportion of the total votes in the company, determined according to the ratio between the nominal value of her shares and the total nominal value of all the shares issued by the company. The 'total votes in the company' in this provision can by necessary implication only refer to votes held in respect of shares having a nominal value. There is no room in this equation for the inclusion of further votes in respect of no par value shares. It would appear as if a company would have to determine the total number of votes attaching to its par value shares and then add to that total one vote for each no par value share.⁹⁹ The alternative would be to interpret the reference in section 195(1)(a) to the nominal value of shares to include the book value of no par value shares, but this interpretation would not make sense against the background of the 'one share one vote' principle that applies to no par value shares. In any event, neither of these solutions accord with the literal meaning of section 195(1)(a).

In relation to the right to call a general meeting, the Companies Act uses at least three different criteria relating to share capital, namely the holding of certain percentages of the company's 'capital', 'issued share capital' and 'shares issued'.

⁹⁸ James "Arranging a Company's Capital" 39 states that in relation to the capital contributed, the one vote allocated to each no par value share could amount to more than the voting right to which a par value share is entitled, but does not suggest how the relative weighting is to be established. See also Blackman, Jooste & Everingham *Companies Act 7-52 – 7-52-1*.

⁹⁹ If ordinary as well as preference shares are voting.

Although these provisions appear to be neutral between par and no par value shares, their application is far from clear. The right to request a general meeting is afforded to members who together hold at least 5 per cent of the 'capital' of the company which confers the right to vote.¹⁰⁰ The inclusion of the reference to voting rights could create the impression that this provision relies solely on voting rights. However, since it refers to the holding of 'capital', another possible interpretation is that regard must be had to the share capital contributed by the members in respect of the voting share capital. Where the company has par value as well as no par value shares that confer the right to vote, there may be a problem apportioning the capital held by the different shares.¹⁰¹

It is not clear whether only the nominal value contributed should be taken into account as 'capital', or also the premium that a shareholder paid. On the one hand it can be argued that the share premium is not really share capital but only treated as if it is, and that only the amounts of the share capital account and stated capital account are relevant. Such an interpretation will favour holders of no par value shares in comparison with holders of par value shares who paid the same consideration, but in the form of a low par value and a high premium. On the other hand, in *Sage Holdings Ltd v The Unisec Group Ltd & Others*¹⁰² the court indicated that 'capital' referred to the 'funds invested' in the company or the 'full issue price' of shares.¹⁰³ This statement has lead commentators to argue that the share premium account also has to be taken into account in determining the percentage of equity share capital held.¹⁰⁴ Although the remarks in *Sage Holdings Ltd v The Unisec Group Ltd & Others* were *obiter*, and further related to a definition of subsidiary which has since been amended, they may still be relevant for purposes of section 226(1A)(b)(ii), which uses a similar test to determine when a director will be deemed to control another company for purposes of the prohibition of loans. The remarks are also relevant for the provisions that refer to

¹⁰⁰ Section 181(1)(a).

¹⁰¹ This problem is unlikely to arise in practice, since the voting rights of preference shares, which in this scenario will be either all the par value or all the no par value shares, are usually excluded.

¹⁰² 1982 (1) SA 337 (W).

¹⁰³ At 353. However, the court also stated that these amounts would be reflected in the share capital account and stated capital account of a company, which is obviously not accurate if the shares have been issued at a premium.

¹⁰⁴ See Oosthuizen "Sage Holdings" 74; Brooks "Share-capital Related Determinants" 103.

the holding of a certain percentage of share capital.

While the interpretation in *Sage Holdings Ltd v The Unisec Group Ltd & Others* would solve the problem of balancing the total contributions of no par value shares and low par value shares issued at a high premium, it would create far greater problems in apportioning the rights of par value shareholders among themselves. The question would arise whether a particular shareholder who acquired shares at a premium would be 'holding' more of the share capital than a shareholder who acquired shares at par. A possible solution would be to work with the average price paid by all the holders of that class, but the Act makes no provision for such a step. Further, the effect of an application of the share premium account on the capital held by holders of par value shares would be uncertain. The suggestion of the court in *Sage Holdings Ltd v The Unisec Group Ltd & Others* would also have to apply to companies that do not have shares without par value, but have different classes of par value shares. It is submitted that this interpretation cannot be supported. The share premium account should thus not be taken into account in determining capital held.

Members holding not less than ten per cent of the 'issued share capital' may demand that voting at a meeting takes place by way of a poll.¹⁰⁵ The difficulty of allocating rights between par and no par value shares once again raises its head. It seems that the emphasis is placed on the issued capital, although in this instance it is not limited to equity capital. The intention was clearly to look at something more than voting rights, because a poll can also be demanded by members who hold ten per cent of the voting rights, giving rise to the same difficulty of determining the total voting rights in the company.¹⁰⁶

A meeting to consider the appointment of an inspector can be called by members holding not less than 5 per cent of the 'shares issued'.¹⁰⁷ This seems to be a reference to the number of shares only, regardless of whether they are par value or no par value shares and regardless of whether they are voting shares or not.

A consideration of the possible reasons why different standards are set for exercising these rights falls outside the scope of this thesis. However, it is clear

¹⁰⁵ Section 198(1)(b)(iii).

¹⁰⁶ Section 198(1)(b) (ii). Alternatively, at least 5 members may demand a poll, s 198(1)(b)(i).

that where a company has voting par value as well as voting no par value shares, the relative equity interests of these shares are not treated on a consistent basis.

2.3.1.6 Prescribed fee on authorised capital

A distinction is made between par and no par value shares in determining the prescribed fee payable on a company's authorised capital. The fee, which is payable in addition to the general prescribed fee of section 63(1), is R5 for each R1000 or part thereof of the nominal capital and R5 for each 1000 no par value shares or part thereof. The two bases upon which the fee is calculated may in particular instances influence a company's decision to use either par value or no par value shares.¹⁰⁸ Shares with a low par value which are to be issued at a high premium will hold obvious advantages over no par value shares which will eventually be issued for a very low consideration, for example, for 1 cent each.¹⁰⁹ Conversely, no par value shares which will be issued for a relatively high consideration will prove to be more economical than shares with a correspondingly high par value.¹¹⁰

The basis for the calculation of the fee when a company increases its capital by further no par value shares differs from that pertaining to initial no par value shares. The fee payable for the increase in authorised no par value shares is calculated with reference to the average issue price of all the existing no par value shares.¹¹¹ The number of further shares is then multiplied by this average price and a fee of R5 is payable for every R1 000 or part thereof.¹¹² This provision in

Continued

¹⁰⁷ Section 257.

¹⁰⁸ See Jooste "No-par-value shares" 228.

¹⁰⁹ For example: the prescribed fee on an authorised capital of 1 million no par value shares which will be issued at 1 cent each to raise R10 000, will be R5 000. However, if the authorised capital is R10 000, divided into 1 million shares with a par value of 1 cent each, the fee will be R50 only. It is interesting to note that the difference in stamp duties between par and no par value shares has also been identified as a factor tipping the scale in favour of the use of par value shares in the USA, see Manning *Legal Capital* 30.

¹¹⁰ For example: the prescribed fee on an authorised capital of R1 million divided into 10 000 shares with a par value of R100 each, will be R5 000. However, the fee on 10 000 no par value shares, which will be issued at R100 each to give stated capital of R1 million, will be R50 only.

¹¹¹ Section 75(3)(b)(i). No provision is made for determining the average issue price of a particular class of no par value share.

¹¹² Section 75(3)(b)(ii).

effect gives a fictitious 'nominal value' to no par value shares.¹¹³ It seems to be based on the assumption that the shares will be issued at approximately the average issue price. In view of the fact that this provision makes no allowance for different classes of no par value shares, this assumption can be disputed. If the company issues the new no par value shares at a lower price - either because different classes are involved, or because the issue was sanctioned under section 82, it will be paying a higher fee than that payable for comparable par value shares.

Another point of criticism against the calculation of the fee upon an increase in authorised no par value shares is that no exception seems to be made for a subdivision of shares where the company will not receive any further consideration.¹¹⁴ The fee would be payable on the original average issue price of the existing shares, multiplied by the number of 'new' shares. Compared to par value shares, where the fee for an increase of shares is determined with reference only to the par value of the new shares,¹¹⁵ even if the new shares are of the same class as existing shares that were issued at a considerable premium, the discrepancy between the fees for par and no par value shares becomes very prominent. Logically, the fee for an increase in no par value shares should have been determined on the basis of the number of shares only. Special provision should be made for an exemption in respect of a subdivision of existing shares. The use of the average issue price of all the no par value shares, without regard to different classes, detracts from the flexibility of no par value shares.

2.3.1.7 The concept of average issue price.

In addition to forming the basis of the prescribed fee on an increase of authorised capital, the average issue price of no par value shares is used for purposes of certain other provisions of the Act. As will be explained below, section 82 regulates the issue of no par value shares at a price lower than the average issue price.¹¹⁶ Fortunately this provision distinguishes between different classes of no par value shares. Likewise, section 85(6) provides for the adjustment of the stated capital

¹¹³ See Blackman, Jooste & Everingham *Companies Act* 5-18.

¹¹⁴ Blackman, Jooste & Everingham *Companies Act* 5-18.

¹¹⁵ Section 75(3)(a).

¹¹⁶ See paragraph 3.1.2 below.

account following a share buy-back with reference to the average issue price of the particular class of shares.¹¹⁷

When no par value preference shares are redeemed out of profits, it is required that an amount equal to the 'book value' of the redeemed shares be transferred to a capital redemption reserve fund.¹¹⁸ The book value is defined as the part of the stated capital account contributed by the shares being redeemed.¹¹⁹ It is not clear how this provision will be applied if no par value shares of the same class were issued at different prices and not all the shares are to be redeemed.¹²⁰

2.3.1.8 Dividends per share

The size of dividends declared is expressed as a percentage of the par value of a share or, in the case of no par value shares, as a fixed amount per share.¹²¹ If a par value share is issued at a premium, reflecting the earnings in relation only to the nominal value, rather than to the total capital invested in the company, gives a distorted view of the profitability of the company.¹²² However, even in respect of no par value shares the perceived profitability of the shares can be deceiving unless the return is expressed as a percentage of the current value of the share.

2.3.2 Evaluation of dual system of shares

The differences alluded to above may provide an explanation for the unpopularity of no par value shares. It appears that no par value shares as currently regulated in the Act are not perceived as flexible but are in fact more onerous than par value shares in a number of respects. A consideration of these differences can assist any decision on the types of shares that should be used in a reformed company law system and the way in which these shares should be regulated. The legal implications resulting from the choice of a particular type of share do not depend as much on the name given to that share as on the way in which the legislation regulates it.

¹¹⁷ See paragraph 6.3.3 below.

¹¹⁸ Section 98(1)(b).

¹¹⁹ Section 98(6).

¹²⁰ See paragraph 6.8 below for a discussion of redemptions.

¹²¹ Van Dorsten *Dividends* 21.

¹²² Louw "Aandele Sonder Pari-waarde" 56

The lack of clarity on the relative voting rights of holders of par value shares and of no par value shares in the same company undermines the principle of proportionate voting rights. It is impossible to give effect to section 195 of the Act where a company has voting preference shares of another kind than its ordinary shares.¹²³

In public companies, par value shares that are initially issued at a premium allow for considerable flexibility in arranging the voting and other rights of shareholders. They can be exploited to affect the balance between different classes of par value shares envisaged by the Act.¹²⁴ This device can also be used by private companies to mask unequal voting rights.

The application of provisions that are dependent on contributions to issued share capital also disadvantages holders of par value shares relative to holders of no par value shares. This is because the full consideration paid in respect of no par value shares is taken into account, but any premium paid on par value shares is disregarded.

It is submitted that, irrespective of the relative merits of par value and no par value shares,¹²⁵ the current dual system is unworkable.

2.4 Share capital and reserve accounts

The consideration received by a company for the issue of its shares is required to be reflected in specific accounts.¹²⁶ The Companies Act contains a number of provisions aimed at ensuring the accuracy of these accounts. A company has to report on these accounts annually.¹²⁷ The Act thus requires disclosure of the capital structure of a company.¹²⁸ In a capital maintenance system, the capital accounts reflect what may not be returned to shareholders. However, as pointed out by the authors of Blackman, Jooste & Everingham *Companies Act* these accounts are no longer of direct concern to creditors, but only for shareholders.¹²⁹

¹²³ See paragraph 2.3.1.5 above.

¹²⁴ See paragraph 2.3.1.5 above.

¹²⁵ An issue which is considered in paragraph 2.9.3 below.

¹²⁶ Sections 75 – 77.

¹²⁷ Schedule 4 article 8.

¹²⁸ See Delport *Verkryging* 49.

¹²⁹ Blackman, Jooste & Everingham *Companies Act* 5-16.

In some respects the share capital accounts can be construed as a notional liability which signifies the rights of shareholders to the 'return of capital' by sharing in the net assets of the company upon dissolution. These accounts reflect the entitlement of shareholders *inter se* and are particularly important if a company has different classes of shares.¹³⁰

2.4.1 Share capital account

The nominal value of the issued par value shares must be reflected as issued share capital in respect of each class of par value shares. Although there is no express provision to this effect, this requirement can be inferred from the provisions of the Companies Act that regulate the conversion of par value shares into no par value shares and *vice versa*.¹³¹ Section 78(1)(a) refers to 'ordinary or preference share capital' and indicates that there should be separate accounts in respect of ordinary and preference shares, Section 78(2) expressly refers to a 'share capital account' and requires it to reflect the consideration received in respect of no par value shares if they are subsequently converted into par value shares. It can thus be inferred that the consideration originally received on par value shares should also be reflected in a share capital account, except for any premium which has to be reflected in a share premium account as required by section 76(1).¹³² This inference is supported by the requirements for the adjustment of capital accounts following a variation of capital¹³³ or a repurchase of shares¹³⁴ as well as from the requirements for a company's balance sheet.¹³⁵ It also appears from form CM14A of the Companies Administrative Regulations, which has to be submitted following a repurchase of shares, that the total issued

¹³⁰ Blackman, Jooste & Everingham *Companies Act* 5-16.

¹³¹ Section 78.

¹³² The share premium account is discussed below.

¹³³ Section 75. See paragraph 2.5 below.

¹³⁴ Section 85(5), discussed in paragraph 6.3.3 below.

¹³⁵ Schedule 4 paragraph 8(1)(c). The balance sheet has to set out the authorised and issued share capital, classes of shares, number of issued shares and their par value if any, amount of issued capital in respect of each class of shares, share premium account, preliminary expenses etc charged against share premium or against stated capital in the accounting period. Shares issued during the accounting period, classes, number, aggregate nominal or stated value and consideration received, paragraph 8(1) and (2). The corresponding amounts for the previous year must also be given.

capital of a company is made up of issued paid-up capital,¹³⁶ stated capital and share premium account. In some instances the Companies Act uses the concept 'issued share capital' to refer to the account(s) in which the par value is reflected.¹³⁷

When par value shares are issued at a discount in accordance with section 81,¹³⁸ the share capital account nevertheless reflects the par value of the shares and not the discounted price.¹³⁹ The structure of the provisions on issued capital, for example the requirement in section 85(5) that the par value of shares acquired by the company be deducted from the share capital account, implies that the par value rather than the discounted consideration has to be reflected. This is also borne out by the requirement that details of any discount 'that has not been written off' must appear in any prospectus subsequently issued by the company.¹⁴⁰

The Companies Act does not contain any provision for the application, as opposed to the 'decrease' or adjustment,¹⁴¹ of a share capital account. Unlike the share premium account and stated capital account, it may not be used for writing off preliminary expenses and expenses and commission incurred in creating or issuing the shares.¹⁴² The share capital account will thus at all times reflect the aggregate par value of the issued shares.

Although section 79 allows capital to be used in the payment of interest, the amount of the paid-up capital is not thereby reduced.¹⁴³ It also appears that the issued capital will not be reduced by commissions paid in terms of section 80.¹⁴⁴ As in the case of a discount under section 81, details of the commission or discount must be disclosed.¹⁴⁵

¹³⁶ Usually referred to as the 'share capital account'.

¹³⁷ See s 85(5); Schedule 4 paragraph 8; Form CM14A.

¹³⁸ As to which, see paragraph 3.1.1 below.

¹³⁹ Cilliers & Benade *Corporate Law* 328. The discount is treated as a fictitious asset.

¹⁴⁰ Section 81(3).

¹⁴¹ See paragraph 6.3.3 below.

¹⁴² Compare s 77(3).

¹⁴³ Section 79(2)(d).

¹⁴⁴ Commissions are discussed in paragraph 3.5 below.

¹⁴⁵ Section 80(1)(c). In this case disclosure is also required in a statement or circular when there is no prospectus.

2.4.2 Stated capital account

The full proceeds of an issue of no par value shares is required to be reflected in a stated capital account.¹⁴⁶ This rule applies also to non-cash consideration.¹⁴⁷ The value of the non-cash consideration, as determined by the directors, must be transferred to the stated capital account.¹⁴⁸ There are indications that a separate stated capital account is envisaged for each class of no par value shares.¹⁴⁹

The stated capital account may be applied in writing off the preliminary expenses of the company or the expenses of and commission on the creation or issue of no par value shares.¹⁵⁰ This exception to the principle that paid-up capital should always be reflected as such in the appropriate account was probably introduced to make the alternative option of no par value shares viable.¹⁵¹ In the case of par value shares, these costs could be written off against any share premium account.¹⁵²

2.4.3 Share premium account

The regulation of the share premium account has been criticised as being out of step with the provisions currently regulating distributions to shareholders.¹⁵³ It has also been said that the share premium account has always been an anomaly, even under the capital maintenance system.¹⁵⁴ A brief exposition of the history of the share premium account could throw some light on these allegations. I will then discuss the composition of the share premium account, after which I will consider the status and application of the share premium account. I will also analyse the possible justifications for the regulation of share premiums, both within a capital maintenance system and a system based on solvency and liquidity. An important issue here is whether shareholders who contributed a premium should enjoy any protection when it comes to the application of the share premium account.

¹⁴⁶ Section 77(1).

¹⁴⁷ See further paragraph 3.3 below on the regulation of non-cash consideration.

¹⁴⁸ Section 77(2).

¹⁴⁹ See paragraph 2.3.1.3 above.

¹⁵⁰ Section 77(3).

¹⁵¹ De Wet & Yeats *Handelsreg* 563.

¹⁵² See s 76(3).

¹⁵³ See Wainer "Problems and Doubts" 133.

¹⁵⁴ Blackman, Jooste & Everingham *Companies Act* 5-23.

2.4.3.1 History of the regulation of share premiums

Until the predecessor of section 76 was introduced in 1952,¹⁵⁵ premiums received on the issue of shares were regarded as distributable surplus.¹⁵⁶ Creditors could rely on the maintenance of the par value share capital of a company, but had no interest in any excess consideration received by the company.¹⁵⁷

The introduction of the share premium account and the limitations imposed on its distribution in effect meant that the capital maintenance principle was extended to premiums received by the company. As a result, dividends could strictly speaking be paid only if the company's net assets exceeded its paid-up share capital as well as the amount reflected in its share premium account. Further, the capital reduction provisions were expressly made applicable to the share premium account.¹⁵⁸ The share premium account could, however, be applied for certain purposes for which the share capital account could not be used.¹⁵⁹

In the Companies Act of 1973 the share premium provisions were re-enacted as section 76. An amendment was necessary in 1974 to extend the application of the provision to pre-existing share premium accounts created under the previous Act.¹⁶⁰ In 1992 two provisos to section 76(3)(c) were inserted to limit the extent to which the share premium account may be applied to provide for a premium on the redemption of shares.¹⁶¹

Until 2001,¹⁶² section 76(1) provided that the provisions relating to the

¹⁵⁵ Section 86 *quat* of the 1926 Companies Act, inserted by s 71 of the Companies Amendment Act 46 of 1952. It was introduced on the recommendation of the Millin Commission, see *Verslag van die Kommissie van Ondersoek insake die Wysiging van die Maatskappywet* (UG 69) of 1948 par 114, following the recommendation of the Cohen Committee in England, see *Report of the Committee on Company Law Amendment* (Cmnd 6659) of 1945 par 108.

¹⁵⁶ *Ex parte Anglo-American Corporation of South Africa Ltd* 1977 (4) SA146 (W) at 149. See also Blackman, Jooste & Everingham *Companies Act* 5-20.

¹⁵⁷ At that stage all shares were par value shares, see paragraph 2.3 above.

¹⁵⁸ This is significant in view of the role that the existence of formal reduction provisions played in the early development of the capital maintenance principle, see Chapter 1 paragraph 2.

¹⁵⁹ Section 86*quat*(2) of the 1926 Companies Act. It could be applied to pay up capitalisation shares, to write off formation costs and commissions, or to provide a premium on redemption of shares.

¹⁶⁰ In this regard, subs (5) was inserted by s 5 of the Companies Amendment Act 76 of 1974.

¹⁶¹ By s 3 of the Companies Amendment Act 82 of 1992. See paragraph 2.4.3.3.2 below for a discussion of these provisos.

¹⁶² Before being amended by the Companies Amendment Act 35 of 2001.

reduction of the share capital¹⁶³ applied to the share premium account. The heading of the section read (as it still does) 'Premiums received on issue of shares to be share capital, and limitation on application thereof'. The share premium account could thus only be applied for the purposes outlined in the Act and the provisions regarding reduction of capital applied to it.¹⁶⁴ The annual duty which was at some stage payable by companies on the amount of their capitalisation¹⁶⁵ applied also to the share premium account.¹⁶⁶

Although section 76(3) was amended in 1999 by the insertion of paragraph (d),¹⁶⁷ subsection (1) was not amended until 2001.¹⁶⁸ Its interpretation during the period when it still referred to the provisions on reduction of capital was uncertain.¹⁶⁹ Some writers argued that the share premium account could be written off freely as the common-law position had been restored,¹⁷⁰ a view that was criticised by others.¹⁷¹

In 2001 the legislature removed the reference in section 76(1) to the obsolete reduction of capital provisions, replacing it with a reference to 'the provisions of this Act relating to the share capital of a company' and adding the words 'as if the share premium account were paid-up share capital of the company'.¹⁷² The heading of the section was not changed, however, and still refers to a limitation on the application of premiums.

¹⁶³ That is, s 83 to s 90 of the Companies Act prior to its amendment in 1999.

¹⁶⁴ See s 76(3) prior to its amendment in 1999 by s 6 of the Companies Amendment Act 37 of 1999. See also Blackman, Jooste & Everingham *Companies Act* 5-25.

¹⁶⁵ Section 174, repealed by s 8 of the Companies Amendment Act 31 of 1986.

¹⁶⁶ See *Ex parte Trencor Ltd* 1977 (2) SA 396 (C) for an example of an unsuccessful application by a company to reduce its share premium account in order to reduce the annual fee on share capital that was levied at the time under s 174. See Blackman, Jooste & Everingham *Companies Act* 5-24 note 1.

¹⁶⁷ By s 6 of the Companies Amendment Act 37 of 1999. See paragraph 2.4.3.3.2 for a discussion of s 76(3)(d).

¹⁶⁸ By s 9 of the Companies Amendment Act 35 of 2001.

¹⁶⁹ See Blackman, Jooste & Everingham *Companies Act* 5-24, Cilliers & Benade *Corporate Law* 337.

¹⁷⁰ Butler "Nuwe Statutêre Bevoegdheid" 288.

¹⁷¹ Blackman, Jooste & Everingham *Companies Act* 5-25 in the original issue. Wainer "Problems and Doubts" 134.

¹⁷² Section 9 of the Companies Amendment Act 35 of 2001.

2.4.3.2 *Composition*

Any premium received on par value shares must be reflected in an account called the share premium account.¹⁷³ Where par value shares are issued for assets and no consideration has been recorded, the assets have to be valued and any excess value over the amount of the par value must be transferred to the share premium account.¹⁷⁴ This requirement regarding non-cash consideration would thus also apply where shares are issued in exchange for shares in another company, as is often the case in mergers and amalgamations of companies.

Unlike the English Companies legislation, which provides for relief in the case of mergers, takeovers and group reconstructions,¹⁷⁵ the South African Companies Act does not provide any exception or relief in such instances. Until the repeal of sections 83 and 84 of the Companies Act¹⁷⁶ companies involved in such transactions often approached the court for a reduction of the share premium account.¹⁷⁷ If par value shares are retained in the new South African legislation, a relief similar to that provided for in the English Companies Acts of 1985 and 2006¹⁷⁸ could be considered for South Africa.

2.4.3.3 *Status of share premium account*

It is provided that the 'provisions relating to the share capital of a company' apply to the share premium account 'as if it was paid-up share capital', except as set out in section 76 itself.¹⁷⁹ The exceptions to the principle established in subsection (1) are then set out in subsection (3) which lists the possible purposes for which the share premium account may be applied.¹⁸⁰

¹⁷³ Section 76(1).

¹⁷⁴ Section 76(2). Meskin *Henochnberg on the Companies Act* argues that the valuation rather than any recorded value will be conclusive, see 155 – 156.

¹⁷⁵ As to which see paragraph 2.4 of Chapter 2.

¹⁷⁶ By s 8 of the Companies Amendment Act 37 of 1999.

¹⁷⁷ See *Ex parte National Packaging Co Limited* 1965 (1) SA 542 (W), decided under the predecessor of s 84, s 48 of the 1926 Companies Act, where a holding company was allowed to reduce its share premium account to pay for shares in its subsidiaries. See also Blackman, Jooste & Everingham *Companies Act* 5-24.

¹⁷⁸ See the English Companies Act 1985 s 131 and s 132 and the English Companies Act 2006, s 611, s 612 and s 614, discussed in Chapter 2 paragraph 2.4.

¹⁷⁹ Section 76(1).

¹⁸⁰ These exceptions that allow application of the share premium account are discussed in paragraph 2.4.3.3.2 below.

The status of the share premium account thus has to be assessed both with reference to the rules that could apply to the account as if it was paid-up share capital as well as to the exceptions or possible applications of the account. These two aspects will be addressed in turn.

2.4.3.3.1 Share capital provisions applicable to the share premium account

Apart from the expressly regulated applications of the share premium account, the provisions of the Act 'relating to the share capital of a company' apply to the share premium account 'as if it was paid-up share capital'.¹⁸¹ The significance of the reference to provisions relating to share capital on the one hand, and paid-up share capital on the other, is uncertain. It seems to require that only the share capital provisions that could apply to paid-up or issued capital should be applied to the share premium account. It would thus have been simpler to state that the provisions of the Act relating to paid-up share capital will apply to the share premium account.

Although section 76(1) states that the provisions 'relating to the share capital of a company' apply to the share premium account as if it was paid-up share capital, it is not at all clear to which provisions this refers.¹⁸² In addition to the specific provisions in Chapter V of the Act under the subheading 'Share capital', various other provisions that refer to share capital are found throughout the Act.

2.4.3.3.1.1 Provisions under the heading 'Share capital'

The heading of Chapter V includes the term share capital and 'Share capital' is used as the subheading to sections 74 to 82.¹⁸³ Each of these sections will be analysed to see in which way they could apply to the share premium account.

Section 74 deals with the division of share capital into par value and no par value shares and can clearly not be applied to the share premium account.¹⁸⁴

¹⁸¹ Section 76(1).

¹⁸² Jooste "Can Share Capital be Reduced" 297 notes this uncertainty, but does not offer any suggestions as to which provisions may be involved.

¹⁸³ The repealed s 83 and s 84 appeared under the heading 'Reduction of Capital'. See Du Plessis "Statute Law" par 351 regarding the legal effect of headings on the interpretation of statutes.

¹⁸⁴ See paragraph 2.3 for a discussion of this provision.

Section 75 regulates the variation of share capital.¹⁸⁵ The authors of Blackman, Jooste & Everingham *Companies Act* raise the possibility that the prescribed fee for increases in share capital¹⁸⁶ could, as a result of the amendment, now have become payable on the share premium account as well.¹⁸⁷ Such an interpretation will have the effect that the fee payable on initial par value shares¹⁸⁸ will be calculated on a different basis than on increased par value share capital, which was not the case under the earlier formulation of this provision.¹⁸⁹

In view of the fact that the prescribed fee is payable when the authorised capital of a company is increased and not when its issued capital is increased through the issue of shares, it is submitted that such an interpretation will be unworkable because the premium, if any, that will eventually be paid on each share will not necessarily be known when the par value shares are authorised, but only when the shares are issued.¹⁹⁰ Moreover, section 76(1) expressly refers to the provisions relating to paid-up share capital, not authorised capital.

The provisions of section 75 are all related to shares as such rather than to 'share capital' and it is thus suggested that there is no scope for the application of section 75 to the share premium account.

Section 76 provides for the share premium account and is thus applicable to this account from the outset.

Section 77 provides that the proceeds of no par value shares are to be stated capital. It clearly finds no application to the share premium account.

Section 78 deals with the conversion of par value share capital into no par value share capital and vice versa.¹⁹¹ It sets out how the capital accounts of a company must be adjusted upon such a conversion. Apart from the express requirement in section 78(1)(b) that the share premium account in respect of converted shares must be transferred to the stated capital account, none of the other provisions of this section can apply to the share premium account.

¹⁸⁵ See paragraph 2.5 below.

¹⁸⁶ See s 75(3).

¹⁸⁷ See Blackman, Jooste & Everingham *Companies Act* 5-25.

¹⁸⁸ In terms of s 63(2), see paragraph 2.3.1.6 above.

¹⁸⁹ Blackman, Jooste & Everingham *Companies Act* 5-25.

¹⁹⁰ In fact, where non-cash consideration is involved, the amount to be reflected in the premium will be known only once the consideration has been valued, s 76(2).

¹⁹¹ See paragraph 2.5.3 below.

Section 79 permits the payment of interest on shares from paid-up share capital.¹⁹² It could be argued that such interest may, as a result of the amendment in 2001, also be paid out of the share premium account. However, since section 79 does not provide for the reduction of the share capital account or stated capital account,¹⁹³ the amount reflected in the share premium account cannot be reduced by the amount of such interest. Such an application would also conflict with section 76(3).

The payment of commissions on the issue of shares is regulated by section 80. Section 80(3) relates to the issued share capital of a company because it provides that a company may not use its 'shares or capital money' to pay commissions and discounts except as allowed under section 80(1). However, this provision cannot apply to the share premium account, in view of the specific exception provided in section 76(3)(b) in respect of commissions and discounts.

Section 81, which regulates the issue of par value shares at a discount, can clearly not apply to the share premium account. Neither can section 82 which regulates the issue price of no par value shares.

2.4.3.3.1.2 Other provisions of Chapter V

Although the heading of Chapter V includes the words 'share capital' none of the subheadings except the one to sections 74 to 82, which have been considered in the previous paragraph, contain a reference to share capital. Despite this, it is necessary to consider whether any of the other provisions in Chapter V of the Companies Act can be said to deal with share capital or issued share capital and so qualify as 'provisions relating to the share capital of a company' for purposes of section 76(1). Sections 85 to 90 regulate distributions to shareholders and have replaced some of the provisions that previously related to the reduction of capital and applied to the share premium account. However, these provisions apply to distributions regardless of the source of the funds used and can thus not be regarded as share capital provisions in the strict sense of the word. Although section 85(5) and (6) regulate the adjustment of accounts reflecting issued share capital, their ambit is restricted to the issued share capital as reflected in the share

¹⁹² See paragraph 5.7 below.

¹⁹³ See s 79(2)(e).

capital and stated capital accounts.

It could be argued that section 85(5) allows the par value of repurchased shares to be deducted from the share premium account - after all, it requires the 'issued capital' to be reduced by the aggregate par value of the shares. Such an interpretation would, however, be out of step with the structure of the share capital account as outlined in the Act as a whole. Moreover, the specific regulation in respect of the share premium account and capital redemption reserve fund in section 85(7)¹⁹⁴ is a strong indication that section 85(5) should not be understood as allowing the share premium account to be reduced also by the par value of the repurchased shares.

Section 85(7) seems to apply to the share premium account. It provides that a premium on repurchase may be paid out of statutory non-distributable reserves of the company, apparently duplicating section 76(3)(d) and section 98(4). The uncertainty regarding the meaning of 'statutory non-distributable reserves' is discussed elsewhere.¹⁹⁵ If this is indeed a reference to the share premium account and capital redemption reserve account, which seems to be the correct interpretation, section 85(7) applies to these accounts not by virtue of the reference in section 76(1) and section 98(1) to provisions that apply to paid-up share capital, but because it expressly and directly applies to the share premium account.

It stands to reason that section 98 cannot apply to the share premium account because it is not a provision relating to share capital. Its purpose is to treat the capital redemption reserve fund 'as if' it was share capital except in the instances set out in section 98(4).¹⁹⁶

2.4.3.3.1.3 Provisions outside Chapter V that refer to share capital

Various provisions refer to share capital, although they do not regulate share capital. The question thus arises whether these can be said to be provisions 'relating' to share capital that have become applicable to the share premium account following the amendment of section 76(1).

¹⁹⁴ And also in s 76(3) and s 98(4).

¹⁹⁵ See paragraph 6.3.4 below.

¹⁹⁶ The same principle applies in the opposite direction, so that s 76 cannot be applied to the capital redemption reserve fund, see paragraph 2.4.4 below.

Section 180 allows two or more members of a company who together hold at least ten per cent of the company's 'issued share capital' to convene a general meeting of the company. It could be asked whether section 76(1) requires the share premium account to be regarded as issued share capital for purposes of this section, thus enabling shareholders who paid a premium to reach this threshold faster. If this question is answered in the affirmative, the amendment of section 76(1) has changed the relative positions of shareholders who have paid premiums and those, usually of another class, who have not. It is unlikely that such a result was intended and it is suggested that section 180 should be regarded as a provision relating to membership rights rather than to share capital.

Section 181(1)(a) provides that members holding at least 5 per cent of the 'capital' conferring the right to vote can compel the board of directors to convene a general meeting. A shareholder in a public company cannot vote in respect of the premium contributed, because section 195 requires the voting rights to be determined according to the par value of each share in relation to the share capital account, which obviously reflects only the par value of each share. Section 181(1)(a) can thus not apply to the share premium account.

Section 198 allows members who are entitled to vote and who in total hold at least ten per cent of the 'issued capital' of the company to demand that voting takes place by way of a poll.¹⁹⁷ This provision differs from section 180 as the entitlement to vote and the holding of issued capital are formulated as separate criteria that both have to be met. However, the considerations that apply to section 180 also apply to this provision.

Section 342, which deals with the application of assets in a winding-up, does not expressly refer to share capital, but requires surplus assets to be divided among members according to their 'rights and interests in the company'. Section 342 can probably not be described as a provision relating to the share capital of a company, although the rights and interests of shareholders may depend on their share in the capital of the company. In this regard it is important to note that the effect of section 76(1) is also not to regard a share premium as share capital contributed to the company. In the absence of a specific arrangement in this regard, a shareholder who contributed a premium would not have any right to the

¹⁹⁷ Section 198(1)(b)(iii). On the other possibilities for demanding a poll, see s 198(1)(b)(i) – (ii).

return of the premium upon liquidation or to share in the surplus on the basis of such a premium.

2.4.3.3.1.4 Evaluation of 'provisions relating to share capital'

In attempting to identify the provisions of the Act that could possibly apply to the share premium account as if it were paid-up share capital, I considered various provisions. The first group of provisions comprised those provisions that are expressly identified in the Companies Act as provisions relating to the share capital of a company. In this regard it was illustrated that none of the provisions under the heading 'Share capital' could apply to the share premium account, except those provisions that in any event applied to the share premium account prior to the amendment of section 76(1). Thus the replacement of the phrase 'provisions relating to the reduction of share capital' with 'provisions relating to the share capital' has not had any effect.

It has also been shown that sections 85 to 90 do not contain any provisions regulating share capital that could apply to the share premium account for purposes of section 76(1). Section 85(7) applies to the share premium account because it is a statutory non-distributable reserve,¹⁹⁸ and not as a result of it being made applicable by virtue of section 76(1). In fact, section 85(7) does not apply to paid-up share capital in general.

An analysis of other provisions that refer to share capital revealed no provision that could apply to the share premium account by virtue of the reference in section 76(1). These provisions deal primarily with membership rights attached to share capital, like voting rights and the right to convene meetings. It was shown that membership rights were not based on contributions to the share premium account, thus excluding the application of these provisions to the share premium account.

I thus conclude that there are no provisions relating to share capital that could apply to the share premium account 'as if it were share capital'. Although the 2001 amendment of section 76(1) succeeded in removing the clearly obsolete reference to the reduction of capital, the replacement phrase has no meaning or effect.

¹⁹⁸ See paragraph 2.4.3.3.1.2 for a discussion of the uncertainty in this regard.

2.4.3.3.2 Application of the share premium account

The share premium account may be applied for the purposes as set out in section 76(3)(a) to (d). A consideration of these possible applications of the share premium account forms an integral part of the interpretation of the principle to which they are supposed to be exceptions, namely that the share premium account is regarded as paid-up share capital for certain purposes.

The meaning of 'applied' was considered in *Ex parte National Packaging Co Ltd*¹⁹⁹ in the context of the predecessor of section 76, section 86 *quat* of the 1926 Companies Act. The court said that it meant that the account could be used without first having to apply for reduction of capital in respect of the share premium account. When the share premium account is applied for one of the specified purposes, the amount standing to the credit of the account is thus reduced.

First, the amount reflected in the share capital account may be reduced by the amount required to pay up unissued shares of the company to be issued to members as fully paid capitalisation shares.²⁰⁰ The amount deducted from the share premium account will be added to the company's share capital account or stated capital account, depending on whether the capitalisation shares have a par value or not.²⁰¹ The effect of this type of application of the share premium account is thus to convert share premium to ordinary paid-up capital. Such a step could obviously not prejudice creditors.²⁰²

Secondly, the share premium account may be applied in writing off the preliminary expenses of the company, or the expenses of, or commission paid or discount allowed on, the creation or issue of any shares of the company.²⁰³ It is not clear which expenses qualify as preliminary expenses, but presumably they should be related to the formation of the company. Expenses incurred in connection with the creation and issue of shares could include the cost of obtaining authorisation to issue further shares, the cost of a prospectus if the shares are being offered to the public and, possibly, the prescribed fee payable in

¹⁹⁹ 1965(1) SA 542 (W) at 543.

²⁰⁰ Section 76(3)(a).

²⁰¹ It is not clear whether such capitalisation shares could also be issued at a premium, but since any such premium would have to be transferred to the share premium account, the account would then not really be 'applied' towards the new premium.

²⁰² See Blackman, Jooste & Everingham *Companies Act* 5-26.

²⁰³ Section 76(3)(b).

terms of section 63(1) or section 75(3). The reference to commission or discount on the creation or issue of shares seems to be to commissions paid in terms of section 80 and discounts allowed under section 81.²⁰⁴ It has been argued that this application cannot really disadvantage creditors, since the expenses, commissions and discounts are not saleable assets.²⁰⁵

The third purpose for which the share premium account may be applied, is to provide for the premium payable on the redemption of redeemable preference shares.²⁰⁶ Unlike the applications provided for in section 76(3)(a) and (b), a redemption premium amounts to a distribution to other shareholders and should thus be more strictly regulated. Two provisos, which were inserted in the Act in 1992,²⁰⁷ limit the extent to which the share premium account may be so applied. The motivation for these provisos seems to be that shareholders who contributed a premium should enjoy some protection against the return of that premium to other shareholders.²⁰⁸ The first proviso states that the share premium account may only be applied to provide for a premium on the redemption of redeemable preference shares if the premium is payable according to the terms of issue of the shares. The terms of issue must have appeared in the articles of the company prior to the allotment and issue of the shares, unless the court sanctioned their insertion into the articles at a later date.²⁰⁹ Although this proviso does not require the premium to have been contributed by the redeemable preference shares, it at least ensures that the shareholders who contributed the premium will have advance warning of this potential application of the premium. The second proviso applies where ordinary shares have been converted into redeemable shares that are redeemable at a premium. Only the portion of the share premium account that

²⁰⁴ These are discussed in paragraphs 3.5 and 3.1.1 below.

²⁰⁵ See Blackman, Jooste & Everingham *Companies Act* 5-26. However, this observation is limited to the application of the share premium account. It will be seen below that the creditors are to an extent protected by the limitation on the payment of commission and discounts, as it prevents funds from leaving the company, see paragraphs 3.1 and 3.5.

²⁰⁶ Section 76(3)(c).

²⁰⁷ By s 3 of Act 82 of 1992. These provisos do not apply to redeemable preference shares issued on or after 1 July 1992, the commencement date of the Companies Amendment Act 82 of 1992, see s 76(3)(c)(iii). Presumably they will also not apply when ordinary shares have been converted into redeemable preference shares prior to this date.

²⁰⁸ See Blackman, Jooste & Everingham *Companies Act* 5-26. Prior to the 1992 amendment, the share premium account could even be applied to provide for the premium payable on the redemption of debentures.

²⁰⁹ Section 76(3)(c)(i).

reflects a premium arising on the original issue of the ordinary shares, may be applied to the redemption premium.²¹⁰ This proviso implies that the terms of conversion should provide for redemption at a premium. The stricter limitation in respect of the contribution of the premium that applies to converted shares is the only measure that really protects shareholders in respect of the premium they contributed.²¹¹ It is not clear why the proviso was not made applicable to (non-redeemable) preference shares that are converted into redeemable preference shares. This results in an anomaly.

The authors of Blackman, Jooste & Everingham *Companies Act* state that it is difficult to apply the first proviso to converted shares because they could not have been issued with an entitlement to a premium upon redemption.²¹² I think that there is no need to apply the first proviso to converted shares, as it appears that the two provisos are alternatives. The first applies only to shares originally issued as redeemable and the second only to converted shares.

The fourth possible application of the share premium account is to provide for the payment of a premium in the case of an acquisition of shares in accordance with section 85.²¹³ This option was added in 1999 when it became possible for companies to repurchase their shares.²¹⁴ A premium upon repurchase amounts to a distribution to the shareholder whose shares are being acquired and has the same effect as the redemption of shares at a premium. It is strange that no provision was made to protect the interests of shareholders who contributed the premium. A proviso similar to that which applies to converted redeemable shares and limits the premium to the premium originally contributed by the shares would have been logically consistent.²¹⁵ It also seems anomalous that the share premium account cannot be applied to provide for the premium over par when shares are repurchased in terms of a court order under section 252.

²¹⁰ Section 76(3)(c)(ii).

²¹¹ Trichardt & Brincker "Capital in Company Law" 148 argue that similar restrictions should apply to applications of the share premium account for all redemptions.

²¹² See Blackman, Jooste & Everingham *Companies Act* 5-26.

²¹³ Section 76(3)(d).

²¹⁴ Section 6 of Act 37 of 1999.

²¹⁵ See also the argument in note 211 above which was made in a different but comparable context.

2.4.3.3.3 Conclusion on status of share premium account

It appears that the requirement of treating the share premium account as issued capital for purposes of the share capital provisions of the Act has no effect on the share premium account. Only those provisions which expressly refer to the share premium account can apply. The reference to the share capital provisions of the Act was inserted to replace the outdated reference to the reduction of share capital, but has no effect or consequence.

Nevertheless, the wording of section 76(1) indicates that the applications referred to in subsection (3) are intended to be exceptions. It provides that 'except as provided in this section' the provisions of the Act relating to share capital will apply to the share premium account as if it was paid-up share capital of the company. Subsection 76(3) refers back to subsection (1) when it states that 'notwithstanding anything contained in subsection (1)' the share premium account may be applied for certain purposes. As could be expected from an exception, subsection (3) is couched in permissive terms and provides that the share premium account 'may' be applied for the purposes listed. Until 1999 this meant that, except under a formal reduction of capital, the company could not make a distribution to shareholders if its assets did not exceed the amounts reflected in its various capital accounts and non-distributable reserves.

The relaxation of the capital maintenance rule²¹⁶ has the effect that the company need no longer retain assets equal to the amounts reflected in the capital accounts.²¹⁷ Although this represents a significant change, the provisions relating to the keeping and adjustment of share capital and reserve accounts of a company have remained relatively unchanged. Companies are not free to adjust their capital accounts as they please, despite the fact that they can make distributions out of assets representing share capital. The new provisions providing for the adjustment of capital accounts when repurchased shares are cancelled²¹⁸ and for the application of the share premium account²¹⁹ are clear indications that the legislature regards the keeping of these accounts as important. Section 76(3)

²¹⁶ By the Companies Amendment Act 37 of 1999.

²¹⁷ Section 90 allows distributions out of capital without adjustments to the capital accounts, see paragraph 5.1 below.

²¹⁸ Section 85(5) and (6).

²¹⁹ Section 76(3)(d) and s 85(7).

enjoyed the attention of the legislature in 1999 when it introduced the new regime. It was not repealed, but amended by the addition of subparagraph (d). There is thus no reason to deviate from the presumption that the legislature does not enact unnecessary or purposeless provisions. It is submitted that an interpretation that the share premium account may be applied or reduced freely, clearly cannot claim to give effect to section 76(3).

Despite the regulation of the share premium account, a company is free to make distributions while it has insufficient assets to cover the total value of its share capital accounts and statutory non-distributable reserves, including the share premium account. The company will, of course, have to comply with the solvency and liquidity tests of section 90(2).²²⁰ This is because there is a difference between the actual assets or funds of the company and the amounts reflected in a particular account. Accounts may be adjusted only as provided in the Act, a principle that applies consistently to the share capital account, stated capital account, share premium account, and capital redemption reserve fund.²²¹

2.4.3.4 Justification of share premium account

2.4.3.4.1 Under capital maintenance

It can be argued that the purpose of the share premium account is to protect creditors, who are entitled to rely on the total consideration received for issued shares.²²² Another explanation is that it aims to protect shareholders who paid the premium against distribution of that premium to other shareholders.²²³

Assuming that creditors should be protected by the paid-up capital of a company, creditors could benefit from limitations imposed on the distribution of the share premium account. However, the share premium account can be reduced through several applications. Apart from paying up unissued shares to be issued as capitalisation shares²²⁴ and writing off preliminary expenses and expenses for

²²⁰ See Cilliers & Benade *Corporate Law* 337; Blackman, Jooste & Everingham *Companies Act* 5-25.

²²¹ The capital redemption reserve fund is discussed below.

²²² De Wet and Yeats *Handelsreg* 560.

²²³ *Shearer (Inspector of Taxes) v Bercain Ltd* [1980] 3 All ER 295 at 300 – 301.

²²⁴ Section 76(3)(a).

or commission on the creation and issue of shares,²²⁵ the share premium account can also be applied to provide for the premium when shares were being redeemed.²²⁶ While the first two applications do not affect the rights of creditors,²²⁷ the third use results in a direct conflict of interest between the preference shareholders to whom a distribution is being made and the creditors (if they can be said to have an interest in the share premium account in the first place). This is also true of the further application introduced in 1999,²²⁸ namely to provide for the premium payable when shares are repurchased by the company in terms of section 85.²²⁹ In this case, however, creditors will be protected by the solvency and liquidity requirements of section 85(4).²³⁰

To say that the purpose of regulating the share premium account is to protect the shareholders who contributed the premium is also problematic, since the shareholders who contributed the premium do not enjoy any preference or right in respect of the share premium account, unless the articles provide otherwise.²³¹ It is only in the case of converted redeemable preference shares that a premium may not be paid out of premiums contributed in respect of other shares.²³²

2.4.3.4.2 Under the new distribution rules

The authors of Blackman, Jooste & Everingham *Companies Act* conclude that there are two reasons for the retention of section 76.²³³ Firstly, it allows companies to write off expenses as provided for in section 76(3)(b). While it cannot be disputed that the account can be applied in this way, it does not explain why such expenses cannot be written off against any other accounts of the company. If a company did not need to create a share premium account in the first place, and

²²⁵ Section 76(3)(b).

²²⁶ Section 76(3)(c). Until 1992 it could also be used to provide a premium on the redemption of debentures, see Blackman, Jooste & Everingham *Companies Act* 5-26.

²²⁷ See Blackman, Jooste & Everingham *Companies Act* 5-26.

²²⁸ By s 6 of Act 37 of 1999.

²²⁹ Section 76(3)(d). See also s 85(7).

²³⁰ See paragraph 6.2 below.

²³¹ See Blackman, Jooste & Everingham *Companies Act* 5-21; Jooste "Can Share Capital be Reduced" 295; *Oakbank Oil Co v Crum* (1882) 8 App Cas 65 (HL); *Birch v Cropper* (1889) App Cas 525 (HL).

²³² See paragraph 2.4.3.3.2 above.

²³³ Blackman, Jooste & Everingham *Companies Act* 5-27.

could instead reflect premiums in a surplus account, it could write off expenses against that surplus account. There is no real connection between a contributed share premium and section 76(3)(b) expenses, commissions and discounts, especially as it is not required that the expenses should relate to the particular class of shares that contributed the premium.²³⁴

The second reason identified by the authors of Blackman, Jooste & Everingham is that section 76 protects holders of non-redeemable shares.²³⁵ This, they argue, is because section 76(3)(c) restricts the premium payable when shares are redeemed. This explanation is not persuasive, because section 76(3)(c) is merely enabling, so premiums can also be paid out of other funds. The provisos to section 76(3)(c) do not limit the premium that can be paid, but only the extent to which it can be funded from the share premium account. The shareholders who contributed to the share premium account do not usually enjoy any liquidation preference on the return of the premium they paid, so the restrictions on the share premium account cannot benefit them. In any event, the protection can be circumvented by repurchasing rather than redeeming shares, because no similar limitations apply to repurchases.²³⁶

The authors postulate that a share premium account might be useful if a company also has no par value shares but has stipulated that only par value shareholders will share in the share premium account upon dissolution. Although this is a valid observation, it is not a cogent reason for retaining the statutory regulation of share premium accounts. In those instances when the articles of a company confer special liquidation rights on certain shareholders in respect of the share premium account, these rights need not depend on the existence of a provision similar to section 76. The company could reflect the premium in any kind of account and regulate its application in its articles.

2.4.3.4.3 Evaluation of justification of share premium account

The protection of creditors and of shareholders has been suggested as justification for the regulation of share premiums.

²³⁴ Such a limitation is imposed in England, see Chapter 2 paragraph 2.4.

²³⁵ Blackman, Jooste & Everingham *Companies Act* 5-27.

²³⁶ See paragraph 2.4.3.3.2 above.

But any potential protection afforded to creditors is substantially eroded by the exceptions that allow application of the share premium account when paid-up capital cannot be used. In particular, the application of the share premium account to provide for a premium on the redemption of shares, infringes the rights of creditors. I think that creditors will be better protected by a consistent application of the financial restrictions of solvency and liquidity to all distributions.

In similar vein, I submit that the low level of protection that shareholders enjoy in respect of the share premium account does not justify the retention of the share premium account as it is currently regulated in the Act. This lack of protection can be attributed to the fact that shareholders who contributed a premium do not enjoy any membership or financial rights with regard to those premiums, unless the articles provide otherwise.

It can also be argued that shareholders who contributed a premium should not have a preferent right in respect of that premium. For purposes of this argument it is necessary to distinguish between premiums payable on the initial issue of shares of a class and premiums payable only on a subsequent issue of shares of a previously issued class. In the latter case the premium reflects the rise in value of the shares since the earlier issue. The new shareholders pay the premium because they acquire a right to share in the (distributable) reserves that have been built up in the company on the basis of the contributions made by the existing shareholders.²³⁷ In such circumstances it would be unfair to grant the new shareholders a stake in the premium they contributed.

Where shares are issued at a premium from the outset, the shareholders could indeed claim that they should enjoy certain rights based on the total contribution they made in comparison to shareholders in other classes and that the premium they contributed should not be distributed to other classes of shareholders. However, the regulation of the relative entitlements of different classes of shares is a matter for the constitution of the company.

As regards creditors, it could be argued that they should not be entitled to rely on a premium contributed upon a subsequent issue of shares of a previously issued class, because they cannot rely on the built-up profits of the company either.

²³⁷ Blackman, Jooste & Everingham *Companies Act 5-20 – 5-21*

When a particular class of shares is issued at a premium from the outset, creditors should be entitled to rely on this premium, because it is actually a disguised capital contribution, possibly made to reduce the prescribed fee on capitalisation. But I think that here, too, creditors are better protected by the solvency and liquidity requirements which should ideally apply to all distributions.

Different considerations seem to apply depending on the reason why or circumstances under which a premium was charged. This distinction was touched upon in *Henry Head & Co v Ropner Holdings Ltd*²³⁸ where reference was made to the difference between an initial premium and a subsequent premium resulting from the excess value of a company's already existing assets over the nominal value of its shares. However, this distinction was rejected by the court.²³⁹

I suggest that there is insufficient justification for the regulation of share premiums.

2.4.4 The capital redemption reserve account

When a company redeems shares out of distributable profits, it has to transfer to an account called the capital redemption reserve fund, an amount equal to the nominal value of redeemed par value shares or the book value of no par value shares.²⁴⁰ The explanation for this requirement is that the capital redemption reserve fund will replace the amounts by which the share capital account or stated capital account will be reduced upon cancellation of the redeemed shares.²⁴¹

The provisions of the Act relating to share capital will apply to the capital redemption reserve fund as if it was share capital, except as provided in section 98.²⁴² This provision is similar to section 76(1) which purports to treat the share premium account as paid-up share capital.²⁴³ It is not clear why the share capital provisions apply to the capital redemption reserve account 'as if it was share capital' rather than 'paid-up share capital' as is the case with the share premium

²³⁸ [1952] Ch 124; [1951] 2 All ER 994 at 997.

²³⁹ See also Pitts "Share Premium Account" 334.

²⁴⁰ Section 98(1)(b).

²⁴¹ See Blackman, Jooste & Everingham *Companies Act* 5-272.

²⁴² Section 98(1)(b), as amended by s 12 of Act 35 of 2001. The provision previously stated that the provisions regarding reduction of capital applied to the capital redemption reserve fund as if it was share capital of the company. See Jooste "Can Share Capital be Reduced" 297 – 298.

²⁴³ Compare s 76(1) and s 98(1)(b).

account. It is suggested that this difference does not have any practical implications. The discussion of the status of the share premium account and the interpretation difficulties thus apply similarly to the capital redemption reserve fund.²⁴⁴ This means that apart from section 98 itself, there are no provisions in the Act that could apply to the capital redemption reserve account.

The capital redemption reserve fund can be applied in paying up unissued shares to be issued as fully paid up capitalisation shares or to provide for the premium payable on the acquisition of shares under section 85.²⁴⁵ It is not clear why the capital redemption reserve may be used for a premium on shares acquired under section 85 but not for a premium when shares are redeemed.²⁴⁶

2.4.5 The section 78(3) reserve account

Section 78 regulates the adjustment of capital accounts when par value share capital is converted into no par value share capital or *vice versa*.²⁴⁷ It allows for the rounding off of fractional amounts, but requires material reductions to be 'placed' to non-distributable reserves.²⁴⁸ The Act contains no further provision regarding the status or application of such a reserve.

2.5 The variation of share capital

The concept of authorised capital contributes to the rather intricate provisions regulating the variation of capital found in section 75. It is not always clear whether a particular subsection of section 75 involves authorised or issued share capital, or both. Although a subdivision or a consolidation of par value shares in terms of section 75(1)(c) or (e) can take place in respect of issued or unissued shares, they will not affect the share capital accounts but only the statement of the company's

²⁴⁴ See paragraph 2.4.3.3 above.

²⁴⁵ Section 98(4). This second possible application was introduced by s 15 of the Companies Amendment Act 37 of 1999. Cilliers & Benade *Corporate Law* 337 incorrectly state that the capital redemption reserve fund may be applied *only* to provide for capitalisation shares, but contradict this in note 88 on the same page.

²⁴⁶ The share premium account can be used for a premium in both these instances. As I already argued in paragraph 2.4.3.3.1.2 above, ss 76 and 98 cannot be described as provisions relating to share capital. For this reason, any argument that the wider applications or exceptions provided for in s 76(3) could have become applicable to the capital redemption reserve fund following the amendments in 2001 must fail.

²⁴⁷ See paragraph 2.3.1.2 above.

²⁴⁸ Section 78(4).

authorised capital. A subdivision of no par value shares under section 75(1)(d) or a consolidation of such shares in terms of section 75(1)(i) will not affect the stated capital account, but will amount to a change in authorised capital.

Variations under section 75 may be made if authorised by the company's articles of association and approved by a special resolution.²⁴⁹

Any variation of capital that involves a change to the company's memorandum must be approved by special resolution or in the way prescribed by a special condition in the memorandum.²⁵⁰ Any variation involving a variation of rights attaching to any class of shares is subject to a variation of class rights clause in the company's articles and to the right of recourse provided for section 102.²⁵¹

2.5.1 Increase and decrease

Section 75(1)(a) provides that a company may increase its share capital by new shares of such amount, or increase the number of its no par value shares, as it thinks expedient. This provision deals exclusively with an increase of authorised capital.²⁵²

The authorised capital can be decreased by cancelling unissued par or no par value shares under section 75(1)(h). Section 75(2) states that such a cancellation is not regarded as a reduction of capital within the meaning of the Act.²⁵³ This is because the shares have not been issued and the capital reduction provisions previously contained in sections 83 and 84 of the Act, related to the reduction of issued capital. Although sections 83 and 84 have now been repealed, the cross-reference to a 'reduction of capital within the meaning of this Act' was not removed when other obsolete references to the reduction of issued capital were removed.²⁵⁴

Section 75(1)(b) concerns no par value share capital only. It allows an

²⁴⁹ Section 75(1).

²⁵⁰ Section 56. Section 75 is expressly made subject to s 56.

²⁵¹ This section provides a right of recourse to dissenting shareholders whose class rights are varied. See also Blackman, Jooste & Everingham *Companies Act 5-5*.

²⁵² See Cilliers & Benade *Corporate Law* 338; Blackman, Jooste & Everingham *Companies Act 5-5*.

²⁵³ Section 75(2).

²⁵⁴ See the Companies Amendment Act 37 of 1999; Companies Amendment Act 35 of 2001.

increase in issued capital by way of a transfer of reserves or profits to the stated capital account. The variation could be done either with or without a distribution of shares. This means that the number of issued no par value shares could either be increased, and issued as capitalisation shares, or be left intact. An increase in the number of no par value shares beyond the number of authorised no par value shares will also result in an increase in authorised capital and should thus be subject to s 75(3)(b) which requires a calculation of the book value of the existing issued shares and payment to the Registrar of the prescribed fee in respect of the number of new shares.²⁵⁵ The authors of *Meskin Henochsberg on the Companies Act* argue that the prescribed fee will not be payable because the increase in stated capital is not due to a fresh issue of shares.²⁵⁶ However, this interpretation is not supported by the language of s 75(3)(b) which clearly sets out to levy the fee on authorised rather than issued capital.²⁵⁷

Where no distribution takes place, or if previously authorised but unissued shares are distributed, the authorised capital is not increased, the book value need not be recalculated, and no fee is payable.²⁵⁸

2.5.2 Consolidation and subdivision

A consolidation of shares under section 75(1)(c) will also amount to an alteration of authorised capital. In the case of par value shares, it will affect the fixed amount (par value) into which the nominal capital is divided, while in the case of no par value shares, it will reduce the authorised capital or number of no par value shares. It is interesting to note that as regards no par value shares reference is made to the number of the 'issued' no par value shares. However, as regards par value shares, reference is made to any part of the company's share capital that can be divided into shares of larger amount than the 'existing' shares. Since the concept 'share capital' is used to refer to the authorised capital,²⁵⁹ and since

²⁵⁵ For example: 100 no par value shares have been issued and the book value is R1 000. The company now increases the number of no par value shares to 200. The fee will now be payable in respect of the 100 new shares at the book value of R10 each.

²⁵⁶ *Meskin Henochsberg on the Companies Act* 152-3.

²⁵⁷ The argument does, however, illustrate why the fee should rather not have been made payable in these circumstances.

²⁵⁸ See Blackman, Jooste & Everingham *Companies Act* 5-6.

²⁵⁹ See s 74 and s 75(1)(a).

authorised but unissued shares could be described as 'existing' it thus seems as if unissued shares can also be consolidated.²⁶⁰ In such a case the issued share capital is thus not affected. This interpretation means that unissued par value shares may be consolidated, but not unissued no par value shares. If there are unissued no par value shares of a particular class, there will thus remain a larger number of no par value shares than would have been the case if the consolidation was done after issue.

A subdivision of no par value shares under section 75(1)(d) amounts to an increase in authorised capital but not an increase in stated capital. As in the case of a consolidation, only issued no par value shares can be subdivided. However, it seems that issued no par value shares can also be subdivided under section 75(1)(a), as this latter provision is not limited to authorised but unissued shares.²⁶¹

The authors of Blackman, Jooste & Everingham *Companies Act* argue that no par value shares cannot really be subdivided because such a subdivision in effect entails the issue of further shares for no consideration.²⁶² While it is no doubt an accurate observation that no consideration is given, I suggest that the provision must be taken to sanction such an issue by implication.

A subdivision of par value shares under section 75(1)(e) will also affect the statement in the memorandum of the division of the capital into shares of a fixed amount. However, although the description of the authorised capital will change, there will not be an increase in the total amount of such authorised capital. As in the case of a subdivision of no par value shares, the issued share capital - in this case as reflected in the share capital account - will not be affected. It is not required that par value shares must have been issued before they can be subdivided.

The subdivision of issued no par value shares will affect the minimum price at which the remaining authorised shares of the same class may be issued without a special resolution as required by section 82.²⁶³ The average issue price will be determined by dividing the increased number of subdivided shares into the total

²⁶⁰ This is also implied by Blackman, Jooste & Everingham *Companies Act* 5-6 where it is stated that in the case of issued shares, the share register will have to be altered.

²⁶¹ See Meskin *Henochsberg on the Companies Act* 152.

²⁶² See Blackman, Jooste & Everingham *Companies Act* 5-6.

²⁶³ See paragraph 3.1.2 below.

stated capital for that class of shares.²⁶⁴

There seems to be some uncertainty regarding the application of section 75(3) to the consolidation and subdivision of shares. Section 75(3)(a) establishes the basis for calculation of the fee upon an increase in par value shares while section 75(3)(b) applies to an increase in no par value shares.²⁶⁵ A subdivision of par value shares will not increase the amount of the authorised capital, and no fee will thus be payable under section 75(3)(a).²⁶⁶

It is not clear whether section 75(3)(b) applies to a subdivision of no par value shares. Applying section 75(3)(b) to a subdivision of no par value shares will have the undesirable effect that the fee on the increase in the number of no par value shares is calculated on the average value of the no par value shares prior to conversion while the company's stated capital will remain intact.²⁶⁷ The authors of *Meskin Henochsberg on the Companies Act* argue that subsection (3)(b), which requires payment of the prescribed fee, cannot apply in cases of an increase in the number of no par value shares under subsection (1)(d) because the stated capital is not increased.²⁶⁸ The same is argued in respect of the issue of capitalisation shares following a transfer from reserves under subsection (1)(b), because the increase in stated capital is due to the transfer and not to the issue of new shares.²⁶⁹ It stands to reason that the fee is not payable if reserves are transferred and no new shares are issued, because subsection (3)(b) requires the fee to be paid only when the number of no par value shares is increased. But when the number of no par value shares is increased, the Act clearly requires the fee to be paid. The argument that the fee is payable only where subsequent to the variation there is an increased number of issued shares, issued at a consideration which can increase the stated capital account through a fresh injection of capital, is not supported by the word of section 75(3)(b). That the correct interpretation gives rise to an undesirable state of affairs cannot be disputed, but the current principle is that the nominal value of par value shares or the number of no par value shares is

²⁶⁴ See s 82(1).

²⁶⁵ See paragraph 2.3.1.6 above.

²⁶⁶ Blackman, Jooste & Everingham *Companies Act* 5-18.

²⁶⁷ See the example in note 255 above.

²⁶⁸ See *Meskin Henochsberg on the Companies Act* 152 – 153. This issue is not dealt with in Blackman, Jooste & Everingham *Companies Act*.

²⁶⁹ *Meskin Henochsberg on the Companies Act* 152 – 153.

taken into account in determining the fee. The Act does not make the fee dependent on the price at which the shares are eventually issued.

2.5.3 Conversion of types of shares

The conversion of par value share capital into stated capital consisting of no par value shares and vice versa is regulated by section 75(1)(f) and section 75(1)(g). Section 75(1)(f) provides that share capital consisting of par value shares may be converted into 'stated capital' constituted by shares of no par value.²⁷⁰ Likewise section 75(1)(g) provides for the conversion of 'stated capital' constituted by no par value shares (not par value shares as such) into share capital consisting of shares having a par value. Since stated capital is the amount represented by the proceeds of the issue of no par value shares,²⁷¹ the use of this term is unfortunate. It may create the impression that only issued no par value shares may be converted and not also unissued no par value shares, which, although they form part of the (authorised) share capital of the company, are not represented in the stated capital account. Such an interpretation would not accord with section 75(4) which clearly contemplates the existence of unissued shares that have been converted under section 75(1)(f) and (g). In this regard, the formulation of section 78(1), which refers to 'share capital' must be preferred. It is suggested that the term stated capital in section 75(1)(f) and (g) should be understood as (authorised) 'share capital'.

2.5.3.1 Conversion of par value share capital into stated capital

Where par value shares are converted into no par value shares as envisaged by section 75(1)(f), section 78(1) requires that 'the whole of the ordinary or preference share capital, as the case may be, and the whole of the share premium account or that part thereof contributed by the shares so converted' must be transferred to the

²⁷⁰ However, existing companies with partly paid par value shares may not convert their shares into no par value shares, s 75(1)(f) proviso. Since all the ordinary or all the preference shares would have to be converted simultaneously (s 74 proviso), such companies would not be able to do a conversion until the outstanding amounts had been paid. The opposite provision which allows conversion from no par value into par value does not require a similar limitation since existing companies could not have no par value shares. No par value shares were introduced at the same time partly-paid shares were abolished.

²⁷¹ Section 77(1). Note that the heading of this section reads 'Proceeds of issue of shares of no par value to be stated capital'.

stated capital account. A company can either convert all its ordinary shares, all its preference shares or all its ordinary and preference shares into no par value shares. If the company issued both ordinary and preference shares at a premium, and is converting only one of these types into no par value shares, it will have to transfer to stated capital only the relevant part of the share premium account which was contributed by the shares being converted. While there is logic in this requirement, it may not always be easy to determine which part of the share premium account relates to the shares being converted. The application of the share premium account does not necessarily preserve the initial relationship between the premium contributed and the class of shares on which it was paid.²⁷²

2.5.3.2 Conversion of stated capital into par value share capital

Section 78(2) regulates the conversion of no par value shares into par value shares under section 75(1)(g). It requires that the whole of the stated capital account or, if only either ordinary or preference no par value shares are being converted, the part of the stated capital account contributed by the shares being converted, be transferred to the share capital account. There is no option to transfer a part of the stated capital to the share premium account and the implication is thus that the par value of the converted shares will have to correspond with the average value of the no par value shares transferred. It may also be difficult to identify the part of the stated capital account that was contributed by the shares that are to be converted. The stated capital account can for instance be applied in writing off preliminary expenses of the company in which case the correlation between the consideration received for the shares and the amount reflected in the stated capital account will not be preserved. When there are ordinary as well as preference no par value shares and only one of these are being converted, it may be difficult to determine which part was contributed by the shares being converted. It may be a solution to apportion any application of the stated capital account that does not relate to a specific issue of shares between the different issues according to the aggregate value of each issue.

Section 78(3) provides for the creation of a statutory non-distributable reserve in respect of fractions and fractional surpluses and amounts that arise

²⁷² See paragraph 2.4.3.3.2 above.

when no par value shares are converted to par value shares and is considered elsewhere.²⁷³

2.5.3.3 Reconversions

Section 75(4) was introduced in 1992 to counter the avoidance of the prescribed fee on authorised capital.²⁷⁴ It applies where par value shares have been converted into no par value shares and are subsequently converted back into par value shares. Any unissued shares in existence at the time of the second conversion must either be cancelled under section 75(1)(h)²⁷⁵ or the company will be liable to pay to the Registrar R5 for each R1000 or part of it by which the nominal share capital will after the second conversion exceed the nominal capital before the first conversion.²⁷⁶ There is no corresponding provision for conversion and reconversion of no par value shares, arguably because few companies started out with no par value shares and thus manipulated the fee structure the other way round. In theory, the same result could be achieved by converting no par value shares into par value shares, subdividing them into shares with lower par value and then reconverting them to no par value shares.

It is not certain whether the initial conversion or the reconversion will be covered by section 75(3)(a). Although the initial conversion will result in an increase in the number of no par value shares and the reconversion in an increase in the number of no par value shares, the implication of subsection (4) is that subsection (3)(a), which provides for increases in par value shares, would not otherwise apply to the reconversion. It is made applicable only in respect of unissued shares, confirming that the fee is not payable on conversions as such.

²⁷³ See paragraph 2.4.5 above.

²⁷⁴ Section 2 of the Companies Amendment Act 82 of 1992.

²⁷⁵ Section 75(4)(b)

²⁷⁶ An example can illustrate this. A (Pty) Ltd has 3 R1 par value shares of which 2 have been issued at a premium of 50c each. It converts them into no par value shares and transfers R3 to stated capital (R1.50 per share). It reconverts those shares to par value shares, but now each share has a par value of R1.50 (The stated capital of R3 divided by the two issued shares.) The remaining unissued share now has a par value of R1.50, which is more than the previous authorised capital. Unless the unissued share is cancelled, the company will have to pay the prescribed fee.

2.5.4 Evaluation of variation of share capital

The rules on the variation of share capital are complex. To a considerable extent, this is caused by the need to accommodate both par value and no par value shares. Closer analysis reveals that the provisions are primarily focused on book entries in the share capital accounts and payment of the prescribed fee due to the Registrar.

This complexity would be justified if it contributed to the protection of either creditors or shareholders. But the only modicum of creditor protection is found in section 75(1)(f) which prevents the conversion of existing partly paid par value shares²⁷⁷ into no par value shares. The interests of shareholders do not feature, as the variation of class rights is regulated in a separate provision.²⁷⁸

I think that these rules should be simplified. If necessary, a different basis should be found for the calculation of the Registrar's prescribed fee, for example, the consideration actually received by the company when it issues shares. This would also solve the problems that arise when no par value shares are subdivided.²⁷⁹

2.6 The reduction of issued capital

Apart from providing for the increase of share capital and for its variation, the Act used to contain specific reduction of capital provisions. These were contained in sections 83 to 90 of the Companies Act, but were removed and replaced by the Companies Amendment Act 37 of 1999.²⁸⁰ The reason for the removal of the reduction provisions was not set out in the Explanatory Memorandum.²⁸¹ It can be surmised that the two procedures were regarded as having become redundant in view of the newly introduced provisions. The Explanatory Memorandum obviously regarded share repurchases as a way of reducing capital. It stated that in modern company law systems '...companies may reduce capital, including the acquisition of their own shares'. The stated purpose of the amendments was to give

²⁷⁷ These would be shares that were in existence when the 1973 Act came into operation, see paragraph 3.4 below.

²⁷⁸ Section 102.

²⁷⁹ See paragraph 2.5.2 above.

²⁸⁰ Sections 83 and 84 were repealed by s 8 of this Act, while the remaining sections were replaced by the new provisions on share repurchases and payments to shareholders.

companies greater flexibility in arranging their financial affairs.²⁸² However, there is some academic debate as to whether this objective has been achieved. Jooste argues that it has not, and that a general enabling provision for the reduction of capital should be introduced.²⁸³ In order to assess the situation, a brief comparison of the old reduction of capital provisions and the ways in which capital can be reduced under the Act as it presently stands, is necessary.

2.6.1 The pre-1999 reduction of capital procedures

The Act provided two alternative procedures. Under section 83 a company with no creditors or that could give security for the payment of all its creditors within twelve months of the reduction, could reduce its paid-up capital by special resolution and without the sanction of the court.²⁸⁴ The section 83-procedure could not be used if the company wanted to make payments in the future or in installments. It could also not be used for non-proportionate reductions of capital.²⁸⁵ The company's articles had to authorise the reduction of its capital. A company that did not satisfy the requirements of section 83 could reduce its paid-up capital with court approval under section 84. If the reduction of capital involved a payment to shareholders of paid-up capital, creditors could object to the reduction.²⁸⁶

Certain motivations for reductions were referred to in the provisions, although they were expressly stated to be without prejudice to the generality of the power to reduce capital.²⁸⁷ A company could reduce its capital in order to return capital in excess of the wants of the company²⁸⁸ or to cancel paid-up capital that was lost or had become useless for the purposes of the company.²⁸⁹ In the latter case the reduction would not involve a payment to the shareholders but a simple write-off in the accounts. It is important to bear in mind that the reduction of capital provisions

Continued

²⁸¹ *Memorandum on the Objects of the Companies Amendment Bill, 1999* (B17D-99).

²⁸² *Memorandum on the Objects of the Companies Amendment Bill, 1999* (B17D-99), see also Jooste "Can Share Capital be Reduced" 299.

²⁸³ Jooste "Can Share Capital be Reduced" 300.

²⁸⁴ Section 83 prior to its repeal by s 8 of the Companies Amendment Act 37 of 1999.

²⁸⁵ Section 83(1) prior to its repeal by s 8 of the Companies Amendment Act 37 of 1999.

²⁸⁶ Section 85 prior to its substitution in 1999 by s 9 of the Companies Amendment Act 37 of 1999.

²⁸⁷ Section 84(1) prior to its repeal by s 8 of the Companies Amendment Act 37 of 1999.

²⁸⁸ See *Ex parte Vlakfontein Gold Mining Co Ltd* 1970 (2) SA 180 (T) at 183.

²⁸⁹ Section 84(1) prior to its repeal by s 8 of the Companies Amendment Act 37 of 1999.

applied also to the statutory non-distributable reserves. It was thus possible, in addition to the various applications provided for in section 76(3) and section 98(4), to write off amounts from these accounts.²⁹⁰

The adjustment of share capital accounts was not prescribed in the reduction provisions. However, section 87 required the special resolution to be in the prescribed form and to set out the then existing share capital, particulars of the proposed reduction and the resultant state of the share capital of the company.²⁹¹ A resolution to reduce share capital was also taken to be a special resolution for the amendment of the company's memorandum.²⁹² A reduction of capital also amounted to a variation of shareholders' rights.²⁹³ Preference shareholders could not be denied the right to vote on a resolution proposing a reduction of capital.²⁹⁴

The effect of a reduction of capital on the proportionate interests of shareholders was one of the important factors a court had to consider when asked to sanction a reduction.²⁹⁵ Certain principles of fairness between shareholders, particularly preserving their rights to a return of capital on dissolution, evolved through case law. In the case of unwanted capital, shares which would rank first as to a capital distribution on winding-up would have to be cancelled first.²⁹⁶ However, where lost capital was being cancelled, ordinary shares were first in line.²⁹⁷ As a general rule shares of the same class would have to be treated

²⁹⁰ And it was often resorted to, at least when companies still had to pay a fee on capitalisation, see *In re X Ltd* 1982 (2) SA 471 (W); *Ex parte Anglo-American Corporation of SA Ltd* 1977 (4) SA 146 (W); *Ex parte Trencor Ltd* 1977 (2) SA 396 (C). However, the reduction was refused in the last case. See also Cilliers & Benade *Korporatiewe Reg* 2 ed 334.

²⁹¹ Forms CM13 and CM14 were used. Form CM14 contained separate columns for authorised and issued capital, and also provided for reduction of the share premium account. These forms were replaced by Form 14A, which is a return of acquisition of own shares, see Government Notice R762 of 18 June 1999.

²⁹² Section 87(2) prior to its substitution by s 11 of the Companies Amendment Act 37 of 1999. Blackman, Jooste & Everingham *Companies Act* 5-12 correctly point out that not all reductions of capital would require an amendment to the memorandum. This is so because shares could revert to the status of authorised but unissued shares and also because reductions could be restricted to the statutory non-distributable reserves which are not reflected in the memorandum.

²⁹³ Jooste "Can Share Capital be Reduced" 295, Blackman, Jooste & Everingham *Companies Act* 5-11.

²⁹⁴ Section 194(1)(b).

²⁹⁵ *Ex parte Vlaktein Gold Mining Co Ltd* 1970 (2) SA 180 (T) at 183. Proportionate reductions could be done under s 83, provided the creditor-related requirements were also satisfied.

²⁹⁶ See *Levin v Felt and Tweeds Ltd* 1951 (2) SA 401 (A) at 411; Cilliers & Benade *Maatskappyereg* 4 ed 155. See also De Wet & Yeats *Kontraktereg en Handelsreg* 583.

²⁹⁷ *Levin v Felt and Tweeds Ltd* 1951 (2) SA 401 (A) at 411.

equally.

It is thus clear that, except if only non-distributable reserves were affected, a reduction of capital would involve either a cancellation of particular shares or a reduction in the amount reflected as paid-up in respect of a particular class of shares. In the case of no par value shares, either the number of shares or the average or book value of the shares would be reduced. In the case of par value shares, the number of shares would have to be reduced or the par value of all the shares in the class would have to be reduced. Some reductions of capital would thus also require the variation of share capital as envisaged in section 75.²⁹⁸

The interests of creditors were protected by their right to object to a reduction of capital involving payment to shareholders.²⁹⁹ The court would only sanction a reduction of capital if satisfied that every creditor had either consented to the reduction or had received payment or security for payment.³⁰⁰

2.6.2 The present position regarding reduction of capital

It is accepted that the Companies Act now provides three ways in which a company can reduce its paid-up capital.³⁰¹ They are:

- a repurchase of shares under section 85
- a redemption of redeemable preference shares under section 98
- a repurchase of shares ordered by court under section 252(3).³⁰²

When a company acquires its shares in terms of section 85, the repurchased shares are cancelled upon acquisition and revert to the status of authorised but unissued shares.³⁰³ The Act prescribes the adjustments that have to be made to the company's share capital accounts upon an acquisition of its own shares.³⁰⁴ The issued or paid-up capital of a company is thus reduced through a repurchase

²⁹⁸ See paragraph 2.5 above.

²⁹⁹ Section 85(1) prior to its substitution by s 9 of the Companies Amendment Act 37 of 1999.

³⁰⁰ Section 86(2) prior to its substitution by s 10 of the Companies Amendment Act 37 of 1999. See also *Ex parte Vlaktein Gold Mining Co Ltd* 1970 (2) SA 180 (T) at 183.

³⁰¹ See Blackman, Jooste & Everingham *Companies Act* 5-2.

³⁰² See Blackman, Jooste & Everingham *Companies Act* 5-15. Jooste "Can Share Capital be Reduced" 294.

³⁰³ Section 85(8).

³⁰⁴ Section 85(5) and (7); see paragraph 6.3.3 below.

of shares. This is the case regardless of whether the company purports to be using profits or share capital as the source of funding for the repurchase. It is a logical consequence of the way in which capital accounts are constituted.

In the case of the redemption of redeemable preference shares, the share capital accounts logically have to be reduced by the amounts reflected in respect of the redeemable shares. However, in view of the requirements regarding the sources from which shares may be redeemed, the company's total issued capital will either not be reduced, or the difference will be represented by a capital redemption reserve.³⁰⁵ There is a possible exception to this principle that the total capital and reserves should be maintained: where shares are to be redeemed out of the proceeds of a fresh issue of shares, and the new shares are issued at a premium it seems that the full issue price, including the premium, can be used to pay for the redemption.³⁰⁶ This would mean that not all the cancelled capital will be replaced. It would also be out of step with section 76 which clearly attempts to limit application of the share premium account in providing for premiums only when shares are redeemed or acquired.³⁰⁷ These anomalies are avoided if section 98(1)(a) read with section 98(2) is interpreted to refer to the nominal value of the new issue only.

One of the orders a court can make following a personal action against oppression of a shareholder, is that the company purchase the shareholder's shares.³⁰⁸ It is also expressly provided that when it orders the purchase of the shares by the company, the court can order it to reduce its capital 'accordingly'.³⁰⁹ This reinforces the logical relation between the reacquisition of shares and a reduction of capital.

The options for applying the share premium account and capital redemption reserve fund have been retained and extended to include providing for a premium when shares are acquired under section 85.³¹⁰ It seems that these reserves can

³⁰⁵ See paragraph 6.8 below.

³⁰⁶ Cilliers & Benade *Corporate Law* 230 note 66.

³⁰⁷ See s 76(3)(c) and (d).

³⁰⁸ Section 252(3).

³⁰⁹ Section 252(3).

³¹⁰ Section 76(3)(d) added by s 6 of Act 37 of 1999 and s 98(4) as amended by s 15 of Act 37 of 1999.

be reduced only through these applications.³¹¹ Another possible reduction, apparently overlooked by Jooste and the authors of *Blackman, Jooste & Everingham Companies Act*, is a reduction of the stated capital account to provide for costs, expenses and commissions on the creation or issue of no par value shares.³¹²

2.6.3 Comparison of old and new position regarding reduction of capital

2.6.3.1 Kinds of reductions possible

The repeal of the capital reduction provisions raises the question of whether a company is still able to reduce its capital to the same extent as before. In particular, can a company reduce its capital by cancelling lost capital? Jooste raised and rejected the possibility that a company could achieve such a reduction by altering its memorandum in terms of section 56(4).³¹³

I submit that a company can nevertheless achieve similar reductions through an acquisition of its shares under section 85, including a cancellation of lost capital. Although section 85 is often said to provide for repurchases or buy-backs, it in fact refers to the 'acquisition' of shares.³¹⁴ A company could thus acquire its own shares without consideration and cancel them to reflect lost capital. The solvency and liquidity requirements of section 85(4) do not apply where the company acquires shares without payment.³¹⁵ The possibilities can be enhanced through variations of share capital under section 75. For example, a company could subdivide its existing par value shares,³¹⁶ followed by a proportionate acquisition of the subdivided shares in order to reduce its share capital account to the desired level.

The repealed provisions permitted a reduction of statutory non-distributable

³¹¹ Blackman, Jooste & Everingham *Companies Act* 5-274-1; Jooste "Can Share Capital be Reduced" 298; Wainer "Problems and Doubts" 134. Also see paragraph 2.4.3.3.3 above.

³¹² Section 77(3). See paragraph 2.4.2 above.

³¹³ Jooste "Can Share Capital be Reduced" 298.

³¹⁴ See paragraph 6.1.1 for a discussion of the meaning of this concept.

³¹⁵ The solvency and liquidity test is discussed in more detail in paragraph 4.1 below.

³¹⁶ It is accepted that a subdivision of par value shares does not trigger s 75(3)(a) and that the company will not become liable for the prescribed fee on an increase in capital, see paragraph 2.5.2 above.

reserves.³¹⁷ Section 85(7) allows limited application of non-distributable reserves when shares are acquired.³¹⁸ However, I think it is now possible to reduce the share premium account and capital redemption reserve to a greater extent than previously by applying them to issue capitalisation shares. Subsequent acquisition of these shares under section 85 would then reduce the share capital accordingly. This is an indirect and perhaps cumbersome way of achieving a general reduction of these reserves. The company may have to increase its authorised capital to provide for the capitalisation shares and may become liable for the prescribed fee in terms of section 75(3). Although this will have adverse cost implications, it may well be cheaper than the court application under the old procedure. I submit that a special resolution for the increase of share capital and a special resolution for the acquisition of the capitalisation shares can be taken at the same meeting, as envisaged in section 62, provided that the capitalisation shares are actually issued between the two resolutions. It is not possible under section 85(1) to approve the acquisition of shares that have not yet been issued.³¹⁹

One method of capital reduction is no longer possible. Previously, it was accepted that a company could use the repealed reduction provisions to reduce its capital to nil.³²⁰ According to Meskin *Henochsberg on the Companies Act* such a reduction would have been used when a company having a share capital was being converted into a company limited by guarantee or a section 21 company.³²¹ Section 23 provides for such conversions, but requires that the share capital be 'cancelled'. It is not possible under the repurchase provisions to acquire all the shares of a company.³²² Has it now become impossible to convert a company with share capital into a guarantee company?

Section 23 refers to a cancellation of capital, not to a (formal) reduction. I think that the legislature never meant to require a separate reduction of capital under the repealed sections 83 to 90 for conversions. The conversion provisions seem able to operate independently of the reduction of capital provisions. In a

³¹⁷ See paragraph 2.6.1 above.

³¹⁸ See paragraph 2.6.2 above.

³¹⁹ See paragraph 6.1.1 below.

³²⁰ See Blackman, Jooste & Everingham *Companies Act* 5-12 and the authority there quoted, *Re Anglo American Insurance Co Ltd* [1991] BCLC 564.

³²¹ See Meskin *Henochsberg on the Companies Act* 41.

³²² Section 85(9). See paragraph 6.3.2 below.

conversion, creditors are protected by the notice requirements³²³ and by the fact that the conversion does not affect the obligations and liabilities of the company,³²⁴ while shareholders are protected by the special resolution requirement. If this argument is accepted, conversions can still take place despite the fact that a company cannot acquire and cancel all its shares. Unless this interpretation is correct, conversions of companies having a share capital into companies limited by guarantee have become impossible.

2.6.3.2 Protection of creditors and shareholders when capital is reduced

Considered from the perspective of creditors, it could appear that they enjoy less protection under the new provisions because they are not given the right to object or insist on payment or security. This right, which was available if a reduction involved a payment to shareholders,³²⁵ has to be compared to the protection creditors enjoy in terms of section 85(4) when a company makes a payment for the acquisition of its shares. If the company satisfies the solvency and liquidity test, the risk of loss to creditors is remote. Further, in the event of an unlawful payment for the acquisition of shares, creditors can recover payment from the shareholders who received payment, and the directors would be liable to restore any unrecovered amount to the company.³²⁶

I think that the protection under the share repurchase provisions is adequate, although not as strong as under the old procedure which has been criticised, it is submitted validly, as an over-protection of creditors.³²⁷

From the point of view of dissenting shareholders it appears that they do not enjoy the same protection as before when their interests were considered by a court. Shareholders are protected by the requirements of authorisation in the articles and a special resolution. Provision is also made for the proportionate treatment of shareholders, although this applies only to some acquisitions.³²⁸ In

³²³ Notice in the *Gazette* is required, s 26(1), and in the case of a public company, also notices to all creditors, s 26(2).

³²⁴ Section 29.

³²⁵ See paragraph 2.6.1 above.

³²⁶ Section 86, see paragraph 6.4 below.

³²⁷ By the Company Law Review in England, see *The Strategic Framework* URN 99/654 (February 1999) 5.4.5 and Chapter 2 paragraph 2.6.

³²⁸ Section 87(2). See paragraph 6.3.2.1 below.

appropriate circumstances the Securities Regulation Code on Takeovers and Mergers may also apply, with the result that its disclosure and other procedural requirements will apply and that majority votes could be excluded.³²⁹

The authors of Blackman, Jooste & Everingham *Companies Act* attempt to justify the lower level of protection of shareholders in a repurchase by contrasting the consensual basis of repurchases with the compulsory nature of reductions.³³⁰ However, I submit that share acquisitions can indeed be forced on dissenting shareholders if the company is acting in pursuance of a specific approval.³³¹ Further, any shareholder whose shares are not being acquired can be equally disadvantaged in relation to shareholders whose shares are being acquired. The consensual principle is thus not an acceptable explanation for reducing the protection of shareholders. The fair treatment of shareholders in a repurchase is considered in more detail elsewhere.³³²

2.6.4 Interpretation of remaining references to reduction of share capital

An interesting issue that arises is how the remaining references in the Act to the reduction of capital should be interpreted. One such reference appears in section 194(1)(b), which provides that holders of preference shares retain the right to vote on resolutions affecting their rights or interests, including a resolution for the reduction of capital. Does this mean that preference shareholders have the right to vote when an acquisition of own shares is proposed? This would qualify as a resolution that affects their rights or interests.³³³ It makes sense to interpret the reference to reduction as a reduction through a repurchase. As regards the redemption of redeemable preference shares, no resolution of the company in general meeting is required. It appears that directors can make the decision if shares are redeemable at the option of the company. The question of voting rights

³²⁹ See the definition of 'acquisition' in Section B 1 of the Securities Regulation Code on Takeovers and Mergers, and rule 29(a)(ii), (iv) and 29(b), considered in paragraph 2.6.3.2 above.

³³⁰ Blackman, Jooste & Everingham *Companies Act* 5-15 – 5-16. The authors suggest, however, that a company could still freeze out shareholders by converting ordinary shares into redeemable shares and then redeeming them.

³³¹ Also see paragraph 6.3 below. In the case of a *pro rata* offer through an offering circular, which is required in the case of a general authorisation, shares would only be acquired from shareholders who offer to sell their shares, s 87(4).

³³² See paragraph 6.3 below.

³³³ See paragraph 6.3.1.2 below.

of preference shareholders cannot arise in the context of reductions by court order under section 252. It is uncertain whether preference shareholders will have the right to vote when statutory non-distributable reserves are reduced through the various applications. Although a formal reduction of these reserves under the repealed reduction of capital provisions seems to have entitled preference shareholders to vote, the position regarding application of reserves as set out in section 76(3) and section 98(4) is problematic. Previously, such applications were not regarded as reductions of capital and so preference shareholders were not entitled to vote unless they could show that their rights or interests were affected.³³⁴ I interpret the reference in section 194(1)(b) to a reduction of capital as covering only an acquisition of shares under section 85. It should be replaced with a direct reference to an acquisition of shares.³³⁵

Section 252, which provides for a statutory personal action of members in cases of oppression, contains two references to the reduction of capital. The first appears in section 252(2)(b) and refers only to a reduction of capital under section 83.³³⁶ Clearly this provision has become obsolete and should be replaced with a reference to an acquisition of shares under section 85. This will oblige shareholders who wish to institute a personal action to do so within six weeks after the passing of the special resolution authorising the acquisition.³³⁷

A more general reference to reduction of capital is found in section 252(3). This subsection provides that when a court orders the company to purchase the shares of a member, it can order the company to reduce its capital 'accordingly'. This confirms that a repurchase of shares amounts to a reduction of capital and by ordering the company to reduce its capital, the court obliges the company to make the necessary adjustments to its capital accounts. This provision could never have referred to the capital reduction provisions of section 83 to 90 because they were separate procedures involving resolutions, notifications, objections and court

³³⁴ This would only be the case if the articles provided for proportionate interests in the share premium account.

³³⁵ See paragraph 6.3.1.2 below regarding which shareholders can vote on a repurchase.

³³⁶ The function of the provision is to set a time limit for instituting an action following certain corporate actions.

³³⁷ Section 252(2)(c) provides that shareholders aggrieved by a variation of class rights have to institute an action within six weeks of the resolution of the class meeting. It is not wide enough to cover all instances of share repurchases or all shareholders who might want to object to a repurchase.

approval. When a court orders a company to repurchase its shares in terms of section 252(3), it would not make sense to require separate compliance with the formal reduction provisions. So this reference cannot be regarded as an outdated reference to the repealed reduction procedure. It would have been preferable to set out the adjustments in more detail or to have referred to the adjustment requirements set out in section 85(5) and (6).³³⁸

It is interesting to note that the Securities Regulation Code on Takeovers and Mergers also refers to a reduction of capital.³³⁹ These provisions were drafted before companies could acquire their own shares.³⁴⁰ However, as they are formulated in very wide terms, they are clearly applicable to reductions of capital through an acquisition of own shares. These provisions are discussed in more detail in relation to share repurchases.³⁴¹

2.7 Loss of capital

One of the grounds for winding-up of a company is if 75 per cent of its issued share capital has been lost or has become useless for the business of the company.³⁴² This seems to be the only provision of the Act concerned with the question whether share capital is represented by assets.³⁴³ This ground is aimed at the protection of shareholders, not creditors, as is evident from the fact that the court will refuse the order if the majority of shareholders are in favour of the company continuing to operate.³⁴⁴

³³⁸ It should perhaps also have been provided that a company can apply its share premium account to provide for a premium when the court has ordered a company to purchase its shares under section 252.

³³⁹ Rule 29(a)(ii), (b).

³⁴⁰ It has not been amended and is thus still in the form it was cast in 1991.

³⁴¹ See paragraph 2.6.3.2 above.

³⁴² Section 344(e). The application may be made by any party entitled to apply for the winding-up of a company, including a member, see s 346(2).

³⁴³ The share capital as reflected in the various accounts cannot be 'lost'.

³⁴⁴ For examples of the application of this ground for winding-up, see *Alpha Bank Bpk v Registrateur van Banke* 1996 (1) SA 330 (A) and *De Jager v Karoo Koeldranke & Roomys (Edms) Bpk* 1956 (3) SA 594 (C). Also see Cilliers & Benade *Corporate Law* 503. Creditors are not necessarily affected, since the loss of share capital is not an indication that the company is unable to pay its debts, see *Ex parte De Villiers NNO: In re Carbon Development (Pty) Ltd in Liquidation* 1993 (1) SA 493 (A).

2.8 Capital structure under the Companies Bill

Chapter 2 part D of the Companies Bill 2008 is entitled 'Capitalization of Profit Companies' and regulates the authorisation and issue of shares, consideration for shares, distributions to shareholders as well as certain other specific applications of company funds, such as financial assistance for the subscription for or purchase of shares and financial assistance to directors and related persons. It has already been explained that neither the *Policy Framework* nor the *Explanatory Memorandum to the Companies Bill 2008* contains much detail on the policy issues.³⁴⁵ The *Explanatory Memorandum* contains two paragraphs in this regard. First, it is said that in order to promote efficiency, par value shares and nominal value should be replaced with a 'capital maintenance regime based on solvency and liquidity'.³⁴⁶ Secondly, shareholders should be protected through the requirement of shareholder approval for certain share issues, for financial assistance to directors, and for the purchase of own shares.

2.8.1 Authorised capital

The concept of authorised capital is retained by the Companies Bill in the sense that the classes of shares and the number of each class of shares that the company is authorised to issue must be set out in its memorandum of incorporation.³⁴⁷ The memorandum must set out the preferences, rights and limitations applicable in respect of each class of shares.³⁴⁸ Unclassified or 'blank' shares, which may later be classified by the board, may also be authorised.³⁴⁹ The authorised capital can be increased or decreased by a special resolution of the shareholders amending the memorandum of incorporation³⁵⁰ or by the board of directors acting in terms of an authorisation to that effect in the memorandum of incorporation of the company.³⁵¹

³⁴⁵ See paragraph 1.1 above.

³⁴⁶ See *Explanatory Memorandum to the Companies Bill 2008*, under the heading 'Company Finance'.

³⁴⁷ Clause 36(1)(a).

³⁴⁸ Clause 36(1)(b)(ii).

³⁴⁹ Clause 36(1)(c).

³⁵⁰ Clause 36(2)(a).

³⁵¹ Clause 36(2)(b) read with (3). The board has to file a notice of amendment to the memorandum of association when it has acted in pursuance of its authority to vary the

The Companies Bill dispenses with the requirement of shareholder approval by ordinary resolution whenever shares are issued.³⁵² Instead, it targets two specific problem areas and prescribes shareholder approval by special resolution in these two instances. The first is the issue of shares to directors and officers, future directors and officers, or related persons. The issue must be approved by special resolution except in certain specific circumstances.³⁵³

The issue of further shares in a class that will substantially influence the voting rights within that class, is the second instance. Where further shares are issued in a transaction or series of integrated transactions and the voting power of the new shares amounts to more than 30 per cent of the voting power of all the existing issued shares of that class immediately before the transaction or series of transactions, the issue must be approved by special resolution of the shareholders.³⁵⁴

Although it may be a good idea to subject substantial issues to shareholder approval, the proposed provision is problematic. It is restricted to a specific class of shares and pays no regard to the total voting power in the company. A simple example will illustrate its limitations. Say a particular class of shares has ten per cent of the total votes in the company. The voting power that the new shares will have once they are issued, expressed as a percentage of the voting power of the shares immediately before the issue, is 33 per cent.³⁵⁵ This means that the issue will trigger the provision. Shareholder approval is thus necessary despite the fact that the voting power of each shareholder has been diluted by only 3,3 per cent. However, if the company has only one class of shares, and has issued 10000 shares in that class, a further 4285 shares can be issued without a special resolution of the shareholders. The voting power of the new shares will be just under 30 per cent³⁵⁶ of the voting power of the shares immediately before the issue. Shareholder approval is not required for this issue, although each

Continued

authorised capital of the company, clause 36(4).

³⁵² See s 221 of the Act, discussed in paragraph 2.1 above.

³⁵³ Clause 41(1). The exceptions include issues in accordance with pre-emptive rights, issues in proportion to the director's shareholding and issues pursuant to public offers, see clause 41(2).

³⁵⁴ Clause 41(3). The concept 'series of integrated transactions' is defined in clause 41(4)(b).

³⁵⁵ $13,3 / 103,3 = 13\%$

³⁵⁶ Approval is required when the voting power is more than 30 per cent.

shareholder's rights have been diluted by 30 per cent.

It is also not certain whether the provision is intended to apply to the issue of shares of a new class. The voting power of the new class prior to the issue would be nil, so that any new issue would constitute an infinite increase in the voting power of that class. It could, however, be argued that the provision presupposes some existing voting power and would thus apply only where shares of the same class have been issued previously.

This provision bears some similarity to section 6.21(f) of the MBCA, with the crucial difference that the latter provision looks at the total voting power of all the issued shares of the company. Another difference is that the MBCA sets a much lower level of 20 per cent.

Another problem is that this provision pays regard only to voting power. Distribution rights of further shares can also dilute the interests of shareholders. A company can issue an unlimited number of non-voting shares, entitled to distributions, without having to obtain shareholder approval.

The Companies Bill also proposes pre-emptive rights when private companies issue further shares.³⁵⁷ Pre-emptive rights represent a default option in the Companies Bill and a company may exclude or limit these rights in its Memorandum of Incorporation.

In certain circumstances pre-emptive rights are excluded, for example when shares are being issued for future consideration.³⁵⁸ This proposal is less onerous than the position in England where pre-emptive rights are compulsory for public companies.³⁵⁹ However, the *JSE Limited Listings Requirements* provide for pre-emptive rights in respect of listed shares and will probably continue to do so.³⁶⁰

The forms of consideration for shares that will trigger or exclude pre-emptive rights under the Companies Bill differ from the position in other jurisdictions. In New Zealand pre-emptive rights apply regardless of the nature of consideration involved.³⁶¹ In England such rights apply to cash consideration only, which would

³⁵⁷ Clause 39.

³⁵⁸ Clause 39 refers to issues in terms of clause 40(5) – (7), which deals with unpaid or partly paid shares. Another notable exclusion relates to employee share schemes.

³⁵⁹ See Chapter 2 paragraph 2.1.

³⁶⁰ See *JSE Limited Listings Requirements* paragraph 3.30, discussed in paragraph 2.1 above.

³⁶¹ See Chapter 3 paragraph 2.1.

include an undertaking to pay cash in the future,³⁶² but not to issues for non-cash consideration. If the provision in the Companies Bill is enacted, pre-emptive rights will apply both to issues for cash and for non-cash consideration, unless the consideration is to be transferred in the future. A company can avoid the operation of pre-emptive rights by simply agreeing to issue shares for future consideration. On the other hand, if shares are issued for non-cash consideration, transferable upon issue of the shares, pre-emptive rights will apply. This does not make sense. Pre-emptive rights are often excluded in the case of non-cash consideration in order to facilitate share exchanges in mergers and amalgamations. There seems to be no logic behind linking pre-emptive rights to the time when the consideration will be given. I suggest that this proposal needs reconsideration. If it is decided that pre-emptive rights should apply to cash consideration only, as is the case in England, a definition of 'cash' should be inserted.

2.8.2 *Minimum issued capital*

Although no minimum issued share capital is prescribed, the Companies Bill expressly states that there should always be at least one share in issue to at least one person other than a company that is part of the same group of companies to which the company belongs.³⁶³ This provision will prohibit the shares of a subsidiary from being held exclusively by the holding company and its subsidiaries. Despite this, the Companies Bill recognises the notion of a wholly owned subsidiary, although the definition depends on the holding company holding or controlling 'all of the general voting rights' in the subsidiary rather than on shareholding.³⁶⁴ This requirement seems absurd especially as the definition of 'wholly owned subsidiary' will not be satisfied if the outside shareholder carries any general voting right in respect of the share. A wholly owned subsidiary would have to issue at least one non-voting share to a token outside shareholder in order to comply with the minimum issued capital requirement. The intention may have been to prohibit all the shares in a holding company from being held by one or more of its subsidiaries, but this situation is in any event precluded by the limit

³⁶² See Chapter 2 paragraph 3.2.

³⁶³ Clause 35(3)(b).

³⁶⁴ Clause 3(1)(b).

placed on shares that may be held by subsidiaries.³⁶⁵

The motivation behind the requirement that at least one share must be in issue, is presumably to facilitate the running of the company³⁶⁶ and to prevent its informal liquidation and dissolution.³⁶⁷ However, this purpose may not be achieved, as the provision as currently formulated does not require the issued share to have any particular attributes like being entitled to vote and to receive the net assets on liquidation.

A company is required to have at least one class of authorised shares that confer the right to vote on every matter to be decided by shareholders and at least one class entitled to receive the net assets on liquidation.³⁶⁸ However, it is not a requirement that any of these shares should have been issued.³⁶⁹

2.8.3 Types of shares

The Companies Bill proposes a system of compulsory no par value shares.³⁷⁰ However, par value shares issued by pre-existing companies continue to have their assigned par value for the time being.³⁷¹ The Minister has to make regulations regarding the transitional status and conversion of par value shares and capital accounts.³⁷² These regulations have to preserve the rights of shareholders as far as possible.³⁷³

It seems that authorised but unissued par value shares are not covered by this provision, as it refers to par value shares that have been 'issued'.³⁷⁴ The effect on authorised but unissued par value shares is unclear, but presumably a company will not be able to issue them as par value shares. I think the company

³⁶⁵ Clause 48(3)(a), as to which see paragraph 6.9.6 below.

³⁶⁶ Compare s 6.03(b) – (c) of the MBCA, see Chapter 4 paragraph 4.4.2.

³⁶⁷ See Van der Linde "A Company's Purchase of its Own Shares" 69.

³⁶⁸ Clause 37(3)(b).

³⁶⁹ Compare clause 35(3)(b).

³⁷⁰ Clause 35(2).

³⁷¹ Schedule 7 Item 6(2).

³⁷² Schedule 7 Item 6(3). These regulations have to be made in consultation with the Minister of Finance and have to take effect when the Act comes into operation.

³⁷³ Schedule 7 Item 6(3)(a). To the extent that this is possible in view of the purpose of transition, the regulations have to provide for compensation by the company to the shareholders who lose any such rights, see Schedule 7 Item 6(3)(b).

³⁷⁴ This is apparently not an oversight, since the transitional provision also requires the shares to be held by a shareholder immediately before the date on which the new Act comes into

should be allowed to treat them as the same number of authorised no par value shares.

2.8.4 Capital accounts

The Companies Bill does not regulate the way in which the consideration received for shares should be reflected in the company's share capital accounts.³⁷⁵ In fact, it does not appear necessary for the board to determine the specific monetary value of consideration received for the issue of shares.³⁷⁶

Clause 51(6) of the Companies Bill, 2007 required an adjustment to the stated capital account following a repurchase of shares and thus implied that the full consideration received would have to be reflected in a stated capital account. In comments on this Bill submitted to the Department of Trade and Industry, I pointed out that this was an anomaly as it implied that a company should have a stated capital account reflecting the consideration received. This requirement is not repeated in the Companies Bill of 2008.

2.8.5 Variation of share capital

The Companies Bill contains a provision regarding the variation of share capital.³⁷⁷ Unlike the current Act which regulates the consequences of variations in considerable detail, the draft clause enables a company by special resolution to amend its capital or to delegate certain powers in this regard to the board of directors.³⁷⁸ Because share capital accounts are not regulated, the variation provision is far less complex than section 75 of the Act.³⁷⁹

Directors will enjoy more discretion than under the present Act. This is in line with the increased discretion in respect of the authorisation of further shares.³⁸⁰

Continued

operation, see Schedule 7 item 6(2).

³⁷⁵ This is in line with the MBCA.

³⁷⁶ Clause 40(2). See the similar position under the MBCA, discussed in Chapter 4 paragraph 4.2.1.

³⁷⁷ Clause 36(2).

³⁷⁸ The power to vary authorised but unissued share capital can be delegated to the board, clause 36(2) read with clause 36(3).

³⁷⁹ See paragraph 2.5 above.

³⁸⁰ See paragraph 2.8.1 above.

2.9 Evaluation of capital structure

2.9.1 *Evaluation of the concept authorised capital*

Both the Act and the Companies Bill rely on the concept of authorised capital. The need to state a company's authorised capital in its constitutive documents can be questioned. Creditors are not protected by the statement of authorised capital, since not all the authorised shares need to be issued. Neither is the investing public protected by the limit on the number of shares a company may issue, because apart from the relative ease with which the authorised capital may be increased, it does not limit the amount that can be raised from the public. In the case of par value shares the company can raise additional funds by issuing the shares at a premium, and in the case of no par value shares there is no indication of the maximum consideration for which they may be issued. Unsophisticated creditors or investors may be misled into believing that the authorised capital determines the assets of the company, especially when these shares have a par value.³⁸¹

The advantage of authorised capital is the degree of protection it offers to existing shareholders against the dilution of their relative stakes in the company. The level of protection a shareholder enjoys is determined by two factors. First, it depends on the ratio between issued and unissued shares. If a company has a very high number of authorised but unissued shares, the stakes of existing shareholders can be substantially eroded without an increase in authorised capital. The second factor is the ability of a shareholder to influence any decision to increase the authorised capital. The current Act gives a shareholder who is unable to block a special resolution no protection through the statement of authorised capital. The Companies Bill retains the special resolution requirement, but also provides as an alternative that the Memorandum of Incorporation may delegate the power to increase the authorised capital to the board of directors. This delegation will increase flexibility but at the same time decrease the protection of shareholders.

³⁸¹ This argument is sometimes used to support proposals for the abolition of the par value concept, see paragraph 2.8.3 below. Creditors will be able to determine the extent of the company's issued capital from its financial statements, because Schedule 4 to the Act requires the balance sheet of a company to set out certain details of its issued capital, see Part 1 B

The desirability of retaining authorised capital cannot be assessed in isolation from other measures that also serve to protect the relative interests of shareholders. These other measures recognise that only an actual issue of shares will affect shareholder interests and so limit the power of directors to issue shares. Two such measures can be distinguished, namely shareholder approval and pre-emptive rights.

Both the Companies Act and the Companies Bill require shareholder approval for the issue of shares, although in the latter case this is restricted to substantial issues and issues to directors.³⁸² While the Act requires an ordinary resolution, which can be a general approval unless the shares are issued to directors, the Companies Bill prescribes a special resolution for the instances where approval is required. I prefer the approach of the Companies Bill that identifies particularly risky issues and subjects them to stricter requirements, while directors are afforded more discretion in issuing shares in other cases. I submit that this will give more meaningful protection to shareholders. However, the percentage set for substantial issues, namely those involving at least 30 per cent of the voting rights of the existing shares, is a relatively high threshold in comparison to that of the MBCA.³⁸³ Further, I have illustrated through examples that the current proposal of looking at the voting power of a specific class in isolation makes little sense, and that regard should be had to the total voting power in the company.³⁸⁴

While the Corporate Laws Amendment Act 24 of 2006 introduced 'deemed' pre-emptive rights into the Act, these pre-emptive rights apply only to certain further share issues and various aspects of their application are uncertain.³⁸⁵ I argued that the new rules may be effective in excluding external shareholders but not in protecting shareholders against a dilution of their relative interests.³⁸⁶ The Companies Bill makes provision for pre-emptive rights in respect of further share

Continued

paragraph 8.

³⁸² See paragraph 2.8.1 above.

³⁸³ See paragraph 2.8.1 above.

³⁸⁴ See Chapter 6 paragraph 7.5 for the suggested wording.

³⁸⁵ See paragraph 2.1 above.

³⁸⁶ See paragraph 2.1 above.

issues in private companies.³⁸⁷ The provision embodies a default option which can be excluded in the Memorandum of Incorporation,³⁸⁸ while the current Act does not permit the disapplication of the deeming provision. The proposed pre-emptive rights in the Companies Bill do not afford existing shareholders a ‘top-up’ opportunity, that is, the right to take up shares that are not subscribed for by their fellow shareholders. The current deemed pre-emptive rights in a company with Table B articles will be more successful in excluding external shareholders because all the available shares must be divided among the shareholders who are willing to take them. A top-up provision could be particularly useful in a private company premised upon family control.³⁸⁹

Pre-emptive rights as contained in the Companies Bill will improve the protection of shareholders in private companies in relation to the control aspect of their shareholding in the company and will constitute an improvement on the current position which treats all shareholders equally.³⁹⁰ These rights may not succeed in preserving relative distribution entitlements, but that would be difficult to apply across class structures where distribution entitlements of some classes are fixed and others residual in nature.

Listed companies that issue further shares for cash are likely to continue to be subject to pre-emptive rights under the *JSE Limited Listings Requirements*, requiring pro rata treatment of shareholders in substantial further cash issues.³⁹¹ If this is the case, it makes little sense to exclude pre-emptive rights in public unlisted companies. For this reason I submit that pre-emptive rights should be made applicable to all companies as default option.³⁹² However, a top-up provision should apply only to private companies in view of the additional motivation of maintaining a closed circle of shareholders.

Most of the other jurisdictions surveyed also use the concept of authorised

³⁸⁷ These pre-emptive rights in respect of further issues by the company must not be confused with restrictions on the transferability of shares by shareholders which often take the form of pre-emptive rights. As is the case under the present s 20(1)(a), the Companies Bill simply requires a private company to restrict the transferability of its shares without prescribing how this should be done, see clause 1 s v ‘private company’ and clause 8(2)(b).

³⁸⁸ See paragraph 2.8.1 above.

³⁸⁹ In this regard, see the proposal in Chapter 6 paragraph 7.5.

³⁹⁰ See also Delport “Capital Rules” 412.

³⁹¹ See paragraph 2.1 above.

³⁹² See the proposal in Chapter 6 paragraph 7.5.

capital. This is the case even in systems that have abolished the traditional legal capital or maintenance of capital systems.

Delaware,³⁹³ California³⁹⁴ and American states that have adopted the MBCA³⁹⁵ rely on the concept of authorised capital. The authorised shares may be increased by majority vote and separate class votes are required if the new shares will rank prior to the particular class.³⁹⁶ Shareholder approval is not generally required for share issues, although the MBCA requires it for substantial non-cash issues. Pre-emptive rights apply only if expressly included in a corporation's constitution. However, state legislation usually provides a standard set of opt-in pre-emptive rules which a corporation can simply incorporate by reference. Listed companies may be subject to federal regulation applying pre-emptive principles to cash issues. Several stock exchanges also prescribe shareholder approval for substantial non-cash issues.

The exceptions are New Zealand, and, when the relevant part of CA 2006 comes into operation, England.³⁹⁷ These systems do not rely on authorised capital. In New Zealand the constitutive documents of a company contain no reference to share capital. Directors have the power to issue shares, unless this power is restricted in the articles. The greater discretion given to directors in New Zealand is offset by a specific duty to consider the fairness of an issue to existing shareholders. In England shareholder approval is necessary for the issue of shares, but the power to issue shares may be delegated to the directors for a limited period. Pre-emptive rights apply in England and in New Zealand. While the extent of pre-emptive rights in England is narrower in that only cash issues are involved, public companies may not exclude these rights. In New Zealand issues for any kind of consideration are subject to pre-emptive rights, but these rights can be excluded by all companies. Moreover, certain issues of shares are deemed to constitute an alteration of class rights and must be approved by separate classes or interest groups, and are further subject to the appraisal remedy. Shareholders in New Zealand thus enjoy particularly strong protection against the dilution of their

³⁹³ See Chapter 4 paragraph 1.2.1.

³⁹⁴ See Chapter 4 paragraph 2.2.1.

³⁹⁵ See Chapter 4 paragraph 3.2.1.

³⁹⁶ This is a broad generalisation, see Chapter 4 paragraphs 2.2.1, 3.2.1 and 4.2.1 for small differences in the requirements.

equity interests, despite the absence of authorised capital.

I have shown that the proposed pre-emptive rights are more limited than those applicable in New Zealand and in England.³⁹⁸ Further, the Companies Bill requires shareholder approval in exceptional circumstances only, exposing shareholders to the risk of a relatively substantial erosion of their equity interests. In view of this, I recommend that the notion of authorised capital should indeed be retained.

The possibility of including a provision, based on the example in the English Companies Act of 1985,³⁹⁹ to the effect that any reference to capital on the stationery and order forms of a company must be to its paid-up capital, was considered. But if no par value shares are used there is little danger of investors and creditors being misled, as the statement of authorised capital will not involve an amount of money, but will merely mention the number of no par value shares of each class.

If companies are no longer required to have or disclose an authorised capital, an alternative basis must be found for the fee which is currently payable under section 63(1). The way in which the fee is currently calculated causes distortions between par value and no par value shares.⁴⁰⁰ It may thus in any event be preferable to calculate the fee based on actual issued capital. If a system of compulsory no par value shares is adopted, a fee based on the capital raised by each company should be easy to implement. At this stage the Companies Bill does not provide for a fee on share capital.

2.9.2 Evaluation of minimum capital

The Act does not prescribe a minimum amount of issued capital, but requires the subscribers to the memorandum to take up at least one share each. However, there is no general statutory requirement that a share should always remain in issue.⁴⁰¹ The draft Bill expressly requires at least one share to be in issue,

Continued

³⁹⁷ See Chapter 2 paragraph 2.1.

³⁹⁸ See paragraph 2.8.1 above.

³⁹⁹ See CA 1985 s 351(2), discussed in Chapter 2 paragraph 2.1.

⁴⁰⁰ See paragraph 2.3.1.6 above.

⁴⁰¹ See paragraph 2.2 above.

although the formulation of this provision has been criticised.⁴⁰²

With the exception of England, which prescribes a minimum issued and paid-up capital for public companies in the interest of creditors, all the jurisdictions regulate the minimum capital purely in the interest of the proper functioning of the company. As is the case in South Africa, the legislation in England, New Zealand, Delaware and California does not expressly prescribe the attributes of the initial minimum issued shares.⁴⁰³ However, express restrictions are found in South Africa, Delaware and California regarding the kind of shares that should remain in issue following certain acquisitions of shares.⁴⁰⁴ In contrast, it is a statutory requirement under the MBCA that there should at all times be at least one or more issued shares that together have unlimited voting rights and the right to the net assets of the corporation upon dissolution. This latter approach is preferable as it avoids uncertainty and also facilitates simplification of the requirements for repurchases or redemptions. In view of the criticisms against the proposed provision of the Companies Bill, an alternative provision will be recommended.⁴⁰⁵

2.9.3 Evaluation of kinds of shares

The dual system of par value and no par value shares as currently regulated in the Act has been criticised elsewhere.⁴⁰⁶

This is aptly illustrated by comparison with Delaware, the only other jurisdiction surveyed that provides for a dual system of par and no par value shares. Although the capital maintenance or legal capital doctrine still applies in Delaware, its regulation of how the consideration received for par value and no par value shares should be reflected in share capital and reserve accounts differs from South African law in important respects.⁴⁰⁷ In Delaware it is not required that the full consideration received for no par value shares should be reflected as stated capital. Neither is share premiums regulated, although the board of directors has

⁴⁰² See paragraph 2.8.2 above.

⁴⁰³ See paragraph 2.2 above; Chapter 2 paragraph 2.2; Chapter 3 paragraph 2; Chapter 4 paragraphs 2.2.2 and 3.2.2.

⁴⁰⁴ See paragraph 6.3.2 below and Chapter 4 paragraphs 2.2.3 and 3.2.2.

⁴⁰⁵ See Chapter 6 paragraph 7.4 and the proposed provision entitled 'Requirement to have shareholders'.

⁴⁰⁶ See paragraph 2.3.2 above.

⁴⁰⁷ See Chapter 4 paragraph 2.2.4.

the discretion to reflect any portion of a premium as share capital.

New Zealand is the only jurisdiction to have adopted a compulsory no par value system.⁴⁰⁸ In California and under the Model Business Corporations Act shares need not, but may, have a par value.⁴⁰⁹ Although companies may attach a par value to their shares, this value will have no legal significance. In England only par value shares are allowed.⁴¹⁰

It is disappointing that the South African debate surrounding the nature of shares seems to have focused primarily on one of the disadvantages of par value shares, namely the artificiality and 'historical insignificance' of the par value assigned to a share which is perceived as potentially misleading to investors and creditors.⁴¹¹ One of the arguments against par value shares is that they serve no purpose in a system which requires shares to be fully paid up upon issue, because the only function of par value was to indicate the outstanding liability of shareholders in a system of unpaid or partly paid shares.⁴¹² This argument does not withstand closer scrutiny. Although the par value may be used to determine liability to creditors, a shareholder is liable to the company for the total issue price of her shares, including any premium payable. If unpaid or partly paid shares were allowed, the outstanding liability to the company would thus not be determined with reference only to the nominal value of the share. It would also be possible to allow unpaid or partly paid no par value shares, in which case the outstanding liability would be determined with reference to the agreed consideration only.⁴¹³

Par value shares are also criticised because existing shareholders are not properly protected against the dilution of the value of their shares.⁴¹⁴ While the criticism against the current section 81 is justified,⁴¹⁵ the problem cannot be attributed to the par value system as such. Better protection for par value shareholders could have been enacted by taking into account the full issue price of

⁴⁰⁸ See Chapter 3 paragraph 2.

⁴⁰⁹ See Chapter 4 paragraphs 2.2.3 and 3.2.3.

⁴¹⁰ See Chapter 2 paragraph 2.3.

⁴¹¹ See McLennan "Abolition of Par-value" 43 note 3; *Policy Framework* 2.2.3.

⁴¹² McLennan "Abolition of Par-value" 43.

⁴¹³ In South Africa partly paid shares were abolished at the same time that no par value shares were introduced, but these decisions were not interdependent. See paragraph 3.3 below on the time when consideration must be received by the company.

⁴¹⁴ See Blackman, Jooste & Everingham *Companies Act* 5-39.

⁴¹⁵ See paragraph 3.1.1 below.

shares, that is, the nominal value as well as any premium.⁴¹⁶

McLennan concludes that, apart from some complex and meaningless provisions, there is no harm in par value shares. He nevertheless suggests that South Africa should allow only no par value shares.⁴¹⁷ He provides no detailed suggestions as to how the no par value shares should be regulated. As South Africa already allows no par value shares, a discussion of the extent to which the current no par value share provisions, many of which were designed to approximate the position of par value shares, should be retained or varied in a new system would have been useful.

The *Policy Framework*⁴¹⁸ alludes to the relationship between par value and the share premium account. The suggestion that the 'outdated distinction between share premium and par value' should be abandoned,⁴¹⁹ is far from clear. Although the document points to one of the main problems associated with par value shares, namely the regulation of the share premium account, it is submitted that this is not a problem inherent in par value shares as such, as can be seen from the Delaware experience.

I submit that the designation of shares as either par value or no par value shares has little relevance for creditors in a system which subjects distributions to solvency and liquidity. The focus should rather be on the protection of shareholders. Par value shares allow a company considerable freedom to arrange the voting and distribution rights of different classes of shareholders disproportionately to the consideration paid in respect of those shares. Although companies should not be denied the flexibility of treating different classes of shareholders differently, this should be done openly and not through a manipulation of par values. For this reason, I suggest that no par value shares are preferable.

The no par value shares proposed in the Companies Bill will not be subject to the problems currently experienced with no par value shares. It is a challenge to convert current par value shares into no par value shares, particularly in

⁴¹⁶ As was suggested in the Van Wyk de Vries *Main Report* 34.16 – 34.18. See also paragraph 3.1.1 below.

⁴¹⁷ McLennan "Abolition of Par-value" 43. The author does not give any examples of the complex and meaningless provisions.

⁴¹⁸ See *Policy Framework* 2.2.3.

⁴¹⁹ *Policy Framework* 2.2.3.

companies that presently have par value as well as no par value shares.⁴²⁰ Nevertheless, it is suggested that the elimination of the problems caused by the current dual system is a necessary step in the future regulation of share capital.

2.9.4 Evaluation of share capital accounts

Some of the most complex provisions in the Act regulate the share capital and non-distributable reserve accounts of a company. While these provisions were necessary while the capital maintenance doctrine was applied, their justification has to a large extent fallen away. Despite this, the legislature has preserved the share capital structure as supported by the share capital and statutory non-distributable reserve accounts, requiring adjustments to be made when there is a variation or reduction of capital.⁴²¹ It is equally clear that the intention is not that the amounts standing to the credit of these accounts should necessarily be represented by assets.⁴²²

Although shareholders may have an interest in share capital accounts which reflect their equity interests, this is not true of the share premium account. Yet I have illustrated that the regulation of the share premium account is the most problematic aspect in the share capital structure of companies.⁴²³ The uncertainties about the legal implications of the share premium account and the interpretation of section 76 clearly warrant the reconsideration of such an account under a reformed Companies Act.⁴²⁴ The share premium account does not serve any useful purpose as it protects neither shareholders nor creditors.⁴²⁵

The interpretation of statutory exceptions such as those in sections 76(3), 77(3) and 98(4) has become problematic since the capital maintenance principle was abolished.⁴²⁶ The share premium account cannot be singled out as an anomaly. The problem extends to the comprehensive regulation of share capital and non-distributable reserve accounts in a system that no longer attaches

⁴²⁰ Guidance can be sought from the transitional provisions that applied in New Zealand and Australia when these jurisdictions abolished par value shares.

⁴²¹ See paragraphs 2.5 and 2.6.2.

⁴²² See paragraph 4.1 below.

⁴²³ See paragraph 2.4.3 above.

⁴²⁴ See paragraph 2.4.3.3 above.

⁴²⁵ See paragraph 2.4.3.4.3 above.

⁴²⁶ See paragraph 2.4.3.3.3 above.

significance to these accounts.

Obviously, most of the problems surrounding the share premium account will be removed if par value shares are abolished.⁴²⁷ Attention will have to be given to transitional provisions that would apply to existing share premium accounts.

England is the only other jurisdictions surveyed that regulates share capital accounts, including share premium accounts. However, the fact that the English approach remains based on capital maintenance, raises the question whether capital accounts need to be regulated in a system based on solvency and liquidity.

The Companies Bill does not regulate the way in which the consideration received for shares should be reflected in the company's accounts.⁴²⁸ In fact, it does not even seem necessary for the board to determine the specific monetary value of consideration received for the issue of shares.⁴²⁹ I support this approach because the accounts reflect only the internal entitlements of shareholders.

2.9.5 Evaluation of the variation of share capital

As is the case with the regulation of share capital accounts, the complexity of the variation of capital provisions is not justified by their purpose. The imposition of a fee on authorised capital accounts for much uncertainty.⁴³⁰ The variation of share capital provisions pay little direct attention to the protection of creditors and shareholders, although variation of class rights principles may be relevant.⁴³¹

The Companies Bill does not regulate share capital accounts and consequently also not their variation. However, it contains an enabling provision allowing the variation of share capital by special resolution of the shareholders or by the directors if the memorandum so provides.⁴³² The extended powers of directors that the Companies Bill proposes can potentially be used to the detriment of existing shareholders. This risk is offset by the flexibility that will be afforded to

⁴²⁷ See Cassim "Reform of Company Law and Capital Maintenance" 286.

⁴²⁸ See paragraph 2.8.4 above.

⁴²⁹ Clause 40(2). See the similar position under the MBCA, USA Chapter paragraph 4.2.1.

⁴³⁰ See paragraph 2.5 above.

⁴³¹ See paragraph 2.5.4 above. Fiduciary duties may also play a role in the protection of shareholders where the main purpose of a variation of capital is to force out minority shareholders. An example of such a variation is a consolidation of shares (a 'reverse stock split') accompanied by a cancellation or redemption of fractional shares, see Kaplan & Young "Corporate Eminent Domain" 68.

⁴³² See paragraph 2.8.5 above.

directors to make important financing decisions without undue delay and formalities. The exercise of directors' powers will, after all, depend on an express delegation in the memorandum of the company and will be subject to the standards of conduct required of directors including the duty to exercise powers for their proper purpose.

Also, dissenting shareholders may in appropriate circumstances rely on the proposed appraisal remedy.⁴³³ However, it would seem that an increase of authorised shares will not trigger appraisal as it would not amount to a change in the preferences, rights, limitations or other terms of existing shares, although it may affect the interests of the shareholders. Appraisal will also not be available if the power to vary share capital has been given to the directors, because then there is no resolution of the general meeting that the dissenter could have voted against.

I support the proposals of the Companies Bill with regard to variation of capital, but recommend that the appraisal remedy should also be made available in respect of capital increases that may affect existing classes.

2.9.6 Conclusion on reduction of capital

The relative merits of a formal reduction of capital procedure and the reduction of capital through an acquisition of own shares have been considered earlier.⁴³⁴ The difficulties regarding the interpretation of references to the reduction of capital in the Act have also been highlighted.

Of the other legal systems that have been surveyed, New Zealand, California and the Model Business Corporations Act of the USA do not regulate share capital accounts and therefore do not have reduction of capital provisions. In both England and Delaware provision is made for the reduction of capital as a procedure independent of share repurchases.

In England a repurchase or redemption of shares will generally result in the adjustment of the share capital account to reflect the shares that have been cancelled.⁴³⁵ However, a capital redemption reserve will then have to be created if

⁴³³ See clause 164.

⁴³⁴ See paragraph 2.6.3 above.

⁴³⁵ Unless the shares are to be held by the company as treasury shares, see Chapter 2 paragraph 5.6.

profits have been applied to the redemption or repurchase. The total non-distributable funds or 'capital' will remain the same. The only exception is when private companies repurchase their shares out of capital, resulting in a reduction of capital. The reason for the retention of the court-sanctioned capital reduction procedure is that repurchases in that jurisdiction have limited scope as a capital reduction mechanism.⁴³⁶

In Delaware repurchases do not automatically result in adjustments to the company's stated capital. This is a result of the low level of correspondence between stated capital and the consideration received on the issue of shares.⁴³⁷ The Delaware General Corporation Law sets out all the different possible reductions of capital in one provision, including optional reductions following a repurchase of shares.⁴³⁸ Different financial restrictions apply to repurchases and to reductions of stated capital. A repurchase is a form of distribution and has to be funded out of surplus.⁴³⁹ Reductions of stated capital are subject to compliance with a liquidity test.⁴⁴⁰

It is suggested that South Africa does not need a separate reduction of capital procedure. The need for separate procedures regulating repurchases and reductions of capital in England and Delaware can be explained by the fact that they have retained the capital maintenance principle in respect of distributions.

The absence in the Companies Bill of any reference to reduction of capital, and of a requirement pertaining to adjustment of capital accounts following repurchases is in line with the underlying principle of non-regulation of share capital accounts and cannot be faulted.

3 CAPITAL CONTRIBUTIONS

Shareholders are liable only for the amount outstanding on their shares. Limited companies are thus sometimes referred to as companies limited by shares.⁴⁴¹ This terminology is no longer used in South Africa because shares are required to be

⁴³⁶ See Chapter 2 paragraph 5.3.5.

⁴³⁷ See Chapter 4 paragraph 2.2.4.

⁴³⁸ See Chapter 4 paragraph 2.2.6.

⁴³⁹ See Chapter 4 paragraph 2.5.2.

⁴⁴⁰ See Chapter 4 paragraph 2.2.6.

⁴⁴¹ The 1926 Companies Act, which allowed partly paid shares, referred to a company limited by shares, see s 5 of the Companies Act 46 of 1926.

fully paid up upon issue and there can thus not be outstanding consideration.⁴⁴² Instead, the phrase 'company having a share capital' is used in the Act.⁴⁴³ Section 65(1) sets out the effect of incorporation and states that the liability of members to contribute to the assets of the company on winding up (if any) is such as is provided by the Act. This reference to a liability to contribute on winding-up pertains to the liability of members of a company limited by guarantee as set out in section 52(3)(b).⁴⁴⁴ Section 52(2), which can be regarded as the corresponding provision for companies with share capital, makes no reference to the limitation of liability of shareholders, but instead requires the memorandum to state the number of shares each subscriber undertakes to take up.

Consideration paid for shares is also the 'investment' of the shareholder in the company on which a return in the form of dividends is expected. It is used in the determination of the shareholder's equity interest in the company. The regulation of consideration for shares is an integral element in addressing the interests of shareholders. It preserves the built-in proportionality by ensuring that shareholders who obtain comparable equity interests do so for comparable consideration.

3.1 Size of capital contribution

The minimum capital contribution payable when shares are issued depends on whether the shares are par value shares or shares without a par value.⁴⁴⁵ In the case of par value shares, the consideration must be at least equal to their par value.⁴⁴⁶ Put differently, par value shares may not be issued at a discount. This rule has not been enacted in legislation, but a statutory exception is provided

⁴⁴² See Blackman, Jooste & Everingham *Companies Act* 5-238. See also the Van Wyk de Vries *Main Report* par 32. It is an interesting question whether s 92 also precludes the levying of further assessments on shares, eg on the basis of a provision in the articles. The answer would depend on whether the further contribution is regarded as 'consideration' for the shares. The levying of further assessments is expressly addressed in the legislation of New Zealand, see Chapter 3 paragraph 3.1; California, see Chapter 4 paragraph 3.3.1; and under the MBCA, see Chapter 4 paragraph 4.3.1.

⁴⁴³ See s 19(1)(a).

⁴⁴⁴ Although the Act provides for instances of personal liability of members, like s 66 which imposes liability where the membership of a public company falls below the prescribed minimum, these are not restricted to contributions on winding-up.

⁴⁴⁵ See also paragraph 2.3 above.

⁴⁴⁶ *Ooregum Gold Mining Co of India Ltd v Roper* [1892] AC 125 (HL); *Etkind & Others v Hicor Trading Ltd & Another* 1999 (1) SA 111 (W).

for.⁴⁴⁷ No par value shares, on the other hand, may be issued for any consideration.⁴⁴⁸

According to the authors of Blackman, Jooste & Everingham *Companies Act* the abolition of the capital maintenance doctrine raises questions about the continued existence of this rule.⁴⁴⁹ If the rule has no application outside the capital maintenance principle, a conclusion that the rule still applies in our law can, according to the learned authors, only be justified by reading an implied prohibition into the statutory exception allowing discounts in certain circumstances.⁴⁵⁰ However, if the rule also has the purpose of protecting existing shareholders, then the prohibition against discount still forms part of our law.⁴⁵¹ The authors of Blackman, Jooste & Everingham *Companies Act* support the second conclusion. The alternative purpose, which is unrelated to capital maintenance, thus justifies the conclusion that the common-law rule has been retained. The authors do not go into detail regarding the scope of the implied prohibition and just assume that it would correspond exactly with the common-law prohibition. It is at least arguable that any prohibition implied from the discount exception may be more limited than the common-law no discount rule. Since the discount exception applies only to existing classes of shares, the implied prohibition may also have to relate only to existing classes. Such a prohibition, which would protect shareholders, would leave a company free to issue new classes of shares at a discount.

Although it cannot be denied that the rule against discount results in some protection for shareholders,⁴⁵² it is clear that historically the rule is primarily linked to creditor protection.⁴⁵³ It is submitted that the rule still forms part of South African law despite the fact that its main purpose is aligned with capital maintenance. It is

⁴⁴⁷ In s 81, see paragraph 3.1.1 below. Section 92 does not enact the common-law rule, but is merely a timing provision, see paragraph 3.4 below.

⁴⁴⁸ In certain instances, an issue price has to be approved by special resolution, see paragraph 3.1.2 below.

⁴⁴⁹ Blackman, Jooste & Everingham *Companies Act* 5-36.

⁴⁵⁰ Blackman, Jooste & Everingham *Companies Act* 5-36. See paragraph 3.1.1 below for further discussion of the discount exception. Similar issues regarding statutory exceptions to common-law rules arise in relation to the share premium account and the power to acquire shares, see paragraphs 2.4.3 and 6.1 below.

⁴⁵¹ Blackman, Jooste & Everingham *Companies Act* 5-36.

⁴⁵² See *Ex parte South African General Mining Co (Pty) Ltd* 1940 PH E14 (W) which recognises the interests of creditors and shareholders.

⁴⁵³ See *Ooregum Gold Mining Co of India Ltd v Roper* [1892] AC 125 (HL) 145.

also submitted that the line of argument referred to in the previous paragraph cannot be supported as a way of determining whether the rule actually still applies. While the purpose of a rule can be relevant in a policy decision as to whether the rule should be retained or repealed, it cannot be used as an independent indicator of whether the rule has in fact been abolished or not. The presumption that the legislature does not change the common law more than necessary,⁴⁵⁴ points towards a conclusion that the no discount rule is still part of South African law. This conclusion is also in line with other instances where the legislature has retained the rules regarding the structure of share capital despite its reforms of the distribution rules.⁴⁵⁵

3.1.1 *The issue of par value shares at a discount*

The issue of par value shares at a discount is an exception to the common-law no discount rule. Strict application of the common-law principle that a shareholder is liable to give consideration at least equal to the par value of shares issued can, however, have the undesirable effect of inhibiting the raising of further capital by a company. When the issued shares of a company are worth less than their par value, the company will struggle to find subscribers for further authorised but unissued shares it wants to issue. The company could avoid the no discount rule by refraining from issuing previously authorised shares and instead creating a new class of shares with a lower par value. Apart from the fact that the company will incur additional costs to increase its authorised share capital, such a step would also complicate the capital structure of the company.

A statutory exception to the no discount rule was first introduced in the 1929 English Companies Act.⁴⁵⁶ It was also implemented in South Africa and is currently contained in section 81 of the Companies Act. The English provision⁴⁵⁷ was repealed in 1980 when the Second Company Law Directive was implemented.⁴⁵⁸

⁴⁵⁴ See Du Plessis “Statute Law” paragraph 328.

⁴⁵⁵ See, for example, the adjustment of capital accounts following an acquisition of own shares, discussed in paragraph 6.3.3 and the application of the share premium account to provide for a premium on the repurchase of own shares, discussed in paragraph 2.4.3.3.2.

⁴⁵⁶ See s 47 of the English Companies Act 1929 (19 & 20 Geo 5, c 23), see also the *Company Law Amendment Committee Report* Cmd 2567 (1925 – 1926) (Greene Committee) paragraph 19.

⁴⁵⁷ At that stage s 57 of the English Companies Act 1948 (11 & 12 Geo 6, c 38).

⁴⁵⁸ See Schedule 4 of the English Companies Act 1980 (c 22).

3.1.1.1 Requirements

A company may issue par value shares at a discount if the following requirements have been met:

- the shares must be of a class already issued⁴⁵⁹
- at least one year should have elapsed since the certificate to commence business was issued or since the first issue of that class of shares⁴⁶⁰
- the discount must be approved by special resolution⁴⁶¹
- the discount must be sanctioned by the court⁴⁶²
- the shares must be issued within 1 month after the date of sanction or within such extended time allowed by court.⁴⁶³

Although the fact that existing shares stand at a discount in the market can be regarded as the main motivation for allowing discount on a further issue, it is not expressly required that the shares should be valued or trading at less than their par value.⁴⁶⁴ However, the requirements that the shares should be of a class already issued⁴⁶⁵ and that one year must have elapsed from commencement of business or issue of class of shares⁴⁶⁶ give effect to this consideration. The time limit also reduces the risk that a discount could prove to be unfair in view of subsequent changes in the financial position of the company and the value of its existing shares.

The existing shareholders are protected by the requirement that the discount must be approved by special resolution.⁴⁶⁷

When asked to sanction a discount, the court must have regard to all the

⁴⁵⁹ Section 81(1) introductory part.

⁴⁶⁰ Section 81(1)(b).

⁴⁶¹ Section 81(1)(a).

⁴⁶² Section 81(1)(c).

⁴⁶³ Section 81(1)(d).

⁴⁶⁴ See *Report of the Committee upon the Amendment of the Law under the Companies Acts* Cmd 9138 (1918) pars 45 – 46, (Wrenbury Committee). *Company Law Amendment Committee Report* Cmd 2567 (1925 – 1926) (Greene Committee) par 19.

⁴⁶⁵ Section 81(1).

⁴⁶⁶ Section 81(1)(b).

⁴⁶⁷ Section 81(1)(a).

circumstances of the case and make an order it thinks fit.⁴⁶⁸ The court will take into consideration the interests of prospective shareholders and creditors, and the effect on present shareholders and creditors.⁴⁶⁹ The court can impose further requirements.⁴⁷⁰

3.1.1.2 Consequences of discount issues

Every prospectus issued after a discount issue must contain particulars of the discount allowed or 'so much of that discount as has not been written off at date of issue of the prospectus'.⁴⁷¹

Apart from the reference to the disclosure of the extent to which a discount has not been 'written off', the Act does not prescribe the accounting treatment of discounts. However, the aggregate nominal value of the shares must still be reflected in the share capital account.⁴⁷² 'Writing off' would thus involve accounting entries to ensure that the difference between the nominal capital of the company and its true capital is extinguished.⁴⁷³

Failure to disclose a discount in the prospectus constitutes a criminal offence by every director and officer who is knowingly a party to such failure.⁴⁷⁴ Interestingly, it is not an offence to issue shares at a discount contrary to section 81(1).

The disclosure requirement is aimed at the protection of future shareholders. However, no additional disclosure is required if the offer is not an offer to the

⁴⁶⁸ Section 82(2).

⁴⁶⁹ See *Ex parte South African General Mining Co (Pty) Ltd* 1940 PH E14 (W). See also *Biala Pty Ltd v Mallina Holdings Ltd* (1997) 23 ACSR 725 (Fed C of A) 731.

⁴⁷⁰ In *Re 'Air North West' Pty Ltd* (1988) 6 ACLC 1 at 143 the Australian court imposed an obligation on the company, for five years after the discount, to inform future shareholders of the discount previously given. See also Blackman, Jooste & Everingham *Companies Act* 5-38.

⁴⁷¹ Section 81(3). This rule has an effect similar to the additional requirement imposed by the court in *Re 'Air North West' Pty Ltd* (1988) 6 ACLC 1 (see preceding note), but its operation is limited to public offers.

⁴⁷² See Cilliers & Benade *Maatskappyereg* 4 ed 140 – 141. It is also stated that the discount will be reflected as a fictitious asset, but this explanation is not repeated in the later work by these authors, Cilliers & Benade *Corporate Law*.

⁴⁷³ In *Re Melacare Industries of Australia Pty Ltd* (1993) 12 ACSR 236 SC (NSW) the court said that the public should not be misled by the difference between nominal and true capital. In view of the lack of any requirement that capital funds should actually be separated from other funds, or that the assets should equal or exceed the amount of the share capital, this is difficult to understand.

⁴⁷⁴ Section 81(4).

public. Although the special resolution authorising the discount will enjoy publicity, the extent to which the discount has been written off will not appear from the resolution. It seems anomalous that a statement pertaining to commission allowed is required as an alternative under section 80(1)⁴⁷⁵ while no such disclosure is required in respect of discount allowed.

3.1.2 The issue of no par value shares at lower issue price

The absence of a nominal or par value means that no par value shares cannot be issued at a premium or a discount. The freedom of a company to issue no par value shares for any consideration is seen as their main advantage. However, section 82 limits the freedom of directors to determine the price. It requires a special resolution when further no par value shares of an existing class are to be issued at a price below a specified minimum.⁴⁷⁶ The minimum issue price is determined by dividing that part of the stated capital contributed by the already issued shares by the number of issued shares of that class.⁴⁷⁷ It is interesting that reference is made to 'that part of the stated capital contributed by the already issued shares'. If the stated capital account has been applied as envisaged in section 77(3), the remaining part of stated capital contributed by the issued shares may be less than the capital initially contributed.⁴⁷⁸ If the stated capital account has not been applied, the minimum issue price will in effect be the average issue price.⁴⁷⁹ The Van Wyk de Vries Commission initially recommended that an issue of no par value shares below the immediately preceding issue price should require a special resolution.⁴⁸⁰ In its supplementary report the Commission concluded that using the immediately preceding issue price would be impracticable⁴⁸¹ and instead

⁴⁷⁵ See paragraph 3.5 below.

⁴⁷⁶ Section 82(1).

⁴⁷⁷ Section 82(1).

⁴⁷⁸ Blackman, Jooste & Everingham *Companies Act* 5-39. This has interesting implications for stated capital and for the book value of no par value shares.

⁴⁷⁹ Transfers out of profits or reserves to the stated capital account under s 75(1)(b), without a distribution of shares, will not have an effect on the minimum issue price, as only the part of stated capital 'contributed' by the existing no par value shares must be taken into account.

⁴⁸⁰ Van Wyk de Vries *Main Report* 34.18.

⁴⁸¹ The Commission did not explain why it would be impracticable, but this could be because some time may have lapsed since the previous issue and the market value of the shares may have changed in the meantime.

recommended the present formulation.⁴⁸²

The directors have to issue a report on the reasons for the proposed lower issue price.⁴⁸³ A copy of this report must accompany the notice convening the meeting at which the special resolution is to be taken.⁴⁸⁴ A copy of the report must also be lodged with the Registrar together with the special resolution.⁴⁸⁵

Section 82 does not apply in the case of a proportionate offer to existing shareholders, with or without the right to renounce in favour of others.⁴⁸⁶ It is clear from this exception, as well as from the fact that only a special resolution is required to authorise the issue of no par value shares at a lower price, that the protection of shareholders is the only purpose of section 82. Creditor protection is not an aim of section 82, because the actual consideration received will be reflected as stated capital.

3.2 Form of capital contribution

Consideration for shares may be paid in cash or kind.⁴⁸⁷ Consideration must, however, have a monetary value which can be reflected in the capital accounts of the company. While non-cash consideration is clearly acceptable, it is nevertheless interesting to consider the argument that the term 'subscription' is or should be restricted to instances where shares are issued for cash consideration.⁴⁸⁸ Although this argument is usually raised in the context of offers to the public and concerns the meaning of the word 'subscription' in section 145, it may have implications for the nature of the consideration that a company can agree to accept when it issues and allots shares pursuant to subscription offers.

The crucial question is whether an issue and allotment is in all cases preceded by subscription or whether shares can be issued and allotted independently of subscription. Proponents of the narrow interpretation of subscription see it as an application to take up previously unissued shares for

⁴⁸² Van Wyk de Vries *Supplementary Report* 86.02.

⁴⁸³ Section 82(2).

⁴⁸⁴ Section 82(2).

⁴⁸⁵ Section 82(3).

⁴⁸⁶ Section 82(4).

⁴⁸⁷ *Famatina Development Corporation Ltd v Bury* [1910] AC 439 (HL).

⁴⁸⁸ See Delpont "Offer to the Public" 390, Cassim "A Lost Opportunity" 272 – 273.

cash, but do not suggest alternative terminology to describe an agreement to take up shares otherwise than for cash. Nevertheless, this interpretation would imply that when a shareholder has agreed to 'subscribe' for shares, only cash consideration would be acceptable.

The wider interpretation, which was favoured by the court in *Gold Fields Ltd & Another v Harmony Gold Mining Company Ltd & Others*⁴⁸⁹ is based on the premise that the existence of various references to non-cash consideration imply that the legislature intended treating all agreements to take up shares in the same way and that the term 'subscription' is not inherently restricted to cash consideration. This interpretation, which it is submitted is correct, merely means that cash as well as non-cash consideration is acceptable, regardless of the name given to the agreement between the company and the prospective shareholder.

'Paid in cash' means that there must be a liquidated sum due and immediately payable. Promissory notes are not cash, but if they are subsequently honoured and paid, it will constitute cash consideration.⁴⁹⁰ The English Companies Act defines cash to include a cheque accepted in good faith with no reason to suspect that it would not be honoured, as well as an undertaking to pay cash in the future.⁴⁹¹ Similarly the MBCA refers to 'cash equivalents' which are short term debt instruments.⁴⁹² It is suggested that the South African approach in this regard should be relaxed so that common forms of payment such as cheques and promissory notes will be regarded as cash rather than as non-cash consideration.⁴⁹³

Payment otherwise than in cash can consist of property or services. The allotment of shares for consideration otherwise than cash, is subject to additional regulation under section 93.⁴⁹⁴ The courts will not easily interfere with the discretion of the directors to accept particular non-cash consideration as adequate.⁴⁹⁵ A court will interfere only if the consideration is patently inadequate or

⁴⁸⁹ 2005 (2) SA 506 (SCA).

⁴⁹⁰ *Re Biltong Asbestos Co Ltd* 1925 CPD 356 at 359 – 360.

⁴⁹¹ See Chapter 2 paragraph 3.2.

⁴⁹² See Chapter 4 paragraph 4.3.3.

⁴⁹³ The question as to what constitutes cash is also considered in Delpont "Offer to the Public" in relation to s 169(3). Also see s 76(1), (2), s 77(2), s 92, s 165(3).

⁴⁹⁴ See paragraph 3.3 below.

⁴⁹⁵ *Ooregum Gold Mining Co of India Ltd v Roper* [1892] AC 125 (HL) 148. See also Blackman,
Continued

if there are indications of fraud or *mala fides* on the part of the directors. The directors have to be satisfied that the non-cash consideration is adequate.⁴⁹⁶

In view of the requirement that the consideration should be received by the company prior to the allotment and issue of the shares,⁴⁹⁷ future services are not acceptable consideration, because there will not be a debt presently due by the company which can be set off against the consideration.⁴⁹⁸ The timing provision thus influences the nature of the consideration that can be accepted by the company. An issue and allotment for an unacceptable form of consideration will be void.⁴⁹⁹

One of the issues that had to be decided in *Etkind & Others v Hicor Trading Ltd & Another*⁵⁰⁰ was whether the transfer of shares and claims by a subscriber to a subsidiary of the issuer could be regarded as consideration for the issue of further shares by the holding company. The court found that the increase in the value of the holding company's shareholding in its subsidiary constituted consideration in the hands of the holding company.⁵⁰¹ The court further stated that the holding company could have arranged that the subsidiary issue further shares to it.⁵⁰² It would seem that the court regarded the potential of the subsidiary issuing further shares to the holding company as tantamount to consideration received by

Continued

Jooste & Everingham *Companies Act* 5-247. In *Etkind & Others v Hicor Trading Ltd & Another* 1999 (1) SA 111 (W) it was argued that the existence of the security interest of the pledgee of the assets reduced their value to below the issue price of the shares. The court did not attempt to value the consideration, since the transaction was at arms length and for the *bona fide* commercial purpose of acquiring an assessed loss and a corporate entity with continuing leases and other agreements. It held that there was no reason to suspect that the R850 000 represented by the new issue had not been met, see at 122.

⁴⁹⁶ See *Park Business Interiors Ltd v Park* [1992] BCLC 1034 CS (OH) where shares were issued in discharge of a company's debt in respect of pre-incorporation expenses. After incorporation the company agreed to refund those expenses. The court held that the company did receive consideration for the shares it gave, because it was obliged to pay the expenses when it issued the shares in satisfaction of that debt. When shares are allotted in recognition of past services for which the company was not obliged to pay, no consideration is received, *Re Eddystone Marine Insurance Co* [1893] 3 Ch 9.

⁴⁹⁷ Section 92, see paragraph 3.3 below.

⁴⁹⁸ *Etkind & Others v Hicor Trading Ltd & Another* 1999 (1) SA 111 (W) at 122, see also *Re The Contributories of the Rosemount Gold Mining Syndicate* 1905 TH 169 at 192; *Middelburg Prospecting Syndicate Ltd v Goodwin* 1906 TS 899 at 906; *Re Eddystone Marine Insurance Co* [1893] 3 Ch 9.

⁴⁹⁹ See *Bauermeister v C C Bauermeister (Pty) Ltd & Another* 1981 (1) SA 274 (W) at 277.

⁵⁰⁰ 1999 (1) SA 111 (W).

⁵⁰¹ *Etkind & Others v Hicor Trading Ltd & Another* 1999 (1) SA 111 (W) at 121.

⁵⁰² *Etkind & Others v Hicor Trading Ltd & Another* 1999 (1) SA 111 (W) at 121.

the holding company. It is difficult to see how the issue by a wholly owned subsidiary of further shares to its holding company could make any difference to the situation. The consideration paid to the subsidiary by the subscriber for the new shares in the holding company would, on the court's construction, already have increased the value of the holding company's shareholding. Any further shares subsequently issued by the wholly owned subsidiary will in effect amount to a subdivision of shares and will not add any value to the holding company. Moreover, the subsidiary would in turn have to have received consideration for the issue of the further shares. Presumably the consideration it received from the subscriber to shares in its holding company (and intended as consideration for holding company shares) would then simultaneously be regarded as consideration for the shares that the subsidiary will subsequently issue to its holding company. It seems that this construction is rather strained and out of step with what the parties actually agreed upon.

Whether an increase in the value of a holding company's shareholding in its subsidiary can properly be regarded as payment to and receipt by it of 'the issue price or other consideration' as intended by section 92(1) is debatable. The issue price or other consideration is determined in the subscription agreement. It is this price or consideration which must be received by the issuing company. Where the consideration agreed to by the subscriber comprises shares and claims, these should be transferred to the issuer. If the agreed consideration is that the subscriber will cause a certain increase in the value of an asset held by the issuer - such as its shareholding in its subsidiary - it is that increase that must be 'received' by the issuer. In view of the further requirements regarding non-cash consideration,⁵⁰³ including the lodging of a copy of the contract pertaining to the consideration, it is important that the actual consideration that will be received by the issuer should be set out.⁵⁰⁴ The court, however, paid no regard to the requirements pertaining to non-cash consideration, despite the fact that the consideration as construed by it would certainly amount to non-cash consideration. It is further curious that the court nevertheless decided that the consideration had not been received by the company, since the increase in the value of the

⁵⁰³ See paragraph 3.3 below.

⁵⁰⁴ See also paragraph 3.4 below regarding the timing of the consideration.

shareholder's shareholding would not necessarily depend on actual transfer of the shares and claims, but could be brought about by the conclusion of the agreement giving rise to an enforceable right. There thus seems to be an inconsistency between the court's view of the nature of the consideration and its application of the statutory principles to it.

3.2.1 The problem with capitalisation shares

When shares are issued by a company as fully paid-up capitalisation shares or bonus shares,⁵⁰⁵ the company does not receive cash or property from the shareholders. It has been suggested that the consideration consists of the fact that the shareholders give up their hope of obtaining the profits in cash and agree to capitalise those profits.⁵⁰⁶ The advantage that the company is said to derive is that it is placed in a better position to offer security to future creditors.⁵⁰⁷ However, it is clear that the company does not receive goods and that an accounting entry is not really payment.⁵⁰⁸ The issue of capitalisation shares constitutes 'manifest non-compliance with the principle that assets are supposed to come into the corporate till when shares of the company are issued'.⁵⁰⁹ Further, the construction that the consideration consists of the retention of distributable profits cannot be applied to instances when the company funds the capitalisation issue from its share premium account or capital redemption reserve, which would otherwise be non-distributable.⁵¹⁰ Since the shareholders have no specific entitlement to these reserve accounts and since the company will be replacing non-distributable reserves with share capital, it is difficult to see any consideration passing to the company.⁵¹¹ But it is also clear that this absence of consideration does not

⁵⁰⁵ In theory capitalisation shares and bonus shares are synonyms. However, the term 'bonus share' may be misleading because shareholders do not necessarily receive any financial benefit, see Woods "Capitalization Issues" 126. Woods suggests that the term bonus shares should be reserved for employee shareholder schemes.

⁵⁰⁶ See Blackman, Jooste & Everingham *Companies Act* 5-247.

⁵⁰⁷ See *Gibaud v CIR* 1928 CPD 168 at 174.

⁵⁰⁸ See Manning *Legal Capital* 47, 129. See also *Osborne v Steel Barrel Co Ltd* [1942] 1 All ER 634 (CA) at 637 – 638.

⁵⁰⁹ Manning *Legal Capital* 129.

⁵¹⁰ See *CIR v Legal and General Assurance Society Ltd* 1963 (3) SA 876 (A) where the court acknowledged the difference between capitalisation of distributable profits and capitalisation of a non-distributable premium.

⁵¹¹ *CIR v Collins* 1923 AD 347 at 363 – 364; *CIR v Legal and General Assurance Society Ltd* 1963 (3) SA 876 (A). It must be remembered that when *CIR v Collins* was decided share

adversely affect the company or its creditors.

The issue of fully paid-up capitalisation shares is referred to in three provisions of the Companies Act. First, section 90(3) expressly excludes such an issue from the definition of 'payment' as envisaged in section 90.⁵¹² The other two instances are found among the possible applications of the two statutory non-distributable reserves. Both the share premium account⁵¹³ and the capital redemption reserve⁵¹⁴ may be applied in providing for capitalisation issues. While the Act thus expressly provides for capitalisation issues out of non-distributable reserves, it is silent on the capitalisation of profits for this purpose. When profits are used, it is clear that the company could achieve the same result by declaring dividends and then retaining those dividends as consideration for the issue of the further shares. Although it cannot be disputed that the issue of capitalisation shares does not harm the company or its creditors,⁵¹⁵ it is not clear how such issues comply with the consideration requirement. It appears that capitalisation issues contravene both the common-law rule that consideration at least equal to the par value should pass to the company and section 92 which requires the full issue price or other consideration to be paid to and received by the company.

3.3 The regulation of non-cash capital contributions

A company is required to keep a register of allotments of shares⁵¹⁶ and to lodge a return of allotments with the Registrar.⁵¹⁷ Among other information, the register and the return have to state the amount paid for the shares allotted.⁵¹⁸ Failure to lodge a return of allotments is a criminal offence,⁵¹⁹ but will not affect the validity of the issue and allotment.⁵²⁰

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premium accounts were not yet regulated, see paragraph 2.4.3.1 above.

⁵¹² See paragraph 5.1.3 below.

⁵¹³ Section 76(3). See paragraph 2.3.3.2 above.

⁵¹⁴ Section 98(4). See paragraph 2.4.4 above.

⁵¹⁵ See *Osborne v Steel Barrel Co Ltd* [1942] 1 All ER 634 (CA) at 637 – 638 for an analysis of what happens when a company allots shares.

⁵¹⁶ Section 93(1).

⁵¹⁷ Section 93(3).

⁵¹⁸ Section 93(2).

⁵¹⁹ Section 93(5).

⁵²⁰ *Moosa v Lalloo & Another* 1957 (4) SA 207 (N) at 220. A court can allow a company to replace an incorrect return with a correct one, *Ex parte Northern Transvaal (Messina) Copper*

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Additional disclosure requirements apply to non-cash consideration. The register as well as the return of allotment has to contain full particulars of the consideration and of the contract or transaction concerned.⁵²¹ A copy of the contract in writing constituting the title of the allottee to the allotment, together with any contract of sale, for service or other consideration in respect of which the allotment was made, has to be lodged with the Registrar.⁵²² If the contract is not in writing, a memorandum setting out full particulars of the contract has to be lodged. Moreover, while the names and addresses of all allottees have to be contained in the register of allotments kept at the registered office of the company,⁵²³ this information must in the case of non-cash allotments also be disclosed in the return of allotments lodged with the Registrar.⁵²⁴ The purpose of these provisions is to protect both the public and existing shareholders.⁵²⁵ The register of allotments can be inspected like the register of members.⁵²⁶ The return of allotments must be submitted as prescribed in Form CM15. Information regarding the authorised capital and previously issued share capital has to be set out,⁵²⁷ followed by particulars of the new issue⁵²⁸ and a summary of the issued capital following the allotment.⁵²⁹ Item 6 of the form applies only to the allotment of shares otherwise than for cash. In respect of no par value shares, item 6(a) requires disclosure of the issue price per share as well as the 'deemed' stated capital. For par value shares the nominal amount of each share, the premium on each share and the 'total amount of capital deemed to be paid-up' have to be disclosed. It seems that the word 'deemed' is used to reflect the fact that non-cash consideration is not really 'paid' to the company.

There is no express reference to the valuation of non-cash consideration in

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Exploration Ltd 1938 WLD 258 at 259. Rectification of a return can also be ordered, *Ex parte Keir & Cawder (South Africa) Ltd* 1968 (2) SA 207 (T) at 208.

⁵²¹ Section 93(2) – (3).

⁵²² Section 93(3)(b).

⁵²³ Section 93(2).

⁵²⁴ Section 93(3)(b).

⁵²⁵ See Blackman, Jooste & Everingham *Companies Act* 5-261 and the authority there quoted.

⁵²⁶ Section 93(6) read with s 113.

⁵²⁷ See items 1 to 4 of Form CM 15.

⁵²⁸ Form CM 15, items 5 and 6. Item 6 is relevant to shares allotted otherwise than for cash.

⁵²⁹ Form CM 15 item 7.

either section 93 or the prescribed form for the return of allotments.⁵³⁰ But valuation is prescribed by other provisions dealing with par value and no par value shares respectively. Section 76(2) applies where 'assets are acquired by the issue of (par value) shares of a company and no consideration is recorded'. It requires the assets to be valued in order that any excess over par value can be transferred to the share premium account. Section 77(2) requires directors to determine the value of non-cash consideration for no par value shares so that this value can be reflected as stated capital. A comparison of these valuation provisions reveals three significant differences between the two provisions:

- In the case of par value shares, valuation is not required in respect of all forms of non-cash consideration, but only for 'assets'. For no par value shares any consideration otherwise than cash must be valued.
- Valuation in respect of par value shares can be avoided by recording a consideration. No such exception is provided for in respect of no par value shares.
- It is not stated who should value the assets received in respect of par value shares. Independent or professional valuation is not required. In the case of no par value shares, it is expressly stated that the directors must determine the value of the consideration.

3.3.1 Discrepancy between issue price and value of consideration

If there is a discrepancy between the value of non-cash consideration and the issue price recorded in respect of the shares, the question arises which will be conclusive. The answer seems to depend on whether or not a company is obliged to determine an issue price. Section 92(2) requires the 'full issue price of **or** other consideration for shares' to have been paid to and received by the company. It would seem that 'issue price' and 'other consideration' are used as alternatives so that an issue price is not necessarily required. However, the use of the words 'paid to **and** received by' points in the opposite direction as other consideration would usually be delivered rather than 'paid'. Further, section 92(2)(b) provides that allotments to intermediaries of shares that are not fully paid-up shall be void if the

⁵³⁰ See Form CM 15.

full issue price is not paid within the prescribed period. Reference is made only to the full issue price and not to the alternative of other consideration. Unless the implication is that offers to the public through intermediaries should always be cash offers, it seems that the term issue price must be understood as including non-cash consideration. The authors of Blackman, Jooste & Everingham *Companies Act* conclude that there is always an issue price, even if the consideration does not consist of cash but is 'other consideration'.⁵³¹ This conclusion is supported by the information required to be disclosed in the prescribed form for returns of allotment.⁵³² The authors of Meskin *Henochsberg on the Companies Act*, on the other hand, argue on the basis of *Shearer v Bercairn Ltd*⁵³³ and *Henry Head & Co Ltd v Ropner Holdings Ltd*⁵³⁴ that the actual value of the non-cash consideration is conclusive.⁵³⁵

I suggest that these two opinions can be reconciled by considering exactly what the issue price or the actual value is regarded as conclusive of. The issue price is an amount agreed upon contractually between the company and the subscriber. In order to establish whether the company will have a right to claim additional payment from the subscriber, this agreement must be analysed. When the company places a value on an asset and agrees to accept it in lieu of cash, it does not have a claim against the subscriber if it later appears that the asset is worth less than the valuation.⁵³⁶ On the other hand, as far as the company's share capital accounts are concerned, the valuation, or, in the case of par value shares, the amount recorded as consideration, must be conclusive. If an asset is given as consideration for the issue of shares and it appears that the asset is worth more than the specified issue price, the excess is clearly required to be reflected as either share premium or stated capital, depending on the type of share.⁵³⁷

⁵³¹ See Blackman, Jooste & Everingham *Companies Act* 5-239. It is not clear whether these authors really have in mind a price sounding in money or whether they adopt a wide definition of price as including a particular asset without any reference to a fixed sum of money.

⁵³² Form CM 15, discussed above.

⁵³³ [1980] 3 All ER 295 (Ch).

⁵³⁴ [1952] Ch 124; [1951] 2 All ER 994.

⁵³⁵ Meskin *Henochsberg on the Companies Act* 155 – 156.

⁵³⁶ See Blackman, Jooste & Everingham *Companies Act* 5-256; *Duke Group Ltd v Pilmer* (1999) 31 ACSR 213. See Oditah "Takeovers, Share Exchanges and the Meaning of Loss" 436 – 437 for a discussion of the possible claim a company could have against an adviser who valued non-cash consideration incorrectly.

⁵³⁷ See s 76(2) and s 77(2).

3.4 Timing of capital contribution

Although partly-paid shares were allowed under the 1926 Companies Act, section 92(1) of the current Act provides that the full issue price or other consideration for shares must be paid to and received by the company prior to or upon the allotment and issue of those shares.⁵³⁸ The impact of this provision on the kinds of consideration that can be accepted for the issue of shares in South Africa has already been alluded to.⁵³⁹ A purported issue and allotment of shares in violation of this provision, is void.⁵⁴⁰ However, the court can validate an invalid allotment and issue of shares.⁵⁴¹ The full issue price includes any premium payable on par value shares. In the case of non-cash consideration, the value of the consideration must satisfy the full issue price.⁵⁴² However, a court will not enquire into the sufficiency of the consideration unless it is illusory or clearly indicative of a discount.⁵⁴³

Although section 92 is often discussed in conjunction with the no discount rule, this statutory rule differs from the common-law rule. Section 92(1) is a timing provision prescribing when the total agreed consideration or issue price of both par value and no par value shares should be received while the common-law principle⁵⁴⁴ concerns only the extent of the consideration in relation to the par value of a share.

The effect of section 92(1) is that only fully paid shares may be issued by a company. Prior to the introduction of this provision⁵⁴⁵ companies could issue partly paid shares. The Van Wyk de Vries Commission concluded that a system of partly

⁵³⁸ The meaning of the concepts 'allot' and 'issue' is discussed in Blackman, Jooste & Everingham *Companies Act* 5-241 – 5-246, 5-256-4 – 5-258. See also *Mosely v Koffyfontein Mines Ltd* [1911] 1 Ch 73 84 (CA); *Osborne v Steel Barrel Co Ltd* [1942] 1 All ER 634 (CA) at 637 – 638.

⁵³⁹ See paragraph 3.2 above.

⁵⁴⁰ *Bauermeister v C C Bauermeister (Pty) Ltd & Another* 1981 (1) SA 274 (W) at 277.

⁵⁴¹ Section 97(1). For an example, see *Ex parte Durban Deep Roodepoort Ltd* 2002 (6) SA 537 (W) where the court took into account the fact that the shares were traded on international stock markets, that the current holders of the affected shares could not be identified, and that most of the shareholders supported the validation. It is also interesting to note that in *Bauermeister v C C Bauermeister (Pty) Ltd & Another* 1981 (1) SA 274 (W) the court, despite holding that the allotment was void, nevertheless refused to order rectification of the register of members.

⁵⁴² *Etkind & Others v Hicor Trading Ltd & Another* 1999 (1) SA 111 (W) at 122.

⁵⁴³ *Etkind & Others v Hicor Trading Ltd & Another* 1999 (1) SA 111 (W) at 122.

⁵⁴⁴ See paragraph 3.1 above.

paid shares was unduly complex.⁵⁴⁶ It required cumbersome legislative provisions regulating the liability of the subscriber and of transferees of the shares.⁵⁴⁷ The Commission argued that the same result could be achieved by binding shareholders to take up further unissued shares in future.⁵⁴⁸ While it is no longer possible for a company to issue partly paid shares some provision is still made for existing partly paid shares issued before the coming into operation of the Companies Act of 1973.⁵⁴⁹

In *Etkind & Others v Hicor Trading Ltd & Another*⁵⁵⁰ an issue and allotment of shares was held to be void because the consideration had not been received by the company. As has already been pointed out⁵⁵¹ the court was prepared to accept that the transfer of assets to a subsidiary of the issuing holding company would constitute consideration in the hands of the issuing company because it would increase the value of its shareholding in its subsidiary. However, because the assets had not yet been transferred to the subsidiary at the time the shares were issued and allotted by the holding company, the court held that section 92(1) had been contravened.⁵⁵² A clear distinction was drawn between the sale of the assets and claims and their subsequent transfer by cession. The court's approach can be questioned. If the consideration consists of an increase in the value of the shareholding in a subsidiary, the proper enquiry should be whether such an increase has occurred and not whether the assets have been transferred to the subsidiary. It is arguable that the increase in shareholding will take place as soon as the subsidiary obtains the right to claim transfer of the assets and not only upon their actual transfer. However, the court restricted its enquiry to the actual transfer of the shares and assets to the subsidiary.⁵⁵³ It is submitted that the court should

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⁵⁴⁵ In the 1973 Act, it did not appear in the 1926 Act.

⁵⁴⁶ Van Wyk de Vries *Main Report* RP 45/1970 par 32.

⁵⁴⁷ See Cilliers & Benade *Maatskappyereg* (1968) 152 – 155.

⁵⁴⁸ Van Wyk de Vries *Main Report* RP 45/1970 par 32.

⁵⁴⁹ See s 4(2) and s 338(2).

⁵⁵⁰ 1999 (1) SA 111 (W)

⁵⁵¹ See paragraph 3.2 above.

⁵⁵² *Etkind & Others v Hicor Trading Ltd & Another* 1999 (1) SA 111 (W) at 121. The discussion of this case by Blackman, Jooste & Everingham *Companies Act* 5-241 incorrectly reflects the facts and the judgment. They state that the subsidiary had received the shares and that the only question was whether the increase in value of the subsidiary's shares in the hands of the holding company was sufficient to meet the issue price of the shares.

⁵⁵³ *Etkind & Others v Hicor Trading Ltd & Another* 1999 (1) SA 111 (W) at 121.

in the first place not have accepted such a strained interpretation of consideration, as section 92(1) clearly requires that regard should be had to the agreed price or consideration, which should have been paid to or received by the company, rather than to any incidental benefits received by the company.

Section 92(2) provides an exception to the requirement of section 92(1). When shares are issued and allotted to an intermediary with a view to them being offered to the public as fully paid shares, they need not be fully paid up prior to being allotted to the intermediary. The offer to the public must be proceeded with within one month of allotment and if it is not taken up in full within two months from the date of allotment, the allotment of any shares that have not been fully paid up will be void.

3.5 The regulation of commissions

The common law did not prohibit or regulate commission because it was regarded as payment for services rendered and not as a form of discount.⁵⁵⁴ A provision regulating the payment of commission was first introduced in England in 1908 but it placed no limit on the amount of commission that could be paid.⁵⁵⁵ The current form of the provision is derived from the recommendations of the Greene Committee⁵⁵⁶ which wanted to target abuses.

Section 80 regulates the payment of commission in consideration of a person subscribing or agreeing to subscribe for shares of the company, or procuring or agreeing to procure subscriptions. Although reference is often made to underwriters' commission, the section 80(1) is not restricted to underwriters and commission can apparently be paid to anyone in consideration of subscribing for shares.⁵⁵⁷ However, since commission is a payment to someone as remuneration for services rendered to the company, persons who do nothing more than subscribe for shares in response to an invitation may not be paid a commission

⁵⁵⁴ *Metropolitan Coal Consumers' Association v Scrimgeour* [1895] 2 QB 604 (CA) at 606. See also *Acutt v Seta Prospecting and Developing Co* 1907 TS 799 at 818. But see *Re Biltong Asbestos Co Ltd* 1925 CPD 356 regarding a disguised discount.

⁵⁵⁵ Section 89 of the Companies (Consolidation) Act 1908 (8 Edw 7, c 69). See Blackman, Jooste & Everingham *Companies Act* 5-32.

⁵⁵⁶ *Company Law Amendment Committee* Cmd 2657 (1925 – 1926) paragraph 44.

⁵⁵⁷ See De Wet and Yeats *Kontraktereg en Handelsreg* 568 note 262.

under this provision.⁵⁵⁸ While section 80(1) also refers to commission paid to persons who procure subscriptions, the payment to a broker of brokerage which a company could lawfully pay prior to the introduction of this provision, is not affected at all by section 80.⁵⁵⁹

A company may pay commission if so authorised by its articles.⁵⁶⁰ The commission may not amount to more than ten per cent of the issue price or any lesser rate fixed by the articles.⁵⁶¹ The amount or rate of commission must be disclosed in the prospectus (in the case of an offer to the public) or in a statement in the prescribed form and also in any circular or notice sent out which invites subscription for the shares.⁵⁶² The number of shares for which persons unconditionally agreed to subscribe at a commission must be disclosed in the same way.⁵⁶³ When disclosure has to take place by way of a statement, the statement must be lodged with the Registrar prior to payment of the commission.⁵⁶⁴ Failure to lodge the required statement with the Registrar constitutes a criminal offence by the company and by every director or officer who was knowingly a party to the default.⁵⁶⁵

The payment of disguised commissions is prohibited by section 80(3). It provides that except for commission paid in terms of section 80(1) and discount allowed under section 81:

no company shall apply any of its shares or capital money either directly or indirectly in payment of any commission, discount or allowance to any person in consideration of his subscribing or agreeing to subscribe, whether absolutely or conditionally, for any shares of the company, whether the shares or money be so applied by being added to the purchase price of any property acquired by the company or the money be paid out of the nominal purchase price or contract price, or otherwise.

⁵⁵⁸ Blackman, Jooste & Everingham *Companies Act* 5-32; see also Pennington *Company Law* 406.

⁵⁵⁹ Section 80(4). See also Blackman, Jooste & Everingham *Companies Act* 5-34.

⁵⁶⁰ Section 80(1)(a).

⁵⁶¹ Section 80(1)(b).

⁵⁶² Section 80(1)(c).

⁵⁶³ Section 80(1)(d).

⁵⁶⁴ Section 80(2).

⁵⁶⁵ Section 80(6).

Although this appears to be the only provision of the Act that expressly limits the application of funds representing issued share capital,⁵⁶⁶ its interpretation is uncertain.

The problem lies in reconciling section 80(3) with section 80(1). Meskin *Henochsberg on the Companies Act* argues that s 80(1) is permissive and does not contain an implied prohibition on the payment of commission otherwise than in accordance with it.⁵⁶⁷ The only prohibition, according to this interpretation, is the one in subsection (3) which prevents the payment of commission out of share capital. Commission can thus be paid freely, except if share capital is used - in which case the requirements of subsection (1) have to be met. If subsection (1) applied to any commission payments regardless of the source of funding, then subsection (3) would be unnecessary.⁵⁶⁸ This interpretation is supported by the fact that subsection (3) is couched in prohibitory rather than permissive terms.

The contrary interpretation of the authors of Blackman, Jooste & Everingham *Companies Act*, namely that any commission regardless of the source of funding can be paid only in compliance with subsection (1), is supported by the fact that the prohibition in subsection (3) is not stated before the exception and that the introductory sentence of subsection (1) does not expressly refer to the payment of commission out of share capital.⁵⁶⁹ According to this interpretation the purpose of subsection (3) is to make it clear that even share capital can be used to pay the limited commission allowed by subsection (1). Apart from the fact that it has always been possible for companies to pay commission,⁵⁷⁰ one would have expected a permissive formulation if it was indeed the purpose of the subsection.

I support the first interpretation. Nevertheless this uncertainty is unfortunate because it detracts from the real purpose of subsection (3), namely to prohibit indirect or disguised commissions which would affect the interests of creditors and shareholders.⁵⁷¹

Another aspect of section 80 that can be criticised is subsection (5). It

⁵⁶⁶ Section 76(3) and s 98(4) have a similar effect in respect of non-distributable reserves.

⁵⁶⁷ Meskin *Henochsberg on the Companies Act* 162.

⁵⁶⁸ Blackman, Jooste & Everingham *Companies Act* 5-33.

⁵⁶⁹ See Blackman, Jooste & Everingham *Companies Act* 5-33.

⁵⁷⁰ *Metropolitan Coal Consumers' Association v Scrimgeour* [1895] 2 QB 604 (CA).

⁵⁷¹ See Blackman, Jooste & Everingham *Companies Act* 5-34.

permits other persons such as vendors to a company and promoters of a company to pay commissions out of money or shares they received from the company if such commissions would also have been allowed if paid directly by the company. The authors of Blackman, Jooste & Everingham *Companies Act* correctly point out that this provision seems to be unnecessary because payments in these circumstances would in any event amount to indirect commissions paid by the company. The possible application of the requirements in subsection (1) to payments by these persons is also problematic.⁵⁷²

3.6 Capital contributions under the Companies Bill

3.6.1 Size of capital contribution

Shares must be issued for a consideration that the board of directors has determined to be adequate.⁵⁷³

A determination by the board that consideration is adequate may only be challenged based on a breach of the standard of conduct for directors⁵⁷⁴ and where, in addition, the directors would be liable to the company in accordance with the principles of the common law relating either to breach of fiduciary duty or in delict.⁵⁷⁵

The consequences of a successful challenge as to adequacy are not dealt with comprehensively. It seems clear that the directors will be liable, as they will be in breach of their duties to the company. The position of subscribers is unclear, but it is suggested that this will depend on whether or not the determination is invalidated by a successful challenge. If the determination remains valid, the subscriber should not be liable, as the shares will be regarded as fully paid once the determined consideration has been received.⁵⁷⁶ However, should the

⁵⁷² See Blackman, Jooste & Everingham *Companies Act* 5-34. However, it is interesting that the source of payment here is the purchase price of goods sold to the company or shares given by the company as payments: it is thus not restricted to shares and share capital.

⁵⁷³ Clause 40(1)(a).

⁵⁷⁴ Set out in clause 76 of the Companies Bill.

⁵⁷⁵ Clause 40(3). It is not clear whether a breach by any single director would suffice or whether the whole board should be found to have breached the standard of conduct. It would seem that since clauses 76 and 77 refer to individuals, a breach by any of the members of the board would constitute sufficient ground to challenge the determination of adequacy.

⁵⁷⁶ See clause 40(4)(a).

determination be invalidated - and in this regard it is significant that it is the determination itself which can be challenged⁵⁷⁷ - the subscriber might be liable for the difference between the initial invalid determination and the adequate consideration determined after the successful challenge.

The fact that liability is imposed on the directors for the loss or damage suffered by the company does not indicate whether or not the issue is invalidated, because the company may suffer loss or damage either way. If the issue is declared void, the company will have incurred wasted expenses, especially if an offer to the public was involved. Should the issue be valid, the company's loss will be equal to the difference between the issue price and the adequate consideration.⁵⁷⁸ I recommend that the consequences of a successful challenge to a determination should be clearly stated in the legislation.

3.6.2 Form of capital contribution

When shares are being issued for consideration, the consideration may comprise anything of value given and accepted in exchange for the shares.⁵⁷⁹ The following are expressly included: (a) any money, property, negotiable instrument, securities, investment credit facility, token or ticket; (b) any labour, barter or similar exchange of one thing for another; (c) any other thing, undertaking, promise, agreement or assurance, irrespective of its apparent or intrinsic value, or whether it is transferred directly or indirectly'.⁵⁸⁰ As the introductory words of the definition require consideration to be anything of value, it is difficult to see how something could qualify as consideration irrespective of its 'intrinsic' value. I recommend that a definition of consideration should not be contained in the Companies legislation.

Alternatively, shares may be issued in terms of conversion rights pertaining to previously issued securities of the company,⁵⁸¹ or as capitalisation shares.⁵⁸²

⁵⁷⁷ See clause 40(3).

⁵⁷⁸ See Oditah "Takeovers, Share Exchanges and the Meaning of Loss" 436 – 437. As the unissued shares are not really assets in the hands of the issuing company, construing a loss is not without difficulties.

⁵⁷⁹ Clause 40(1)(a). Clause 1 s v 'consideration' defines consideration as 'anything of value given and accepted in exchange for any property, service, act, omission or forbearance or any other thing of value'.

⁵⁸⁰ Clause 1 s v 'consideration'.

⁵⁸¹ Clause 40(1)(b).

⁵⁸² Clause 40(1)(c). See also clause 47, discussed in paragraph 4.3 below.

This express regulation of the consideration issue, especially in the case of capitalisation shares, obviates the need to resort to an artificial explanation of consideration⁵⁸³ and is to be welcomed.

3.6.3 The regulation of non-cash capital contributions

The Companies Bill does not prescribe any additional requirements for non-cash consideration. Regardless of the form of consideration, the directors have to determine that the consideration is adequate. It is submitted that this requirement will adequately protect the existing shareholders.

However, provision should be made for a further determination by the board where unpaid or partly paid shares were issued for future cash consideration, but the company later agrees to accept non-cash consideration instead. This situation is not covered by the current formulation of clause 40(5) which seems to deal only with the determination of the value of the consideration initially agreed on.

The draft Companies Bill 2007⁵⁸⁴ required shareholder approval for substantial issues only where the consideration was something other than cash, or for less than market value,⁵⁸⁵ but this requirement is extended to all kinds of consideration in the Companies Bill of 2008.⁵⁸⁶

3.6.4 Timing of capital contribution

Shares are fully paid when the company has received the consideration determined by the board.⁵⁸⁷ However, shares do not have to be fully paid prior to being issued.⁵⁸⁸ Where the consideration is in the form of an instrument that is not negotiable by the company at the time the shares are to be issued, the consideration is deemed to have been received at any time only to the extent that the instrument is negotiable by the company.⁵⁸⁹ Where the consideration is in the form of an agreement for future services, future benefits or future payment, it is

⁵⁸³ See paragraph 3.2.1 above.

⁵⁸⁴ Available at <http://thedti.gov.za/ccrdlawreview/COMPANIESBILL07.htm> (2008-02-28).

⁵⁸⁵ See clause 38(4)(a) of the draft Companies Bill 2007.

⁵⁸⁶ Clause 41(3), see paragraph 2.8.1 above.

⁵⁸⁷ Clause 40(4)(a).

⁵⁸⁸ See clause 40(5).

⁵⁸⁹ Clause 40(5)(a)(i).

deemed to have been received, and the shares paid up, only to the extent that the obligations have been fulfilled.⁵⁹⁰

It is not clear whether this provision requires the directors to value the consideration. Because the adequacy of the consideration must be determined when the shares are issued, and since it is not required that a cash value should be attached to the consideration, it would seem that the directors need not value the consideration in monetary terms. Instead, they could determine which part or percentage of the agreed services or goods have been received and treat the shares as paid up to that extent. This can be contrasted with the position in New Zealand where the shares are treated as paid up, but the directors have to make a fresh adequacy determination when it receives further consideration.⁵⁹¹

The consequences of unpaid or partly paid shares are regulated extensively in the Companies Bill. It uses the mechanism of placing shares in 'escrow', a concept not defined in the Companies Bill. Escrow is a legal arrangement whereby an asset is held in custody pending fulfilment of a specified condition.⁵⁹² It is commonly used in American real estate transactions and is also used in the MBCA in the context of unpaid or partly paid shares.⁵⁹³ It is not clear why this term is preferred above the established trust construction of South African law.

The draft Companies Bill 2007 merely gave the company the power to place the shares in escrow or make another arrangement restricting their transfer.⁵⁹⁴ The company could nevertheless issue the shares directly to the subscriber.⁵⁹⁵ There was no general restriction on the transfer of unpaid or partly paid shares, and the voting and distribution rights attaching to these shares were not regulated. In comments that I submitted to the DTI on this draft Bill, I suggested that these aspects required further attention. These submissions appear to have been implemented in the Companies Bill.

The Companies Bill 2008 no longer gives the company a choice: when shares are to be issued otherwise than as fully paid shares, the company must

⁵⁹⁰ Clause 40(5)(a)(ii).

⁵⁹¹ See Chapter 3 paragraph 3.3.

⁵⁹² See *The Oxford Pocket Dictionary of Current English 2008* s v 'escrow'.

⁵⁹³ See Chapter 4 paragraph 4.3.4.

⁵⁹⁴ See clause 37(6)(b) of the draft Companies Bill 2007.

⁵⁹⁵ Clause 37(6)(a) of the draft Companies Bill 2007.

issue the shares and transfer them to a third party to be held in escrow.⁵⁹⁶ The shares will then be transferred to the subscribing party at a later stage in accordance with the conditions of the escrow agreement.⁵⁹⁷ Transfer will depend on the extent to which the instrument has become negotiable or the obligations have been fulfilled.⁵⁹⁸

The company may cancel shares placed in escrow if the instrument is dishonoured after it became negotiable, or if the subscribing party fails to comply with the outstanding obligations.⁵⁹⁹

The Companies Bill addresses the problem regarding the restriction on the transfer of unpaid or partly paid shares. Clause 40(6)(d)(i) provides that while shares are in escrow, they may not be transferred by or at the direction of the subscribing party unless the company has expressly consented to the transfer in advance.⁶⁰⁰ This power of the company to refuse transfer will enable it to safeguard its interest in receiving the outstanding consideration. In the absence of a transfer restriction, the subscribing party would nevertheless have remained contractually liable to the company for the outstanding consideration, but the company may have experienced problems in enforcing its claim, especially if it were not able to cancel the shares following a transfer.⁶⁰¹ Although it is not expressly stated, it would seem that a transfer without the company's consent would be invalid. It would also seem that even in the event of a valid transfer, the shares will remain in escrow, on behalf of the transferee, until fully paid.⁶⁰² In such a case, the company would retain its power to cancel the shares in the event of default by the subscribing party.⁶⁰³

The membership rights in relation to shares that are in escrow are regulated in clause 40(6), but an escrow agreement may provide otherwise. The default rule

⁵⁹⁶ Clause 40(5)(b). The draft Companies Bill 2007 made it optional for the shares to be placed in escrow, see clause 37(6).

⁵⁹⁷ Clause 40(5)(b)(ii).

⁵⁹⁸ Clause 40(6)(d)(ii), (iii).

⁵⁹⁹ Clause 40(6)(d)(iv). The company first has to make a demand as set out in clause 40(7).

⁶⁰⁰ Clause 40(6)(d)(i).

⁶⁰¹ See clause 40(6)(d)(iv) read with 40(7).

⁶⁰² Under clause 40(6)(d)(ii), (iii) transfer is allowed only to the extent that the company has received consideration or the instrument has become negotiable.

⁶⁰³ The power to cancel is given in respect of 'shares that have been issued but are in escrow', see the introductory sentence of clause 40(6).

is that the voting rights of such shares may not be exercised at all and that the subscribing party can also not exercise appraisal rights in respect of those shares.⁶⁰⁴ However, the subscribing party is entitled to pre-emptive rights and distributions to the extent that the instrument has become negotiable⁶⁰⁵ or the obligations have been fulfilled.⁶⁰⁶ The insertion of these provisions addresses the submissions I made to the Department of Trade and Industry in commenting on the draft Companies Bill 2007. As unpaid or partly paid shares may contribute to broad-based black economic ownership of companies, it is vital that there should be clarity on the measurement of the economic interest attaching to unpaid or partly paid shares.⁶⁰⁷

The company may, rather than pay a distribution over to the subscribing party in respect of an unpaid or partly paid share, credit its amount against the outstanding consideration.⁶⁰⁸

3.7 Evaluation of capital contribution

3.7.1 Evaluation of size of capital contribution

I argued that the common-law rule against the issue of shares at a discount remains part of South African law, despite the introduction of new distribution rules. It is not necessary to read a new implied prohibition into the exception provided by the Act, in view of the established common-law principle.⁶⁰⁹

The prohibition against discount offers a marginal degree of protection to shareholders and also to creditors. Creditors benefit because the company will receive at least the par value of the shares, meaning it will start out with more funds than would have been the case if it gave a discount. Shareholders benefit because there is at least some minimum level of contribution required from other

⁶⁰⁴ Clause 40(6)(a).

⁶⁰⁵ Clause 40(6)(b).

⁶⁰⁶ Clause 40(6)(c)(i).

⁶⁰⁷ See the Ownership Code, Code 100, available at www.dti.gov.za 18-03-2008. See also Luiz & Van der Linde "Broad-Based Black Economic Empowerment" 473; Marais & Coetzee "Black Ownership" 518, although these articles discuss the draft codes.

⁶⁰⁸ Clause 40(6)(c)(ii).

⁶⁰⁹ This situation differs from that pertaining to the application of the share premium account. In that case, there is no common-law prohibition on the return of share premiums, but only an enabling statutory provision, see paragraph 2.4.3.3.3 above.

shareholders. However, in view of the use of shares with an insignificant par value, issued at a large premium, this protection is largely illusory.

Discount on par value shares may be given with the approval of the court. The discount exception in section 81 was compared to the limitation on the issue of no par value shares at a price below their average issue price contained in section 82. While both provisions aim to protect existing shareholders, section 81 also protects creditors and future shareholders. However, neither of these provisions is effective in preventing the uncontrolled dilution of shareholder value.

In other jurisdictions no par value shares can generally be issued for any consideration determined by the directors, whose determination will be conclusive unless fraud was involved. New Zealand was seen to be the only jurisdiction always to require a formal resolution by directors regarding the fairness of the consideration. In California a resolution is required only when non-monetary consideration is accepted

If the company prospers, the value of its shares will usually be higher than their issue price, as a result of growth in the company's assets. As McLennan points out in relation to both par value and no par value shares, if the market value has risen since the shares were issued, the value of the existing shareholders' holdings will still be diluted by an issue at the average price of no par value shares or nominal value of par value shares.⁶¹⁰ The effect is aggravated when existing par value shares were issued at a premium, because section 81 does not take into account any premium contributed in respect of the existing shares.⁶¹¹ This was recognised by the Van Wyk de Vries Commission when it concluded that reliance on the nominal value of par value shares provided only illusory protection to shareholders.⁶¹² For this reason the Commission recommended the future consideration of a rule similar to section 82, taking into account the actual issue price inclusive of any premium, for par value shares.⁶¹³

McLennan concludes that protection against diluting the equity should not be

⁶¹⁰ McLennan "Abolition of Par-value" 41, see also Blackman, Jooste & Everingham *Companies Act* 5-39.

⁶¹¹ This will be so unless the present value of the shares happens to be equal to their par value.

⁶¹² Van Wyk de Vries *Main Report* 34.16 – 18; *Supplementary Report* 86.02.

⁶¹³ It is not clear whether the Standing Advisory Committee ever reconsidered this issue. Section 81 and 82 have, however, remained unchanged.

through legislation, but rather through the common-law shareholder remedies.⁶¹⁴ The fiduciary duties of directors imply that they should issue shares for the maximum consideration that can be obtained,⁶¹⁵ unless good reasons exist for accepting a lower consideration. Such reasons could include rewarding employees or existing shareholders.⁶¹⁶ Shareholders are also protected by section 221 which restricts the power of directors to issue and allot shares.⁶¹⁷

I think that existing shareholders would be better protected by a provision that requires a declaration by directors that an issue price is fair and reasonable in view of the present value of previously issued shares of that class. Alternatively, a special resolution can be required to sanction the issue of shares at a price significantly lower than their current value. It does not make sense to require an exact determination of the value of the shares whenever new shares are to be issued. For this reason a special resolution could be required for issues at a price known by the directors to be significantly lower than the present value of the shares.

The Companies Bill requires shares to be issued for adequate consideration.⁶¹⁸ This will provide more protection than is currently the case for par and no par value shares. 'Adequate consideration' is a flexible concept which would allow directors to take into account the company's current financial situation as well as market conditions. The Companies Bill does not impose additional requirements regarding the minimum issue price which can be compared to section 82 of the current Act.⁶¹⁹

Clearly, the present value of existing shares will be a factor that the directors will have to take into account in determining the adequacy of the consideration. Directors will be personally liable for loss caused to the company by a determination in breach of the standard of conduct expected from them.⁶²⁰

⁶¹⁴ McLennan "Abolition of Par-value" 41.

⁶¹⁵ See Delpont *Verkryging* 405.

⁶¹⁶ *Shearer (Inspector of Taxes) v Bercaïn* [1980] 3 All ER 295 at 308.

⁶¹⁷ See paragraph 2.1 above.

⁶¹⁸ Clause 40(4)(a), see paragraph 7.6.2.

⁶¹⁹ The draft Companies Bill 2007 did refer to issues at below the fair market value of shares and required approval by special resolution if the issue was of a substantial number of shares, clause 38(4)(a). The Companies Bill 2008 requires shareholder approval for substantial issues regardless of the consideration involved.

⁶²⁰ Clause 40(3) read with clause 77(2)(a), (b), see Chapter 5 paragraph 7.6.2.

I submit that the provisions of the Companies Bill 2008 provide shareholders with sufficient protection, especially when the restrictions on the issue of shares are taken into account.⁶²¹ Specific provision need not be made for issues below the current market value of the shares.

However, I must emphasise that the consequences of a successful challenge regarding the adequacy of consideration on the validity of the issue and allotment are not addressed in the Companies Bill.⁶²²

There are various ways of regulating the consequences of an issue of shares for inadequate consideration or otherwise in violation of the requirements pertaining to consideration. In England, an allotment at a discount will be valid, but the allottee is liable for the amount of the discount.⁶²³ Similarly, where a public company agrees to issue shares for unacceptable consideration, the allotment will be valid but the allottee will be liable to pay the issue price in cash.⁶²⁴ The directors will be liable at common law for breach of their duties.⁶²⁵ The New Zealand Companies Act makes provision for criminal liability of directors should they fail to comply with the formalities.⁶²⁶ However, that Act is silent on the possible liability of shareholders or the validity of the issue and allotment. In Delaware and California the consideration determined by the directors will be conclusive unless fraud is involved.⁶²⁷ Although this is not regulated by statute, the implication seems to be that the issue will be valid, but that in cases of fraud the shareholder will be liable to pay extra consideration because the determination was not conclusive. The MBCA provides that a determination by the board of directors will be conclusive and that a shareholder who paid the determined consideration is not liable for any further amount.⁶²⁸ Although directors could be held liable for breaching the standard of conduct, the provision relating to the determination of consideration does not make the conclusiveness of the determination dependent on compliance with the standard of conduct. The MBCA

⁶²¹ See paragraph 2.8.1 above.

⁶²² See paragraph 3.6.1 above.

⁶²³ See Chapter 2 paragraph 3.1.

⁶²⁴ See Chapter 2 paragraph 3.2.

⁶²⁵ See Chapter 2 paragraph 3.1.

⁶²⁶ See Chapter 3 paragraph 3.1.

⁶²⁷ See Chapter 4 paragraphs 2.3.1 and 3.3.1.

⁶²⁸ See Chapter 4 paragraph 4.3.1.

thus avoids the confusion arising from the proposed provision in the Companies Bill which apparently allows a challenge to the determination itself.

I submit that the provisions in the Companies Bill on adequacy of consideration should enjoy further attention and will make a specific recommendation in this regard in the final chapter.⁶²⁹

3.7.2 Evaluation of form of capital contribution

Anything of value can be given in consideration for the issue and allotment of shares. Although there was previously uncertainty in this regard, it is clear that the term 'subscription' includes offers to take up shares for non-cash consideration.⁶³⁰

Despite this general rule, the requirement that the company should actually receive the full consideration when it issues the shares restricts the kinds of consideration that are acceptable. An undertaking to render services in the future is not considered a proper form of consideration in South Africa.⁶³¹ This is also the position in California,⁶³² Delaware,⁶³³ and for public companies in England.⁶³⁴ However, the effect of this rule is less severe in these jurisdictions than in South Africa because unpaid or partly paid shares are permitted there.⁶³⁵ Also, an issue and allotment for an improper consideration, for example future services, will be void in South Africa, while in these other systems it will merely render the subscriber liable to pay the consideration in cash. I submit that the exclusion of future consideration is unduly restrictive and out of step with international practice.

The judgment in *Etkind & Others v Hicor Trading Ltd & Another*⁶³⁶ illustrates the limiting effect of the requirement on the nature of the acceptable consideration. I argued that although the court interpreted 'consideration' widely, it was not prepared to adopt a flexible and logically consistent interpretation of the receipt requirement.⁶³⁷

⁶²⁹ See Chapter 6 paragraphs 3.1 and 7.6.

⁶³⁰ See paragraph 3.2 above.

⁶³¹ See paragraph 3.2 above

⁶³² See Chapter 4 paragraph 3.3.2.

⁶³³ See Chapter 4 paragraph 2.3.2.

⁶³⁴ See Chapter 2 paragraph 3.2.

⁶³⁵ See Chapter 2 paragraph 3.2; Chapter 4 paragraphs 2.3.2 and 3.3.2.

⁶³⁶ 1999 (1) SA 511 (W).

⁶³⁷ See paragraphs 3.2 and 3.4 above.

The Companies Bill considerably broadens the scope of what will be acceptable consideration. The definition of consideration includes a long list of options and expressly includes anything of value 'irrespective of its apparent or intrinsic value'. It is recommended that the Companies Act should not contain a definition of consideration.⁶³⁸ The meaning of the concept should be clear from general principles of South African law. A definition of 'cash' should be inserted, though.⁶³⁹

3.7.2.1 Evaluation of capitalisation issues

Capitalisation issues clearly contravene section 92 and so are problematic from a consideration perspective.⁶⁴⁰ Attempts to construe a notional consideration are unconvincing. Nevertheless, capitalisation issues do not prejudice creditors, since they are actually the opposite of distributions.

The consideration aspect of the issue of capitalisation shares is expressly regulated in England, New Zealand and under the MBCA. In England it is expressly provided that the requirement that consideration must be paid does not detract from the company's power to issue capitalisation shares.⁶⁴¹ In New Zealand it is provided that 'other securities of the company' qualify as consideration.⁶⁴² Also, when capitalisation shares are issued from reserves of the company the board is not required to determine the consideration by resolution.⁶⁴³ The MBCA expressly provides for the issue of shares for no consideration in the case of share dividends.⁶⁴⁴

The express recognition that shares may be issued otherwise than for consideration is a positive feature of the Companies Bill.⁶⁴⁵ Treating capitalisation issues and conversions as exceptions to the rule obviates the need to resort to artificial explanations of consideration.⁶⁴⁶

⁶³⁸ See paragraph 3.6.2 above.

⁶³⁹ See Chapter 6 paragraph 7.6 and the suggested definition of 'cash'.

⁶⁴⁰ See paragraph 3.2.1.

⁶⁴¹ See Chapter 2 paragraph 3.2.

⁶⁴² See Chapter 3 paragraph 3.2.

⁶⁴³ See Chapter 3 paragraph 3.2.

⁶⁴⁴ See Chapter 4 paragraph 4.3.1.

⁶⁴⁵ See paragraph 3.6.2 above.

⁶⁴⁶ As to which, see paragraph 3.2.1.

3.7.3 Evaluation of regulation of non-cash capital contributions

The regulation of non-cash consideration is of interest to shareholders because non-cash issues can be used to hide a dilution in the value of existing shareholdings. In a capital maintenance system, creditors also have an interest in the regulation of non-cash consideration, because it will affect the size of the share capital yardstick and accordingly the extent of possible distributions.

Specific disclosure requirements apply when a company accepts non-cash consideration. The register of allotments has to contain details of the consideration and a copy of the contract or a written memorandum setting out its terms must be lodged with the Registrar. The consideration also has to be valued in order to be reflected in the share capital accounts of the company.⁶⁴⁷ I have shown that there are significant differences between the requirements regarding the valuation of non-cash consideration, depending on whether the shares involved are par value or no par value shares.⁶⁴⁸ There seems to be no justification for these distinctions.

The regulation of non-cash consideration in the Act has been criticised by Delport for not offering creditors and shareholders meaningful protection.⁶⁴⁹ First, disclosure comes only once the shares have already been issued. Secondly, while fiduciary duties of directors are relevant, they are imprecise. Thirdly, shareholder actions are inadequate. I submit that these criticisms are valid.

The South African valuation provisions are very lenient compared to the requirements in the other jurisdictions surveyed.⁶⁵⁰ In England, valuation by an independent expert is required when a public company issues shares for non-cash consideration.⁶⁵¹ In New Zealand, despite the absence of any concept of nominal or issued share capital, the directors have to determine the present cash value of non-cash consideration and certify that it is at least equal to the amount credited as consideration for the shares.⁶⁵² Delaware does not prescribe valuation, but shareholders can incur liability in respect of watered shares if the value of non-

⁶⁴⁷ See paragraph 3.3 above.

⁶⁴⁸ See paragraph 3.3 above.

⁶⁴⁹ See Delport "Capital Rules" 413.

⁶⁵⁰ See paragraph 3.3 above.

⁶⁵¹ See Chapter 2 paragraph 3.3.

⁶⁵² See Chapter 3 paragraph 3.3.

cash consideration is less than the nominal value of the shares.⁶⁵³ In California a formal resolution of directors is required when non-monetary consideration is accepted.⁶⁵⁴ Under the MBCA shareholder approval is required for substantial non-cash issues.⁶⁵⁵

The Companies Bill does not regulate non-cash consideration any differently from cash consideration. It is also clear that the monetary value of non-cash consideration need not be determined. Shareholders are protected by the requirement that the consideration must be adequate. However, I recommend that particulars of any non-cash consideration should be disclosed to shareholders, in order to enable them to assert their rights against directors who accept inadequate consideration.⁶⁵⁶ I also recommend that the directors should have to determine the adequacy of non-cash consideration if they later agree to accept non-cash consideration in respect of shares that have been issued for future cash consideration.⁶⁵⁷

3.7.4 Evaluation of timing for capital contribution

The time when a company receives the consideration for an issue of shares is primarily of interest to the company. However, just as shareholders have an interest in the consideration paid by other shareholders to obtain a comparable interest in the company, they are affected by the benefits enjoyed by these other shareholders in relation to the consideration they have actually contributed. Creditors may also be interested in whether the company has actually received funds from the shareholders, but this interest is remote provided the company can pay its debts.

The Act requires that the full issue price of shares must be received by the company when it issues shares. This requirement implies that only fully paid shares are allowed. An issue of shares in violation of this requirement is void. The

⁶⁵³ See Chapter 4 paragraph 2.3.5.

⁶⁵⁴ See Chapter 4 paragraph 3.3.3.

⁶⁵⁵ See Chapter 4 paragraph 4.3.3.

⁶⁵⁶ See Chapter 6 paragraph 7.6 and subclause (3) of the proposed provision 'Consideration for shares'. See also Giugni "Consideration" 385 – 386 on the importance of disclosure in this context.

⁶⁵⁷ See Chapter 6 paragraph 7.6.

judgment in *Etkind & Others v Hicor Trading Ltd & Another*⁶⁵⁸ illustrates how easily a transaction can fall foul of this requirement on technical grounds.⁶⁵⁹

None of the other jurisdictions surveyed contain a requirement that shares should be fully paid up. The level of regulation of unpaid or partly paid shares varies among jurisdictions. Regulated aspects include the allocation of proportionate voting and distribution rights, forfeiture of shares for non-payment, restrictions on the transfer of shares, liability for outstanding consideration upon transfer of shares, and the crediting of distributions against the outstanding consideration.

In England shares in private companies need not be paid up to any extent when they are issued, while at least one quarter of the nominal value plus the full premium must be paid when shares are allotted by public companies.⁶⁶⁰ In the case of public companies the future consideration may not be due more than five years after the date of allotment and the consequences of non-compliance with this rule are addressed.⁶⁶¹ English legislation does not regulate the implications of unpaid or partly paid shares in detail, leaving this to the company's articles.⁶⁶²

In New Zealand, shares need not be paid up when issued and the legislation provides for the continued liability of the person who initially undertook to pay the issue price.⁶⁶³ The directors are also given the power to refuse registration of the transfer of shares if not fully paid. But voting and dividend rights are not regulated.

The regulation in Delaware and California is more comprehensive.⁶⁶⁴ Both these jurisdictions provide for dividends in proportion to the consideration actually paid on unpaid or partly paid shares. Provision is also made for forfeiture of shares should the shareholder default on an instalment. The original subscriber or holder remains liable for the issue price, and *bona fide* transferees are not liable. Creditors are given the right to enforce payment of the outstanding consideration in certain circumstances.

⁶⁵⁸ 1999 (1) SA 111 (W). See paragraph 3.4 above.

⁶⁵⁹ See paragraphs 3.2 and 3.3.

⁶⁶⁰ See Chapter 2 paragraph 3.4.

⁶⁶¹ See Chapter 2 paragraph 3.2. Future services are unacceptable consideration, even if they are to be rendered within five years.

⁶⁶² See Chapter 2 paragraph 3.2.

⁶⁶³ See Chapter 3 paragraph 3.4.

⁶⁶⁴ See Chapter 4 paragraph 2.3.4 on Delaware and paragraph 3.3.4 on California.

The MBCA does not regulate this in much detail, but provides that the company may place the shares in escrow or otherwise restrict their transfer.⁶⁶⁵ Under the Uniform Commercial Code, a transferee who takes transfer without knowledge of the outstanding liability will not be liable to the company in respect of it.

The Companies Bill proposes the re-introduction of unpaid or partly paid shares.⁶⁶⁶ It provides that shares will be paid when the consideration has been received by the company.⁶⁶⁷ However, where the consideration is in the form of an instrument that is not negotiable by the company at the time the shares are to be issued, or is in the form of an agreement for future services, future benefits or future payment by the subscribing party, such consideration is deemed to have been furnished at any time only to the extent that the instrument has become negotiable by the company or that the obligations in terms of the agreement have been fulfilled.⁶⁶⁸

The Bill proposes that the unpaid or partly paid shares will be issued, but placed in escrow in the hands of a third party. This will have the effect of restricting the transfer of unpaid or partly paid shares. It would seem that this requirement is rather restrictive when compared to for example the MBCA, as it does not leave room for any alternative forms of restriction on transfer. However, an uncomplicated approach is probably a good idea while the business community (re-)acquaints itself with unpaid or partly paid shares.

The participation rights pertaining to shares placed in escrow and their entitlement to distributions are expressly regulated, but could be changed in an escrow agreement.⁶⁶⁹ Provision is also made for the forfeiture of shares and for crediting distributions against the unpaid consideration. The only aspect that is not regulated is the liability of the initial shareholder in the case of a transfer. It is

⁶⁶⁵ See Chapter 4 paragraph 4.3.4.

⁶⁶⁶ See paragraph 3.6.4 above.

⁶⁶⁷ Clause 40(4).

⁶⁶⁸ Clause 40(5).

⁶⁶⁹ See paragraph 3.6.4 above. The default rule is that the voting rights of such shares may not be exercised at all and that the subscribing party can also not exercise appraisal rights in respect of those shares. However, the subscribing party is entitled to pre-emptive rights and distributions to the extent that the instrument has become negotiable or the obligations have been fulfilled. The company may, rather than pay the distribution over to the subscribing party, credit its amount against the outstanding consideration.

suggested that the transferor or other person who initially incurred the obligation will remain liable to the company on the basis of contract and that the liquidator can collect the debt from the shareholder if the company is liquidated while the liability remains outstanding.

I view the proposals of the Companies Bill on unpaid or partly paid shares as sensible.⁶⁷⁰ However, provision should be made for an adequacy determination by the board where unpaid or partly paid shares were issued for cash consideration, but the company later agrees to accept future non-cash consideration when a further payment is due.⁶⁷¹ This situation is not covered by the current formulation of clause 40(5) as the shares will not originally have been issued for consideration in the form of an agreement for future services, benefits or payments. I will formulate a proposal in this regard.⁶⁷²

4 DISTRIBUTIONS

The previous parts of this chapter are devoted to an analysis of the share capital structure of a company and of the regulation of the capital contribution that a shareholder has to make in exchange for a share in the company. These two aspects relate to the formation of the share capital of a company. It is this share capital that forms the focus of the capital maintenance doctrine. While this doctrine does not insist that companies should at all times have assets representing their share capital, it does prohibit distributions to shareholders unless the company's assets exceed the value of its share capital.⁶⁷³ The connection between the share capital and the regulation of distributions was thus obvious as far as creditors are concerned. However, distributions also affect the interests of shareholders and in this regard the principle of proportionality relies on the share capital of the company, more particularly, on the shareholder's relative stake in it.

For these reasons the Companies Act was designed to ensure that share

⁶⁷⁰ Some of these may have been introduced in the Companies Bill 2008 as a result of comments this writer submitted on the draft Companies Bill 2007, see paragraph 3.6.4 above.

⁶⁷¹ See paragraph 3.6.4 above and Chapter 6 paragraph 7.6.

⁶⁷² See Chapter 6 paragraph 7.6 and subclause (4) of the proposed provision entitled 'Consideration for shares'.

⁶⁷³ This is the basic point of departure of the capital maintenance doctrine. However, there are various exceptions and intrusions into this principle, particularly in relation to dividends, see Chapter 1 paragraph 2.

capital is raised and properly reflected in specific accounts, and that the shareholders actually give the full consideration reflected in these accounts. Despite the introduction of new distribution rules, which no longer attach significance to the share capital structure of the company, the legislature attempted to preserve the basic structure of share capital accounts by providing for the compulsory adjustment of share capital accounts following share repurchases. Further, the distributions that were expressly regulated in the Act were retained with very minor amendments that do not go to the core of the matter.⁶⁷⁴

The Companies Act does not contain an inclusive definition of 'distribution'. However, it provides for the following distributions:

- payments of interest on share capital in terms of section 79
- payments for the acquisition of shares in terms of section 85
- payments by reason of shareholding in terms of section 90
- payments for the redemption of shares in terms of section 98.

The requirements and consequences of each of these four kinds of distributions will be explored more fully in separate paragraphs. However, at this stage a brief explanation of the basic principles underlying the regulation of each is necessary. This is done with reference to the financial restrictions that apply and the effect of the distribution on the share capital structure of the company. Apart from giving an overview of the regulation of distributions, this structure also facilitates comparison with the proposals under the Companies Bill which does not adopt such a fragmented approach.

The payment of interest on share capital is allowed in exceptional circumstances only and requires the sanction of the court.⁶⁷⁵ No financial restrictions are prescribed. However, although the interest may be 'charged to capital' the payment of interest does not reduce the amount of paid-up capital reflected in the share capital accounts.

When a company makes a distribution through a payment to acquire its own

⁶⁷⁴ The only changes were the introduction of a further possible application of the share premium account and the capital redemption reserve to provide for a premium paid on repurchase, s 76(3)(d) and s 98(4).

⁶⁷⁵ This kind of distribution is discussed in paragraph 5.7 below.

shares, it has to satisfy the solvency and liquidity test.⁶⁷⁶ An acquisition of own shares will result in the reduction of the company's share capital. Although the Act regulates the 'acquisition' of own shares, it is only when the company gives consideration that a distribution is involved. The acquisition of own shares for consideration is referred to as the 'repurchase' of shares.

Although payments by reason of shareholding are subject to the same financial restrictions that apply to share repurchases, namely solvency and liquidity, they do not have the same effect on the share capital of the company.⁶⁷⁷ While repurchases are reductions of share capital,⁶⁷⁸ payments, even if made out of funds representing capital, are not.⁶⁷⁹

Payments for the redemption of shares may be made only out of certain sources, namely distributable profits and the proceeds of a further issue of shares.⁶⁸⁰ The aggregate of the company's paid-up share capital and non-distributable reserves will not be reduced. These restrictions were originally devised as an exception under the capital maintenance doctrine.

Despite the fragmented approach to distributions it is sensible to consider the financial restrictions that apply to 'payments' under section 90 and to repurchases under section 85 here, before the individual requirements for the different distributions are analysed. This not only eliminates unnecessary repetition, but also facilitates comparison with the uniform financial restrictions proposed under the Companies Bill for all distributions. Moreover, these two kinds of distributions that are subject to the solvency and liquidity test arguably represent the most common forms of distributions made by companies.⁶⁸¹

Different elements of the solvency and liquidity test are considered, followed by a discussion of the time when the solvency and liquidity test should be applied and satisfied.

⁶⁷⁶ The acquisition of own shares is discussed in paragraph 6 below.

⁶⁷⁷ Payments by reason of shareholding, including dividends, are discussed in paragraph 5 below.

⁶⁷⁸ See paragraph 6.3.3 below and paragraph 2.6.2 above.

⁶⁷⁹ See paragraph 5.1 below.

⁶⁸⁰ See paragraph 6.8 for a discussion of the redemption of shares.

⁶⁸¹ The redemption of redeemable preference shares is of fairly limited application, as it does not concern ordinary shares. The payment of interest in terms of s 79 is seldom resorted to.

4.1 Financial restrictions for distributions

Although certain distributions like the redemption of shares are subject to different financial restrictions, the general approach is based on the requirements of solvency and liquidity. This test is set out in section 85(4) for repurchases and in section 90(2) for other payments as defined, which includes dividends.

A company may not make any payment in whatever form to its shareholders if there are reasonable grounds for believing that the company would after the payment be unable to pay its debts as they become due in the ordinary course of business⁶⁸² or that the company's total assets would after the payment be less than its total liabilities.⁶⁸³

4.1.1 Reasonable grounds for believing

The company can make payment unless there are reasonable grounds for believing that the solvency and liquidity measures will not be satisfied. The actual solvency and liquidity of the company is apparently not relevant. If the company is indeed insolvent or unable to pay its debts, payment would in theory be lawful provided there were no 'reasonable' grounds for believing that this was the position. Conversely, the test would still have been contravened if there were indeed reasonable grounds to believe that the company would not satisfy the test, and it later turns out that the company was for some or other reason, such as a sudden increase in the value of its assets or unexpected early payment of a debt owed to it, indeed not insolvent or unable to pay its debts when it made payment.⁶⁸⁴

This approach can be contrasted with that followed in respect of close corporations where the actual solvency and liquidity of the corporation is relevant.⁶⁸⁵ While actual solvency and liquidity may afford creditors better protection, it seems to be easier from a practical perspective to apply the 'reason to believe' standard when considering the permissibility of a payment about to be

⁶⁸² Section 85(4)(a), s 90(2)(a).

⁶⁸³ Section 85(4)(b), s 90(2)(b).

⁶⁸⁴ This issue of a divergence between actual solvency and liquidity and the existence of reasonable grounds in this regard is also dealt with in connection with the liability of directors, see paragraph 6.4.1.1 below.

⁶⁸⁵ See the Close Corporations Act 69 of 1984 s 39(1)(b) – (d), s 40(b) – (d), s 51(1)(a) – (c).

made. However, a positive formulation allowing the recovery of payments that appear *ex post facto* to have been made in violation of the standards of solvency and liquidity may afford creditors better protection.⁶⁸⁶

Payment may be made unless there is 'reason to believe' that the specified circumstances exist. Although it is not specified who should or should not have such reason to believe, it is often assumed that it must be the directors or officers who cause the company to make payment. However, it is clear that the standard is more objective than this. It is thus not necessary to attempt to proscribe a certain state of mind to specific persons such as directors. The determining factor is the existence of a reason or ground for a specific belief.

The authors of Blackman, Jooste & Everingham *Companies Act* criticise the formulation of the test which prohibits payments 'if there are reasonable grounds for believing'. They state that the test appears to have objective as well as subjective elements. The phrase 'reasonable grounds' and the absence of an indication as to who should hold the belief point to an objective test. However, a 'belief' is inherently subjective, even if it belongs to the reasonable man. It is also suggested that the word 'reasonable' should rather have belonged to 'belief' than to 'grounds'.⁶⁸⁷ Linguistically, this would indeed have made better sense.

The meaning of the word 'believe' further seems to indicate that the mere existence of grounds for suspecting that the company may not satisfy the criteria is not sufficient reason to prevent the making of a payment. It is suggested that the requisite belief can only be held if it appears more likely than not that the company is insolvent or unable to pay its debts. The negative formulation of the test could thus in a particular case have a different outcome than would have been the case if payment depended on the existence of a reasonable belief that the company would indeed satisfy the criteria.

4.1.2 The liquidity element

The liquidity test is set out in section 85(4)(a) and section 90(2)(a). It prohibits payment if there is reason to believe that 'the company is, or would after the payment be, unable to pay its debts as they become due in the ordinary course of

⁶⁸⁶ This issue will be considered in paragraph 6.4.1.4 below in relation to the liability for unlawful payments.

⁶⁸⁷ Blackman, Jooste & Everingham *Companies Act* 5-119.

business'. It is not specified for how long after the payment the company should remain able to pay its debts. Perhaps the intention was that this should depend on the nature of the company's ordinary course of business, taking into account the debts that could at that stage be expected to become due. For listed companies, the JSE Listings Requirements require the directors to make a prediction for the twelve months following the date of payment.⁶⁸⁸ It has been argued that a similar time period should be introduced for all companies.⁶⁸⁹ In the case of close corporations, the liquidity requirement is divided up into two parts, namely:

- that the corporation must be able to pay its debts as they become due in the ordinary course of its business
- that the transaction must, in the particular circumstances not in fact render the corporation unable to pay its debts as they become due in the ordinary course of its business.⁶⁹⁰

Apart from the obvious difference that the liquidity test in the Companies Act has been formulated more compactly by taking into account only the position after the transaction or payment, it is also concerned with illiquidity in general rather than illiquidity caused by the particular payment only. This formulation avoids the need to determine which liability caused the inability to pay. Nevertheless, if the company's inability to pay its debts is caused by another event it would probably only be relevant for purposes of section 85(4)(a) and section 90(2)(a) if it was foreseeable at the stage when the reasonable belief had to be formed. There may thus not be much practical difference between these tests.

The position regarding obligations in terms of earlier unexecuted repurchase contracts is uncertain. It would seem that they have to be included as liabilities. However, it could be doubted whether such obligations can ever be regarded as debts due in the ordinary course of the company's business. It is suggested that this issue should be addressed in the legislation so as to make it clear that they can be disregarded, as is the case in California and under the Model Business

⁶⁸⁸ See the *JSE Limited Listings Requirements* paragraph 5.69(c)(i). The prediction must cover the ability of the company as well as of the group to pay its debts as they arise.

⁶⁸⁹ See Cassim "New Statutory Provisions" 766.

⁶⁹⁰ See the Close Corporations Act 69 of 1984 s 39(1)(c); s 40(c), s 51(1)(b).

Corporations Act.⁶⁹¹

4.1.3 The solvency element

Section 85(4)(b) and section 90(2)(b) contain the solvency test. If there is reason to believe that 'the consolidated assets of the company fairly valued would after the payment be less than the consolidated liabilities of the company' payment may not be made. The meaning of 'consolidated' could cause confusion. It has been suggested by Delpont that this provision recognises the group concept in our law and that the consolidated financial position of the group is relevant when a holding company acquires its own shares.⁶⁹² This interpretation of 'consolidated assets' and 'consolidated liabilities' is based on the similarity of these phrases to consolidated financial statements prepared by a holding company. This interpretation cannot be supported: although consolidated financial statements are the most common form of group financial statements, it is by no means the only form.⁶⁹³ No explanation is given as to why the legislature would have elevated one form of group financial statements above others. Moreover, when a company that is not part of a group wants to make payment for the acquisition of its own shares, it would not have consolidated financial statements and would thus, on a logical extension of Delpont's argument, not be able to apply the test. Since it would be absurd to conclude that the test cannot be applied to a single company, it must be concluded that the word 'consolidated' has a wider meaning that does not rely on the group situation. It would also not make sense to apply the one meaning in certain cases and the other meaning in other instances. It makes much more sense to understand 'consolidated' according to its ordinary non-technical meaning.

It is submitted that the authors of Blackman, Jooste & Everingham *Companies Act*⁶⁹⁴ are correct in asserting that the word 'consolidated' adds nothing to the meaning of 'assets and liabilities'. The authors discuss the legislative drafting history and speculate that the word may have been inserted to replace the reference to the 'realizable' value of assets in the Canadian provision

⁶⁹¹ Chapter 4 paragraph 3.5.2 (California) and paragraph 4.4.2 (MBCA).

⁶⁹² Delpont "Company Groups" 123.

⁶⁹³ See s 289(1)(b)(i) – (iii).

⁶⁹⁴ Blackman, Jooste & Everingham *Companies Act* 5-70.

on which section 85(4) was based.⁶⁹⁵

However, the *JSE Limited Listings Requirements* require the directors to declare that the company and the group are solvent and will remain solvent for the ensuing twelve months.⁶⁹⁶

4.2 The time for application of the financial restrictions

The time when the financial restrictions must be satisfied depends on the interpretation of 'payment'. Section 85(4) and section 90(2) prohibit the 'making' of a payment if there are reasonable grounds for believing that the company may be unable to pay its debts or may be insolvent. However, there are no specific rules indicating exactly when a payment is regarded as having been made or having taken effect.

The question arises whether the test must be applied when the company authorises, agrees to, or incurs an obligation in respect of the distribution or when it actually transfers money or property to the shareholder.

Cassim argues, in relation to share repurchases, that the solvency and liquidity tests must be satisfied both at the time when the contract is entered into and subsequently when payment is made.⁶⁹⁷ He does not consider the difficulties that could arise if the outcome of the test applied at the two stages would differ. Logically, if the obligation was incurred while the company did not satisfy the test, it would be void. It would then not matter that the company was actually solvent and able to pay its debts when it eventually made payment, as the payment would be unlawful.

Cassim's interpretation is not supported by the words of section 85. Section 85(1), which gives a company the power to approve the acquisition of its own shares, makes no mention of the financial situation of the company. It uses the term 'acquisition', which is wide enough to cover acquisitions without consideration in which case it would be unnecessary to insist on solvency and liquidity. Section 85(4) expressly refers to 'payment' only. The assumption of a liability is not usually

⁶⁹⁵ See *Explanatory Memorandum to Draft Bill GG 18868* 8 May 1998 Notice 724.

⁶⁹⁶ See par 5.69 of the *JSE Limited Listings Requirements*. There are also requirements regarding availability of working capital.

⁶⁹⁷ Cassim "New Statutory Provisions" 768 – 769. Curiously, the author nevertheless states that a company's undertaking is conditional upon its solvency and liquidity at the time of performance.

considered to constitute a payment.⁶⁹⁸ Further, section 88, which deals with the enforceability of the contract, clearly envisages that the test will be applied at the time of execution of the contract. It also recognises by necessary implication that the underlying obligation is not extinguished by the company's insolvency or inability to pay its debts. It is thus clear that only the time of actual payment is relevant. This conclusion is supported by the judgment in *Capitex Bank Ltd v Qorus Holdings Ltd & Others*.⁶⁹⁹

Section 90 also contains various indications that the authorisation of a distribution does not amount to a 'payment'. The first indication is found in the verbs used in conjunction with payment(s). In two instances reference is made to the 'making' of payments⁷⁰⁰ and liability is imposed in respect of the 'receipt' of payments.⁷⁰¹ The only reference to approval or authorisation is in the context of authorisation in the articles.⁷⁰² Secondly, the definition of payment as a 'transfer' of money or property⁷⁰³ also points to the completion of a distribution rather than its authorisation.

Leading commentaries agree that the test must be satisfied only when the company actually transfers money or property. The authors of *Meskin Henochsberg on the Companies Act* state that an 'actual payment' rather than a reorganisation of capital is envisaged.⁷⁰⁴

The authors of *Blackman, Jooste & Everingham Companies Act* are also of the view that the company has to satisfy the solvency and liquidity test when it makes payment and not, for example, when it declares a dividend. However, their justification can be criticised as it appears that they make the meaning of payment dependent on when, in their view, the financial restrictions have to be met. With reference to the liquidity test they explain that the declaration of a dividend does not affect the company's ability to pay and, 'since the company has to satisfy the

⁶⁹⁸ Blackman, Jooste & Everingham *Companies Act* 5-71.

⁶⁹⁹ 2003 (3) SA 302 (W) at 309.

⁷⁰⁰ Section 90(1) reads: 'A company may **make** payments...'. Similarly subsection (2) states: 'A company shall not **make** any payment' (emphasis supplied).

⁷⁰¹ Section 90(4).

⁷⁰² Section 90(1).

⁷⁰³ Section 90(3).

⁷⁰⁴ *Meskin Henochsberg on the Companies Act* 186(3).

test when it makes payment', the original incurring of the debt is not a payment.⁷⁰⁵ It is submitted that the meaning of 'payment' should indicate when the financial restrictions have to be met and not the other way round.⁷⁰⁶ Despite the criticism against this argument, it succinctly illustrates the point that it makes little sense to require compliance with a liquidity test with reference to the position immediately following the declaration of a dividend if the subsequent payment of that dividend is also subject to the company's solvency and liquidity.

Closely related to the issue of when the requirements have to be satisfied, is the issue of whether the obligation that is being incurred has to be taken into account. In this regard the authors of *Blackman, Jooste & Everingham Companies Act* conclude that it would be illogical to do so, because otherwise there would be no need for testing the effect of the payment on the solvency and liquidity of the company.⁷⁰⁷ Moreover, they argue, claims in respect of repurchases are subordinated in terms of section 88(3).

It is suggested that there is a far simpler explanation in support of this conclusion. Although the test is considered when the company is about to make payment, it is the financial position of the company at the moment immediately after payment that must be assessed. For purposes of the solvency element, the underlying obligation would thus have been extinguished. The liquidity element also envisages that the obligation should be disregarded, as it refers to the situation 'after the payment'. This explains why it is not necessary to include a provision along the lines of section 52(4)(a) of the New Zealand Companies Act, which expressly provides that the liability incurred in terms of the authorisation need not be taken into account.⁷⁰⁸

4.3 Distributions under the Companies Bill

The Companies Bill contains a single definition of 'distribution'.⁷⁰⁹ Any distribution is subject to the solvency and liquidity test set out in clause 4 of the Companies

⁷⁰⁵ Blackman, Jooste & Everingham *Companies Act* 5-118-1.

⁷⁰⁶ While the actual formulation of the financial restrictions can be of assistance, the possibility that the restrictions may have to be met at two stages cannot be dismissed in advance without considering the context.

⁷⁰⁷ Blackman, Jooste & Everingham *Companies Act* 5-71.

⁷⁰⁸ See Chapter 3 paragraph 4.

⁷⁰⁹ Clause 1 s v 'distribution'.

Bill.⁷¹⁰ The definition of distribution comprises three subparagraphs dealing with the three main methods by which distributions can be made, namely:

- a transfer of money or property⁷¹¹
- the incurrance of an obligation⁷¹²
- the forgiveness or waiver of an obligation.⁷¹³

Each of these methods will qualify as a distribution regardless of whether made directly or indirectly.⁷¹⁴ The definition expressly excludes liquidation distributions.⁷¹⁵ The reason for this is that in a liquidation the surplus assets will be distributed to shareholders only once the debts have been paid. This provides welcome clarity.

The first method of distribution is a direct or indirect transfer, by a company of money or other company property, other than its own shares, to or for the benefit of one or more of its shareholders or the shareholders of another company in the same group of companies.⁷¹⁶ A number of specific examples are provided. The generality of the last example indicates that this is an exhaustive list of distributions that can be effected by way of transfer of money or property.

The examples are:⁷¹⁷

- dividends
- payments in lieu of a capitalisation share
- consideration for the acquisition of own shares
- consideration for the acquisition by any company in a group of shares of another company in the group
- transfers in respect of any of the shares of that company or of another company within the same group, except under the appraisal remedy.⁷¹⁸

⁷¹⁰ Clause 46.

⁷¹¹ Clause 1 s v 'distribution' paragraph (a).

⁷¹² Clause 1 s v 'distribution' paragraph (b).

⁷¹³ Clause 1 s v 'distribution' paragraph (c).

⁷¹⁴ See the introductory words of the definition in clause 1 s v 'distribution'.

⁷¹⁵ See the concluding words of the definition in clause 1 s v 'distribution'.

⁷¹⁶ Clause 1 s v 'distribution' paragraph (a).

⁷¹⁷ See subparagraphs (a)(i) – (iv) of the definition in clause 1 s v 'distribution'.

⁷¹⁸ Clause 1 s v 'distribution' paragraph (a)(iv) read with clause 164(19). A 'surrender' of shares

It is clear that the first four examples are transfers by reason of shareholding. The final example is a residual category covering any other kind of transfer provided it is in respect of shares.

The second method by which a distribution can be made is by incurring a debt or obligation in favour of a shareholder or a shareholder of another company in the group.⁷¹⁹ It is unclear whether the incurring of a non-monetary obligation by a company, for example to render a service or to refrain from doing something, will also constitute a distribution and, if so, how it will be quantified. It is not expressly stated that the obligation must be incurred in respect of shares or by reason of the shareholding of the shareholder.

The third instance, namely forgiveness or waiver by a company of a debt or other obligation owed to the company by a shareholder or shareholder of a company within the group is also not expressly required to be in respect of or by reason of shareholding.⁷²⁰

Although the word 'indirectly' in the introductory sentence of the definition is perhaps wide enough to cover distributions by a company to shareholders of other companies in the group,⁷²¹ the definition expressly recognises the group context in relation to distributions. An action that would qualify as a distribution if made to the company's own shareholders will also constitute a distribution if made to shareholders of any other company within the group.

Despite the fact that the issue of capitalisation shares does not constitute a distribution, clause 47 regulates certain aspects of such issues. The board may, if permitted by its memorandum of incorporation, offer shareholders a cash payment as alternative to the capitalisation shares,⁷²² which will qualify as a distribution.⁷²³ The board may only offer an election to receive cash in lieu of capitalisation shares if, having considered the solvency and liquidity test as required by clause 46 on the assumption that every shareholder would elect to receive cash, it is satisfied that the company will satisfy that test immediately upon the completion of the

Continued

under the appraisal remedy is also not regarded as an acquisition of shares, see clause 48(1).

⁷¹⁹ Clause 1 s v 'distribution' paragraph (b).

⁷²⁰ Clause 1 s v 'distribution' paragraph (c).

⁷²¹ See the discussion in Chapter 4 paragraph 4.4.1 of the meaning of 'indirect' in the MBCA definition of distribution.

⁷²² Clause 47(3)(a).

⁷²³ Clause 1 s v 'distribution' paragraph (a)(ii), and see paragraph 4.3 above.

distribution.⁷²⁴

The Companies Bill rules that all shares of a class must be treated equally, unless the memorandum expressly provides otherwise.⁷²⁵ It further states that the memorandum can entitle the shareholders to 'distributions' calculated in specific ways⁷²⁶ and may provide for preferences as to distributions or liquidation rights in respect of different classes of shares.⁷²⁷

4.3.1 Financial restrictions under the Companies Bill

The solvency and liquidity test is set out in clause 4. The test can be divided into a solvency element⁷²⁸ and a liquidity element,⁷²⁹ both of which must be satisfied.

4.3.1.1 Declaration by directors

Before a distribution is made, the board of directors must acknowledge that it has applied the solvency and liquidity test and has reasonably concluded that the company will satisfy the test immediately after completion of the proposed distribution.⁷³⁰ This resolution is required even where the distribution was not authorised by the board, but is pursuant to an existing obligation or a court order.⁷³¹ It appears that the board can acknowledge its application of the solvency and liquidity test at any stage prior to the distribution.

4.3.1.2 The solvency element

The solvency element will be satisfied if, considering all reasonably foreseeable financial circumstances of the company at the time:

- the fair value of the company's assets equal or exceed its fairly valued liabilities, or

⁷²⁴ Clause 47(3)(b).

⁷²⁵ Clause 37(1).

⁷²⁶ Clause 37(4)(c).

⁷²⁷ Clause 37(4)(d).

⁷²⁸ Clause 4(1)(a).

⁷²⁹ Clause 4(1)(b).

⁷³⁰ Clause 46(1)(c).

⁷³¹ Clause 46(1)(c) operates independently of clause 46(1)(a).

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- if the company is a member of a group of companies, the consolidated assets of the company, as fairly valued, equal or exceed the consolidated liabilities of the company, as fairly valued.⁷³²

The application of the alternative test set out above seems problematic. Firstly, reference is made to the consolidated assets of the 'company' and not of the group. The concept of consolidated assets is used in the Companies Bill in one other instance only, namely in regard to an auditor's report to be included in a prospectus.⁷³³ In that context an auditor's report in respect of a holding company may deal with the assets three alternative ways, one of which is with the consolidated assets of the (holding) company and all its subsidiaries.⁷³⁴ Consolidated assets are thus associated with a holding company and not with a specific subsidiary. This means that not every company that is a member of a group can be said to have consolidated assets.⁷³⁵ It appears that the drafters intended to refer to the consolidated assets of the group, rather than of the company.

Secondly, although the Companies Bill mentions group or consolidated financial statements,⁷³⁶ there is presently no detail regarding the format of such statements. As in the case of an auditor's report,⁷³⁷ it is likely that consolidated assets and liabilities will be merely one of various alternative methods of compiling group financial statements. In view of the limitations regarding the financial information that may be taken into account in applying the solvency and liquidity test,⁷³⁸ it will thus be impossible for a company that uses one of these other types of group statements to comply with the requirements of this test.

I consider the merit of the extension of the solvency test to the group context

⁷³² Clause 4(1)(a). This clause does not split up the test as has been done here. Instead it reads: 'the assets of the company or, if the company is a member of a group of companies, the consolidated assets of the company, as fairly valued, equal or exceed the liabilities of the company or, if the company is a member of a group of companies, the consolidated liabilities of the company, as fairly valued'.

⁷³³ Schedule 3 paragraph 26(3)(b)(iii).

⁷³⁴ Schedule 3 paragraph 26(3).

⁷³⁵ See also the argument regarding the meaning of 'consolidated' in the Act, paragraph 4.1.3 above.

⁷³⁶ See clause 1 s v 'financial statements'.

⁷³⁷ See Schedule 3 Part B paragraph 26(3) of the Companies Bill, dealing with the contents of an auditor's certificate in connection with offers to the public.

⁷³⁸ See clause 4(2)(a)(ii).

elsewhere.⁷³⁹

A further qualification to the solvency and liquidity test applies where a distribution takes the form of a transfer of money or property. This qualification relates to the protection of preferred classes of shareholders and applies unless the company's memorandum of incorporation provides otherwise. The person applying the solvency and liquidity test should not take into account as a liability the amount required to satisfy the preferential rights upon liquidation of classes that enjoy priority over the (preferential)⁷⁴⁰ liquidation rights of those receiving the distribution, if the company were to be liquidated at the time of the distribution.⁷⁴¹ The justification for restricting this qualification to distributions by way of transfers, thus excluding distributions by way of the incurrence or forgiveness of an obligation, is not apparent. The position in such methods of distribution is unclear. One possible implication is that a person applying the test for purposes of these other two kinds of distribution should always consider preferential liquidation rights. Alternatively, it may imply that such preferential rights may never be taken into account for such distributions, regardless of the provisions of the memorandum of incorporation. Both alternatives seem absurd.

Although the provision refers to the application of the solvency and liquidity test, it is clear that the preferential liquidation rights of preference shareholders are relevant for the solvency element and not the liquidity element. This is because liquidation rights cannot be regarded as debts due in the ordinary course of business. There is no requirement that fixed preferential dividends should be taken into account for purposes of assessing the company's ability to pay its debts in the ordinary course of business.

4.3.1.3 *The liquidity element*

The liquidity element will be satisfied if it appears that the company will be able to pay its debts as they become due in the course of business for a period of 12

⁷³⁹ See paragraph 4.4.1 below.

⁷⁴⁰ As currently formulated the provision is applicable only if the shareholders receiving the distribution also enjoy liquidation rights that are preferential, but rank behind the preferential liquidation rights of another class. It appears that the third occurrence in clause 4(2)(c) of the phrase 'preferential liquidation rights' should have been 'liquidation rights' only. This is because ordinary shareholders will not have 'preferential' liquidation rights.

⁷⁴¹ Clause 4(2)(c).

months.⁷⁴² If the distribution is in the form of a transfer of money or property, the period ends 12 months after the date on which the distribution is made. In all other cases it ends 12 months after the date on which the solvency and liquidity test is considered.⁷⁴³

Unlike the solvency element, which seems to refer to the financial position of a group of companies, the liquidity element does not refer to a group.

4.3.1.4 Standard of application of solvency and liquidity test

The Companies Bill prescribes the way in which the solvency and liquidity test is to be applied. Any financial information to be considered concerning the company must be based on accounting records and financial statements that satisfy the requirements set out in clause 28 and clause 29 respectively of the Bill.⁷⁴⁴ It would seem that 'financial information' should not be equated with 'reasonably foreseeable financial circumstances' to which reference is made in the introductory sentence of clause 4(2)(a).

The test must be based on a 'fair valuation of the company's assets and liabilities, including any reasonably foreseeable contingent assets and liabilities, irrespective whether arising as a result of the proposed distribution, or otherwise'.⁷⁴⁵ In addition to this compulsory consideration of a fair valuation, the board or other person applying the test 'may consider any other valuation of the company's assets and liabilities that is reasonable in the circumstances'.⁷⁴⁶

The option of considering a valuation of the company's assets that is not a fair valuation, but nevertheless 'reasonable in the circumstances' seems absurd. The intention might have been to modify either the requirement that contingent assets and liabilities should be taken into account or the requirement pertaining to liabilities arising from the proposed distribution itself. The drafting of this provision requires further attention.

Liabilities that will arise from a proposed distribution must be included as

⁷⁴² Clause 4(1)(b).

⁷⁴³ See paragraph 4.3.1.5 below for a discussion of when the test must be considered and when a distribution is regarded as having been made.

⁷⁴⁴ Clause 4(2)(a).

⁷⁴⁵ Clause 4(2)(b)(i).

⁷⁴⁶ Clause 4(2)(b)(ii).

contingent liabilities.⁷⁴⁷ This requirement creates the impression that the test is to be applied with reference to a moment in time before the distribution has been made. It seems to conflict with clause 46(1)(b) and (c) where reference is made to the fact that the company will satisfy the solvency and liquidity test immediately 'after completing' the distribution. Although the completion of a distribution will usually result in the extinguishing of the liability, it seems that this provision may be relevant when the distribution takes the form of the incurring of a debt or obligation that is not immediately enforceable.⁷⁴⁸ I consider this issue below in relation to the time for application of the restrictions.⁷⁴⁹

The solvency and liquidity test is also referred to in clause 46(1)(b) and (c). These two subparagraphs refer to satisfaction of the test immediately after completion of the distribution, while clause 4 refers to satisfaction of the test 'at a particular time'. A possible explanation is that the solvency and liquidity test is used not only for distributions, but also for the regulation of financial assistance for the acquisition of shares⁷⁵⁰ and financial assistance to directors.⁷⁵¹

Clause 46(1)(b) imposes an objective solvency and liquidity standard. It prohibits a company from making a distribution unless it 'reasonably appears' that the company will satisfy the solvency and liquidity test after completion of the distribution. This paragraph does not state to whom this should be reasonably apparent, so it can be assumed that the test must be applied from the perspective of an objective bystander. A resolution by the board that it has 'reasonably concluded' that the company will satisfy the test is set as an additional requirement.⁷⁵² This test differs in important respects from the test currently contained in sections 85(4) and 90(2) of the Act.⁷⁵³

⁷⁴⁷ Clause 4(2)(b)(i). The reference in this provision to 'the' distribution may create the impression that the test is relevant only when a distribution is being authorised. However, the solvency and liquidity test is also used for other purposes, such as the financial assistance provisions in clauses 44 and 45. It is submitted that the words 'the distribution or otherwise' should be replaced with 'a distribution, financial assistance transaction, or otherwise'.

⁷⁴⁸ Under the exception in clause 46(4)(b). It cannot be used if the obligation is immediately enforceable, as intended in clause 46(4)(a).

⁷⁴⁹ See paragraph 4.3.1.5 below.

⁷⁵⁰ Clause 44.

⁷⁵¹ Clause 45. These instances require application of the test after provision of the financial assistance, see clause 44(2)(d)(i) and clause 45(2)(d)(i).

⁷⁵² Clause 46(1)(c).

⁷⁵³ See paragraph 4.4.1 below.

4.3.1.5 Timing for application of the solvency and liquidity test under the Companies Bill

Generally, the solvency and liquidity test must be satisfied when the distribution is completed.⁷⁵⁴ However, clause 46(4) sets out a separate timing rule for distributions made by way of the incurrance of a debt or obligation.⁷⁵⁵ It provides that the requirements of clause 46 apply when the board resolves that the company may incur the obligation.⁷⁵⁶ The requirements apply not upon the actual incurring of the obligation, but rather upon authorisation. This seems to be the position even when the company will incur the obligation at a future date only or subject to fulfilment of a condition. Interpretation of this clause is complicated by the fact that it is not only the financial restrictions that must be applied at the time of the resolution, but all the requirements of the clause, including the board resolution. Clause 46(1)(b) and (c) require the solvency and liquidity test to be satisfied immediately after 'completion' of the distribution. Paragraph (b) of the definition of a distribution suggests that no distribution is made until an obligation is actually incurred. Clause 46(4) thus contains a degree of circularity.

I submit that a definition of the moment of completion of such a distribution should have been included in the timing rule. This could be defined either as the time of authorisation or as the time the debt or obligation is actually incurred. I suggest that the time when the obligation is incurred is the better option. But a specific timing rule may possibly be superfluous, since it appears from paragraph (b) of the definition that a distribution is made at the time when the obligation is incurred. It is then only necessary to state that the reduction or extinguishing of a debt or obligation that has been incurred as a distribution, will not be regarded as a further distribution. It appears from clause 46(4)(b) that this is the idea behind the timing provision, as this clause provides that its requirements do not apply to any subsequent action of the company in satisfaction of the debt or obligation that qualified as a distribution.

This timing provision is undermined by an exception that does not qualify the whole of clause 46(4), but only the rule in clause 46(4)(b) stating that the

⁷⁵⁴ Clause 46(1)(b).

⁷⁵⁵ As described in paragraph (b) of the definition of 'distribution', see paragraph 4.3 above.

⁷⁵⁶ Clause 46(4)(a).

requirements should not be applied again when the debt or obligation is satisfied. As currently formulated, the implication is that the resolution, or the terms and conditions of the debt or obligation, could oblige the company to comply with all the requirements of clause 46 for a second time.⁷⁵⁷ It is unlikely that this was the intention of the drafters. The intention may have been to apply the financial restrictions not when the incurring of the debt is authorised, but only when actual payments are made.⁷⁵⁸ This exception would apply only in instances where, in terms of the resolution or terms and conditions of the debt or obligation, each payment in satisfaction of the debt or obligation is subject to the company's solvency and liquidity. However, in order to achieve this outcome, the qualification would have to appear not in clause 46(4)(b) but in the main part of clause 46(4). The Companies Bill does not succeed in drawing a distinction between compliance with the financial restrictions and the other requirements including authorisation.

4.3.1.6 The 120 day rule

When more than 120 business days⁷⁵⁹ have passed since the board's acknowledgement that it has applied the solvency and liquidity test and has reasonably concluded that the company will satisfy it, and the company has not yet completed the distribution, clause 46(3) applies. The board has to reconsider the solvency and liquidity test.⁷⁶⁰ The company may not proceed with or continue a distribution unless the board adopts a further resolution acknowledging that it has applied the solvency and liquidity test and has reasonably concluded that the company will satisfy it. This provision is based on the example of the MBCA but it seems to be given a wider application in the Bill than it has in that Act.⁷⁶¹ The 120-day rule in the MBCA applies only to 'other distributions'. Separate timing provisions apply to a reacquisition of shares and a distribution of indebtedness and these are not subject to a re-evaluation. The rule is necessary in the MBCA

⁷⁵⁷ The introductory sentence of clause 46(4) refers to the 'requirements of this section' that is, section 46.

⁷⁵⁸ This would be in line with the timing provision in section 6.40(g) of the MBCA, see Chapter 4 paragraph 4.3.3.

⁷⁵⁹ The term 'business days' is defined in clause 1. The use of business days for the timing provision could complicate its application. It is to be noted that the MBCA rule uses calendar days, see Chapter 4 paragraph 4.3.3.

⁷⁶⁰ Clause 46(3)(a).

⁷⁶¹ Section 6.40(e)(3) of the MBCA, see Chapter 4 paragraph 4.4.3.

because the test for other distributions must be applied at the time of authorisation of the distribution, unless payment is to take place more than 120 days later. It should also be borne in mind that the liquidity requirement in the MBCA does not set a time limitation, while the proposed provision requires the liquidity prediction to be made for a period of 12 months.⁷⁶²

It appears to be unnecessary to require a reconsideration despite the fact that the company does not intend proceeding or continuing with the distribution in the ensuing period of 120 business days. Yet the implication of the proposed formulation is that once the first acknowledgement has been made, periodic reconsiderations have to take place regardless of when the company intends proceeding or continuing with the distribution. A company that does not intend implementing a distribution within 120 business days of its authorisation would thus be wise to postpone the adoption of the acknowledgement until shortly before the intended implementation. It is suggested that it would be preferable for the legislature to require a reconsideration only at the stage when the company is about to proceed with or continue a distribution. A recommendation is thus made for the improvement of this provision.⁷⁶³

4.4 Evaluation of distributions in general

The current regulation of distributions is fragmented. Although the common-law capital maintenance doctrine has been abolished, some distributions continue to be regulated under the previous principles. While the new rules on payments and share acquisitions rely on the same financial restrictions of solvency and liquidity, their impact on the share capital structure of the company differs significantly. The degree of regulatory bias that accompanies this flexibility can be assessed only after full consideration of the requirements and consequences of each type of distribution.⁷⁶⁴

The Companies Bill contains a definition of 'distribution' that is similar to the definitions of the New Zealand Companies Act and the MBCA. However, in addition to the transfer of money or property and the incurring of a debt, the

⁷⁶² See clause 4(1)(b).

⁷⁶³ See Chapter 6 paragraph 7.10.

⁷⁶⁴ See Chapter 6 paragraph 4. Even then, the effect of taxation and external economic factors will be left out of the equation, in view of the scope of this thesis, see Chapter 1 paragraph 3.

definition in the Companies Bill contains a third category, which is not mentioned expressly in these other two definitions. This is the forgiveness or waiver of a debt or obligation.⁷⁶⁵ This category will be particularly useful because it covers the waiver of a claim for outstanding consideration on unpaid or partly paid shares.⁷⁶⁶

Certain aspects of the proposed definition can be criticised.⁷⁶⁷ The first criticism relates to the fact that a distribution is not expressly required to be 'in respect of' or 'by reason of' the shareholding of the shareholder, except in one of the specific examples of a distribution.⁷⁶⁸ While the specific examples of distributions by way of transfer leave no doubt about the relationship between the distribution and shareholding, it is unfortunate that the definition does not expressly require the incurrance or forgiveness of an obligation to be 'in respect of' shares.

The definitions in the MBCA⁷⁶⁹ and the New Zealand Companies Act⁷⁷⁰ expressly impose such a qualification in respect of the incurring or forgiveness of an obligation. In England, although the purpose of the definition of distribution is different, the Company Law Review identified the lack of an express reference to shareholding or shares as a weakness.⁷⁷¹

A qualification can probably be read into the definition, so that it would relate to a shareholder in that capacity only. However, it would be preferable to make it clear that the incurring or forgiveness of a debt owed by a shareholder will be regarded as a distribution only if it is in respect of shares or by reason of shareholding.

A second, more serious criticism against the definition in the Companies Bill is its treatment of groups of companies. Distributions in the group context are not restricted to distributions by a subsidiary to the shareholders of its holding company or to shareholders of a co-subsiary, but apparently extend to

⁷⁶⁵ See paragraph 4.3 above.

⁷⁶⁶ See paragraph 3.6.4 regarding unpaid or partly paid shares under the Companies Bill. In the New Zealand Companies Act 1993 s 57, the cancellation of liability in respect of a share is deemed to be a distribution, see Chapter 3 paragraph 4.1.

⁷⁶⁷ See paragraph 4.3 above for an explanation of the definition. See Chapter 6 paragraph 7.9 for a suggested definition.

⁷⁶⁸ Clause 1 s v 'distribution' paragraph (a)(iii)(bb). See paragraph 4.3 above.

⁷⁶⁹ See Chapter 4 paragraph 4.4.1

⁷⁷⁰ See Chapter 3 paragraph 4.1.

⁷⁷¹ See Chapter 2 paragraph 5.1.

distributions by a holding company to the shareholders of its subsidiary. Since the holding company cannot, strictly speaking, make a distribution to itself, it would seem that such a distribution would have to be made to any other shareholders of the subsidiary. It is unlikely that any distribution by a holding company to shareholders of its subsidiary can take place in respect of their shares except if the holding company is buying their shares from them. According to the definition, a purchase by a holding company of further shares in its subsidiary constitutes a distribution made by the holding company to its own shareholders.⁷⁷² The express inclusion under distributions by way of transfer, of consideration given for the acquisition by any company in a group of shares in any other company in the group, confirms this interpretation.⁷⁷³ Was this the intended result? Distributions are in essence dispositions without value,⁷⁷⁴ while consideration for the acquisition of further shares in a subsidiary is clearly for value. None of the other jurisdictions surveyed regards such payments by a holding company to shareholders of its subsidiary as distributions by the holding company.

The implications of regarding a transaction that would qualify as a distribution by a company if made to its own shareholders, as a distribution if made to shareholders of any other company in the group are difficult to predict, but the cumulative effect of the word 'indirectly' and the group extension seems to be that the same distribution may be regarded as a distribution by more than one company in the group. If so, the application of the requirements for distribution in such instances may be problematic. I consider the extent to which the proposed solvency and liquidity test attempts to accommodate this extended definition in my evaluation of the solvency test below.⁷⁷⁵

A comparative analysis is necessary to evaluate whether the proposed definition of the Companies Bill is unique in its inclusion of a group of companies. The definition in California expressly includes a transfer, purchase or redemption

⁷⁷² However, as Blackman, Jooste & Everingham *Companies Act 5-99* point out, such an acquisition clearly poses no risk and need not be regulated.

⁷⁷³ Clause 1 s v 'distribution' paragraph (a)(iii)(bb), see paragraph 4.3 above.

⁷⁷⁴ This is so even in the case of consideration for the acquisition of shares, since a company's own shares have no value in its own hands. See also Calnan "Corporate Gifts" 91, Doran "Transactions at an Undervalue" 170.

⁷⁷⁵ See paragraph 4.3.1 below.

by a subsidiary (in respect of shares in the holding company).⁷⁷⁶ One of the purposes of the inclusion of an indirect transfer in the MBCA definition was seen to be the regulation of repurchases by a subsidiary, but neither the definition itself nor the solvency and liquidity test refer to a subsidiary.⁷⁷⁷ The New Zealand definition makes no reference to a subsidiary,⁷⁷⁸ but this can be explained by the fact that under New Zealand law a subsidiary may not acquire shares in its holding company.⁷⁷⁹

There is thus no precedent in any of the other jurisdictions surveyed for a general group extension, although a specific inclusion in respect of subsidiaries is fairly common. The intention of the drafters may have been to cover the acquisition by a subsidiary of shares in its holding company as well as indirect or disguised distributions, but the *Explanatory Memorandum* does not refer to the policy underlying this extension.

I have identified a number of difficulties in relation to the proposed definition and recommend that the idea of adding a general group dimension to the regulation of distributions should be abandoned. Express regulation in a separate provision of the giving of consideration by a subsidiary for the acquisition of shares in its holding company is preferable.⁷⁸⁰ I suggest that the notion of an indirect distribution adequately covers any other group transactions that may amount to distributions. In such cases the distribution will be made by the company whose shareholders receive the distribution. The company supplying the funds will have to justify the expense in some or other way and, if it happens to be a wholly owned subsidiary, it is likely that the payment will also qualify as a distribution by the subsidiary to the holding company.

Thirdly, the express exclusion of appraisal payments from the definition of 'distribution' can be questioned. This exclusion has the effect that shareholders who insist on being paid for their shares as a result of their dissent with certain

⁷⁷⁶ See Chapter 4 paragraph 3.4.1.

⁷⁷⁷ See Chapter 4 paragraph 4.4.1.

⁷⁷⁸ See Chapter 3 paragraph 4.1.

⁷⁷⁹ See Chapter 3 paragraph 6.7.

⁷⁸⁰ See also paragraph 6.7 below. The question whether the acquisition by a subsidiary of shares in its co-subsiary (which is not a subsidiary of itself) should be regulated, is addressed in paragraph 6.10.7 below.

corporate actions, receive payment in preference to creditors.⁷⁸¹ There seems to be no good reason for excluding appraisal payments from the ambit of distributions. It must be remembered that a shareholder relying on the appraisal remedy need not even prove that she was prejudiced by the resolution. Yet the Companies Bill affords such a shareholder the same status as a creditor, while a shareholder who succeeded under the oppression remedy will have to wait for payment until the company is able to satisfy the solvency and liquidity test. It is unacceptable to leave the ball in the court of the company to approach the court if it does not wish to make the appraisal payment because of its financial position. A company who wishes to favour its dissenting shareholders may apparently do so, because it is not obliged to approach the court.

Appraisal payments are subject to the financial restrictions in California,⁷⁸² New Zealand⁷⁸³ and under the MBCA.⁷⁸⁴

It seems that a payment for shares made in compliance with a court order will be regarded as a distribution and thus subject to the solvency and liquidity test. I submit that appraisal payments and payments in terms of a court order should be regulated in a more coherent fashion and I will make a recommendation on this.⁷⁸⁵

4.4.1 Evaluation of the financial restrictions of solvency and liquidity

I submit that the application of a solvency and liquidity test as a general restriction on distributions adequately protects the interests of creditors. The current Act does not use this test for all distributions, but it forms the backbone of the regulation of distributions.⁷⁸⁶ A comparison of the solvency and liquidity test in the Companies Bill and the test currently contained in section 85(4) and section 90(2) of the Act is necessary, as they differ in several respects.

First, the test in clause 46(1)(b) is cast as a positive statement. The current test prohibits a distribution if there is reason to believe that the company will not

⁷⁸¹ The company can apparently decide whether it wants to pay, because it is given the right, but is not obliged to, approach the court to rearrange its obligation to pay the appraisal amount. See paragraph 6.9 below for a further discussion of this issue.

⁷⁸² See Chapter 4 paragraph 3.4.1.

⁷⁸³ See Chapter 3 paragraph 4.1.

⁷⁸⁴ See Chapter 4 paragraph 4.4.1.

⁷⁸⁵ See Chapter 6 paragraph 7.9 and the suggested definition of distribution.

⁷⁸⁶ The payment of interest on share capital under s 79 is not often resorted to, and redemption is

satisfy the test⁷⁸⁷ while the test proposed in the Bill allows a distribution only if it reasonably appears that the company will satisfy the test.

Second, the need for a positive enquiry and resolution is emphasised by clause 46(1)(c) which deals with the board acknowledgement. The current test does not require any declaration or resolution of the board, and so imposes a negative duty on the directors.⁷⁸⁸ Both tests contain an objective element, because under the proposed test objective factors will be relevant in assessing whether the directors' conclusion was indeed reasonable. However, compliance with clause 46(1)(c) does not depend on whether the directors have based their acknowledgement on reasonable grounds, but on whether they have in fact made the requisite acknowledgement by way of a resolution. The requirement in clause 46(2) that the company should fully carry out a distribution once the board has adopted the solvency resolution,⁷⁸⁹ seems to conflict with the objective requirement in clause 46(1)(b).⁷⁹⁰ Although the board has to base its resolution on the financial position of the company immediately after completion of the distribution,⁷⁹¹ the company may no longer reasonably appear to satisfy the test at that later stage of up to 120 business days after acknowledgement when it makes the distribution. It may be that these different standards were enacted for the purpose of distinguishing between the validity of a distribution on the one hand, and the liability of directors on the other hand.⁷⁹² But it is strange that the company is obliged to proceed with what is in effect an unlawful distribution, merely based on the board's formal acknowledgement. If the board's solvency resolution carries such weight, provision should perhaps be made for a retraction where it subsequently appears that the company will not satisfy the test.

Third, the solvency element in the Companies Bill requires that the financial position of a group of companies must be taken into account. There seems to be

Continued

restricted to redeemable preference shares.

⁷⁸⁷ See paragraph 4.1.1 above.

⁷⁸⁸ The *JSE Limited Listings Requirements* require a declaration by the directors, see paragraph 5.69(c).

⁷⁸⁹ Unless more than 120 business days have lapsed since the board's acknowledgement. See clause 46(3).

⁷⁹⁰ See also the discussion of the enforceability of authorised or permitted distributions in paragraph 5.8.2 below.

⁷⁹¹ Clause 46(1)(c).

⁷⁹² See further paragraph 4.4.1.1 below.

no good reason why the financial situation of the group should be taken into account for this purpose, but not for the liquidity requirement. I have indicated that the use of the phrase 'consolidated assets of the company' creates uncertainties.⁷⁹³ Even if this is taken as a reference to the consolidated assets of the group rather than of the company, the justification of this requirement can be questioned. The financial position of a group of companies hardly seems relevant where a subsidiary is making a distribution to its shareholders other than the holding company, especially when the proposed definition of 'subsidiary' does not require the holding company or its other subsidiaries to hold any shares in the subsidiary.⁷⁹⁴ Conversely the financial position of a subsidiary in which the holding company holds no shares or only a relatively low percentage of shares, should not be relevant when the holding company makes a distribution.

I submit that this provision should be reconsidered for the same reason as the blanket extension of 'distribution' to include any shareholder of a company in the group.⁷⁹⁵ Perhaps the idea should be limited to the instance of a subsidiary that is a wholly owned subsidiary as presently defined in the Act, namely a subsidiary with all its shares held by the holding company and its other subsidiaries.⁷⁹⁶

4.4.1.1 Evaluation of reasonable grounds for believing versus acknowledgement of consideration

I have illustrated that the way in which the solvency and liquidity test is currently formulated imposes a negative rather than a positive duty on the company.⁷⁹⁷ In a sense, the test in section 85(4) can be described as an insolvency and illiquidity test rather than a solvency and liquidity test. This is because payment is allowed in principle, unless there are reasonable grounds to believe that the company is insolvent or will be unable to pay its debts. This formulation derives from the Canada Business Corporations Act.⁷⁹⁸

⁷⁹³ See paragraph 4.3.1.2 above.

⁷⁹⁴ See the definition of 'subsidiary' in clause 1 and the deeming provision in clause 3.

⁷⁹⁵ See paragraph 4.4 above.

⁷⁹⁶ Although the Bill uses the term wholly 'owned' subsidiary, its definition does not rely on shareholding at all, see clause 3.

⁷⁹⁷ See paragraph 4.1.1 above.

⁷⁹⁸ See s 40 of the Canada Business Corporations Act RSC 1985 c C-44.

Despite the use of the phrase 'reasonable grounds to believe' the test is objective rather than subjective because the outcome does not depend on the actual belief of the company or its directors but on that of a reasonable person. The determining factor is the existence of a reason or ground upon which a conclusion could reasonably be reached.⁷⁹⁹

Moreover, it is the existence of reasonable grounds to believe in a certain future state of affairs that is conclusive.⁸⁰⁰ The test is thus based on a prediction or forecast rather than on the actual financial position of the company. Provided the prediction was reasonable, the test is satisfied even if the prediction later appears to have been wrong. Conversely, the distribution will be technically unlawful if the prediction was unreasonable at the time, but is later proved to be accurate.⁸⁰¹ I have cautioned that this could result in a potential conflict between company law and insolvency law, at least in relation to the solvency element. In an insolvent winding-up of a company the actual solvency of the company at the time of payment is measured in order to assess whether the payment will be voidable.

By contrast, the financial restrictions applicable to close corporations require a positive enquiry into the corporation's solvency and liquidity as a prerequisite for payment. It is submitted that different results could be reached in borderline cases depending on whether a positive or negative duty is involved.

From a comparative perspective it emerges that the other jurisdictions that subject distributions to a solvency and liquidity test all impose a positive duty on the company or its directors. A formal solvency declaration is required in England, and auditor confirmation is also necessary.⁸⁰² In New Zealand directors also have to sign a solvency certificate.⁸⁰³ In California and under the MBCA a solvency declaration is not required, but the test is cast in purely objective format.

The provision in the Companies Bill that requires a resolution by directors that they have considered the solvency and liquidity test and concluded that the

⁷⁹⁹ See paragraph 4.1.1 above.

⁸⁰⁰ See paragraph 4.1.1 above.

⁸⁰¹ Although in such a case it is unlikely that action will be taken to recover the unlawful distribution.

⁸⁰² See Chapter 2 paragraph 6.2.2. Note, however, that in England the solvency and liquidity test is applied only for share repurchases out of share capital.

⁸⁰³ See Chapter 3 paragraph 4.3.

company will satisfy it, must be welcomed.⁸⁰⁴ It will ensure that the interests of creditors and, to the extent that liquidation preferences must be taken into account, shareholders enjoy proper consideration.

An exploration of the solvency and liquidity test proposed in the Companies Bill discloses that the test must be applied 'considering all reasonably foreseeable financial circumstances of the company at the time'. These introductory words imply that a prediction is envisaged. This is reinforced by the first words of the liquidity element, namely 'it appears that the company will be able'. Yet, the solvency element does not state that it should 'appear' that the assets 'will' exceed the liabilities, but is formulated objectively with reference to a particular point in time. This results in tension between the introductory words of the test and the solvency element.

I suggested, in comments submitted to the Department of Trade and Industry on the 2007 draft Companies Bill, which contained the same solvency test as the 2008 Companies Bill, that the consideration of foreseeable circumstances militates against the notion of a solvency test and that these words should rather be used in relation to the liquidity element only. This results in a combination of actual solvency and predicted liquidity, as exemplified by the Californian provision.

In California, the retained earnings test and the asset-liability ratio test depends on the actual financial position of the company while the liquidity element seems to be based on a prediction or assumption made immediately before the distribution.⁸⁰⁵ In England, New Zealand and under the MBCA the lawfulness of a distribution depends on the corporation's actual compliance with the restrictions when the distribution is made.⁸⁰⁶ However, in all these jurisdictions additional factors are relevant to determining liability for an unlawful distribution.

Other jurisdictions show a more sophisticated approach in which a distinction is drawn between the application of the test for purposes of authorisation of a distribution and for purposes of imposing liability for unlawful distributions. It stands to reason that the authorisation or making of a distribution will have to be based on a prediction or at least an assumption about the company's solvency

⁸⁰⁴ See paragraph 4.3.1.1 and clause 46(1)(c) of the Companies Bill.

⁸⁰⁵ See Chapter 4 paragraph 3.4.2.

⁸⁰⁶ See Chapter 2 paragraph 6.2.2, Chapter 3 paragraph 4.2, Chapter 4 paragraphs 3.4.2 and 4.4.2.

and liquidity. But creditors' interests are affected by the actual solvency or liquidity of the company rather than by the accuracy of predictions or assumptions. So it makes sense to base liability for the return of unlawful distributions on the actual financial position of the company as it appears after the event. As I argue below, such an approach does not exclude the possibility of limiting *prima facie* liability with reference to the conduct or state of mind of the directors who authorised or shareholders who received the distribution.⁸⁰⁷

The Companies Bill already contains provisions that facilitate a distinction between how the test is applied when distributions are authorised as opposed to when liability is imposed. Clause 46(1)(b) allows a company to make a distribution if it 'reasonably appears' that the company will satisfy the test, while clause 46(1)(c) requires a resolution by the board that it has 'reasonably concluded' that the company will satisfy the test. By contrast, liability can be imposed on directors only if 'immediately after making all of the distribution ... the company does not satisfy the solvency and liquidity test' and, in addition, if it was unreasonable at the time of the decision to conclude that the company would satisfy the solvency and liquidity test after making the relevant distribution. However, since the notion of an assumption or prediction has in effect been built into the solvency and liquidity test itself, there is no basis for working with actual solvency and liquidity. The attempted distinction is thus ineffective. I suggest that this problem can be overcome by removing the words 'considering all reasonably foreseeable circumstances at the time' from the introductory sentence of the solvency test and inserting them at the beginning of the liquidity element.⁸⁰⁸

4.4.1.2 Evaluation of the liquidity element

A liquidity element is a common feature of the financial restrictions in the jurisdictions that have abolished capital maintenance or legal capital.⁸⁰⁹ Although the overarching test in New Zealand is called a 'solvency test' it contains a balance-sheet solvency element as well as an equity solvency or liquidity

⁸⁰⁷ See paragraph 6.10.4 below.

⁸⁰⁸ See Chapter 6 paragraph 7.12 for a proposal in this regard.

⁸⁰⁹ See Chapter 3 paragraph 4.2 for New Zealand, Chapter 4 paragraph 3.4.2.3 for California and paragraph 4.4.2 for the MBCA.

element.⁸¹⁰ The terms 'equity insolvency test', 'equity solvency' and 'equity test' are all used to refer to what is generally called the liquidity test in South Africa.

Despite the apparent similarity between liquidity tests, there are differences in approach. In some instances a specific time period is prescribed, in others not. The test can be based either on a mere expectation of continued liquidity or on actual continued liquidity, coupled with an element of causation. The provision can prescribe that certain liabilities are excluded or included, or give no further guidance in this regard.

The liquidity element of the solvency and liquidity test in the Act requires an assessment of the company's ability to pay its debts as they arise in the ordinary course of business and does not refer to a particular time limit during which the company should remain able or be expected to remain able to pay its debts as they arise in the ordinary course of business.⁸¹¹

The Companies Bill proposes to introduce a 12 month period in respect of which the prediction of continued liquidity should be made. A precedent for this approach can be found in the *JSE Limited Listings Requirements*⁸¹² and also in England.⁸¹³ No particular time period is coupled to the liquidity element in New Zealand, California or in the MBCA. I submit that the specification of a time period will provide more certainty for directors when they authorise a distribution. However, it may disadvantage creditors of companies that have longer-term commitments that are clearly foreseeable, but not payable within 12 months. It is submitted that the imposition of a time limit is undesirable and that the 'ordinary course of business' of each company should be the decisive factor in judging its liquidity.⁸¹⁴

If it is deemed necessary to impose a specific time period in order to protect creditors, this should rather be done by way of a presumption that the company

⁸¹⁰ See Chapter 3 paragraph 4.2.

⁸¹¹ See paragraph 4.1.2 above.

⁸¹² See *JSE Limited Listings Requirements* paragraph 5.69(c), discussed in paragraph 4.1.2 above.

⁸¹³ See CA 1985 s 173(3)(b); CA 2006 s 714(3)(b), discussed in Chapter 2 paragraph 6.2.2.

⁸¹⁴ See Murphy "Equity Insolvency" 870 who argues that the widely differing circumstances under which companies operate makes a time frame impracticable. Murphy, writing on the American MBCA which in its Official Comment sets out guidelines for the application of the test, suggests that guidance should be given as to how a reasonable time should be established for each company, for example by using operating cycles. See also Chapter 4 paragraph 4.4.2.

did not satisfy the test if it is liquidated within a specified period. An example can be found in the Close Corporations Act where payments to members made within two years of the winding-up of a close corporation are recoverable unless the members can prove that the corporation satisfied the solvency and liquidity test at the time of payment.⁸¹⁵ In effect, a two year period is thus imposed coupled with a reverse onus. This would provide more protection to creditors than the current and proposed tests, because the creditors or liquidator do not have to prove that the assessment was unwarranted if the company is indeed liquidated shortly after the distribution. The directors still have to base their assessment on the company's expected ability to pay its debts, depending on the ordinary course of its business.

However, I submit that creditors will be adequately protected by a simple liquidity test, without reference to any time period. The question of the voidability of a distribution in an ensuing liquidation should be determined under insolvency law.

Causation is not relevant in the liquidity element of the Act or under the proposed liquidity element in the Companies Bill. The specific effect of a distribution on the company's ability to pay its debts is relevant in the liquidity test of the Close Corporations Act, where it is required that the payment should not render the close corporation unable to pay its debts,⁸¹⁶ and in the California Corporations Code, where the distribution should not seem 'likely to result' in inability to pay.⁸¹⁷ However, in both these instances the test must be applied with reference to the moment before the distribution is made. A test which expressly requires the position to be determined immediately after a distribution has been made, has by implication already discounted the effect of the distribution. If a presumption is introduced to the effect that a company which is liquidated within a specified period is deemed not to have complied with the solvency and liquidity test, then lack of causation should be an element of a defence shareholders can raise in order to escape liability for the return of distributions received by them, as is currently the case in the liability provision of the Close Corporations Act.⁸¹⁸ However, I have asserted that such a presumption should not be introduced.

The Act does not contain any specific guidelines as to which debts should be

⁸¹⁵ See s 70 of the Close Corporations Act 69 of 1984.

⁸¹⁶ See paragraph 4.1.2 above.

⁸¹⁷ See Chapter 4 paragraph 3.4.2.3.

⁸¹⁸ Section 70(2)(c) of the Close Corporations Act.

taken into account in determining the company's ability to pay. This is also the case in most of the other systems surveyed. However, the MBCA expressly prescribes that claims in respect of previously authorised distributions (other than the distribution in respect of which the test is being applied) must be disregarded if their enforceability depends on the company's solvency and liquidity at the time of payment.⁸¹⁹ This is a useful exclusion, given the uncertainty as to whether such a claim can ever be regarded as a debt due in the ordinary course of a company's business.⁸²⁰

The Companies Bill unfortunately does not provide for the exclusion of liabilities which are subordinated depending on the company's solvency and liquidity. To the contrary, it expressly requires any reasonably foreseeable contingent liabilities to be taken into account at a fair value. I submit that it is fair to value such subordinated claims at nil, but that it is preferable to exclude them expressly.⁸²¹

4.4.1.3 Evaluation of the solvency element

All jurisdictions that have adopted alternatives to the capital maintenance or legal capital doctrine include a solvency element as an integral part of the financial restrictions on distributions. The difference between a solvency test and the capital maintenance test is that the latter requires a margin over solvency which is equal to the share capital of the company.

A comparison of the solvency requirements applicable in the different jurisdictions shows that the current South African test is relatively lenient and out of step with international trends. This is because the South African test is satisfied whenever the assets equal the liabilities following a distribution. No provision is made for the protection of preference shareholders.⁸²²

The Californian standard is probably the strictest in that the alternative tests of retained earnings and asset-liability ratios each require a margin of assets over

⁸¹⁹ See Chapter 4 paragraph 4.4.2.

⁸²⁰ See paragraph 4.1.2 above.

⁸²¹ See Chapter 6 paragraph 7.12.

⁸²² Even the Canadian provision on which the South African test is based requires that share capital and reserves be treated as a liability and that liquidation preferences of preferent classes must be provided for, see s 40 of the Canada Business Corporations Act RSC 1985 c C-44.

liabilities subsequent to the distribution.⁸²³ The retained earnings test has the effect that the assets have to exceed the liabilities by at least the value of the original investment of shareholders while under the asset-liability ratios test the total assets have to exceed the total liabilities by a margin of 25 per cent.⁸²⁴ In addition, the liquidation preferences of any senior classes of shares have to be covered by retained earnings, while arrear cumulative preference dividends must be covered by an excess of assets over liabilities.⁸²⁵

Liquidation preferences of classes of shareholders enjoying priority over the shareholders to whom the distribution is being made also have to be provided for in New Zealand⁸²⁶ and under the MBCA.⁸²⁷

The standard of the South African solvency and liquidity test is comparable to that in England.⁸²⁸ However, in England the application of this test is limited to instances where private companies repurchase their shares out of share capital. Other distributions must be made out of distributable profits, implying that there will be an excess of net assets over share capital,⁸²⁹ which in the case of public companies must be at least equal to the prescribed minimum capital of £50 000.⁸³⁰

Preference shareholders are also protected under capital maintenance or legal capital systems such as England and Delaware. In relation to dividends, the most common form of distribution, the terms of issue of the preference shares will entrench their right to receive dividends in priority to other classes of shares. Their liquidation preferences are safeguarded by the rule that contributed capital, including the capital in respect of which they enjoy the preference, must be maintained. In Delaware the rights of preference shareholders are regulated expressly in the event of a repurchase of shares funded out of a capital reduction surplus.⁸³¹

⁸²³ See Chapter 4 paragraphs 3.4.2.1 and 3.4.2.2.

⁸²⁴ The ratio of current assets to current liabilities could differ, depending on the circumstances. See Chapter 4 paragraph 3.4.2.2.

⁸²⁵ Regardless of whether the corporation relies on the retained earnings or asset-liability ratio test, see Chapter 4 paragraph 3.4.2.4.

⁸²⁶ See Chapter 3 paragraph 4.2.

⁸²⁷ See Chapter 4 paragraph 4.4.2.

⁸²⁸ See Chapter 2 paragraph 6.2.2.

⁸²⁹ See Chapter 2 paragraphs 5.2.1 and 6.2.1.

⁸³⁰ See Chapter 2 paragraph 2.2.

⁸³¹ See Chapter 4 paragraph 2.5.2.

The introduction of protection for preference shareholders was considered by the company law reform project.⁸³² However, the Companies Bill proposes as default option that such rights will not be taken into account.⁸³³ Further, if the memorandum of incorporation provides that preferential liquidation rights should indeed be taken into account as liabilities of the company, it seems that this may only be done when the distribution is in the form of a transfer of money or property and not also when an obligation is incurred or forgiven.⁸³⁴

I recommend that, as is the case in the MBCA and in New Zealand, the default option should be that liquidation preferences must be taken into account, leaving it to companies to expressly exclude this protection if it is not required. It is difficult to justify why a company that has chosen to provide for preferential rights to the return of capital, should be allowed to make distributions to ordinary shareholders that will endanger those rights. At least, if the memorandum is required to provide expressly that liquidation preferences will not be taken into account when distributions are made, potential investors in preference shares will be alerted to this fact and can make an informed decision.

4.4.1.4 Evaluation of standards for application of the financial restrictions

The Act requires that the assets and liabilities of the company should be 'fairly valued'. No further detail is provided as to how this should be done.⁸³⁵ In contrast, specific instructions are contained in the New Zealand Companies Act⁸³⁶ and in the MBCA⁸³⁷ to the effect that the enquiry must be based on the most recent financial statements that comply with the financial disclosure requirements or on a fair or reasonable basis, while certain assets and liabilities that must either be included or excluded are specified. The Californian asset-liability ratio test also expressly excludes certain assets and liabilities.⁸³⁸

⁸³² See *Policy Framework* 4.3.2.

⁸³³ See clause 4(2)(c), discussed in paragraph 4.3.1.4 above.

⁸³⁴ See paragraph 4.3.1.4 above where the obscurity and ambiguity of this provision is discussed in more detail.

⁸³⁵ Compare the amended s 228(4) which requires the fair value of a company's undertaking or assets to be determined as described in financial reporting standards.

⁸³⁶ See Chapter 3 paragraph 4.2.

⁸³⁷ See Chapter 4 paragraph 4.4.2.

⁸³⁸ Chapter 4 paragraph 3.4.2.2.

The provisions in the Companies Bill are comparable to those in New Zealand and under the MBCA.⁸³⁹ However, I criticised certain aspects of their formulation.⁸⁴⁰ I suggest that a degree of legislative guidance on the application of the test is necessary. However, the standards for the solvency element and the liquidity element should be clearly distinguished, because the liquidity element necessarily involves a consideration of aspects that may not appear from the financial statements of the company.

I consider it unnecessary to take the obligation to be incurred into account as a liability, either for purposes of the solvency element or the liquidity element, since it is the financial position immediately after the distribution that must be established.⁸⁴¹

It appears that outstanding obligations under other repurchase contracts need to be included as liabilities for purposes of the solvency element.⁸⁴² However, it is uncertain whether debts due in respect of earlier repurchases should be taken into account in assessing the liquidity of the company as these debts can hardly be regarded as debts due in the ordinary course of the company's business and are in any event not enforceable while the company is unable to pay its debts. I suggest that this issue should be addressed in the legislation in order to clarify whether such debts must be taken into account, as is the case under the MBCA.⁸⁴³

It appears that the reference to 'consolidated' assets and liabilities of a 'company' could cause confusion when determining what assets and liabilities must be considered when the solvency test is applied.⁸⁴⁴

Unfortunately this term is also used in the Companies Bill, albeit with the qualification that the company should be a member of a group. As the proposed test is currently formulated, the consolidated assets have to be taken into account whenever a group company makes a distribution and not only when it makes a distribution to the shareholders of another company in the group. This seems to be

⁸³⁹ See clause 4(2)(a).

⁸⁴⁰ See paragraph 4.3.1.4 above.

⁸⁴¹ See paragraph 4.3.1.4 above.

⁸⁴² See paragraph 4.1.2 above.

⁸⁴³ See Chapter 4 paragraph 4.4.2.

⁸⁴⁴ See paragraph 4.1.3 above.

an unnecessary complication⁸⁴⁵ that will make unjustified inroads into the separate legal personality of a subsidiary making a simple distribution to its own shareholders who, it must be remembered, might not even include the holding company.⁸⁴⁶

I suggest that this provision should be reconsidered in conjunction with the proposed definition of 'distribution'.⁸⁴⁷ The regulation of distributions in the group context should be limited to instances where a subsidiary makes a distribution to shareholders of its holding company, and it should be made clear whether the financial restrictions will in such a case be applied independently to the subsidiary and the holding company, to the subsidiary and holding company as a unit, or to the group as a whole. In this regard, I suggest that the preferable option is that the test should be satisfied by both the holding company and the subsidiary.⁸⁴⁸

4.4.2 Evaluation of the time for the application of the financial restrictions

Under the Act, the solvency and liquidity test must be satisfied at the time when payment, in the sense of an actual transfer of money or property, takes place.⁸⁴⁹ It is at this stage that there should not be reasonable grounds for believing that the company will be insolvent or unable to pay its debts after payment. The wording of sections 85(4) and 90(2) do not support the application of the test when a repurchase or payment is authorised.⁸⁵⁰

South Africa is the only one of the solvency and liquidity jurisdictions surveyed that consistently applies the financial restrictions at the time of actual payment or transfer. In New Zealand the test must be satisfied at the time of authorisation of a distribution, although payment is prohibited if the directors are no longer satisfied that the company will comply with the solvency and liquidity test.⁸⁵¹ A distinction between different kinds of distributions and the time when

⁸⁴⁵ Especially in view of the uncertainty regarding the determination of the 'consolidated' assets and liabilities from the financial statements, see paragraph 4.3.1.2 above.

⁸⁴⁶ For example, when the holding company can control the voting rights in the general meeting or the majority in the board, see clause 3.

⁸⁴⁷ See paragraph 4.3 above.

⁸⁴⁸ See also paragraph 6.9.6 below.

⁸⁴⁹ See paragraph 4.2 above.

⁸⁵⁰ See paragraph 4.2 above.

⁸⁵¹ See Chapter 3 paragraph 4.3.

their effect should be measured is also evident in the MBCA.⁸⁵²

The timing rules in New Zealand, California and under the MBCA are more complex in that they distinguish between different kinds of distributions.⁸⁵³ As regards dividend-like payments (payments other than for share repurchases) in New Zealand, the board has to consider the financial restrictions at the time of authorisation and be satisfied that the company will be solvent and liquid immediately after the distribution. It is thus not the financial position at the time of authorisation that is considered, but the prospective position at the time of payment. Further, the directors may not proceed with the actual distribution or payment if they are no longer satisfied that the company will comply with the financial restrictions.⁸⁵⁴ In California the time when a distribution is made is expressly regulated in respect of different kinds of distributions with the result that the financial restrictions are sometimes applied at the time of authorisation of the distribution and sometimes at the time of actual payment or transfer.⁸⁵⁵ In the case of a dividend, the date of authorisation is used and not the record date or payment date.⁸⁵⁶ Under the MBCA the financial restrictions have to be met at the time of 'giving effect' to a distribution.⁸⁵⁷ Although both the declaration and the payment of a dividend are mentioned as examples in the definition of a distribution, the time for application of the financial restrictions is expressly regulated. Dividend-like distributions fall under the general timing rule and are thus deemed to take effect on the date of authorisation, provided payment is made within 120 days of the authorisation.⁸⁵⁸ If payment is to take place more than 120 days after authorisation, the financial restrictions must be met on the date of actual payment.⁸⁵⁹ Under the MBCA if an indebtedness is distributed, the effect must be measured on the date the indebtedness is distributed, except if each payment is

⁸⁵² See Chapter 4 paragraph 4.4.3.

⁸⁵³ See paragraph 4.2 above, Chapter 3 paragraph 4.3, Chapter 4 paragraphs 3.4.3 and 4.4.3.

⁸⁵⁴ See Chapter 3 paragraph 4.3.

⁸⁵⁵ See Chapter 4 paragraph 3.4.3.

⁸⁵⁶ California General Corporation Law s 166. Note that California also does not mention the incurring of obligations in its definition of 'distribution'. See also Chapter 4 paragraph 3.4.3.

⁸⁵⁷ See Chapter 4 paragraph 4.4.3.

⁸⁵⁸ However, the payment of a dividend at any stage while the company is insolvent, even within the 120 day period, would be liable to be set aside as a fraudulent conveyance, see Chapter 4 paragraphs 1 and 4.4.6.

⁸⁵⁹ Section 6.40(e)(3) of the MBCA, see Chapter 4 paragraph 4.4.3..

made subject to the corporation's solvency and the debt is subordinated to those of ordinary trade creditors.⁸⁶⁰ This sophisticated timing rule illustrates a correlation between the status of a claim in respect of a distribution and the timing rule.

In view of the tendency in systems based on solvency and liquidity to rely to some extent on the date of declaration of a dividend, the question arises whether the South African approach of using the date of payment as the time when the financial restrictions have to be satisfied, needs to be reconsidered. It is more complex to use the date of declaration, coupled with further qualifications such as a 120-day rule or the prohibition of payment if directors are no longer satisfied of the solvency and liquidity of the company, or to rely on fraudulent conveyance law. In any event this approximates the result of the date-of-payment approach. I submit that the current timing rule in section 90 offers an uncomplicated solution that properly protects creditors.

This approach will continue under the provisions of the Companies Bill, because dividends are included under the first category of distributions, namely the transfer of money or property.⁸⁶¹ The effect of a dividend thus has to be measured when the distribution is 'made'.

The comparative study also shows that there are specific rules for distributions by way of the incurring of an indebtedness. Although the meaning of 'payment' in section 90 refers to an actual transfer of money or property, the distribution of a debt instrument may qualify as a transfer of property and thus as a payment for purposes of section 90.⁸⁶² The financial restrictions would thus have to be satisfied when the payment is made, in this case when the debt instrument is transferred and not when payments are effected in terms of the debt instrument. The subsequent payments cannot strictly be regarded as payments by virtue of shareholding but should rather be attributed to ownership of the debt instrument.⁸⁶³ If such a distribution is not regarded as a transfer of property, but as an ordinary incurring of an obligation, each payment on the instrument should be regarded as a payment for purposes of section 90.

The different timing rules can be explained through the correlation between

⁸⁶⁰ See s 6.40(e), (g), see Chapter 4 paragraph 4.4.3.

⁸⁶¹ See paragraph 4.3 above.

⁸⁶² See paragraph 5.1.1 below.

⁸⁶³ It may be that the instrument has been transferred to a non-member.

the status of a shareholder's claim in respect of a previously authorised distribution and the time when the effect of the distribution is measured. If a shareholder acquires an unconditional unsubordinated claim that is immediately enforceable, the restrictions have to be satisfied at the time when the claim is created. Conversely, if the shareholder's claim is postponed or subordinated, the test must be satisfied when payment is made.

It is suggested that the approach in South Africa, where the effect of a distribution⁸⁶⁴ is measured at the time when money or property is transferred, and the shareholder receives a subordinated claim, offers a sensible and relatively uncomplicated solution. It also accords with the time when the effect of distributions giving rise to contractually subordinated claims for payment is measured in terms of the MBCA.

The Companies Bill seeks to introduce a specific timing rule that will distinguish between different kinds of distributions.⁸⁶⁵ A distribution by way of the incurring of an obligation or debt must comply with the restrictions when it is authorised by the board and not when the debt or obligation is satisfied.⁸⁶⁶ All other distributions must be evaluated when the company intends to 'make' a 'proposed' distribution. This seems to be a reference not to the initial authorisation of a distribution, but to an intended transfer of money or property.⁸⁶⁷ It appears that the directors are required to adopt the resolution acknowledging their proper application of the solvency and liquidity test at this stage. If, however, the distribution has not been completed within 120 business days of an acknowledgement by the directors that they have successfully applied the solvency and liquidity test, a new assessment must be done.⁸⁶⁸

The formulation of the 120 day rule in the Companies Bill has been criticised.⁸⁶⁹ Although the draft clause appears to be based on a provision of the

⁸⁶⁴ Either a payment in respect of an acquisition of shares (s 85) or a payment otherwise by reason of shareholding (s 90).

⁸⁶⁵ See paragraphs 4.3.1.5 and 4.3.1.6 above.

⁸⁶⁶ See clause 46(4)(a) of the Companies Bill.

⁸⁶⁷ This is confirmed by paragraph (a) of the definition of a distribution as a 'transfer by a company of money or property'. Each payment would thus qualify as a distribution.

⁸⁶⁸ See clause 46(3) of the Companies Bill, discussed in paragraph 4.3.1.6 above.

⁸⁶⁹ See paragraph 4.3.1.6 above.

MBCA,⁸⁷⁰ the circumstances in which it is proposed to apply differ substantially from its scope in the MBCA.⁸⁷¹ Under the MBCA the general time of measurement is when a distribution is authorised, while the Companies Bill uses the time of 'making' of a distribution as the point of departure. Another important difference is that under the MBCA the directors are not required to adopt a specific resolution acknowledging that they have successfully applied the financial restrictions,⁸⁷² while the Companies Bill does require such a resolution.

I support the requirement of a declaration or formal acknowledgement resolution, because it places a positive duty on directors and thus appears more likely to prevent unlawful distributions.⁸⁷³ The disadvantage, though, is that compliance with this formality introduces a specific date for application of the financial restrictions and thus impairs flexibility. As a result, some arrangement becomes necessary to address the situation. It is in this regard that a formal reconsideration serves a useful purpose. Even though the test is first applied when the company is about to 'make' a distribution, rather than when the distribution is authorised, there may be an unexpected delay between the first consideration and the completion of the distribution. The directors will then have to take positive steps to assess the financial situation of the company. I recommend that the 120 day rule should apply to any kind of distribution, but that a reconsideration should only be required when the company is about to proceed with the distribution.

However, the acknowledgement by the directors should not be overemphasised. It appears from the Companies Bill that a company will be obliged to proceed with a distribution on the basis of a current acknowledgement.⁸⁷⁴ This will oblige a company to proceed with and complete a distribution on the basis of the directors' acknowledgement even when it appears, within the 120 day period, that the company no longer satisfies the test.⁸⁷⁵

I suggest that the New Zealand approach of prohibiting implementation of a distribution whenever the directors are no longer satisfied of the company's

⁸⁷⁰ See Chapter 4 paragraph 4.4.3.

⁸⁷¹ See paragraph 4.3.1.6 above.

⁸⁷² See Chapter 4 paragraph 4.4.2.

⁸⁷³ See paragraph 4.4.1.1 above.

⁸⁷⁴ Clause 46(2), see paragraph 5.8.2 below.

⁸⁷⁵ See paragraph 5.8.2 below.

solvency and liquidity offers a better solution to dealing with a change in the financial situation of a company between the date of an acknowledgement by the directors and the date of implementation of a distribution.⁸⁷⁶ I regard this general prohibition as preferable to the English approach of imposing strict time limits between the authorisation and completion of distributions.⁸⁷⁷

I also suggest that a company should be prohibited from proceeding with a distribution if the directors are no longer satisfied that the company's financial situation allows it. In such a case the shareholder should not be able to enforce her claim, despite the existence of a current positive acknowledgement by the directors. This proposal does not obviate the need for a formal reconsideration by the directors, but merely attaches less weight to the acknowledgement.

In the final chapter several recommendations are made in this regard.⁸⁷⁸

5 DIVIDENDS AND OTHER PAYMENTS TO SHAREHOLDERS

Section 90 regulates the making of 'payments' to shareholders by reason of their shareholding. Certain aspects of these dividend-like payments have been discussed in relation to distributions in general.⁸⁷⁹ The most important of these is the solvency and liquidity test which applies not only to payments under section 90, but also to share repurchases. In this section the remaining rules that apply to payments under section 90 are considered.

The concept of a 'payment' is narrower than that of a distribution, primarily since it does not include payments for the acquisition of shares.⁸⁸⁰ It is, however, wider than the concept of a dividend.⁸⁸¹ The term 'dividend' is usually reserved for distributions of profits⁸⁸² while 'payment' is defined without reference to the source of funds distributed.⁸⁸³

⁸⁷⁶ See Chapter 3 paragraph 4.3.

⁸⁷⁷ See Chapter 2 paragraph 6.3.4.5.

⁸⁷⁸ See Chapter 6 paragraph 7.11 and the provision entitled 'Effective date of distribution'; paragraph 7.13 and subclause 1(b) of the provision entitled 'Liability for distributions in violation of solvency and liquidity test'.

⁸⁷⁹ See paragraph 4 above.

⁸⁸⁰ The exclusions from the definition of 'payment' are discussed in paragraph 5.1.3 below.

⁸⁸¹ See paragraphs 5.1.1 and 5.1.2 below.

⁸⁸² See Van Dorsten *Dividends* 26.

⁸⁸³ Although reference is often made to payments out of 'profits' or out of 'capital', the funds of a company are not physically separated into profits and capital. A distribution out of profits is a

Prior to the enactment of section 90 in its current form,⁸⁸⁴ the payment of dividends was not regulated by legislation but by the common law.⁸⁸⁵ In accordance with the capital maintenance principle, distributions out of share capital were not allowed, except under a formal reduction of capital or upon the winding-up of a company.⁸⁸⁶ Profits could be distributed to shareholders by way of dividends.⁸⁸⁷

Section 90(1) is cast as an enabling provision. It states that a company may make payments in accordance with section 90 and its articles. However, subsection (2), which sets out the financial restrictions, contains a clear prohibition on the making of any payment in violation of the solvency and liquidity requirements. The concept of a payment is defined in subsection (3). Subsection (4) regulates the liability of shareholders who receive payments that do not comply with subsection (2). Various aspects of section 90 will now be analysed.

5.1 Kinds of payments regulated

A 'payment' is defined for purposes of section 90 as including any direct or indirect payment or transfer of money or other property to a shareholder of the company by virtue of the shareholder's shareholding in the company.⁸⁸⁸ Certain payments that are regulated by other provisions of the Act are expressly excluded.⁸⁸⁹

The difference between payments under section 90 on the one hand and payments for the acquisition of shares under sections 85, 98 and 252 on the other hand, is that these latter instances involve not only a distribution of capital but also

Continued

payment that is made in circumstances where the excess of assets over issued share capital and non-distributable reserves of the company is sufficient to cover the amount of the distribution. In contrast, a distribution will be made out of capital to the extent that the company's net assets will after the payment be less than its share capital and reserves.

⁸⁸⁴ By s 14 of the Companies Amendment Act 37 of 1999. The repealed s 90 dealt with certain criminal offences pertaining to formal reductions of capital, see Cilliers & Benade *Corporate Law* 2 ed 331 – 337 for a discussion. See McLennan "Dividends" 126ff for an overview of the new position.

⁸⁸⁵ See Van Dorsten *Dividends* 1 – 2.

⁸⁸⁶ See *Re Exchange Banking Co (Flitcroft's Case)* (1882) 21 ChD 519 (CA) at 533; *Re Guinness v Land Corporation of Ireland* (1882) 22 ChD 349 (CA) at 356; *Hill v Permanent Trustee Co of New South Wales Ltd* (1889) 2 Ch 629 (CA) at 669; *Cohen NO v Segal* 1970 (3) SA 702 (W) at 705 – 706.

⁸⁸⁷ Meskin *Henochsberg on the Companies Act* 186(3).

⁸⁸⁸ Section 90(3).

⁸⁸⁹ Section 90(3), see paragraph 5.1.3 below.

an alteration or subrogation of the rights of the shareholders.⁸⁹⁰ Acquisitions of own shares result in a reduction of share capital,⁸⁹¹ and are thus per definition paid out of capital funds.⁸⁹² Although the company may have assets in excess of its share capital, the payment is out of capital because it is reflected as such in the share capital accounts.

Payments under section 90, on the other hand, are not followed by adjustments to share capital accounts and are thus not reductions of share capital, regardless of whether or not the company's net assets exceed its share capital. Section 90 thus allows capital funds to be paid to shareholders without a reduction of capital.⁸⁹³ Such a payment will consequently not reduce the amount of the shareholder's claim to the return of capital upon liquidation or dissolution of the company. Another difference between payments under section 90 and payments for the repurchase of shares is that the latter are frequently selective rather than proportional.⁸⁹⁴

5.1.1 Direct or indirect payment or transfer of money or property

The first feature of the definition that merits comment is the inclusion of the word 'payment' as a transaction that would qualify as a payment. The intention behind this tautology was probably to convey the idea that indirect payments are also included.

It is not clear whether the words 'direct or indirect' relate to payment only or also to the transfer of money or property, but it is suggested that these words qualify both payments and transfers.

The difference between a payment and a transfer of money needs to be considered. Payment generally presupposes the existence of a debt while a

⁸⁹⁰ Blackman, Jooste & Everingham *Companies Act* 5-113, 5-117.

⁸⁹¹ See paragraph 2.6 above and paragraphs 6.3.3 and 6.8.1 below. In the case of a redemption, the reduction is, however, offset by the fresh capital or the capital redemption reserve fund, see paragraph 6.8.1 below.

⁸⁹² Blackman, Jooste & Everingham *Companies Act* 5.113; 5-117.

⁸⁹³ Blackman, Jooste & Everingham *Companies Act* 5-112. The concept 'capital funds' refers to funds that represent share capital which is the case where the company does not have assets valued in excess of its share capital.

⁸⁹⁴ Payments under s 90 may, however, be disproportionate if the articles provide accordingly, see paragraph 5.1.2 below.

transfer of money does not necessarily imply an underlying debt.⁸⁹⁵ Further, certain methods of extinguishing obligations do not involve a physical transfer of money, for example set-off. However, set-off would probably still qualify as an indirect transfer of money.

A transfer of 'property' refers to movable or immovable property. A dividend *in specie* is a good example of a 'payment' by way of the transfer of property.

An indirect payment or transfer would be present where the company arranges for payment through another person or entity, for example its holding company or subsidiary. Payments made on behalf of or in favour of a shareholder would also be regarded as indirect payments.

The authors of Blackman, Jooste & Everingham *Companies Act* suggest that the repayment by a company of money advanced to it by a third party for the purpose of making payments would not qualify as a payment because it is not made to a shareholder.⁸⁹⁶ Their conclusion appears to be correct, but it is suggested that the reason is that the company will have made a payment to the shareholder at the time when the funds advanced by the third party were transferred to the shareholder by or on behalf of the company. A payment cannot be excluded from the ambit of section 90 merely because it is made to someone other than the shareholder, since payments made to third parties would in certain circumstances qualify as indirect payments to shareholders.

5.1.1.1 Is the incurring of an obligation covered?

The definition of 'payment' in section 90 does not mention the incurring of an obligation in favour of a shareholder. The possibility that it may be regarded as an indirect payment is raised by the authors of Blackman, Jooste & Everingham *Companies Act*, but rejected as unsound.⁸⁹⁷

A personal right is not property and the incurring of an obligation to make payment would thus not qualify as a payment or transfer for purposes of section 90. It is submitted that it would be untenable to regard the incurring of a debt as an indirect payment. It would mean that the financial restrictions would have to be

⁸⁹⁵ *Harrismith Board of Executors v Odendaal* 1932 AD 539.

⁸⁹⁶ Blackman, Jooste & Everingham *Companies Act* 5-116 – 5-117.

⁸⁹⁷ See Blackman, Jooste & Everingham *Companies Act* 5-116.

applied twice, since section 90 does not exclude the subsequent payment from its ambit. It is suggested that the South African legislature clearly intended the financial restrictions to be applied at the time of payment or transfer only and not at the time when the liability is first incurred.⁸⁹⁸ This may explain why the definition of payment in section 90 does not expressly include the incurring of a debt.

If the incurring of a debt were to be regarded as an indirect payment, it would also cause interpretation problems of sections 86 and 90(4). It would make no sense to hold directors or shareholders personally liable for the amount of an obligation incurred towards them if they had not yet received property or money. It is also evident that section 88 maintains a distinction between the existence of an obligation to pay and actual payment and that the enforceability of payment for the acquisition of shares, rather than the incurring of an obligation, depends on solvency and liquidity.⁸⁹⁹

It is a feature common to the definitions of 'distribution' in New Zealand⁹⁰⁰ and under the MBCA⁹⁰¹ that not only the transfer of money or other property is mentioned, but also the incurring of an obligation or debt in favour of the shareholder.

It is submitted that the legislature's decision to refrain from including a reference to the incurring of a debt, despite the example of the MBCA and New Zealand definitions, is a clear indication that it did not intend to include the creation of an obligation under the concept of a payment. The fact that it was deemed necessary in those jurisdictions to expressly include the incurring of a debt as a distribution implies that it would not otherwise have qualified as an indirect transfer of money or property in those jurisdictions.

The absence of a specific timing rule for the application of the financial restrictions to the incurring of a debt supports the conclusion that it is only the actual transfer of money or property that qualifies as a payment.⁹⁰² Although the time when the financial restrictions have to be met cannot be used to determine whether a payment has been made, there is an important correlation between the

⁸⁹⁸ See paragraph 4.2 above.

⁸⁹⁹ See paragraph 6.5 below.

⁹⁰⁰ New Zealand Companies Act s 2(1) s v 'distribution', see Chapter 3 paragraph 4.

⁹⁰¹ MBCA s 1.40(6); see Chapter 4 paragraph 4.4.1.

⁹⁰² See paragraph 4.2 above.

definition of a payment or distribution and the timing rule, since the timing rule has to provide for the different transactions that are regarded as distributions or payments.⁹⁰³

A feature of the general definitions of 'distribution' in New Zealand, California and in the MBCA is the inclusion of references to specific methods by which distributions can be made. In addition to express references to purchases, redemptions or other acquisitions of shares, necessitated by the more comprehensive nature of the concept of a distribution, which are present in all three definitions, the definitions of California and the MBCA expressly mention dividends.⁹⁰⁴ The South African section 90, on the other hand, does not contain any examples.

The distribution of an 'indebtedness' is expressly mentioned in the MBCA and New Zealand definitions.⁹⁰⁵ As has been explained earlier,⁹⁰⁶ the word in this context refers to debt instruments such as promissory notes and bonds. In South Africa such a distribution of a debt instrument would probably qualify as a transfer of property and can be distinguished from the incurring of an obligation not embodied in a debt instrument. The express inclusion of the distribution of an indebtedness in the MBCA is followed up with a specific timing provision that applies to this specific type of distribution.⁹⁰⁷

5.1.1.2 Comparison of dividends and 'payments'

The MBCA regards both the declaration and the payment of a dividend as distributions.⁹⁰⁸ The California Corporations Code refers to the transfer of cash or

⁹⁰³ See paragraph 4.2 above. In addition to the correlation between definition and timing rules, there is also a correlation between the timing rule and the status or ranking of a distribution claim, see paragraph 4.4.2 above.

⁹⁰⁴ See Chapter 3 paragraph 4.1; Chapter 4 paragraphs 3.4.1 and 4.4.1.

⁹⁰⁵ See Chapter 3 paragraph 4.1 and Chapter 4 paragraph 4.4.1. Further examples in the New Zealand definition include a purchase of property and the redemption or other acquisition of shares. In the MBCA the declaration or payment of a dividend and a purchase, redemption, or other acquisition of shares are mentioned.

⁹⁰⁶ See Chapter 4 paragraph 4.4.1.

⁹⁰⁷ See Chapter 4 paragraph 4.4.3. In New Zealand a specific timing provision is not necessary, as all distributions are measured at the time of authorisation, although they may not be completed if the circumstances have changed, see Chapter 3 paragraph 4.3.

⁹⁰⁸ This is necessary in view of the timing provision which is discussed in Chapter 4 paragraph 4.4.3.

property by way of dividend or otherwise.⁹⁰⁹ Dividends, in the narrow sense of a distribution of profits,⁹¹⁰ clearly fall within the definition of payment in section 90. If a dividend is paid following the declaration of a final dividend, it would constitute a payment in the ordinary sense of the word since the company would have become indebted to the shareholder in the amount of the dividend.⁹¹¹ The payment of interim dividends would qualify as transfers of money, since there is no prior declaration which gives rise to a claim for payment on the part of the shareholder.⁹¹² As a result, the financial restrictions of section 90(2) apply to interim as well as final dividend payments in addition to any restrictions imposed by the articles of a company.

I suggest that the declaration as opposed to payment of a dividend cannot be regarded as a payment for purposes of section 90.⁹¹³ This is because the creation of an obligation to pay does not amount to a payment or transfer of money or property. I will also explain below that the effect of section 90(2) is that a shareholder no longer has an unconditional claim against the company in respect of a declared dividend as was the case under the common law.⁹¹⁴

At common law any payment or benefit given by virtue of shareholding that was neither a return of capital following a capital reduction nor a liquidation dividend was regarded as a dividend in the wide sense of the word, regardless of what the company called it.⁹¹⁵ The courts are prepared to characterise certain disguised transactions as distributions to shareholders.⁹¹⁶

The meaning of 'payment' in section 90 is the same as that of 'dividend' in the wide sense.⁹¹⁷ It can be expected that the courts, drawing on the established

⁹⁰⁹ Section 166 of the California Corporations Code, see Chapter 4 paragraph 3.4.1.

⁹¹⁰ *South African Iron and Steel Industrial Corporation Ltd v Moly Copper Mining and Exploration Co (SWA) Ltd* 1993 (4) SA 705 (NmHC) at 712.

⁹¹¹ *Utopia Vakansie-oorde Bpk v Du Plessis* 1974 (3) SA 148 (A). However, as a result of the operation of section 90(2), the obligation will be conditional upon the company's satisfaction of the solvency and liquidity test.

⁹¹² See Van Dorsten *Dividends* 37 – 38; Blackman, Jooste & Everingham *Companies Act* 5-153.

⁹¹³ See Blackman, Jooste & Everingham *Companies Act* 5-150.

⁹¹⁴ See paragraph 5.4 below.

⁹¹⁵ *R A Hill v Permanent Trustee Co of New South Wales Ltd* [1930] AC 720 (PC) at 731.

⁹¹⁶ See *Aveling Barford Ltd v Perion Ltd* [1989] BCLC 626 where the sale by a company of an asset at an undervalue to another company controlled by the beneficial shareholder of the seller-company was held to be a distribution.

⁹¹⁷ See Blackman, Jooste & Everingham *Companies Act* 5-135. As a result of the abolition of the capital maintenance doctrine, dividends or payments may also now lawfully be made out of

principles regarding disguised dividends, will ignore terminology or form and rather consider the substance of a payment.

5.1.1.3 *Is the payment of interest on share capital a 'payment'?*

The payment of interest on shares or share capital is another example of a payment by virtue of shareholding. The prohibition against the payment of dividends out of capital applied with equal force to interest payments.⁹¹⁸ Section 79 of the Companies Act provides for the payment of interest on shares in certain circumstances and, prior to the amendments introduced by Act 37 of 1999, used to function as an exception to the common-law rule.⁹¹⁹ Unlike certain other payments that are expressly regulated by other sections of the Companies Act, payment of interest on shares has not been excluded from the definition of 'payment' for purposes of section 90. Section 90 should thus also apply to the payment of interest on shares, in addition to the requirements of section 79.⁹²⁰

The retention of section 79, which was originally enacted as an exception, but now imposes more onerous requirements than the general rule, creates the same kind of problems that arise in relation to the applications of the share premium account.⁹²¹ Section 79(1) is cast as an enabling provision, allowing interest to be paid on shares issued for the purpose of raising money for the construction of buildings or the provision of plant. It does not repeat the common-law prohibition against payments to shareholders otherwise than out of profits. Section 79(2) contains a prohibition against the payment of 'such' interest unless the requirements of the section are complied with. Section 79 can only be given effect by implying a prohibition against the payment of interest on shares. The first difficulty in implying such a prohibition is whether it should extend to any interest payments or only to interest 'charged to capital expenses'. The heading to section

Continued

capital funds. For this reason these authors suggest that the term 'dividend' should henceforth be used in its narrower sense to distinguish a division of profits from distributions out of capital funds.

⁹¹⁸ See *Re Alexandra Palace Co* (1882) 21 ChD 149 at 157; *Re National Bank of Wales Limited* (1899) 2 Ch 629 (CA) at 669.

⁹¹⁹ See paragraph 5.7 below. This option has not been used often, as it is easier to use debentures to finance such operations, see Blackman, Jooste & Everingham *Companies Act* 5-30.

⁹²⁰ The requirements are discussed in paragraph 5.7 below.

⁹²¹ See paragraph 2.4.3.3 above.

79 reads 'Payment of interest out of capital in certain instances'. This suggests that the prohibition extends only to the payment of interest otherwise than out of profits. This also accords with the capital maintenance rule. The reference to 'such' interest in section 79(2) should thus be regarded as a reference to interest 'charged to capital' as envisaged by subsection (1). It must be noted that despite the reference to share capital in the heading, subsection (1) does not provide for the reduction of share capital by the amounts paid out as interest but only for the interest to be charged to capital expenditure. This means that it may be reflected as part of the costs of establishing the infrastructure and also that it may be paid despite the fact that the value of the company's assets does not exceed the amount of its share capital.⁹²²

The second difficulty lies in establishing whether the implied prohibition covers interest on all shares or alternatively only on shares issued to finance construction work.⁹²³ The original purpose of the provision, coupled with the fact that it was left unchanged in 1999, indicates that a general prohibition should be inferred and not only a prohibition in respect of shares issued to finance construction and plant. If the wider prohibition is accepted as correct, the implication would be that interest out of capital may never be paid on shares issued for purposes other than the financing of construction and plant, not even if section 90 is complied with. If the narrower prohibition were to be accepted it would mean that interest out of capital may be paid on shares issued for any other purpose subject to compliance with section 90 only. In both instances the position regarding shares issued for the financing of construction would be that the requirements of section 79 as well as of section 90 have to be met. Where interest is to be paid out of profits, section 79 would not apply, but section 90 would.

If it is indeed the case that 'capital' may not be employed in paying interest on shares issued otherwise than to fund construction and plant, not even if the requirements of section 90 are met, it is clearly an undesirable situation. Apart from the difficulty in establishing whether a particular payment is interest or perhaps some other kind of payment, there seems to be no distinction in principle between interest payments and other payments by reason of shareholding that

⁹²² That is, out of funds representing share capital.

⁹²³ Section 79(1) reads: 'Where any shares of a company are issued for the purpose of raising money to defray the expenses of the construction the company may pay interest...'

could justify this disparate treatment.⁹²⁴

5.1.2 *By reason of shareholding*

An implication of the fact that the payment is 'by virtue of the shareholder's shareholding in the company' is that payments to shareholders of a particular class would, as in the case of dividends, generally have to be proportionate.⁹²⁵

The phrase 'by virtue of **shareholding**' can be contrasted with the phrase 'in respect of **shares**' in the MBCA⁹²⁶ and the words 'in relation to **shares**' in the New Zealand Companies Act.⁹²⁷ The definitions of distribution in these two jurisdictions are wider than the South African definition of 'payment' as they also include share acquisitions, which need not necessarily be proportionate. The words of section 90 seem to focus on continued shareholding and imply proportionate treatment of shareholders.

The fact that section 90 does not provide for the adjustment of the share capital accounts that apportion shareholder rights and further lacks any of the formalities usually associated with disproportionate treatment of shareholders⁹²⁸ strengthens the presumption against selective payments.⁹²⁹

The principle of equality of treatment applies unless the articles of the company expressly permit the company to deviate from it. A question that arises is to what extent any existing arrangements in the articles of companies pertaining to 'dividends' would also apply to 'payments' as defined in section 90. It is further important to know whether the common law principles regarding dividends will also protect shareholders when other payments by reason of shareholding are being

⁹²⁴ Section 79 is discussed in paragraph 5.7 below.

⁹²⁵ Blackman, Jooste & Everingham *Companies Act* 5-136. Van Dorsten *Dividends* 41 – 43. See *McClurg v Canada* 76 DLR (4d) 217 (SCC) at 228. However, the presumption of equality can be negated by the articles or by agreement, see *Patakh Centre (Pty) Ltd v Stern NO* 1978 (1) SA 259 (D) at 263 – 264; *McClurg v Canada* 76 DLR (4d) 217 (SCC). See also Meskin *Henochsberg on the Companies Act* 186(3) where it is argued that selective payments would be possible if provided for in the company's articles. See *Anglo-Transvaal Collieries Ltd v SA Mutual Life Assurance Society* 1977 (3) SA 631 (T) and the further appeal at 1977 (3) SA 642 (A); *Donaldson Investments (Pty) Ltd & Others v Anglo-Transvaal Collieries Ltd* 1979 (1) SA 959 (W); appeal at 1983 (3) SA 96 (A). See also the discussion by Sher "Preference Shareholders" 87.

⁹²⁶ See MBCA s 1.40(6), discussed in Chapter 4 paragraph 4.4.1.

⁹²⁷ New Zealand Companies Act 1993 s 2 s v 'distribution', discussed in Chapter 3 paragraph 4.1.

⁹²⁸ For example, a special resolution.

⁹²⁹ See also Blackman, Jooste & Everingham *Companies Act* 5-136.

made.

As will be explained below, a company can make payments under section 90 only if its articles allow it to do so.⁹³⁰ A company could replace the provisions of its articles regulating dividends with comprehensive provisions regulating payments, including the relative entitlement to payments of different classes of shares.⁹³¹ However, if a company alters its articles by merely inserting an authorisation to make payments as envisaged in section 90, retaining existing references to dividends, several uncertainties arise.

The answers to the following questions are far from clear:

- Can holders of participating preference shareholders rely on 'payments' made to ordinary shareholders to conclude that the ordinary shareholders have received the prerequisite dividend that triggers their participation rights?
- Can preference shareholders complain if payment is made to ordinary shareholders before the preference dividend has been paid?
- If the articles provide for different dividends only, does this mean that the general principle of equality nevertheless applies in respect of other payments so that preference shareholders who have received their dividend are also entitled to share in payments? In other words, does the principle of exhaustiveness in relation to preference shares apply only to dividends in the narrow sense or to all payments?
- Can the holders of one class of ordinary shares complain if payments are made to another class of ordinary shares despite the fact that both classes are entitled to share in dividends according to the nominal value of their shares?
- To what extent can a company avoid giving effect to the relative entitlements of shareholders by designating a distribution as a payment rather than a dividend?
- Can directors authorise payments despite a provision in the articles reserving for the general meeting the power to declare a dividend?

⁹³⁰ See paragraph 5.5 below.

⁹³¹ It would obviously have to be mindful of a possible alteration of class rights, see s 56(5).

5.1.3 Exclusions

The exclusions from the definition of 'payment' are:

- an acquisition of shares in terms of section 85⁹³²
- a redemption of redeemable preference shares in terms of section 98⁹³³
- any acquisition of shares in terms of an order of court⁹³⁴
- the issue of capitalisation shares in the company.⁹³⁵

The definitions of 'distribution' in New Zealand, California and under the MBCA are wider than the South African definition of 'payment', as they also include the acquisition of shares by way of purchases, redemptions or otherwise.

Due to the fragmentation of the South African distribution rules, share acquisitions in any form are expressly excluded from the definition of 'payment' as they are regulated in other provisions of the Act. It is not clear why reference is made to 'acquisition' and 'redemption' rather than to a 'payment' in respect of an acquisition or redemption, but it is submitted that the exclusion relates to the payment itself.

The need for excluding an issue of capitalisation shares from the definition of 'payment' can be explained by the fact that the company will be capitalising profits it could otherwise have distributed to its shareholders. Since the funds remain in the company, capitalisation has the opposite effect from a distribution. The company does not transfer or dispose of any of its property⁹³⁶ and the capitalisation issue has no effect on the total assets and liabilities of the company or on its ability to pay its debts. Technically the shareholders do receive property in the form of shares,⁹³⁷ but the intrinsic value of each shareholder's interest in the company remains the same. It is interesting to note that in New Zealand and under the MBCA the definition of 'distribution' also excludes capitalisation shares by stating that a distribution is the transfer of money or assets 'other than the

⁹³² See paragraph 6.1 below.

⁹³³ See paragraph 6.8 below.

⁹³⁴ See s 252 of the Act.

⁹³⁵ See paragraph 3.2.1 above for a discussion of capitalisation issues.

⁹³⁶ See *CIR v Collins* 1923 AD 347 at 363 – 364. In this case the court had to determine whether the issue of capitalisation shares resulted in the shareholder receiving an amount in money or money's worth which could be subject to income tax.

⁹³⁷ Shares are regarded as movable property, see s 91.

company's own shares'.⁹³⁸ This clearly implies that capitalisation shares are regarded as assets, but that their issue is nevertheless not regarded as a distribution.

The issue of the possible exclusion of interest payments provided for in section 79 has been mooted above.⁹³⁹ As a result of the limitation imposed by the purpose for which the shares must have been issued, it would be necessary to restrict any exclusion to interest payable on such qualifying shares so that interest payments on shares issued for purposes other than financing construction would be subject to section 90. However, it is suggested that the need for a provision such as section 79 has fallen away in view of the abolition of the capital maintenance principle.⁹⁴⁰

5.2 Financial restrictions

Section 90(2) imposes the financial restrictions of solvency and liquidity on payments by virtue of shareholding. It is cast as a very clear prohibition and it is suggested that it applies to all companies regardless of the content of their articles and irrespective of whether or not their articles provide for payments in terms of section 90.⁹⁴¹ Companies that may in terms of their articles pay dividends out of profits only, will thus in addition have to satisfy the financial restrictions of solvency and liquidity.⁹⁴²

There are two differences between the common-law financial restrictions on the payment of dividends and those imposed by section 90(2). First, the balance sheet test has become less onerous. At common law the assets of a company would have to exceed not only its liabilities but also the amount of its share capital before a dividend could be paid. The company would thus have to maintain a certain margin over solvency. Under the new rules an excess over liabilities is sufficient. From a balance sheet perspective the new test is thus less restrictive than the common-law test.

⁹³⁸ See Chapter 3 paragraph 4.1 and Chapter 4 paragraph 4.4.1.

⁹³⁹ See paragraph 6.1.1.

⁹⁴⁰ See the further discussion of s 79 in paragraph 5.7 below.

⁹⁴¹ See *Meskin Henochsberg on the Companies Act* 186(3).

⁹⁴² Although payments out of profits would not usually create a solvency problem, the same is not true of liquidity.

The second difference lies in the addition of the liquidity test set out in section 90(2)(a). While the solvency test in section 90(2)(a) is less restrictive than the common-law capital maintenance yardstick, the capital maintenance doctrine did not enquire into the liquidity of a company as a prerequisite for the declaration and payment of dividends. The liquidity test has thus introduced a new dimension to the financial restrictions for distributions.

The solvency and liquidity test is discussed in paragraph 4.1 above.

5.3 Timing for the application of the financial restrictions

As has been explained earlier, the solvency and liquidity test must be applied at the time of payment.⁹⁴³ This rule must be compared to the common-law rule that a dividend was validly declared provided the company had the requisite profits when it declared the dividend.⁹⁴⁴ Section 90 does not require the company to consider its financial position at the time of declaration of a dividend or authorisation of a payment, but only when actual payment or transfer takes place.

The timing principle has important implications for the status of the shareholder's claim following the declaration of a dividend.

5.4 Status of claim in respect of authorised but unpaid distributions

While the position of a shareholder in respect of payment for the acquisition of shares is expressly regulated in section 88,⁹⁴⁵ the status of a claim in respect of a section 90 distribution which has been authorised but not yet paid, such as a declared but unpaid dividend, is not expressly regulated.

Prior to the introduction of the current section 90, a shareholder obtained an unconditional right to enforce payment of a declared dividend.⁹⁴⁶ The validity of a dividend depended on the existence of profits on the date of declaration of the dividend and not the date of payment. Van Dorsten⁹⁴⁷ refers to the situation where

⁹⁴³ See paragraph 4.2 above.

⁹⁴⁴ See *Industrial Equity Limited v Blackburn* (1977) 13 CLR (Aust HC) at 578 – 579; *Marra Developments Ltd v BW Rofe Pty Ltd* (1977) 3 ACLR 185 (CA NSW) at 207 – 209. The enforceability of a declared dividend is considered in paragraph 5.4 below.

⁹⁴⁵ See paragraph 6.5 below.

⁹⁴⁶ See Van Dorsten *Dividends* 99; *Utopia Vakansie-oorde Bpk v Du Plessis* 1974 (3) SA 148 (A); *Boyd v CIR* 1951 (3) SA 525 (A). See also the authority referred to in note 944 above.

⁹⁴⁷ See Van Dorsten *Dividends* 99.

a company 'loses its distributable profits' between the time of declaration and the time of payment and states that the debts will not be enforceable in such circumstances. However, the cases quoted by Van Dorsten,⁹⁴⁸ actually address the situation where it subsequently appears that the company did not in fact have the requisite profits at the time the dividend was declared. It seems clear that where the company did in fact have profits at the time of declaration of the dividend but its financial position deteriorated subsequent to the declaration, the company could nevertheless lawfully pay the dividend.⁹⁴⁹ However, such a payment while the company's liabilities exceed its assets may be impeachable under the Insolvency Act as a disposition without value.⁹⁵⁰

Section 90(2) has substantially changed the common-law position of shareholders following the declaration of a dividend. The effect of section 90(2) is that the shareholder's claim will be conditional upon the company's solvency and liquidity.⁹⁵¹ Because the financial restrictions apply at the time of actual payment, the shareholder does not have the status of an ordinary creditor in respect of the declared dividend but rather a contingent or subordinated claim. The position is thus similar to that under section 88 in that the shareholder cannot enforce payment if the claims of creditors have not been paid.

There are, however, important differences between the regulation in section 88 of an unpaid claim for the acquisition of a share and the position with respect to an unpaid section 90 distribution in the event of liquidation. Firstly, the position of preference shareholders is expressly dealt with in section 88. In the event of liquidation the claim for payment of the purchase price of shares will rank after the claims of shareholders of classes that enjoy priority over the class of acquired shares.⁹⁵² This provision offers some protection to preference shareholders.

Secondly, section 88 confirms that the seller-shareholder will retain a claim for payment. However, should a company be wound up with outstanding liabilities

⁹⁴⁸ See *McGregor v De Beers Consolidated Mines* (1903) 20 SC 284 at 291; *Cohen NO v Segal* 1970 (3) SA 702 (W) at 705. See also *Enterprise Wholesalers (Pty) Ltd v Ebrahim* 1954 (2) SA 262 (N) at 267.

⁹⁴⁹ See *Utopia Vakansie-oorde Bpk v Du Plessis* 1974 (3) SA 148 (A); *Boyd v CIR* 1951 (3) SA 525 (A). See also Blackman, Jooste & Everingham *Companies Act* 5-148 – 5-153.

⁹⁵⁰ See Cilliers & Benade *Corporate Law* 346.

⁹⁵¹ See Blackman, Jooste & Everingham *Companies Act* 5-153.

⁹⁵² Section 88(3), discussed in paragraph 6.5 below.

in respect of section 90 payments, the position of shareholders who have not been paid is less certain. It could be that they will retain their claims, which will be subordinated to those of other creditors.⁹⁵³ However, since the requirements of section 90(2) will no longer be capable of being satisfied,⁹⁵⁴ it may be argued that the shareholder's claim will remain unenforceable.⁹⁵⁵ This conclusion is reinforced by the absence of any express regulation along the lines of section 88(3). If it was necessary to include a provision in respect of repurchases, its absence in relation to other payments may indicate that a different position obtains in this latter instance.

There does not seem to be a good reason for this different treatment of unpaid distributions. Section 88 refers to a contract between the shareholder and the company. In the case of section 90 there would not usually be a separate contract between the shareholder and the company, although reliance could possibly be placed on the contractual nature of the articles to conclude that the shareholder has a contractual entitlement to a payment that has been authorised in accordance with the articles. It is suggested that the status of a claim for payment under section 90 should be expressly regulated. This apparent oversight is another illustration of an anomaly caused by the fragmented regulation of distributions.

5.5 Authorisation

Section 90(1) allows the making of payments by a company 'subject to the provisions of this section and if authorised thereto by its articles'. While section 90(1) is formulated as an enabling provision, it is clear from the outset that two limitations are imposed. First, the provisions of section 90 have to be complied with, and second, the articles must authorise the payment.

It is not clear in which way the articles of association have to authorise the payment. It may either mean that a payment must not be in conflict with the

⁹⁵³ This position is supported by Blackman, Jooste & Everingham *Companies Act* 5-153.

⁹⁵⁴ See *Ex parte De Villiers & Another NNO: In re Carbon Developments (Pty) Ltd (in liq)* 1993 (1) SA 493 (A) 504 – 5. Even in the case of a liquidation of a company able to pay its debts, it may be argued that the company will as a result of the winding-up no longer be able to pay its debts as they arise in the ordinary course of its business.

⁹⁵⁵ See Luiz & Van der Linde "Subordination Agreements" 103.

articles⁹⁵⁶ or that the payment must be expressly authorised by the articles. The wording of the subsection, especially the inclusion of the word 'thereto', seems to suggest that the articles have to state expressly that the company may make payments to its shareholders, or even that the company may make payments subject to section 90. This latter type of authorisation seems to be envisaged by the authors of *Meskin Henochsberg on the Companies Act* who refer to the alteration of the company's articles 'authorising it to make payments under s 90'.⁹⁵⁷ This interpretation is also supported by the fact that the same words in section 85 are generally understood as requiring an express authorisation.⁹⁵⁸ It would also be sufficient if, rather than referring expressly to section 90 the articles authorised the company to make payments to shareholders subject to solvency and liquidity.

On a literal interpretation of section 90 it would seem that a company will not be able to make any payments to shareholders if its articles are silent on payments to shareholders. The company which previously had an inherent power to declare and pay dividends will no longer be able to do so.⁹⁵⁹ However, if the articles provide for some kinds of payment only, only such payments would be possible. The articles of a company can thus impose restrictions in addition to those contained in section 90. In this regard the model articles contained in Schedule 1 of the Act still provide that dividends may be paid out of profits only.⁹⁶⁰ A company with these articles will thus be able to make payments that can be described as dividends out of profits, but will not be able to make any other payments to its shareholders under section 90.⁹⁶¹

⁹⁵⁶ In which case it should rather have read 'subject to the provisions of this section and its articles'. This would make it clear that the purpose of section 90(1) is merely to leave room for the imposition by a company of further limitations on payments to shareholders.

⁹⁵⁷ *Meskin Henochsberg on the Companies Act* 186(3).

⁹⁵⁸ See Blackman, Jooste & Everingham *Companies Act* 5-62 and see paragraph 6.3.1.1 below.

⁹⁵⁹ It is not a common-law requirement that the articles should authorise dividends, see *Patakh Centre (Pty) Ltd v Stern* 1978 (1) SA 259 (D) at 263. In this regard the common law position was that the general meeting could declare dividends unless the articles gave this power to the directors. The model articles provide that the general meeting may declare a dividend, but that the amount may not exceed that recommended by the directors. The articles can also impose limitations. See also Van Dorsten *Dividends* 34 – 35.

⁹⁶⁰ See article 86 of Table A and article 85 of Table B.

⁹⁶¹ The word 'dividend' in the narrow sense already implies that profits must be used, as a dividend is a *pro rata* distribution of profits, see Blackman, Jooste & Everingham *Companies Act* 5-107. The existence of the capital maintenance rule would obviously have limited the kinds of payments company articles would have provided for.

It has been suggested that the word 'dividend' in the model articles may have a wider meaning than a division of profits to shareholders while the company is a going concern, and would, for example, include the payment of interest on share capital.⁹⁶² However, the provision in the articles should not be confused with the common-law rule which prohibits the return of capital. It is this rule that prohibits dividends as well as any other payment by reason of shareholding out of share capital.⁹⁶³ It is suggested that the term 'dividend' in the articles of a company would in most instances have been intended to refer only to dividends in the narrow sense.⁹⁶⁴

It is submitted that unless a company's articles allow it to make payments other than 'dividends', the company would thus not be able to benefit from the introduction of the new regime allowing it to make payments otherwise than out of profits. The model articles do not provide for any other payments which could possibly be regarded as payments under section 90. Although provision is made for the reduction of share capital⁹⁶⁵ which could include the making of payments to shareholders by way of the return of capital, payments in terms of section 90 do not result in a reduction of share capital despite the fact that they may have been made 'out of capital'.⁹⁶⁶ It would thus appear that a company that has adopted the model articles will not be able to make payments other than dividends unless its articles are altered.

⁹⁶² Blackman, Jooste & Everingham *Companies Act* 5-135. The authors thus argue that the purpose of this article is not to limit the funds or profits from which dividends in the narrow sense may be paid, but to make it clear that such other payments would also have to be made out of profits. This interpretation can be criticised. Just as in the case of dividends in the strict sense, the common-law also prohibits the making of any other payments to shareholders out of capital. The function of the article is to restrict the source from which dividends may be paid. There is a difference between 'profits' and amounts 'otherwise than capital', see Blackman, Jooste & Everingham *Companies Act* 5-139 note 1.

⁹⁶³ For example, the rule against the return of capital to shareholders also prohibits the payment of interest to shareholders, see *Re National Bank of Wales Limited* (1899) 2 Ch 629 (CA) at 669; *Re Alexandra Palace Co* (1882) 21 ChD 149 at 157. For this reason, it is unlikely that the term 'dividend' in existing articles would have been intended to include interest payments. The same applies to payments out of assets representing share capital.

⁹⁶⁴ See also paragraph 5.1.2 above regarding the re-interpretation of articles referring to dividends only.

⁹⁶⁵ See Table A article 31(g), Table B article 30(g).

⁹⁶⁶ See paragraph 5.1 above. Whether this article can be regarded as authorisation for a company to repurchase its shares under section 85 is discussed in paragraph 6.3.1.1 above.

5.6 Liability for distributions made in contravention of the Act

The fragmentation of the distribution rules also leads to a fragmented approach to the imposition of liability for unlawful distributions. Section 90(4) imposes liability on a shareholder who receives any payment contrary to the financial restrictions set out in section 90(2). The liability is towards the company. Section 86, on the other hand, provides for liability in respect of payments for the acquisition of shares in violation of section 85(4). The consideration that follows is thus restricted to the recovery of unlawful payments under section 90, although certain important differences between the two situations will be alluded to. A complete evaluation of the liability provisions can only be made if the two sets of liability provisions are assessed together, especially in view of the proposals in the Companies Bill. The liability provisions dealing with share repurchases under the current Act⁹⁶⁷ and the proposals in respect of distributions in general under the companies Bill⁹⁶⁸ are evaluated elsewhere.⁹⁶⁹

When section 90(4) is compared to section 86(2) and (3), which provides for liability in the case of share repurchases, it is obvious that shareholders feature more prominently in section 90. While section 86 allows the court to impose liability on shareholders upon application by a director or a creditor, section 90(4) states bluntly that shareholders 'shall be liable'. Unlike section 86, no provision is made for the discretion of the court.

As is the case in section 86, the state of mind of the recipient is irrelevant for purposes of section 90(4).⁹⁷⁰ A shareholder will be liable despite having been unaware that the financial restrictions have been contravened.⁹⁷¹ It is interesting to consider the common-law position of shareholders who received an unlawful dividend. In England the courts have relied on the constructive trustee principle and have accordingly held that the amount of an unlawful dividend can be recovered only from shareholders who were aware of the unlawfulness of a

⁹⁶⁷ See paragraph 6.4 below.

⁹⁶⁸ The liability provisions of the Companies Bill are considered in relation to share repurchases, see paragraph 6.9.3 below.

⁹⁶⁹ See paragraph 6.10.4 below.

⁹⁷⁰ See paragraph 6.4.2 below.

⁹⁷¹ See Blackman, Jooste & Everingham *Companies Act* 5-129. Criticism against this strict liability will be considered in the context of the liability provisions applicable to share repurchases, see paragraph 6.4.2 below.

distribution.⁹⁷² However, under South African law the shareholders will be liable to restore the unlawful dividend to the company on the basis of unjustified enrichment, regardless of whether or not they were aware of its unlawfulness.⁹⁷³ The position of shareholders under section 90(4) is thus comparable to their position at common law. The rights of the company, and indirectly of its creditors, take precedence over the reliance that the shareholder may have placed on the validity of the payment received.

Only the company will be able to enforce repayment by the shareholders. Although all distributions to shareholders have the same effect from the creditors' perspective, creditors are not given any right to recover payments made in contravention of section 90.⁹⁷⁴ The creditors' right under section 86(3) to claim from directors is attractive not only because it may be less costly to sue a few directors than a whole class of shareholders, but also because it offers additional pockets from which funds may be recovered. Consideration could be given to affording creditors an action against shareholders directly.

The directors, who under section 86(1) are primarily liable for unlawful payments in respect of share repurchases,⁹⁷⁵ are not mentioned at all in section 90(4). It is difficult to conceive of an explanation for this diverging approach.⁹⁷⁶ As has been noted by the authors of *Meskin Henochsberg on the Companies Act*, the circumstances are comparable.⁹⁷⁷ The apparent impunity of directors is rather illogical if regard is had to the fact that while shareholders have to approve share repurchases by special resolution, they are not required to be involved in the authorisation of 'payments'.

Despite the failure of section 90 to impose liability on directors, they will most likely be liable to the company on the basis of a breach of fiduciary duties.⁹⁷⁸ The directors also risk being held personally liable for the company's debts in terms of

⁹⁷² See Chapter 2 paragraph 6.6.

⁹⁷³ See Blackman, Jooste & Everingham *Companies Act* 5-129 note 6; Van Dorsten *Dividends* 125 – 127. See also *Cohen NO v Segal* 1970 (3) SA 702 (W).

⁹⁷⁴ This inconsistency is also noted by Cassim "Reform of Company Law and Capital Maintenance" 286.

⁹⁷⁵ See paragraph 6.4.1 below.

⁹⁷⁶ See Cassim "Reform of Company Law and Capital Maintenance" 286 who argues that directors who consented to an unlawful dividend should be liable.

⁹⁷⁷ *Meskin Henochsberg on the Companies Act* 186(4).

⁹⁷⁸ See Van Dorsten *Dividends* 124 – 125.

section 424, as the unlawful dividend may show that the company's business is being carried on recklessly.⁹⁷⁹

5.7 Payment of interest on capital

Section 79 allows the payment of interest on shares out of capital under certain circumstances. The purpose for which the shares are issued must be to raise money for the construction or provision of certain capital assets which cannot be made profitable for a long period.⁹⁸⁰ The company may pay interest for the period and charge it to capital as part of the cost of construction or provision of the capital infrastructure. This provision is not often used in practice.⁹⁸¹

The payment of interest must be authorised in the company's articles or by special resolution.⁹⁸² The approval of the Minister must also be obtained.⁹⁸³ The Minister may appoint someone to conduct an enquiry in the matter, and the company will be liable for the costs of the enquiry.⁹⁸⁴ The Minister will determine the period for which interest may be paid and this may not extend beyond the end of the half year following the half year during which the construction has been completed or the plant has been provided.⁹⁸⁵ The Minister also determines the rate, which may not exceed 6 per cent per annum.⁹⁸⁶ Although the company is allowed to use capital funds, the payment of interest is not regarded as a return of capital and the amount paid up on the shares is thus not regarded as having been reduced.⁹⁸⁷ The implication of this is that the interest is similar to a dividend.

The payment of interest on shares is also a payment by virtue of a shareholder's shareholding and is thus also included under the provisions of section 90.⁹⁸⁸ Unlike certain other payments specifically regulated by other sections of the Companies Act, payment of interest on shares has not been

⁹⁷⁹ See Meskin *Henochsberg on the Companies Act* 186(4).

⁹⁸⁰ Section 79(1). The section mentions the construction of works and building and the provision of plant.

⁹⁸¹ Blackman, Jooste & Everingham *Companies Act* 5-30.

⁹⁸² Section 79(2)(a).

⁹⁸³ Section 79(2)(a).

⁹⁸⁴ Section 79(2)(b).

⁹⁸⁵ Section 79(2)(c). The concept 'half year' is defined in subsection (3).

⁹⁸⁶ Section 79(2)(d).

⁹⁸⁷ Section 79(2)(e).

⁹⁸⁸ See paragraph 5.1.1.2 above.

excluded from the definition of 'payment' for purposes of section 90. It would thus seem that the company would still have to comply with the financial restrictions of section 90 before it makes any interest payment authorised under section 79.

If it is indeed the case that 'capital' may not be employed in paying interest on shares issued otherwise than to fund construction and plant, not even if the requirements of section 90 are met, it is clearly an undesirable situation. Apart from the difficulty in establishing whether a particular payment is interest or perhaps some other kind of payment, there seems to be no distinction in principle between interest payments and other payments by reason of shareholding that could justify this disparate treatment.

It is suggested that there is no longer any need for a specific provision allowing interest to be paid on shares.⁹⁸⁹ This provision was intended to soften the impact of the capital maintenance principle. Section 90 affords sufficient flexibility in relation to payments to shareholders. Although section 79 does not impose financial restrictions for interest payments, I submit that the solvency and liquidity tests would impose appropriate limitations even where shareholders invest in capital-intensive projects that may not become profitable soon.

5.8 Dividends and other payments under the Companies Bill

In view of the central definition of 'distribution' in the Companies Bill and the more coherent approach to the regulation of different kinds of distributions, many of the rules apply to share repurchases and other distributions alike. The basic definition of 'distribution' under the Companies Bill and the financial restrictions are considered in a previous section.⁹⁹⁰ Additional rules apply to share repurchases, which are considered in the next section.⁹⁹¹ In this section only two aspects will be addressed, namely authorisation of distributions and the status of a claim in respect of authorised but unpaid distributions. This will facilitate comparison with the present regulation of payments under section 90 of the Act. Although the Companies Bill regulates liability for unlawful distributions in general, I consider these provisions in the context of liability for unlawful repurchases.⁹⁹² Once again,

⁹⁸⁹ This sentiment is shared by Blackman, Jooste & Everingham *Companies Act* 5-30.

⁹⁹⁰ See paragraph 4.3 above.

⁹⁹¹ See paragraph 6.9 below.

⁹⁹² See paragraph 6.9.3 below.

the purpose is to facilitate comparison between the proposals of the Companies Bill and the current position. The current provisions regulate liability in respect of repurchases in a more comprehensive fashion than liability in respect of unlawful payments.⁹⁹³

5.8.1 Authorisation of distributions

Distributions have to be authorised by the board,⁹⁹⁴ except those made in compliance with a court order or pursuant to an existing legal obligation of the company.⁹⁹⁵ It appears that the initial authorisation by the board can be given at any stage before the distribution is made. This authorisation has to be distinguished from the solvency and liquidity acknowledgement that is discussed elsewhere.⁹⁹⁶

The Bill does not prescribe any authorisation or approval of distributions by the general meeting. However, a company's memorandum of incorporation could impose such a requirement in respect of all or any distributions by the company.⁹⁹⁷

5.8.2 Status of claim in respect of authorised but unpaid distributions

The requirements of clause 46 must be met before distributions may be made. Although there is no prescribed time when the board has to adopt the resolution acknowledging its application of the solvency and liquidity test, it is provided that the distribution must be 'fully carried out' once the board has adopted the resolution containing the acknowledgment.⁹⁹⁸ It seems that the distribution becomes enforceable once the board has made the acknowledgment. However, the enforceability lasts for 120 business days only. If the distribution has not been completed within this period, it cannot be carried out until a further acknowledgment has been made.

Enforceability depends on the acknowledgment rather than on objective

⁹⁹³ See paragraph 5.6 above in relation to liability for unlawful payments. Liability for unlawful repurchases under the Act is considered in paragraph 6.4 below.

⁹⁹⁴ Clause 46(1)(a)(ii).

⁹⁹⁵ Clause 46(1)(a)(i).

⁹⁹⁶ See paragraph 4.3.1.1 above.

⁹⁹⁷ The directors would be obliged to comply with such a requirement, see clause 76(3). Liability for non-compliance with the provisions of the memorandum of incorporation is imposed by clause 77(2)(b)(iii).

solvency and liquidity. A shareholder is apparently entitled to insist on implementation of the distribution, despite the fact that the objective solvency and liquidity test is not satisfied. I have alluded to this anomaly above.⁹⁹⁹

A specific arrangement exists for the enforceability of distributions in terms of a court order. If it appears that the company would not satisfy the solvency and liquidity test if it were to comply immediately with the court order, the company may apply to a court for an order varying the original order.¹⁰⁰⁰ The court can then make an order that ensures payment in terms of the original order is made at the earliest possible date compatible with the company satisfying its other financial obligations as they become due and payable.¹⁰⁰¹

The enforceability of share repurchase agreements is regulated in clause 48 and is discussed below.¹⁰⁰²

5.9 Evaluation of dividends and other payments

Section 90 allows the distribution of the net assets of a company regardless of whether or not they represent share capital. Even if share capital is in effect used for a payment, there is no adjustment of share capital accounts.¹⁰⁰³ It is for this reason that section 90 is credited as the provision that has abolished the capital maintenance concept in South Africa.¹⁰⁰⁴ It is this provision that makes it possible for a company to distribute its total net assets to shareholders as opposed to only those assets that represent the excess over share capital and reserves.¹⁰⁰⁵ A company can thus make a payment to its shareholders despite the fact that its net assets are worth less than the amount of its share capital and non-distributable reserves.¹⁰⁰⁶ The share repurchase provisions require an adjustment of capital

Continued

⁹⁹⁸ Clause 46(2). This rule is subject to the 120-day rule set out in clause 46(3).

⁹⁹⁹ See paragraph 4.4.2 above.

¹⁰⁰⁰ Clause 46(5)(a).

¹⁰⁰¹ Clause 46(5)(b).

¹⁰⁰² See paragraph 6.9.4 below.

¹⁰⁰³ See Blackman, Jooste & Everingham *Companies Act* 5-112; Jooste "Can Share Capital be Reduced" 296.

¹⁰⁰⁴ See Blackman, Jooste & Everingham *Companies Act* 5-14; 5-103; 5-112. See also Cassim "Reform of Company Law and Capital Maintenance" 285.

¹⁰⁰⁵ See Chapter 1 paragraph 2 for an explanation of the application of the capital maintenance principle in relation to the net assets of a company.

¹⁰⁰⁶ See Cilliers & Benade *Corporate Law* 344 – 351 and Blackman, Jooste & Everingham

accounts¹⁰⁰⁷ and can thus, despite the more modern financial restrictions, still be regarded as a reduction of capital that does not actually violate the concept of capital maintenance.¹⁰⁰⁸

A positive feature of section 90 is the use of the same financial restrictions that apply in the case of share repurchases. The financial restrictions of solvency and liquidity imposed by section 90(2) applies to all payments to shareholders, even when such payments are made in terms of company articles that allow dividends out of profits only, and ensure a uniform approach.¹⁰⁰⁹

Section 90 is problematic in that its regulation of payments differs in material respects from the regulation of payments in respect of share acquisitions. I have already referred to the uncertainty regarding the status of claims in respect of authorised but unpaid 'payments'.¹⁰¹⁰ The lack of an express director liability provision has also been criticised.¹⁰¹¹ These anomalies can be attributed to the fragmentation in the regulation of different distributions.

A further problem in section 90 relates to the adjustment of common-law principles on dividends and existing dividend provisions in articles of companies to encompass the wider range of payments that have become possible.¹⁰¹² Unless payments are regarded as dividends, preference shareholders in particular are in a difficult position.

While the rights of preference shareholders are protected by the financial restrictions under the MBCA (the adjusted net worth test)¹⁰¹³ and in New Zealand,¹⁰¹⁴ the South African legislation does not provide any protection for the rights or interests of preference shareholders. This problem is aggravated by the fact that, for obvious reasons, the common law does not regulate payments

Continued

Companies Act 5-107 on the previous position.

¹⁰⁰⁷ See paragraph 6.3.3 below.

¹⁰⁰⁸ Jooste "Can Share Capital be Reduced" 294. See, however, Cilliers & Benade *Corporate Law* 344 who state that the principle of capital maintenance was abolished by section 85 to 89 of the Act.

¹⁰⁰⁹ See paragraph 5.2 above.

¹⁰¹⁰ See paragraph 5.4 above.

¹⁰¹¹ See paragraph 5.6 above.

¹⁰¹² See paragraph 5.1.2 above.

¹⁰¹³ See Chapter 4 paragraph 4.4.2.

¹⁰¹⁴ See Chapter 3 paragraph 4.2.

otherwise than out of profits.¹⁰¹⁵ South Africa should give consideration to regulating the position of preference shareholders when distributions are made, whether in the form of share acquisitions or of payments. It is a pity that the model articles in Schedule 1 of the Act have not been amended to reflect the new distribution rules. It may take time for companies to adjust their articles so that these problematic aspects are addressed.

In New Zealand the term 'dividend' has been extended to include any distribution which is not a share repurchase or the provision of financial assistance.¹⁰¹⁶ It is further expressly provided that dividends have to be proportionate to the shareholding of members of a specific class or to the consideration paid. It appears that South Africa could also benefit by the introduction of a statutory definition of a dividend which is wider than the traditional common-law concept. This will make it clear that the principle of equality or proportionality applies, and may also solve the problem of interpreting the articles of companies that were drafted under the previous rules.

Cassim criticises the fact that a special resolution is not required for section 90 payments.¹⁰¹⁷ However, companies can impose restrictions on the directors, and it is quite common for articles to provide that dividends must be recommended by directors and approved by the shareholders by ordinary majority.¹⁰¹⁸ Directors usually also have the discretion to pay interim dividends without approval of the general meeting.¹⁰¹⁹ On the assumption that payments under section 90 have to comply with the principle of proportionality, I submit that it is an unnecessary impairment of flexibility to subject any payment by reason of shareholding to approval by special resolution.¹⁰²⁰

On the other hand, the shareholders will face liability in respect of unlawful payments and clearly have an interest in controlling unusual payments under section 90. The solution in the *JSE Limited Listings Requirements* may offer a

¹⁰¹⁵ It does regulate reductions of share capital, see paragraph 2.6 above. However, payments under s 90 are not reductions of share capital.

¹⁰¹⁶ See s 53(1) of the New Zealand Companies Act 1993, discussed in Chapter 3 paragraph 5.

¹⁰¹⁷ Cassim "Reform of Company Law and Capital Maintenance" 286.

¹⁰¹⁸ See Table A article 84 and Table B article 83.

¹⁰¹⁹ See Table A article 85 and Table B article 84.

¹⁰²⁰ Cassim "Reform of Company Law and Capital Maintenance" 287 concedes that a distribution under section 90 'cannot fairly be compared with a share buy-back'.

suitable compromise. Cash dividends paid out of retained income, as well as scrip dividends and capitalisation issues, need not be approved by shareholders. However, shareholder approval is required for all other 'payments', which include any payment out of capital funds and any non-cash distribution.¹⁰²¹ Approval can either be a specific approval of a particular payment or a general approval, but a general approval cannot be used in respect of payment exceeding 20 per cent of the company's share capital plus reserves.¹⁰²²

Under the Companies Bill all distributions will be subject to a uniform set of rules, although additional requirements will apply to share repurchases.¹⁰²³ For this reason, I evaluate the distribution rules of the Companies Bill elsewhere.¹⁰²⁴ It is sufficient to emphasise here that the coherent regulation of distributions in the Companies Bill will eliminate many of the problems associated with section 90 of the Act. A particular advantage of the Companies Bill is that it requires the memorandum to set out the rights and preferences of each class of shares in respect of distributions in general rather than in respect of dividends only.¹⁰²⁵ This will avoid the uncertainties that presently exist about 'payments' where articles regulate the payment of 'dividends' only.¹⁰²⁶

6 SHARE REPURCHASES

6.1 Power to acquire shares

Section 85(1) states that a company may, by special resolution and if authorised thereto by its articles, approve 'the acquisition of shares issued by the company'. The words 'by the company' belong to 'shares issued' and not to 'acquisition', as is clear from the Afrikaans text 'wat deur die maatskappy uitgereik is'. Despite this wide formulation it is clear that section 85(1) relates to the acquisition 'by a company' of its own shares.¹⁰²⁷ This intention appears from a reading of the

¹⁰²¹ *JSE Limited Listings Requirements* par 5.85. It seems that an ordinary resolution will suffice.

¹⁰²² *JSE Limited Listings Requirements* par 5.86.

¹⁰²³ See paragraph 4.3 above.

¹⁰²⁴ See paragraph 4.4 above.

¹⁰²⁵ See clauses 36(1)(b)(ii), 37(2)(b) and 37(4) and paragraphs 2.8.1 and 4.3 above.

¹⁰²⁶ See paragraph 5.1.2 above.

¹⁰²⁷ Blackman, Jooste & Everingham *Companies Act* 5-40.

provisions as a whole. It is also evident from the headings to Chapter V and to section 85 which speak of the acquisition by the company. It was clearly not intended to subject to approval by special resolution every acquisition of a company's shares by whomever, as this would make share transfers unworkable and bring share markets to a halt.

The power to approve the acquisition of own shares is given subject to the section 'and any other applicable law'.¹⁰²⁸ It is not clear which particular applicable legal principles the legislature had in mind. The Securities Services Act¹⁰²⁹ and the Securities Regulation Code on Takeovers and Mergers¹⁰³⁰ contain provisions that could apply to the acquisition of own shares.¹⁰³¹ The reference would also include common-law principles of company law embodying directors' duties and providing for the fair treatment of shareholders.¹⁰³² An interesting question is whether this qualification could also refer to other provisions of the Act in terms of which shares can be acquired, namely section 98 which provides for the redemption of shares and section 252 which provides that the court may order a company to purchase its shares. If this is the case, another question that arises is whether the qualification has the effect of excluding these acquisitions from section 85 or of imposing its requirements in addition to those that already apply to the particular acquisition. The relationship between section 85 and these acquisitions is considered in more detail in the following paragraph.

6.1.1 Meaning of acquisition

Although the concept of an 'acquisition' of own shares is used, the company does not actually acquire its shares, since they have to be cancelled as issued shares

¹⁰²⁸ Section 85(1).

¹⁰²⁹ Act 36 of 2004.

¹⁰³⁰ GNR 29 of 1991, as amended.

¹⁰³¹ Section 75 of the Securities Services Act, for example, prohibits a company from acquiring its own shares in order to manipulate the market for its shares. Rule 7.1 of the Securities Regulation Code on Take-overs and Mergers requires disclosure of certain dealings during an offer period, including dealings by the offeree company. Rule 19 has not been amended to include an acquisition by an offeree company of its own securities as an instance of prohibited frustrating action. Such an acquisition would, however, conflict with general principle 7 and would thus be against the spirit of the Code. Rule 29(a)(ii) refers to an offer being implemented through a reduction of capital and could thus also apply when a company acquires its own shares, see paragraph 2.6.3.2 above.

¹⁰³² See paragraph 2.6.3.2 above.

'upon acquisition'.¹⁰³³ At most, the company in effect acquires authorised but unissued shares which are not property in its hands.¹⁰³⁴

The term acquisition is not defined for purposes of section 85.¹⁰³⁵ It is not very clear which transactions should be regarded as 'acquisitions' for purposes of section 85(1). The impact of the reference to 'issued' shares is also relevant in this regard. In particular, it must be considered whether the term acquisition covers only a transfer of previously issued shares, or whether the issue and allotment of shares following a subscription would also qualify as an acquisition of issued shares by the subscriber. Since it would be pointless for a company to issue and allot shares to itself unless they could be held in treasury, this question is only relevant in relation to subsidiaries and will accordingly be considered elsewhere.¹⁰³⁶

The plain words of section 85(1) seem to include any kind of acquisition of issued shares, although the financial restrictions in section 85(4) apply only when a payment has to be made by the company. The common law prohibited both the purchase of own shares and the holding by a company of its own shares in order to protect share capital and to avoid the abuse of a company trafficking in its own shares.¹⁰³⁷ The prohibition against the acquisition of own shares was inferred from the existence of formal reduction of capital provisions.¹⁰³⁸ The prohibition did not extend to acquisitions which did not reduce the company's share capital. Under the common law companies could thus acquire their own shares in other ways than repurchase, for example by donation, and these shares could be held on behalf of the company by a trustee.¹⁰³⁹ The effect of section 85 on these instances

¹⁰³³ Blackman, Jooste & Everingham *Companies Act* 5-63. See paragraph 6.6 below for a discussion of the status of repurchased shares.

¹⁰³⁴ See Price "Acquisition of Own Shares" 61 regarding some practical consequences of the fact that no property is transferred to the company. Although Price deals with the position in England, similar considerations apply in South Africa.

¹⁰³⁵ It is, however, defined in s 440A, for purposes of Chapter XVA, as 'including purchase or subscription'.

¹⁰³⁶ See paragraph 6.7 below.

¹⁰³⁷ *Trevor v Whitworth* (1887) 12 App Cas 409 (HL); *Wolfe v Liquidators Smyth and Crawford* 1914 CPD 187; *Sage Holdings Ltd v The Unisec Group Ltd & Others* 1982 (1) SA 337 (W) at 347 – 349; *The Unisec Group Ltd & Others v Sage Holdings Ltd* 1986 (3) SA 259 (T) at 264 – 265.

¹⁰³⁸ See *Trevor v Whitworth* (1887) 12 App Cas 409 (HL) at 415 – 416, 423, 438.

¹⁰³⁹ *Re Castiglione's Will Trust* [1958] Ch 549; [1958] All ER 480. This judgment is criticised by Gower "Companies Owning Their Own Shares" 314, because the company will in effect

of acquisitions is not clear. It could be argued that authorisation in the articles and a special resolution will now be required for all acquisitions. If this position is accepted, it is submitted that the status of shares previously so acquired will not be affected so that they may continue to be held on behalf of the company by a trustee.

However, the authors of Blackman, Jooste & Everingham *Companies Act* argue¹⁰⁴⁰ that a donation of shares to the company 'presumably' does not constitute an 'acquisition' by it of its own shares. No reason is given, but reference is made to the Canadian position where, unlike South Africa, the legislation expressly allows a company to accept shares surrendered to it as a gift and where such shares are not required to be cancelled.¹⁰⁴¹ The conclusion of these authors can be supported, and it is submitted that justification can be found in interpreting the new provisions against the background of the common-law prohibition. The requirements of section 85 should thus apply only to acquisitions which were not previously allowed. This is in line with the presumption that a statute amends the existing law only to the extent that is necessary.¹⁰⁴²

It is not clear whether these implications were considered by the legislature. It is recommended that this uncertainty should be cleared up by expressly providing for acquisitions otherwise than for value.

The redemption of shares can also be regarded as an acquisition. Unlike section 90(3) which expressly excludes a payment in redemption of shares from the definition of 'payment' for purposes of section 90, section 85 does not expressly exclude the redemption of shares from the meaning of 'acquisition'. It is submitted that the authors of Blackman, Jooste & Everingham *Companies Act* are correct in their conclusion that section 85 does not apply to redemptions because they are comprehensively provided for in a separate provision, namely section 98.¹⁰⁴³

Continued

acquire voting rights in respect of these shares.

¹⁰⁴⁰ Blackman, Jooste & Everingham *Companies Act* 5-63.

¹⁰⁴¹ See s 37 of the Canada Business Corporations Act 1985.

¹⁰⁴² See Du Plessis "Statute Law" paragraph 328.

¹⁰⁴³ Blackman, Jooste & Everingham *Companies Act* 5-63. See paragraph 6.8 below regarding redemptions.

6.2 Financial restrictions for repurchases

The financial restrictions for share repurchases consist of a liquidity element, set out section 85(4)(a), and a solvency element, contained in section 85(4)(b). Both have to be satisfied.

The introductory sentence of section 85(4) provides that a company may not make any payment 'in whatever form' to acquire any share issued by it if there are reasonable grounds for believing that the circumstances in either of the two subparagraphs are present.

'Payment' is not defined in section 85(4) and it is not clear what the phrase 'in whatever form' contributes to its meaning. Payment is, however, defined in section 90(3), for purposes of that section, as including any direct or indirect payment or transfer of money or property to a shareholder.¹⁰⁴⁴ Certain payments are expressly excluded by section 90(3), including payments for shares acquired under section 85. Presumably section 85(4) envisages any counter-value, whether in money or in kind, given in consideration of the acquisition of shares.

The financial restrictions are discussed elsewhere.¹⁰⁴⁵

6.2.1 *The timing for the application of the financial restrictions*

The relevant time for enquiring into the solvency and liquidity of the company is when it is about to make any payment for the acquisition of its shares. However, it is the financial position immediately after the payment has been made that must be determined. This aspect is discussed elsewhere.¹⁰⁴⁶ As a result of the fact that the test must be satisfied at the time of payment rather than the time of authorisation, shares may be acquired by the company on credit.

6.3 Procedure and other requirements

One of the central concerns regarding share repurchases is the risk of unfair treatment of shareholders, particularly when selective repurchases are made.¹⁰⁴⁷ For this reason, it is important to consider aspects such as the authorisation for

¹⁰⁴⁴ See paragraph 5.1 above.

¹⁰⁴⁵ See paragraph 4.1 above.

¹⁰⁴⁶ See paragraph 4.2 above.

¹⁰⁴⁷ See, for example, Cassim "New Statutory Provisions" 774; Cassim "Reform of Company Law and Capital Maintenance" 287;

repurchases and the procedural requirements. Further, because a reduction of capital is involved, the rules regarding adjustment of share capital accounts also merit attention.

The acquisition of a company's own shares can be unfair towards either the vendor-shareholder or the non-selling shareholders.¹⁰⁴⁸ Since approval is by special resolution, the agreement of the vendor shareholder is not required unless she holds sufficient shares to block a special resolution.¹⁰⁴⁹ It can be argued that even in the case of a voluntary sale to the company, shareholders do not have a free choice. If no offer is made to a shareholder, she has to remain a shareholder or find a purchaser other than the company. If an offer is made, the shareholder can likewise not choose to maintain the *status quo* - she has to either sell in order to preserve her relative stake, or refuse to sell and thus accept an increase in her ownership participation.¹⁰⁵⁰

The company has a duty not to discriminate unfairly between shareholders; otherwise it would constitute a fraud on the minority.¹⁰⁵¹ Such a fraud could be perpetrated not only in the case of targeted or selective repurchases but also in general offers if the controllers who approve the offer have no intention of selling their own shares.¹⁰⁵²

Over the years the courts developed a certain hierarchy for reductions of capital. In the case of a reduction based on the loss of capital, the shares of the lowest ranking shareholders were cancelled. When the purpose of a reduction was to distribute excess capital, the classes ranking first in respect of liquidation distributions, were cancelled first.¹⁰⁵³ The share repurchase provisions contain no similar hierarchy. In view of the uncertainty of the application of the common-law principles to share repurchases, it is important to provide sufficient statutory protection for shareholders when a company embarks on a repurchase of its shares.

¹⁰⁴⁸ See Chapter 1 paragraph 1.

¹⁰⁴⁹ Blackman, Jooste & Everingham *Companies Act* 5-44 create the incorrect impression that all share repurchases are based on consensus between the selling shareholder and the company.

¹⁰⁵⁰ See Blackman, Jooste & Everingham *Companies Act* 5-47.

¹⁰⁵¹ See Blackman, Jooste & Everingham *Companies Act* 5-78.

¹⁰⁵² Blackman, Jooste & Everingham *Companies Act* 5-78.

¹⁰⁵³ See paragraph 2.6.1 above.

It is for this reason that section 87(1)(a) and section 87(4) lay down rules regarding the fair treatment of shareholders. The offer that has to be made to all shareholders in terms of section 87(1)(a), is discussed below.¹⁰⁵⁴ Section 87(4) compels the company, when acquiring shares in response to an offer to all shareholders, to acquire shares as far as possible on a *pro rata* basis. It is suggested that the company has to acquire the shares in proportion to the number of shares offered by each shareholder and not to their total shareholding in the company.¹⁰⁵⁵ However, as will be shown below, compliance with this procedure can be avoided with relative ease.

6.3.1 Authorisations

One of the primary shareholder protection mechanisms can be found in the authorisation requirements for share repurchases.¹⁰⁵⁶ In *Capitex Bank Ltd v Qorus Holdings Ltd & Others* the court described authorisation in the articles and approval by special resolution as 'internal requirements'.¹⁰⁵⁷ Since the articles and any special resolution are clearly public documents of the company, the court's remark must be understood as a reference to the internal relations in the company.

6.3.1.1 Articles of association

Before a company may approve the acquisition of its shares under section 85, its articles of association must authorise it to do so.¹⁰⁵⁸ The model articles have not been amended since the introduction of the new distribution provisions. Article 31(g) of Table A and article 30(g) of Table B provide that a company may reduce its share capital in any manner. As is explained above,¹⁰⁵⁹ the reduction of capital provisions have been deleted and companies can now reduce their share capital through repurchases or other acquisitions. It could be argued that these articles authorise companies to reduce their share capital by way of a share repurchase.

¹⁰⁵⁴ See paragraph 6.3.2.1 below.

¹⁰⁵⁵ See also Blackman, Jooste & Everingham *Companies Act 5-92-1*.

¹⁰⁵⁶ See Cilliers & Benade *Corporate Law 325*.

¹⁰⁵⁷ See *Capitex Bank Ltd v Qorus Holdings Ltd & Others* 2003 (3) SA 302 (W); 2003 CLR 1 (W) at 7.

¹⁰⁵⁸ Section 85(1). The articles can be amended to include such authorisation, see s 62.

However, a contrary argument is that section 85(1) requires authority for the company to 'acquire' its shares¹⁰⁶⁰ and this is clearly not envisaged by the model articles. The authors of Blackman, Jooste & Everingham *Companies Act* are of the view that these articles do not confer the required authority on companies.¹⁰⁶¹

It is submitted that this question should be answered bearing in mind the contractual nature of the articles of association.¹⁰⁶² For this reason, such a radical reinterpretation of existing articles would be unwarranted. However, different considerations apply in respect of companies that have adopted these articles subsequent to the 1999 amendments. The article empowering the company to reduce its capital would, in view of the repeal of the reduction of capital procedure, be an unnecessary provision with no force or effect, unless it was intended to cater for repurchases, the only kind of reduction possible at the time of adoption of the articles. Bearing in mind that the parties must have intended that article to have some effect, the inference can be drawn that they had in mind the reduction of capital by an acquisition of shares.

The authors of Blackman, Jooste & Everingham *Companies Act* suggest that the directors would also have to be authorised in the articles to execute a share repurchase because it would not normally form part of managing the company.¹⁰⁶³ They suggest that an express and separate power should be contained in the articles (subject to prior approval). However, although it may sometimes be difficult to assess which actions constitute management of a company¹⁰⁶⁴ it is submitted that it is unnecessary to provide for such a power. The directors will, after all, be acting in the execution of a special resolution authorising an acquisition of own shares. Executing resolutions should always be considered part of conducting a company's business.

Continued

¹⁰⁵⁹ See paragraph 2.6 above.

¹⁰⁶⁰ Although, as has been explained in paragraph 6.1 above, the company does not actually acquire its shares.

¹⁰⁶¹ Blackman, Jooste & Everingham *Companies Act* 5-14.

¹⁰⁶² In terms of s 65(2).

¹⁰⁶³ Blackman, Jooste & Everingham *Companies Act* 5-62.

¹⁰⁶⁴ See *Ex parte Russlyn Construction (Pty) Ltd* 1987 (1) SA 33 (D); *Ex parte Screen Media Ltd* 1991 (3) SA 462 (W); *Ex parte Tangent Sheeting (Pty) Ltd* 1993 (3) SA 488 (W); *Ex parte Graaf-Reinet Rollermeule (Edms) Bpk* 2000 (4) SA 670 (E) which deal with the question of whether applying for winding-up is part of managing a company. See also Larkin "A Question of Management"; McLennan "Powers of Directors"; Havenga "Directors May Not".

6.3.1.2 *Special resolution*

The acquisition of the company's shares must be approved by special resolution.¹⁰⁶⁵ This measure is an important part of the protection of shareholders.¹⁰⁶⁶ A special resolution is also a requirement for certain share repurchases in England,¹⁰⁶⁷ but not in Delaware, California or under the MBCA.¹⁰⁶⁸ In New Zealand a unanimous resolution is required for direct selective offers, unless the company's constitution expressly allows non-*pro rata* offers.¹⁰⁶⁹

Section 85 does not impose any voting restrictions on shareholders, and as a result there is considerable scope for abuse by controlling shareholders.¹⁰⁷⁰ They could, for example, vote for the acquisition of their own shares at an excessive price. Further, since the Act gives no indication that coercive acquisitions are prohibited¹⁰⁷¹ it appears that the controlling shareholders can even vote to acquire shares from non-consenting minority shareholders.

In relation to non-voting preference shares the authors of Blackman, Jooste & Everingham *Companies Act* argue that the resolution authorising the repurchase of preference shares is not a resolution affecting their rights or interests and that they will thus not be able to vote.¹⁰⁷² Their argument is based on the fact that the resolution authorising the repurchase will result in an offer being made to preference shareholders, which they are not obliged to accept. Their rights and interests will only be affected once shareholders accept the offer and their shares are acquired and cancelled, but then the resolution has already been adopted. It is submitted that a resolution for the purchase of preference shares may indeed be regarded as a resolution which, even though it will result in an offer only, directly

¹⁰⁶⁵ Section 85(1).

¹⁰⁶⁶ See Cilliers & Benade *Corporate Law* 325 where it is described it as the 'initial' protection for shareholders, while Blackman, Jooste & Everingham *Companies Act* 6-54 call it the 'fundamental' protection.

¹⁰⁶⁷ See Chapter 2 paragraph 5.3.1.1 (off-market repurchases) and paragraph 5.3.1.4 (repurchases out of capital). An ordinary resolution suffices for market purchases, see paragraph 5.3.1.3.

¹⁰⁶⁸ See Chapter 4 paragraph 2.6.3 (Delaware), paragraph 3.6.3 (California) and paragraph 4.6.3 (MBCA).

¹⁰⁶⁹ See Chapter 4 paragraph 6.3.2.

¹⁰⁷⁰ For an interesting analysis of theoretical differences between general shareholder approval and approval by disinterested shareholders, see Hill "Changes in the Role of the Shareholder" 201.

¹⁰⁷¹ Unless the *pro rata* offer procedure of s 87(1) and (4) is followed.

¹⁰⁷² Blackman, Jooste & Everingham *Companies Act* 5-65.

affects at least the 'interests' of the preference shareholders.¹⁰⁷³

While it is true that the redemption of redeemable preference shares is not regarded as a variation or abrogation of class rights,¹⁰⁷⁴ there is an important difference between the redemption of shares which were issued on the understanding that they may be redeemed and the repurchase of shares otherwise than in accordance with their terms of issue. In view of the express reference in section 194 to resolutions for the reduction of share capital, it is submitted that preference shareholders will be entitled to vote in respect of any acquisition of own shares, as this would amount to a reduction of capital.¹⁰⁷⁵

A resolution to repurchase ordinary shares will affect the rights or interests of preference shareholders regarding dividends and return of capital unless provision is made for these preferent rights.¹⁰⁷⁶

Section 85 does not provide for a time period within which a special resolution for the repurchase of shares has to be executed. It thus seems possible to authorise a repurchase far in advance of the actual acquisition. In England and in New Zealand repurchases have to be made within specified time periods.¹⁰⁷⁷ The greater flexibility of the South African provisions can be attributed to the fact that the financial restrictions apply at the time of payment and no formal declaration or disclosure of the company's financial position is required. I submit that the South African approach is preferable. However, it seems desirable to regulate the possibility that directors may during the currency of a general approval agree to a future repurchase which will only be executed after the general approval has lapsed.

A specific issue that arises in relation to the prior authorisation of repurchases is whether it is possible to create ordinary redeemable shares by approving in advance the repurchase of shares on terms providing for it taking effect in future either at the option of the company or the seller. The authors of

¹⁰⁷³ See the wide interpretation of 'interests' in *Utopia Vakansie-oorde Bpk v Du Plessis* 1974 (3) SA 148 (A) at 178.

¹⁰⁷⁴ See *Re Saltdean Estate Co Ltd* [1968] 3 All ER 829 (Ch); *Re William Jones & Sons Ltd* [1969] 1 All ER 913 (Ch).

¹⁰⁷⁵ See also paragraph 2.6 above on the reduction of capital.

¹⁰⁷⁶ Blackman, Jooste & Everingham *Companies Act* 5-65.

¹⁰⁷⁷ See Chapter 2 paragraph 6.3.3.5 on the position in England (applicable to repurchases out of capital only) and, in respect of New Zealand, Chapter 3 paragraph 6.3.2 (selective offers) and paragraph 6.3.3 (stock exchange acquisitions subject to prior notice).

Blackman, Jooste & Everingham *Companies Act* say that it is possible.¹⁰⁷⁸ Cassim, on the other hand, does not consider this possibility, but nevertheless argues that the legislature should allow ordinary redeemable shares.¹⁰⁷⁹

I must point out, however, that ordinary redeemable shares will have to be issued as unredeemable shares first, before the shareholders will be able to approve the repurchase that will take place in the future. This is because a company may only obtain approval to acquire its 'issued' shares.¹⁰⁸⁰

6.3.1.3 General and specific approvals.

An approval can be either a general approval or a specific approval for a particular acquisition.¹⁰⁸¹ The Act does not explain the meaning of these terms, but the phrase 'for a particular transaction' clearly qualifies the meaning of specific approval.¹⁰⁸² A general approval remains valid until the next annual general meeting of the company, unless it is revoked earlier by special resolution.¹⁰⁸³ This makes a general approval suitable for conferring a discretion on directors to repurchase shares when they regard it as appropriate.¹⁰⁸⁴ However, as a result of the legislature's failure to correctly identify the circumstances when a *pro rata* offer should be required, the position is now that a general approval must be followed by a *pro rata* offer. This obviously removes the whole point of an approval that remains valid for a year, unless the intention was simply that the board could obtain an authorisation to implement a *pro rata* offer within the ensuing year.

When sections 85 and 87 are read together it appears that the importance of classifying an approval as either specific or general is that the procedural requirements pertaining to the offering circular depend on the type of approval.¹⁰⁸⁵ While it may have been expected that the formalities would depend on the kind of repurchase involved, that is, a selective repurchase or an offer to all shareholders, this is not the case. The procedure is determined by the kind of approval and

¹⁰⁷⁸ Blackman, Jooste & Everingham *Companies Act* 5-66.

¹⁰⁷⁹ See Cassim "New Statutory Provisions" 763.

¹⁰⁸⁰ See s 85(1).

¹⁰⁸¹ Section 85(2).

¹⁰⁸² See Blackman, Jooste & Everingham *Companies Act* 5-68.

¹⁰⁸³ Section 85(3).

¹⁰⁸⁴ Blackman, Jooste & Everingham *Companies Act* 5-91.

¹⁰⁸⁵ See s 87(2)(a), discussed in paragraph 6.3.2.1 below.

although the legislature may have attempted to introduce a correlation between the kind of approval and the kind of offer, it did not succeed in doing so.

As a result, the procedure can be manipulated by signifying an approval as either specific or general.¹⁰⁸⁶ Since an offering circular and *pro rata* acquisition are prescribed in the case of a general approval only, it should have been stated that only general approvals should be allowed in the case of a *pro rata* acquisition - a conclusion which seems to negate the essential nature of a general approval. Unfortunately, a company inviting offers from all its shareholders could easily avoid proper disclosure and the equal treatment of shareholders prescribed by section 87 by using a specific approval rather than a general approval. The advantage of a general approval in enabling directors to make incidental acquisitions is also removed by this curious approach of requiring a circular and *pro rata* acquisition for all general approvals. I recommend that the procedure, including the type of authorisation required, should be prescribed with reference to the nature of the acquisition, determined with regard to its likely effect on shareholders.¹⁰⁸⁷

6.3.2 Other formalities

In terms of section 85(9) a company may not acquire its own shares if 'as a result of such acquisition there would no longer be any shares in issue other than convertible or redeemable shares'. A company can thus not use a repurchase as a way of informal winding-up of its affairs.¹⁰⁸⁸

A company that has acquired its own shares must inform the Registrar of the acquisition within thirty days of such acquisition.¹⁰⁸⁹

6.3.2.1 Procedure for unlisted shares

Section 87 prescribes the procedure for the acquisition by a company of its own shares. This procedure applies unless the shares are acquired in terms of a

¹⁰⁸⁶ This issue is discussed in more detail in Van der Linde "Share Repurchases" 27 – 28 and in Blackman, Jooste & Everingham *Companies Act* 5-91.

¹⁰⁸⁷ See paragraph 6.10.3 below.

¹⁰⁸⁸ It is curious that the conversion provisions of s 75 do not contain a similar limitation. It would seem possible for a company to convert all its shares into redeemable or convertible shares.

¹⁰⁸⁹ Section 87(5).

specific approval¹⁰⁹⁰ or through a registered stock exchange within South Africa.¹⁰⁹¹ In short, the procedure must be followed when the company has authorised the acquisition by way of a general approval. The company has to comply with the following formalities:

The company has to send a written offering circular to each registered shareholder and offer to acquire shares from the shareholder.¹⁰⁹² This circular has to contain certain prescribed details about the offer by the company. A copy of the circular also has to be lodged with the Registrar.¹⁰⁹³ The liability for untruths in such a circular is similar to that in respect of untruths in a prospectus.¹⁰⁹⁴

If the company's offer to acquire shares is taken up in respect of a greater number of shares than the company intends acquiring, it has to acquire the shares *pro rata* from all the shareholders who offered to sell their shares. This requirement is aimed at the fair and equal treatment of shareholders. It is uncertain whether the offer must be taken up *pro rata* to the total shareholding of each shareholder offering to sell her shares or, if she does not offer all her shares, with reference only to the number of shares offered by her. It is suggested that the calculation should relate to the number of additional shares offered by an each shareholder in addition to the portion the company intended acquiring from each shareholder.¹⁰⁹⁵ If one determines the number with reference to the total shareholding, the absurd situation may arise that the company has to take up the offer in respect of more shares than the shareholder is willing to sell.

The company has to notify the Registrar within 30 days of the completion of the acquisition of the date, number and class of shares it acquired.¹⁰⁹⁶ This requirement applies to all acquisitions, regardless of whether they are made under a general or specific approval.

¹⁰⁹⁰ Section 87(2)(a).

¹⁰⁹¹ Section 87(2)(b).

¹⁰⁹² Section 87(1)(a).

¹⁰⁹³ Section 87(1)(b).

¹⁰⁹⁴ Section 87(3).

¹⁰⁹⁵ See the New Zealand position, Chapter 3 paragraph 6.3.1.

¹⁰⁹⁶ Section 87(5).

6.3.2.2 Procedure for listed shares

If a company acquires its listed shares through transactions on the JSE Limited (market purchases), the company need not comply with section 87(1).¹⁰⁹⁷ The company will have to comply with any further requirements that may be set by the JSE Limited.¹⁰⁹⁸ In accordance with section 87(5) the company must inform the Registrar of an acquisition within 30 days.

The *Listings Requirements of the JSE Limited* sets out the procedure and requirements for the acquisition by a listed company of its own shares and by a subsidiary of shares in its holding company.¹⁰⁹⁹ The rules are aimed primarily at ensuring proper disclosure. They also set certain limits regarding the number of shares that may be acquired and the price that may be paid in respect of general repurchases.¹¹⁰⁰ Some of the rules expand on the requirements of section 85, such as the requirements of a statement by the directors pertaining to the solvency and liquidity of the company for the ensuing twelve months.¹¹⁰¹ There are also special disclosure requirements for the acquisition of shares from related parties.¹¹⁰²

In accordance with section 85(2) of the Companies Act, the JSE rules provide for both specific and general approvals.¹¹⁰³ However, it definitively couples the kind of approval with the kind of repurchase involved. A specific approval authorises, and approves the terms of, a particular repurchase, and is used for a 'specific repurchase'.¹¹⁰⁴ Two separate types of specific repurchase are distinguished, namely *pro rata* offers to all shareholders and specific offers from named shareholders.¹¹⁰⁵ A general approval is used for 'a general repurchase of

¹⁰⁹⁷ Section 87(2)(b).

¹⁰⁹⁸ Section 87(6).

¹⁰⁹⁹ *JSE Limited Listings Requirements* pars 5.67 – 5.84. Particulars with regard to disclosure are set out in paragraphs 11.23 to 11.27 and the timing of disclosure is prescribed in Schedule 24.

¹¹⁰⁰ *JSE Limited Listings Requirements* pars 5.68 and 5.72(d).

¹¹⁰¹ *JSE Limited Listings Requirements* par 5.69(c).

¹¹⁰² *JSE Limited Listings Requirements* par 5.69(e). The meaning of 'related parties' is described in pars 10.1 – 10.3.

¹¹⁰³ *JSE Limited Listings Requirements* par 5.67.

¹¹⁰⁴ *JSE Limited Listings Requirements* par 5.67(a).

¹¹⁰⁵ *JSE Limited Listings Requirements* par 5.69. The reference to an offer 'from' specific shareholders indicates that the shareholder must be offering to dispose of shares to the company and it thus appears that acquisitions must be consensual.

securities'.¹¹⁰⁶

Since the rules apply to the acquisition of listed shares, they apply also to the acquisition by a subsidiary of listed shares in its holding company. When a subsidiary undertakes to purchase shares in its listed holding company, the shareholders of the holding company also have to approve of the acquisition by special resolution.¹¹⁰⁷

A company must, after the repurchase of its shares, still comply with the shareholder spread requirements set out in the *JSE Limited Listings Requirements*, which dictates that a prescribed minimum percentage of the shares be held by the public.¹¹⁰⁸

A company or its subsidiary may not repurchase its securities within a 'prohibited period'.¹¹⁰⁹ Once a company has announced that it will repurchase its securities under a specific repurchase, it must pursue the proposal unless the JSE Limited permits it to abandon the proposal.¹¹¹⁰

If a company engages in a specific repurchase from a named shareholder, the shareholders must receive a circular which should contain sufficient information to enable them to decide how to vote. Apart from certain general information, prescribed information about the terms of the repurchase must be set out and a declaration by the directors of the financial situation and prospects of the company for the next 12 months must be included.¹¹¹¹ The shareholders participating in the repurchase, and their associates, may not vote.¹¹¹²

In the case of a *pro rata* offer the company must issue a circular that invites shareholders to tender their securities and states that they may tender more than their *pro rata* entitlement.¹¹¹³ Where additional shares are tendered, the acquisition

¹¹⁰⁶ *JSE Limited Listings Requirements* par 5.67(b).

¹¹⁰⁷ *JSE Limited Listings Requirements* par 5.76.

¹¹⁰⁸ *JSE Limited Listings Requirements* par 5.69(f). The shareholder spread requirements are set out in pars 3.37 – 3.41.

¹¹⁰⁹ *JSE Limited Listings Requirements* par 5.69(h). A 'prohibited period' is a closed period as defined in the definitions of the Listings Requirements, as well as any period during which unpublished price sensitive information exists in relation to the securities, see par 3.67.

¹¹¹⁰ *JSE Limited Listings Requirements* par 5.69(g).

¹¹¹¹ *JSE Limited Listings Requirements* par 11.25.

¹¹¹² *JSE Limited Listings Requirements* par 5.69(b).

¹¹¹³ *JSE Limited Listings Requirements* par 11.23(e).

must be made on an equitable basis.¹¹¹⁴ The particulars that must be contained in this circular are prescribed and a solvency and liquidity declaration by the directors must be included.¹¹¹⁵

A 'general repurchase of securities' gives a renewable mandate to the directors to purchase securities subject to the JSE Limited requirements and any further restrictions set out in the mandate. No more than 20 per cent of the shares of a class may be acquired in terms of a general repurchase in any one financial year.¹¹¹⁶ The acquisition must be implemented on the open market and must be done without any prior understanding or arrangement between the company and the counterparty.¹¹¹⁷ This rule guards against abuse of the general repurchase power to effect a specific repurchase.

The circular which must be sent to shareholders prior to the meeting at which the approval is sought must contain certain prescribed information including particulars of the way in which the board intends utilising the authority.¹¹¹⁸

The price may not be more than 10 per cent above the weighted average of the market value for the securities for the five business days immediately preceding the date on which the transaction was agreed.¹¹¹⁹ A company may at any given stage only appoint one agent to effect the repurchases on the market.¹¹²⁰ The shareholders must be informed after certain specified percentages of shares have been acquired.¹¹²¹ The announcement must contain particulars of the dates of purchases, number and value of shares acquired, highest and lowest prices paid, the extent of the authority remaining, the funds used, and the financial prospects of the company.¹¹²²

The *JSE Limited Listings Requirements* also provides expressly for 'odd lot' offers.¹¹²³ These are non-proportionate offers that are made to shareholders who

¹¹¹⁴ *JSE Limited Listings Requirements* par 11.23(e) read with par 5.33.

¹¹¹⁵ *JSE Limited Listings Requirements* pars 11.23 – 11.24.

¹¹¹⁶ *JSE Limited Listings Requirements* par 5.68.

¹¹¹⁷ *JSE Limited Listings Requirements* par 5.72(a).

¹¹¹⁸ *JSE Limited Listings Requirements* par 11.26(c).

¹¹¹⁹ *JSE Limited Listings Requirements* par 5.72(d). Should there not have been any trades in the preceding 5 day period, the JSE must be consulted for a ruling.

¹¹²⁰ *JSE Limited Listings Requirements* par 5.72(e).

¹¹²¹ *JSE Limited Listings Requirements* par 11.27.

¹¹²² *JSE Limited Listings Requirements* par 11.27.

¹¹²³ *JSE Limited Listings Requirements* pars 5.123 and 11.53.

hold less than 100 shares or, in cases where the company can illustrate that the cost associated with disposing of a specific greater number of shares is equal to or exceeds the total value of that number of shares, such higher number of shares.¹¹²⁴ The rules make it clear that the shareholder must always be given an election of either retaining or selling the odd-lot holding.¹¹²⁵ Expropriation as a default option in respect of shareholders who fail to make an election is allowed only if the articles provide for such expropriation and the specific odd-lot offer has been approved by the company in general meeting.¹¹²⁶

6.3.3 Adjustment of capital accounts

Section 85(5) and (6) regulate the adjustment of share capital accounts following an acquisition of own shares. Adjustment follows logically on the requirement that acquired shares have to be cancelled as issued shares and restored to the status of authorised but unissued shares.¹¹²⁷ Section 85(7) provides for payments out of reserve accounts, including 'statutory non-distributable reserves'.¹¹²⁸

It is interesting to note that the previous reduction of capital provisions did not prescribe the way in which the share capital accounts had to be adjusted, also not in the case where shares were cancelled.¹¹²⁹ Instructions pertaining to the adjustment of share capital accounts are also absent from the redemption provisions of section 98. Similarly section 252 is silent on the adjustment of accounts in instances when a company is ordered to purchase its own shares, although the court may order that the capital be reduced 'accordingly'.

In terms of section 85(6), where no par value shares are acquired, the stated capital account must be decreased by an amount derived by multiplying the number of acquired shares with 'the amount arrived at by dividing the stated capital contributed by issued shares of that class by the number of issued shares

¹¹²⁴ *JSE Limited Listings Requirements* par 5.123(a), (b).

¹¹²⁵ *JSE Limited Listings Requirements* par 5.124(a).

¹¹²⁶ *JSE Limited Listings Requirements* par 5.124(d).

¹¹²⁷ Section 85(8), see paragraph 6.6 below.

¹¹²⁸ Blackman, Jooste & Everingham *Companies Act 5-72* observe that as a result of s 90 there are no longer any reserves that cannot be distributed to shareholders. Nevertheless the term should be interpreted as a reference to share premium account and capital redemption reserve. See paragraphs 2.4.3 and 2.4.4 above for a discussion of these reserves.

¹¹²⁹ See ss 83 – 90 of the Act immediately prior to its amendment in 1999. Section 87(1) merely provided that the special resolution had to set out the existing share capital, particulars of the

of that class'. This latter amount is the average issue price of the shares. Reference is made to the 'stated capital contributed' and not to the amount standing to the credit of the stated capital account. Therefore, if stated capital has been applied, for example to provide for preliminary expenses or commissions,¹¹³⁰ and the repurchase involves all or most of the class of shares, it could happen that the stated capital account will not be sufficient to write off the prescribed amount in respect of the shares acquired. Presumably an apportionment would have to be made.

Section 85(5) regulates the adjustment of a company's issued share capital account where par value shares are acquired by the company. The issued capital has to be decreased by an amount equal to the nominal value of the acquired shares.¹¹³¹

6.3.4 Premiums on acquisition

If par value shares are acquired at a premium, the premium may be paid out of reserves, including the share premium account and the capital redemption reserve fund.¹¹³² It must be noted that this last provision is merely enabling and that the company need not write off the premium against reserves.

The fact that the share premium account and capital redemption reserve account may be used to provide for a premium in respect of par value shares only, is criticised by the authors of Blackman, Jooste & Everingham *Companies Act*.¹¹³³ The authors argue that, as the holders of par value shares¹¹³⁴ have no preferred interest in these reserves, it should also be possible to use these reserves, especially the capital redemption reserve fund, when no par value shares are acquired at a premium.¹¹³⁵ Since a premium can by definition only be paid when there is a nominal or par value,¹¹³⁶ it appears that what they may have in mind is a repurchase at a price which exceeds the average issue price of the no par value

Continued

proposed reduction, and the resultant state of the share capital of the company.

¹¹³⁰ See paragraph 2.4.2 above.

¹¹³¹ Section 85(5).

¹¹³² Section 85(7).

¹¹³³ Blackman, Jooste & Everingham *Companies Act* 5-72.

¹¹³⁴ They actually say 'ordinary' shares, but probably mean par value shares.

¹¹³⁵ Blackman, Jooste & Everingham *Companies Act* 5-72, especially note 2.

¹¹³⁶ As is clearly articulated by the phrase 'premium above the par value' in s 85(7).

shares.

Although it is true that the holders of par value shares have no preferent right to the share premium account,¹¹³⁷ the Act does seem to envisage some or other link between the par value shares in respect of which a premium was contributed and the share premium account in respect of that class.¹¹³⁸ This is apparent from the second proviso to section 76(3)(c) which regulates the application of the share premium account to provide for a premium on the redemption of shares that have been converted into redeemable preference shares.¹¹³⁹ In line with this provision, one would have expected that a premium upon repurchase should only have been allowed out of the premium initially contributed by such shares. Just as in the case of shares later converted into redeemable shares, shares repurchased did not necessarily contribute to the share premium account. From the point of view of shareholders, a decision to repurchase shares at a premium has an impact similar to a decision to convert shares into redeemable shares and to redeem them at a premium. It is submitted that there is no good reason for this distinction between repurchases and redemptions. Perhaps the intention was to allow only the premium contributed by the shares repurchased to be cancelled out again. But this is clearly not in accordance with the wording which expressly refers only to shares being 'acquired' at a premium over the par value.¹¹⁴⁰

While a case can be made out for restricting the application of the share premium account to provide for premiums on the repurchase of par value shares, since a share premium account is necessarily contributed by par value shares, the same cannot be said about the capital redemption reserve fund. A capital redemption reserve fund can arise from the redemption of par value or no par value shares. If there should indeed be some correlation between the type of shares contributing non-distributable reserves and the subsequent application of those reserves, it is difficult to see a distinction between a repurchase at a premium of shares issued at par and a repurchase above the average issue price of no par value shares. In both instances the company is returning more than it

¹¹³⁷ Unless the articles provide otherwise, see paragraph 2.4.3.4.3 above.

¹¹³⁸ Alternatively, the shares should have been issued with the right to receive that premium, see paragraph 2.4.3.3.2 above.

¹¹³⁹ This is discussed in more detail in paragraph 6.8.3 below.

¹¹⁴⁰ Section 85(7).

received for the shares and more than what is reflected as share capital (including non-distributable reserves) in respect of those shares. In one instance it is allowed to reduce its reserves, but not in the other instance. There is no reasonable justification for this divergence.

A second anomaly is that the capital redemption reserve cannot be used to provide for a premium upon the redemption of shares. Since the effect of repurchase and redemption is similar, one would have expected that it would also have been allowed to use the capital redemption reserve to provide for a premium payable upon redemption. The share premium account may be used in both instances, albeit subject to the two provisos in the case of redemption at a premium.

The application of the adjustment provisions to repurchases by subsidiaries in terms of section 89, is considered elsewhere.¹¹⁴¹ However, it makes sense to consider the application of section 85(7) to such repurchases here. In particular the question arises whether a subsidiary can use its share premium account and capital redemption reserve to pay a premium on the acquisition of par value shares in its holding company. It may be argued that since section 85(7) is not concerned with the adjustment of a share premium initially contributed in respect of repurchased shares, a subsidiary should also be able to reduce its share premium account and capital redemption reserve through paying a premium on the shares of its holding company. This would be unusual, especially since the subsidiary can apparently not adjust its issued share capital and stated capital accounts by the par value or average issue price of the shares it acquires.¹¹⁴²

It is suggested that various aspects of section 85(7) need to be reconsidered. It seems that it would have made more sense to provide for the writing off of share premiums contributed in respect of shares being repurchased. It is submitted that if the par value shares had been issued at a premium, this premium should upon repurchase be deducted from the share premium account to the extent that the repurchase price exceeds the par value of the shares, but not exceeding the average premium contributed by the shares. Further, it should be provided that the capital redemption reserve account can be applied in respect of the excess of the

¹¹⁴¹ See paragraph 6.7 below.

¹¹⁴² See paragraph 6.7.2 below.

repurchase price paid by the company over the issue price of the acquired shares. In the case of a repurchase by a subsidiary, no adjustment to the share premium account or capital redemption reserve account of either company should be allowed.

The conceptual difficulties surrounding non-distributable reserves as share capital of the company in respect of which no particular shareholders have any entitlement are vividly illustrated by the issues raised. The proposals I outline in the previous paragraph may, however, address some of the concerns about the status and application of statutory non-distributable reserves if such accounts were to be retained in a future Companies Act.

6.4 Liability for unlawful repurchases

Section 86 regulates some aspects of the liability of directors and shareholders when shares have been acquired contrary to section 85(4), that is, when payment was made in breach of the financial restrictions. The provisions, which will be discussed below, do not regulate the consequences of non-compliance with other requirements or formalities for repurchases. Further, section 86(5) expressly preserves any liability that may be incurred under the Act, any other law, or the common law.

The issue of liability for unlawful repurchases did not directly arise at common law, in view of the prohibition on share repurchases.¹¹⁴³ However, since a repurchase is in essence a distribution by the company, the common-law principles of liability for unlawful dividends should apply also to unlawful payments for the acquisition of shares. This issue is considered in relation to liability for unlawful dividends.¹¹⁴⁴ This uncertainty regarding the liability of shareholders may complicate the interpretation of section 86(2) and (3) which provide for court orders against shareholders.¹¹⁴⁵

The directors also incur common-law liability for the amount of an unlawful

¹¹⁴³ Presumably if a company purported to repurchase its shares, it would be able to recover the purchase price from the shareholder on the basis that the agreement was *ultra vires* and thus void, see *Trevor v Whitworth* (1887) 12 App Cas 409 (HL) at 436.

¹¹⁴⁴ See paragraph 5.6 above.

¹¹⁴⁵ See paragraph 6.4.2 below.

dividend on the basis of a breach of their duties.¹¹⁴⁶ Although liability for an unlawful distributions in the form of payments for a repurchase could probably also be imposed on the same common-law principles, section 86(1) creates a specific statutory liability of directors.¹¹⁴⁷ Directors may further also be liable to the company for breach of their duties when they fail to ensure compliance with any of the non-financial requirements and formalities of sections 85, 87 and 88.

Against the background of the common-law principles of liability, the specific provisions of section 86 can now be considered.

6.4.1 Liability of directors

As sanction for non-compliance with the solvency and liquidity requirements, section 86(1) imposes personal liability on the directors who allowed the company to acquire its shares. These directors are jointly and severally liable to the company.¹¹⁴⁸ The extent of the liability is the amount of the unlawful payment which has not been otherwise recovered by the company. The court may grant relief to a director under section 248.¹¹⁴⁹

Section 86(6) extends the concept of 'director' for purposes of section 86 and section 89 to include directors of a holding company. The reference to section 89 seems to indicate that the directors of a holding company will only be liable if the subsidiary is acquiring shares in the holding company, that is, where section 86 is applied in conjunction with section 89. However, the language is not clear and it could perhaps be argued that the directors of a holding company will also be liable if the subsidiary acquires its own shares. However, in such a case section 89 is not involved. It may have been preferable for section 86(6) to have referred to 'this section read with section 89'.

6.4.1.1 Basis of liability

The solvency and liquidity test does not depend on the subjective belief of the director or directors as to the solvency and liquidity of the company. Because

¹¹⁴⁶ See *Dovey v Cory* [1901] AC 477 HL. See also Van Dorsten *Dividends* 122 – 123; Blackman, Jooste & Everingham *Companies Act* 5-131 – 5-133.

¹¹⁴⁷ See paragraph 6.4.1 below.

¹¹⁴⁸ Section 86(1).

¹¹⁴⁹ The court may do so if it has been established that the director acted honestly and reasonably

section 85(4) works with the existence or not of reasonable grounds, this same objective standard will trigger the liability provisions. However, liability is imposed on directors who, 'contrary to the provisions of section 85(4), allow the company to acquire any share issued by it',¹¹⁵⁰

A first issue that arises is when the company can be said to have 'acquired' its shares contrary to section 85(4). Although section 86(6) starts out by referring to allowing the 'acquisition' of shares, it is clear from the rest of this subsection that it is not the acquisition of shares as such that is relevant, but only the payment of an amount in contravention of section 85(4). The use of the word 'acquire' can be problematic because payment and acquisition need not take place simultaneously.¹¹⁵¹ Section 86(4) specifies the time period within which an action may be instituted as within three years of the date of 'completion of the transaction'. It thus appears that although the making of payment triggers liability, the time limit is calculated from the date when both payment and acquisition have taken place.

Secondly, the meaning of 'allow' needs to be considered. The authors of Blackman, Jooste & Everingham *Companies Act* explain that since the company is the entity which makes the unlawful payment, and not the directors, some or other action of directors relating to the payment needs to be targeted.¹¹⁵² In this sense, 'allow' has a wider meaning than, for example 'authorise' or 'sanction'. The word would also cover instances where a director fails to prevent an unlawful payment, for example when she knows that payment is due and does not supervise the officers who have to decide whether payment can lawfully be made or not. However, if the director was unaware of the payment or could not have prevented the company from making payment, she cannot be said to have allowed payment.¹¹⁵³ It can thus be concluded that the director must at least have been aware of the payment.

Cassim criticises the liability provision as unreasonably strict and argues that

Continued

and ought fairly to be excused.

¹¹⁵⁰ Section 86(1).

¹¹⁵¹ See also paragraph 6.1.1 above where the meaning of this word is discussed in the context of section 85(1).

¹¹⁵² See Blackman, Jooste & Everingham *Companies Act* 5-75.

¹¹⁵³ Blackman, Jooste & Everingham *Companies Act* 5-75.

liability should depend on whether or not the director consented to or voted in favour of the resolution authorising the acquisition.¹¹⁵⁴ Cassim does not attempt to explain the possible meaning of 'allow',¹¹⁵⁵ but assumes that liability could be imposed on a director who was absent from the board meeting which resolved to purchase shares.¹¹⁵⁶

Apart from the fact that Cassim seems to underestimate the importance of the word 'allow', certain aspects of his criticism call for comment:

It would seem that directors will be overprotected if they are liable only for the positive act of consenting to or voting in favour of a resolution and not also for their failure to prevent unlawful payments.

It is not clear which board resolution to repurchase shares Cassim has in mind. One can assume that a board will resolve to propose the adoption by the general meeting of a special resolution containing a specific or general approval. If a general approval is obtained, the board will have to adopt a further resolution to exercise the power given to it in terms of the general approval.¹¹⁵⁷ Lastly, although this is probably not really a resolution 'authorising' the 'purchase' of shares, there may be a board resolution authorising the making of a payment. It is conceivable that payment will often be made without a further board resolution. It appears that Cassim has in mind one or both of the first two resolutions, but not specifically a resolution to make payment.

In view of the timing aspect inherent in section 85(4), the solvency and liquidity tests have to be satisfied when payment is made.¹¹⁵⁸ The solution suggested by Cassim, along the lines of the Canadian provisions,¹¹⁵⁹ is not

¹¹⁵⁴ Cassim "New Statutory Provisions" 770 – 771.

¹¹⁵⁵ In fact, he does not refer to the word 'allow' at all, see Cassim "New Statutory Provisions" 770 where it is stated that s 86(1) 'imposes on the "directors" of a company who acquire shares in breach of the provisions of s 85(4) joint and several liability to restore to the company'.

¹¹⁵⁶ Cassim "New Statutory Provisions" 771.

¹¹⁵⁷ Blackman, Jooste & Everingham *Companies Act* 5-79 explain that directors will always have the discretion whether or not to implement a repurchase, even in the case of a specific approval.

¹¹⁵⁸ See paragraph 4.2 above. Cassim argues that the financial restrictions have to be satisfied both at the time the resolution is adopted and at the time of payment, see Cassim "New Statutory Provisions" 768. His suggestion on director liability nevertheless does not leave scope for the imposition of liability on directors who authorise a resolution at a time when the financial restrictions are satisfied and then subsequently allow payment when it is clear that the restrictions are no longer satisfied.

¹¹⁵⁹ See Cassim "New Statutory Provisions" 770 – 771.

suitable for South Africa. In South Africa it should be irrelevant whether a director voted for or against any earlier board resolution to repurchase shares at a stage when the company's financial situation may well have been different. Regardless of the director's opinion on the desirability or not of a repurchase, she has a duty to prevent the making of payment in contravention of section 85(4). Even if Cassim's argument were to be interpreted as referring to a resolution to make payment it may not solve the problem, because some time may lapse between such a resolution and the eventual payment. I think it is more sensible to consider the position of each director at the actual time of payment and ask whether the director allowed unlawful payment to be made.

A third issue is whether or not the director should have been aware of the fact that the provisions of section 85(4) were contravened, or only that payment was made. Clearly, the lawfulness of a payment depends on purely objective standards.¹¹⁶⁰ However, the word 'allow' implies some state of mind or awareness on the part of the directors. The wording of section 86(1) seems to imply that the director's knowledge of the violation is irrelevant. The words 'contrary to the provisions of section 85(4)' appear in parenthesis between 'The directors of a company who' and the word 'allow'. If the provision had imposed liability on 'directors who allow payment contrary to the provisions of...', it may have indicated that the directors should (knowingly) have allowed unlawful payment. The authors of Blackman, Jooste & Everingham *Companies Act* also state that the director need only have been aware of the fact that payment was made for an acquisition of shares.¹¹⁶¹

Section 86 must be considered in conjunction with section 248 which provides for the granting of relief to directors who acted honestly and reasonably.¹¹⁶² The court will grant relief if it thinks that the director ought fairly to be excused. Although the financial restrictions impose an objective test, and liability does not in the first place depend on the director's knowledge of the unlawfulness of the payment, the director's subjective belief and standard of care displayed will be relevant for purposes of section 248.

¹¹⁶⁰ See paragraph 4.1.1 above.

¹¹⁶¹ See Blackman, Jooste & Everingham *Companies Act* 5-76.

¹¹⁶² Section 86(1) expressly refers to section 248.

6.4.1.2 Extent of liability

The second main issue regarding the liability of directors is the extent of the liability. The directors are jointly and severally liable with each other for the amount of the unlawful payment that has not been recovered by the company. The company could have recovered money from the shareholder or former shareholder or from other directors. It is to be noted that the liability of a shareholder who received payment is not jointly with the directors.

It is not clear whether liability will arise in respect of the full payment or only the extent to which the payment renders the company insolvent or unable to pay its debts. Neither section 85(4) nor section 86 expressly provide for an apportionment.

6.4.1.3 Right of recourse

It is clear that the extent of the director's liability will depend on any amounts recovered by the company. Their liability is reduced only by amounts actually recovered by the company.¹¹⁶³ For this reason, directors are given the right under section 86(2) to apply to court for an order compelling a shareholder or former shareholder to restore to the company any unlawful payment she received. It is important to note that the provision refers to payment to the company and not to the director. Further, it is not a prerequisite that the director should actually have paid any amount to the company before she can bring the application to court. It thus seems that the application by the director can be regarded as a kind of derivative action brought on behalf of the company rather than an ordinary right of recourse.¹¹⁶⁴ Any amount recovered from the shareholder or former shareholder will obviously reduce the liability of the director, which serves as a strong incentive for the director to institute proceedings.¹¹⁶⁵

The question arises whether a director admits her own liability by applying to court for an order against a shareholder or former shareholder. The right to apply is given to a director 'who is liable under subsection (1)'.¹¹⁶⁶ The director would

¹¹⁶³ As Blackman, Jooste & Everingham *Companies Act 5-76* explain, it is not a defence that the company is able to recover payments from other parties.

¹¹⁶⁴ See Blackman, Jooste & Everingham *Companies Act 5-74-1*.

¹¹⁶⁵ See Blackman, Jooste & Everingham *Companies Act 5-75*.

¹¹⁶⁶ Section 86(2).

thus have to allege that she is liable in order to establish her *locus standi*, which may be used by the company to the detriment of the director. Curiously, the shareholder would be able to argue that the director is not liable and thus does not have *locus standi* to bring the application. If the purpose of an application by a director is to facilitate recovery by the company from shareholders, obstacles in the way of recovery should be removed. However, the company has an independent right to recover unlawful payments from the shareholders,¹¹⁶⁷ so the board can cause the company to take the necessary steps for recovery without resorting to section 86(2). However, a director who is for some reason not liable under section 86(1) does not have the right in her own name to apply for an order against shareholders.

The position of a director who has already paid the amount of the unlawful payment to the company requires further attention. A literal interpretation of section 86(2) would imply that such a director will not have *locus standi* to bring an application against the shareholder or former shareholder under section 86(2), because she will no longer be 'liable under subsection (1)'. It is to be hoped that such an interpretation will be avoided because it will skew the balance in favour of the shareholder. If directors know that they will lose their right of recovery, they would have an added incentive to resist or postpone repaying an unlawful payment to the company.

The effect of any recovery by the company subsequent to the director's payment is also uncertain. The director would have paid the amount for which she was liable at the time of payment. It is not clear whether her liability can be reduced retrospectively. Once a director has paid the full amount of the unlawful distribution, the company may no longer have a claim against the shareholder or other directors. It would thus make sense to adjust the director's liability whenever amounts are recovered by the company and to provide for a refund to the director. Alternatively a director who has made payment to the company should be allowed to obtain an order that the shareholder or former shareholder pay the amount to her directly. Section 86(2) gives the court the power to order a repayment by the shareholder to the company only.

Despite the problems regarding recovery from shareholders, a director who

¹¹⁶⁷ See Blackman, Jooste & Everingham *Companies Act 5-74-1*.

has restored the amount to the company will have an ordinary right of recourse against her co-directors who are also liable.¹¹⁶⁸ This right arises from the nature of joint liability.

6.4.2 Liability of shareholders

It was pointed out earlier¹¹⁶⁹ that shareholders will be liable to repay to the company the amount of unlawful distributions, including payments for the acquisition by the company of their shares. This liability arises because the payment is unlawful and thus void.¹¹⁷⁰ The good faith of the shareholder is not directly relevant. This is criticised by Cassim, who is in favour of specific statutory protection of shareholders who received a payment in good faith.¹¹⁷¹ However, as the authors of Blackman, Jooste & Everingham *Companies Act* point out, protection of the good faith of the shareholder would result in the shareholder being preferred to the company's creditors.¹¹⁷²

Even if the English common-law position were to apply in South Africa so that shareholders would be liable in respect of unlawful dividends only if they knew that it was paid out of capital,¹¹⁷³ it is unlikely that this would assist vendor-shareholders because a repurchase is in essence paid out of capital.

Section 86(2) enables directors to apply to court for an order against a vendor-shareholder, and section 86(3) affords creditors and shareholders the right to bring a similar application against the shareholder or former shareholder. In each instance the court can order the shareholder to make payment to the company. These rights of action do not detract from the right of the company itself to enforce repayment by shareholders.¹¹⁷⁴ According to the authors of Blackman, Jooste & Everingham *Companies Act* it would have absurd consequences if only directors, creditors or other shareholders could enforce repayment by the vendor-

¹¹⁶⁸ See Cassim "New Statutory Provisions" 770.

¹¹⁶⁹ See paragraph 6.4 above.

¹¹⁷⁰ See Blackman, Jooste & Everingham *Companies Act* 5-84.

¹¹⁷¹ See Cassim "New Statutory Provisions" 771 – 772.

¹¹⁷² See Blackman, Jooste & Everingham *Companies Act* 5-77.

¹¹⁷³ See Blackman et al 5-129; *Lucas v Fitzgerald* (1903) 20 TLR 16. See also Chapter 2 paragraph 5.6 especially notes 318 and 319. See also paragraph 5.6 above on differences between English and South African law in this regard.

¹¹⁷⁴ See Blackman, Jooste & Everingham *Companies Act* 5-74 – 5-75.

shareholder, but not the company.¹¹⁷⁵

The proceedings under section 86(2) or (3) have to be instituted within three years of the date of completion of the acquisition.¹¹⁷⁶ The 'date of completion of the acquisition' may be later than the date of payment, but it is uncertain exactly when an acquisition will be completed.

As will emerge from the discussion below, there appear to be some differences in the liability of shareholders depending on whether it is the company itself, a director, or a creditor or other shareholder who is taking action.

6.4.2.1 Application by director

A director who is liable under section 86 may, under section 86(2), apply to court for an order compelling a shareholder or former shareholder to refund the unlawful payment to the company. Although the director will reduce her own liability by any amount recovered from the shareholder, the action appears to be in the nature of a derivative action, because the payment will be made to the company.¹¹⁷⁷ Several aspects of this provision seem to be unsatisfactory.

Section 86(2) speaks only of the repayment of 'money' that was paid to the shareholder. This is unfortunate as the implication seems to be that other forms of consideration cannot be recovered by a director. This conclusion is reinforced by the fact that section 86(3)(a) expressly allows creditors and other shareholders to obtain an order for the repayment of money or the return of other consideration given.¹¹⁷⁸

It has been argued that section 86(2) does not give the court the discretion to take into account whether or not the shareholder acted in good faith, because, unlike section 86(3), it does not expressly state that the court may make an order 'if it finds it equitable to do so'.¹¹⁷⁹ Unless it is also argued that the court does not have the power to refuse such an application, which is clearly absurd, this deduction cannot be supported. However, it is unfortunate that these two subsections that both deal with recovery from shareholders have been formulated

¹¹⁷⁵ See Blackman, Jooste & Everingham *Companies Act 5-74 – 5-75*.

¹¹⁷⁶ Section 86(4).

¹¹⁷⁷ See also the discussion of the right of recourse in paragraph 6.4.1.3 above.

¹¹⁷⁸ See paragraph 6.4.2.2 below.

¹¹⁷⁹ Cassim "New Statutory Provisions" 771 – 772.

in such different ways.

Section 86(2) does not set out which other orders the court may make. It merely states that the director can apply for an order that the shareholder repay money to the company. No provision is made for other orders, such as an order that the company reissue shares to the vendor-shareholder or any other order that the court deems fit. It seems that the court should also be given the power under this subsection to order the company to issue an equivalent number of shares to the shareholder.¹¹⁸⁰

6.4.2.2 Application by creditor or shareholder

A creditor (who was a creditor at the time of the acquisition or whose cause of debt arose before the acquisition) or any shareholder (including shareholders who acquired their shares after the acquisition) may apply to court for an order against a shareholder or former shareholder who sold shares to the company and received payment in contravention of section 85(4).¹¹⁸¹

The court may, if it finds it equitable, order that the shareholder or former shareholder return to the company the money or other consideration received for the acquisition of the shares. It may also order the company to issue to the shareholder or former shareholder an equivalent number of shares. Although it may seem unfair to order return of the consideration without a reissue of shares, this is not necessarily the case. In a proportionate repurchase, for example, or where the company has only one shareholder, there will have been no change in the relative equity interests involved so it makes no difference whether shares are reissued or not.

The court is expressly given the power to make any other order as it thinks fit. It is not clear what other orders could be useful. Presumably the court could order partial restoration to the extent of the insolvency or illiquidity. It may also be possible to obtain an order that payment should be made directly to the creditor or shareholder, although a court would probably do so in exceptional circumstances only. The court may perhaps even order that the loan account of a shareholder be debited.

¹¹⁸⁰ See paragraph 6.4.2.2 below for a discussion of such an order.

¹¹⁸¹ Section 86(3).

If the court orders the return of the consideration, the question arises whether the underlying obligation will be extinguished or not. If it is merely the payment that is set aside, the agreement should still be intact so that the company can pay at a later stage when it can satisfy the financial restrictions. Such an order would have the same effect as the subordination that is provided for in section 88.¹¹⁸² However, other orders the court could make may include the setting aside of the agreement, which would have the effect of extinguishing the underlying obligation.

6.5 Enforceability of contracts for the acquisition of own shares

Section 88 expressly provides that a contract for the acquisition by a company of its own shares is enforceable against the company except if execution of the contract would result in a violation of the financial restrictions set out in section 85(4).¹¹⁸³ The vendor-shareholder is thus a creditor of the company. In order to avoid an order for specific performance against it the company will have to prove that payment would compromise either its solvency or its liquidity.¹¹⁸⁴ It is clear that it is the financial position of the company at the time when it is sought to enforce the contract that is relevant.¹¹⁸⁵ Due to the fact that section 88 merely cross-refers to section 85(4) it seems that the company has to prove only that there are 'reasonable grounds for believing' that it will not meet the solvency and liquidity criteria. It may have been preferable to require a higher degree of proof from the company in these circumstances.

The shareholder-vendor will not be able to enforce the contract while the company does not meet the financial restrictions, but will remain entitled to payment as soon as the company is lawfully able to execute the contract.¹¹⁸⁶ The company's inability to pay thus amounts to a kind of temporary impossibility of performance.

¹¹⁸² See paragraph 6.5 below.

¹¹⁸³ Section 88(1). Blackman, Jooste & Everingham *Companies Act 5-95* explain the history of this provision. Although it seems to have been based on the doctrine of consideration which does not apply in South African law, the provision offers a sensible solution.

¹¹⁸⁴ Section 88(2). The company thus has to prove the existence of reasonable grounds for believing that (a) the company is, or would, after making the payment, be unable to pay its debts as they become due in the ordinary course of business; or (b) the consolidated assets of the company fairly valued would after the payment be less than the consolidated liabilities of the company.

¹¹⁸⁵ Because the test must be satisfied when payment is made, see paragraph 4.2 above.

If the company is wound up before the vendor-shareholder has been paid in full, the claim in respect of consideration will be ranked in priority to the other shareholders of the class who have not sold their shares to the company.¹¹⁸⁷ This is a rather exceptional provision since it amounts to a statutory subordination of the claims of certain creditors (shareholder-vendors) to the claims of certain shareholders (those of classes preferent to the class of shares acquired by the company). While the interests of preference shareholders are not taken into account in the application of the financial restrictions,¹¹⁸⁸ they become relevant once the company has been wound up. It is also significant that the vendor-shareholders enjoy priority over the remaining shareholders of their class. The motivation for this seems to be the existence of the contract between the company and the vendor-shareholder. This contract was authorised by the general meeting so that the remaining shareholders can be said to have agreed to this relative advantage.

6.6 The status of repurchased shares

Shares acquired under section 85 have to be cancelled as issued shares and restored to status of authorised shares 'forthwith'.¹¹⁸⁹ It is not clear when shares will be regarded as having been 'acquired'.¹¹⁹⁰ For purposes of this provision it will probably be as soon as the shares are no longer held by the seller. It does not seem necessary that all the obligations of the repurchase agreement should have been extinguished before the shares can be said to have been acquired. Acquisition can thus take place even though the company has not yet paid the consideration for the shares. It seems that the moment of transfer or acquisition can be determined contractually.

Section 85(8) provides that the cancelled shares will remain authorised shares. There is thus no direct option of cancelling them completely, but the company can subsequently cancel its authorised but unissued shares in terms of section 75(1)(h). It is worth noting that section 98 does not expressly provide for

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¹¹⁸⁶ Section 88(3).

¹¹⁸⁷ Section 88(3).

¹¹⁸⁸ See paragraph 4.1 above.

¹¹⁸⁹ Section 85(8).

¹¹⁹⁰ See paragraph 6.1.1 above.

the cancellation of redeemable preference shares upon redemption, but merely states that the redemption of shares will not be deemed to constitute a reduction of authorised share capital.¹¹⁹¹ The effect of these two provisions seems to be similar.

Section 85(8) prescribes the cancellation of shares acquired under section 85 only. The peremptory cancellation of shares acquired by a company means that treasury shares are not allowed in South Africa. It has thus been suggested that treasury shares may indeed be possible if, for example, a company receives its own shares as a dividend *in specie* from its subsidiary.¹¹⁹²

Shares held by a subsidiary in its holding company can for practical purposes be regarded as treasury shares.¹¹⁹³ South African companies with subsidiaries can thus indirectly hold treasury shares up to a limit of 10 per cent of issued shares.¹¹⁹⁴ By allowing subsidiary companies to hold up to 10 per cent of the shares in the holding company, treasury shares are thus indirectly allowed. In keeping with the usual regulation of treasury shares, shares held by a subsidiary may not be voted.¹¹⁹⁵ However, the subsequent sale or transfer of such shares by a subsidiary is not regulated in the Companies Act.

6.7 Acquisitions by a subsidiary

The acquisition by a subsidiary of shares in its holding company can be described as an indirect acquisition of own shares by the holding company.¹¹⁹⁶

It was previously not possible for subsidiaries to acquire shares in their holding companies. Prior to its amendment,¹¹⁹⁷ section 39(1) prohibited the allotment, issue or transfer of shares in a holding company to its subsidiary.¹¹⁹⁸

¹¹⁹¹ Section 98(3).

¹¹⁹² Delpont "Company Groups" 127. However, Delpont explains that the residual common-law prohibition on a company acquiring its own shares should prevent such a situation from arising. Alternatively, he argues, the very nature of a share as a bundle of rights implies that a company cannot hold its own shares.

¹¹⁹³ Blackman, Jooste & Everingham *Companies Act* 5-73; Bhana "Company Law Implications" 245; *JSE Limited Listings Requirements* paragraph 5.75.

¹¹⁹⁴ Section 89. The acquisition by a subsidiary of shares in its holding company is considered in more detail in paragraph 6.7 below.

¹¹⁹⁵ Section 39. See paragraph 6.7 below.

¹¹⁹⁶ See Bhana "Company Law Implications" 238.

¹¹⁹⁷ By s 4 of the Companies Amendment Act 37 of 1999.

¹¹⁹⁸ A subsidiary could, however, continue to hold shares it acquired in its holding company prior to

6.7.1 'Acquisition' by a subsidiary

Section 89 empowers subsidiary companies to acquire shares in their holding company up to a maximum of ten per cent in the aggregate of the number of issued shares in the holding company. The ten per cent limit applies in respect of the total number of issued shares of the holding company that are acquired by all its subsidiaries, apparently regardless of the value of the shares in relation to the total share capital. It would have been more sophisticated to apply the restriction with respect to each class of shares.

It is unfortunate that section 89 limits the number of shares that can be 'acquired' rather than 'held' by subsidiaries. Strictly interpreted, once subsidiaries have acquired 10 per cent in accordance with section 89, no further acquisitions may be made even if the subsidiaries no longer hold all the shares so acquired. Further acquisitions would only be possible if the number of shares of the holding company is increased. This result could have been avoided if the number of shares that may be acquired depended on the balance of shares acquired under section 89 still held by the subsidiaries. The emphasis placed on 'acquisition' rather than 'hold' also means that there is no problem with subsidiaries continuing to hold shares acquired under section 89 if the total number of shares in the company is subsequently reduced so that the acquired shares exceeds the 10 per cent limit.

Section 39(1) regulates the holding by subsidiaries of shares in their holding company that were acquired in accordance with section 89. The amendment of section 39 created a number of problems. Delport¹¹⁹⁹ as well as Wainer¹²⁰⁰ point out that the ten per cent limit of section 89 and the restriction on voting provided for in section 39(1) apply only to shares acquired 'in accordance with section 89'. Shares held by a subsidiary in its holding company that were acquired prior to it becoming a subsidiary are not covered by section 39. Such shares do not count towards the ten per cent limit and, more importantly, are no longer subject to the neutralising of voting rights provided for in the amended section 39(1). It must be noted that the exclusion of voting rights of the subsidiary is a rather

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it becoming a subsidiary, s 39(3) prior to its amendment by s 4 of the Companies Amendment Act 37 of 1999.

¹¹⁹⁹ Delport "Company Groups" 127 – 128.

¹²⁰⁰ Wainer "Problems and Doubts" 135 – 136.

unsophisticated provision to begin with, as it requires the 'percentage' of votes in the company to be reduced by the 'number' of shares acquired by the subsidiary.¹²⁰¹

The extent to which the abolishing of the general prohibition on cross-holdings has enabled subsidiaries to acquire shares in their holding company otherwise than in accordance with section 89, is uncertain. There is a view that any acquisition of shares by a subsidiary qualify as an acquisition for purposes of section 89 and is thus *mutatis mutandis* subject to sections 85 to 88.¹²⁰² This would include the issue of capitalisation shares, with the result that once the ten per cent limit has been reached, no further capitalisation shares may be issued to the subsidiary.¹²⁰³

The contrary view is that shares acquired through capitalisation issues or through dividends *in specie* from co-subidiaries are not acquired in accordance with section 89 and thus not subject to the ten per cent limit, the voting exclusion and the provisions of sections 85 to 89.¹²⁰⁴

This confusion is undesirable. While the word 'acquisition' should clearly not be limited to repurchases, giving it a wide interpretation covering dividends *in specie* and capitalisation shares could cause problems regarding the application of certain of the other requirements for share acquisitions, particularly the authorisation requirement. It would mean that a company engaging in a capitalisation issue may need a special resolution merely because its subsidiary happens to hold a few shares in it. On the other hand, a wide interpretation will give more effect to the purpose behind the ten per cent limit. Recommendations for the improvement of this situation will thus be made.¹²⁰⁵

The difficulties surrounding the interpretation of sections 89 and 39 are well illustrated by the allotment and issue of shares to a subsidiary. It seems fair to assume that a subsidiary subscribing for shares in its holding company will indeed

¹²⁰¹ See Delpont "Company Groups" 125.

¹²⁰² Blackman, Jooste & Everingham *Companies Act 5-98* – 5-99.

¹²⁰³ This situation is not as unlikely as it would seem: while the issue of capitalisation shares will preserve the proportionate interests of shares in a particular class, the 10% limit applies to the total number of shares in the holding company which may include shares in classes not receiving a capitalisation issue.

¹²⁰⁴ Delpont "Company Groups" 127 – 128.

¹²⁰⁵ See paragraph 6.10.7 below.

'acquire' the shares allotted and issued to it.¹²⁰⁶ It would also make sense to treat such acquisitions in the same way as purchases by the subsidiary. It is more difficult to apply this reasoning to the issue of capitalisation shares to the subsidiary, which was expressly allowed as an exception to the general prohibition prior to its repeal in 1999.¹²⁰⁷ The subsidiary will not be making any payment and the application of sections 85 to 88 to this situation does not make sense. Yet, the term 'acquire' in section 89 does not seem to support a distinction between purchases, subscriptions and capitalisation issues.

On the other hand, it could be argued that, because section 85 refers to the approval of the acquisition of shares 'issued' by the company, an approval to allot and issue shares to a subsidiary does not amount to the approval of an acquisition of issued shares, because the shares are not yet in issue when the approval is purportedly given. This would mean that neither an issue following subscription by the subsidiary nor a capitalisation issue would be regarded as acquisitions for purposes of section 89. However, section 89 does not repeat the reference to 'issued' shares.

It is clear that either result is untenable. Legislative intervention is necessary in order to exclude the voting rights of any shares in its holding company that are held by a subsidiary. Clarity is also needed with regard to the proper application of the ten per cent limit and sections 85 to 88. There may also be a problem in recovering consideration from a holding company where its subsidiary acquired its shares through subscription. Since the holding company is not a former shareholder, the directors would not have recourse against it on the basis of section 86(2).

Another complication is that section 39(2) exempts the holding of shares in its holding company by a subsidiary acting in a representative capacity or as a trustee from the voting restriction of section 39(1), but not from section 89, which prescribes that the acquisition must be done in accordance with section 85 to 88 and which imposes a ten per cent limit to acquisitions by a subsidiary.¹²⁰⁸

¹²⁰⁶ The meaning of 'acquire' in s 85 is considered in paragraph 4.1.1 above.

¹²⁰⁷ Section 39(3)(b) as it read prior to its amendment by s 4 of Act 37 of 1999.

¹²⁰⁸ See Blackman, Jooste & Everingham *Companies Act 5-98 – 5-99*.

6.7.2 Requirements

The requirements and procedures for an acquisition under section 89 are *mutatis mutandis* the same as for the acquisition by a company of its own shares. Various uncertainties arise as to the exact application of sections 85 to 88 in the group context.

Wainer explains that it is the authorisations, liabilities and procedural aspects of sections 85 to 88 that apply to acquisitions in terms of section 89.¹²⁰⁹ It is clear that subsections (5), (6) and (8) of section 85, providing for the adjustment of share capital accounts and the cancellation of shares would not apply to the acquisition of shares in a holding company by a subsidiary as the subsidiary will be holding those shares as contemplated in section 39.¹²¹⁰

There seems to be general agreement that section 85(1) to (3), which deals with the authorisation of an acquisition of shares, and section 85(4), which contains the financial restrictions, apply when a subsidiary acquires shares in its holding company.¹²¹¹ However, there is considerably less certainty as to whether the holding company, the subsidiary or both companies should comply with these requirements.¹²¹²

I have previously suggested that it is the articles of association of the subsidiary that should authorise it to acquire shares in its holding company and that the special resolution should be taken by the members of the subsidiary.¹²¹³ Since the subsidiary will be making payment for shares it acquires, it has been said that the financial restrictions should be applied with reference to the subsidiary.¹²¹⁴ If the financial restrictions of section 85(4) should indeed be applied to the subsidiary it will be a strong indication that the other requirements should also be satisfied by the subsidiary and not by the holding company.

An argument could however also be made out that the authorisation should emanate from the holding company. Such an argument can be based on the differences in the wording of sections 85 and 89: section 85 does not provide that

¹²⁰⁹ Wainer "Problems and Doubts" 138.

¹²¹⁰ See Van der Linde "A Company's Purchase of its Own Shares" 71; Loubser "Recent Developments" 9 – 10; Wainer "Problems and Doubts" 138.

¹²¹¹ Blackman, Jooste & Everingham *Companies Act* 5-100; Wainer "Problems and Doubts" 138.

¹²¹² See Meskin *Henochsberg on the Companies Act* 186(2).

¹²¹³ Van der Linde "A Company's Purchase of its Own Shares" 71

a company may acquire its own shares, but provides that a company can 'approve' the acquisition of its shares (by itself); section 89 does not state that a subsidiary can approve the acquisition of shares in its holding company, but that a subsidiary can 'acquire' shares in its holding company. It could thus be said that the approval by the (holding) company is the common feature of these two sections dealing respectively with acquisitions by the company and by a subsidiary. Alternatively, it could even be argued that the approval requirement does not apply at all when a subsidiary acquires shares in its holding company.

Delpont does not deal with the question whether it is the holding company or the subsidiary that has to authorise the acquisition.¹²¹⁵ However, he does indicate that it is a subsidiary that will have to comply with the solvency and liquidity test if it acquired shares in its holding company.¹²¹⁶

The JSE Listing Rules requires a special resolution by the holding company as well as the subsidiary.¹²¹⁷ These rules also require the directors to state that the 'company and the group' will satisfy the prescribed financial restrictions.¹²¹⁸

Bhana states that recognition of the separate existence of the holding company and subsidiary company warrants that the authorisation should emanate from the subsidiary acquiring shares in its holding company.¹²¹⁹ Where the subsidiary also has shareholders other than the holding company, this would result in some protection for these minority shareholders. However, she correctly points out that factually as opposed to legally, an acquisition by a subsidiary is nothing more than an indirect acquisition by the holding company.¹²²⁰ It has the same effect on the shareholders of the holding company that an acquisition of own shares would have.¹²²¹ For this reason she is in favour of requiring authorisation by both the subsidiary and the holding company. The same reasoning is applied to

Continued

¹²¹⁴ Van der Linde "A Company's Purchase of its Own Shares" 71.

¹²¹⁵ See Delpont "Company Groups" 123 – 124. Delpont does, however, criticise the requirement that a wholly owned subsidiary, or for that matter and company with a single shareholder, has to pass a special resolution when it intends acquiring its own shares.

¹²¹⁶ Delpont "Company Groups" 123. Delpont argues that it is only when a holding company is acquiring shares in itself that the consolidated financial position of the group has to be taken into account.

¹²¹⁷ *JSE Limited Listings Requirements* par 5.76.

¹²¹⁸ *JSE Limited Listings Requirements* pars 5.69(c) and 11.26(d).

¹²¹⁹ Bhana "Company Law Implications" 238.

¹²²⁰ Bhana "Company Law Implications" 238.

compliance with the financial restrictions, but without a consideration of the effect of the acquisition on the creditors of the holding company.¹²²²

Although an acquisition by a subsidiary will not lead to adjustments of the share capital accounts, it is not clear whether section 85(7), which permits the application of reserves to cover a premium payable on acquisition, could or should apply to an acquisition by a subsidiary. The authors of Blackman, Jooste & Everingham *Companies Act* conclude that this provision is not applicable,¹²²³ but they classify it together with section 85(5) and (6) as a provision 'requiring the reduction of capital accounts'. However, section 85(7) does not require the adjustment of accounts, it merely authorises the application of reserve accounts. Obviously there is no causal link between a premium payable for shares in a holding company and the statutory non-distributable reserves of the subsidiary and logically a subsidiary should not be allowed to reduce its reserves in this way.¹²²⁴

According to the authors of Blackman, Jooste & Everingham *Companies Act* section 85(9), which prohibits an acquisition that would leave no shares other than convertible or redeemable shares in issue, does not apply to the section 89 situation in view of the 10 per cent limitation.¹²²⁵ However, since the 10 per cent is determined not per class, but in relation to the total number of shares, it is theoretically possible that a subsidiary can acquire all the shares other than convertible or redeemable shares in its holding company.¹²²⁶ It is submitted that a better reason is the fact that shares acquired by the subsidiary will remain in issue. The application *mutatis mutandis* of section 85(9) to an acquisition by the subsidiary does not compel one to regard the shares acquired and held by the subsidiary as if they are no longer in existence.

6.7.3 Liability for unlawful purchases

Section 86(6) gives an indication of the application of the liability provision to the

Continued

¹²²¹ Bhana "Company Law Implications" 243 – 244.

¹²²² Bhana "Company Law Implications" 239.

¹²²³ Blackman, Jooste & Everingham *Companies Act* 5-100.

¹²²⁴ See also the discussion in paragraph 6.3.3 above.

¹²²⁵ Blackman, Jooste & Everingham *Companies Act* 5-101.

¹²²⁶ Although unlikely, this is possible if 90% or more of the total number of shares are convertible or redeemable.

directors of the holding and subsidiary companies.¹²²⁷ The shareholder liability provision also seems easily adapted to the section 89 situation. The creditors of the subsidiary, or any shareholder of the subsidiary, could invoke the provisions of section 86(3). The vendor-shareholder will be liable to restore the consideration received to the subsidiary. Instead of ordering the company to issue shares to the vendor, it would appear that the court would have to order the subsidiary to transfer the shares back to the vendor.

However, if it is accepted for the sake of argument that the financial restrictions must also be met by the holding company, the question arises whether the shareholders and creditors of the holding company will also be entitled to institute proceedings for the recovery of unlawful payments from the shareholder. If it can be argued that the interests of the shareholders and creditors of the holding company required its solvency and liquidity to be considered in the first place, it must follow that they should have a right to proceed against the vendor-shareholders. However, restitution should still be made to the subsidiary that paid the consideration. It is suggested that this problem provides further support for a conclusion that it is the financial position of the subsidiary only that is relevant for purposes of section 89 read with section 85(4).¹²²⁸

If new shares allotted and issued to the subsidiary can be regarded as shares acquired under section 89,¹²²⁹ it does not seem possible to recover the consideration paid by the subsidiary by relying on section 86, since the holding company does not qualify as a shareholder or former shareholder. If the intention is that subsidiaries should be able to subscribe for shares in their holding company subject to compliance with the solvency and liquidity tests, this aspect should also be addressed in the liability provision.

6.7.4 Procedure

The procedure for acquisition would depend on the kind of approval in the subsidiary. In appropriate cases the subsidiary will have to make a *pro rata* offer to the shareholders of the holding company.¹²³⁰

¹²²⁷ Also see paragraph 6.4.1 above.

¹²²⁸ See paragraph 6.10.7 below.

¹²²⁹ See paragraph 6.7.1 above.

¹²³⁰ See paragraph 6.3.2 above on the different procedures for listed and unlisted shares.

6.7.5 Enforceability

The application of section 88 to acquisitions by a subsidiary means that the subsidiary cannot be compelled to perform if payment would violate the financial restrictions. Should the subsidiary be wound up, the implication of section 88(3) seems to be that the vendor-shareholders will rank after the creditors of the subsidiary. There is no room for taking into account the priority rights of preference shareholders in the holding company or the claims of any other shareholders of the holding company.

6.8 The redemption of shares

The Companies Act contains separate provisions for the redemption of redeemable preference shares. Although redemption and repurchase will have the same effect on the capital accounts of a company,¹²³¹ the procedure and financial restrictions for the two options differ in important respects. This divergence can be explained by the historical development of the two procedures. It has been possible since 1939 for companies to redeem preference shares.¹²³² It is submitted that a company may also repurchase its redeemable shares in accordance with section 85 rather than redeem them. It would have to comply with all the requirements for share repurchases, including authorisation by special resolution.¹²³³ Clearly, the price at which the shares are redeemable and the price paid on repurchase would have to be compared and the time difference between repurchase and redemption taken into consideration by the directors in exercising their duty to act in the best interest of the company.

An interesting question is whether a company should be expressly prohibited from purchasing their shares at more than the current redemption price, as is the case in Delaware.¹²³⁴ Although shareholders of South African companies are protected by the fact that they have to authorise repurchases by special resolution, while the authorisation of shareholders is not required in Delaware, a similar

¹²³¹ See paragraph 4 above.

¹²³² See De Wet and Yeats *Kontraktereg en Handelsreg* 572; Blackman, Jooste & Everingham *Companies Act* 5-270. Redemption of redeemable preference shares was made possible by s 21 of the Companies Amendment Act 23 of 1939 which introduced s 43 into the 1926 Companies Act.

¹²³³ See paragraph 6.3.1.2 above regarding which shareholders may vote.

¹²³⁴ See Chapter 4 paragraph 2.6.2.

provision may be particularly useful in instances where directors are given a general approval to acquire shares.

The advantage of redeemable shares is the flexibility introduced into the capital structure of the company. The requirements and consequences were developed against the background of the capital maintenance concept. Preference shares may be redeemable at the option of the company, or on a fixed date or at the option of the shareholder after a fixed date.¹²³⁵ The reason why only preference shares could be made redeemable was to reduce the risk of abuse.¹²³⁶

The Act does not make provision for the status of a claim in respect of the redemption of a share. This is left to be determined according to general principles. As it is clearly stated that shares may be redeemed only out of the specific sources, it stands to reason that no claim for redemption can arise while the company does not have the required funds. However, once a valid obligation has arisen, the shareholder becomes a creditor and will be entitled to payment.¹²³⁷ Contrary to the position in the case of a repurchase, no provision is made for statutory subordination. This appears to be an anomaly because the redemption will have exactly the same effect on creditors as a repurchase. It is significant that in England, the enforceability and ranking of claims in respect of redemptions are regulated in the same way as for repurchases.¹²³⁸

The possibility of using the general share repurchase power to create what are in effect redeemable ordinary shares is alluded to elsewhere.¹²³⁹ This would be done by way of a previously authorised conditional repurchase agreement. However, the financial restrictions for repurchases rather than the limitations of section 98 would apply when the shares are 'redeemed'. There seems to be no reason why such arrangements should not be allowed.

A company that redeems its redeemable preference shares need not comply

¹²³⁵ Section 98(1). See Blackman, Jooste & Everingham *Companies Act* 5-271.

¹²³⁶ See Blackman, Jooste & Everingham *Companies Act* 5-270. These authors refer to *The Purchase by a Company of its Own Shares, A Consultative Document* (1980) Cmnd 7944 Part II par 4 where the risk of abuse of voting power is mentioned as the reason for this limitation. However, another very important reason is to protect the prior right of preference shareholders to the return of capital.

¹²³⁷ See *Choice Holdings Ltd & Others v Yabeng Investment Holding Co Ltd* 2001 (3) SA 1350 (W).

¹²³⁸ See Chapter 2 paragraph 6.5.

¹²³⁹ See paragraph 6.3.1 above.

with the solvency and liquidity test, as redemption is neither an acquisition in terms of section 85 nor a payment under section 90.¹²⁴⁰ Instead, the redemption is subject to the financial restrictions imposed by section 98. The redemption may be made from two possible sources: out of the proceeds of a fresh issue of shares or out of distributable profits of the company.¹²⁴¹

6.8.1 Redemptions out of profits

The first source from which shares may be redeemed is 'profits which would otherwise be available for dividends'. The interpretation of this concept is uncertain. As a result of the radical changes to the distribution rules brought about by section 14 of the Companies Amendment Act 37 of 1999 the concept 'dividend' may have acquired a new meaning. 'Payments', which include dividends, may be made from any funds of the company provided the solvency and liquidity test is satisfied.¹²⁴² Should profits available for dividend now be understood as any funds from which section 90 payments or dividends in the wide sense may be made? It is suggested that profits available for dividend remains a separate concept and that the common-law principles continue to apply in this regard. This conclusion is supported by the fact that the redemption of shares is expressly excluded from the ambit of section 90.¹²⁴³

Where the redemption is funded out of profits available for dividend, an amount equal to the nominal or par value or, in the case of no par value shares, the book value of the redeemed shares, must be transferred to a capital redemption reserve fund which will be subject to the provisions relating to share capital as if it were share capital of the company.¹²⁴⁴ The book value of no par value shares is the part of the stated capital contributed by the preference shares redeemed or to be redeemed.¹²⁴⁵ It is interesting to note that section 85(6), which provides for the adjustment of the stated capital account where no par value shares were acquired by the company, does not employ the concept of book

¹²⁴⁰ Section 90(3) expressly excludes the redemption of shares under s 98 from the meaning of 'payment'.

¹²⁴¹ Section 98(1)(a).

¹²⁴² See paragraphs 5.1.2 and 5.2 above.

¹²⁴³ Section 90(3). Also see paragraph 6 below.

¹²⁴⁴ Section 98(1)(b).

¹²⁴⁵ Section 98(6).

value, but rather the average issue price.¹²⁴⁶ The reason for this difference is not clear. The difficulties surrounding the application of the capital redemption reserve fund to provide for a premium on repurchase have been considered elsewhere.¹²⁴⁷

6.8.2 Redemption out of a fresh issue

The second source from which a redemption may be funded is out of the proceeds of a fresh issue of shares, issued for purposes of the redemption.¹²⁴⁸ The fresh issue of shares is seen to replace the share capital represented by the redeemed shares. It is expressly provided that the company need not increase its authorised share capital, but can issue fresh shares as if the shares about to be redeemed had never been issued.¹²⁴⁹ In the case of par value preference shares the company may issue replacement shares up to the nominal amount of the shares about to be redeemed. When no par value shares are being redeemed, replacement shares up to the book value of the shares about to be redeemed may be issued. There thus seems to be no restriction on the number of no par value shares the company may issue for purposes of the redemption, as long as the total issue price will not exceed the book value of the redeemed shares. The share capital or the number of no par value shares will not be deemed to be increased for purposes of section 75(3).¹²⁵⁰

6.8.3 Redemption premiums

Any premium payable on redemption must be paid out of the share premium account or out of distributable profits.¹²⁵¹ It has been argued that the whole of the proceeds of a fresh issue of shares, including any premium, may be used to pay the nominal value of the redeemed shares.¹²⁵² Although section 98(1)(a) refers plainly to the 'proceeds' of the fresh issue, this does not fit in well with the provisions governing the structure of the share capital. A premium on the fresh

¹²⁴⁶ See paragraph 6.3.3 above.

¹²⁴⁷ See paragraph 6.3.4 above.

¹²⁴⁸ Section 98(1)(a).

¹²⁴⁹ Section 98(2).

¹²⁵⁰ See s 98(2). Section 75(3), which imposes a prescribed fee on increases in the authorised capital of a company is considered in paragraph 2.5.1 above.

¹²⁵¹ Section 98(1)(c).

¹²⁵² See Cilliers and Benade *Corporate Law* 230 and the example in note 66.

issue would have to be added to the share premium account and can thus in accordance with section 76(3) be applied to pay the premium on redemption, but not the nominal value of the redeemed shares. Similarly, the nominal value of the fresh issue of shares may not be used for the premium payable on the redeemable shares.¹²⁵³ If the premium contributed by the newly issued shares is written off in respect of the nominal value of the redeemed shares, section 76(2) and (3) are not given effect.

There is no general requirement in section 98 that the amount taken from the share premium account must in some way have related to the premium payable on the redemption. However, s 76(3)(c)(ii) requires such an allocation where ordinary shares have been converted into redeemable preference shares. Only that portion of the amount standing to the credit of the share premium account which arose on the original issue of such shares may be applied. In the case of redeemable preference shares issued after the commencement of the 1992 Companies Amendment Act, a premium on redemption may only be paid out of the share premium account if it is payable according to the terms of issue of the shares concerned and such terms have been embodied in the articles since prior to the allotment of the shares (or later, with permission of the court).¹²⁵⁴

6.9 Acquisition of own shares under the Companies Bill

The Companies Bill contains a comprehensive definition of 'distribution' that includes the transfer of money or property in consideration for the acquisition by a company of its own of shares.¹²⁵⁵ As a distribution, a share repurchase is thus subject to all the requirements pertaining to distributions.¹²⁵⁶ Clause 48 regulates the acquisition by a company of its own shares as well as the acquisition by subsidiaries of shares in their holding company. Although the giving of consideration for the acquisition of one company in a group of shares in any other company in the group is a distribution,¹²⁵⁷ such acquisitions are not regulated in clause 48, except where a subsidiary is acquiring shares in its holding company.

¹²⁵³ Section 98(1)(a).

¹²⁵⁴ See s 76(3)(c)(i).

¹²⁵⁵ Clause 1 s v 'distribution', discussed in paragraph 4.3 above.

¹²⁵⁶ See paragraph 4.3.1 (financial restrictions) and paragraph 5.8.1 (authorisation) above.

¹²⁵⁷ See clause 1 s v 'distribution' paragraph (a)(iii)(bb), discussed in paragraph 4.3 above.

Although appraisal payments are not regarded as distributions, the company 'may' nevertheless approach the court to vary its obligations if it can prove that its liquidity (but not its solvency) will be impaired.¹²⁵⁸ Compliance with a court order for the acquisition of shares under the oppression remedy will be regarded as a distribution, although the company 'must' approach the court for relief if there is reason to believe that its solvency or liquidity will be impaired. I think that this disparate regulation of procedures with the same basic objective, namely to protect shareholders from being locked into a company, is difficult to justify and makes the law unnecessarily complex.

6.9.1 Power to acquire own shares

In addition to the requirements for a distribution which must be satisfied when a company transfers money or property as consideration for the acquisition of its shares,¹²⁵⁹ the 'decision' that a company will acquire its own shares must satisfy the requirements of clause 46.¹²⁶⁰ It is not clear how a mere decision can satisfy the requirements of clause 46, which are:

- that the board should authorise the distribution
- it should reasonably appear that the company will satisfy the solvency and liquidity test after completing the distribution
- that the board should acknowledge its application of the solvency and liquidity test.

A 'decision' will have no effect on the solvency and liquidity of a company,¹²⁶¹ and the requirements as to an acknowledgement (and especially a reconsideration of the solvency and liquidity test and a subsequent acknowledgement under the 120-day rule) will usually follow rather than precede a 'decision' to acquire shares.

It is also unclear whether a separate decision to acquire shares is envisaged or whether the 'decision' refers to the authorisation of the distribution by the board

¹²⁵⁸ See clause 164(17).

¹²⁵⁹ See clause 1 s v 'distribution' paragraph (a)(iii)(aa).

¹²⁶⁰ Clause 48(2)(a).

¹²⁶¹ The announcement of a decision to repurchase can influence the price of the company's shares, but not the value of its assets and liabilities.

under clause 46.¹²⁶² The impression is created that, in contrast with any other resolution under clause 46 to make a distribution,¹²⁶³ a repurchase resolution can be taken only if the company is solvent and liquid at the time of the resolution. The general scheme of the Companies Bill is to require satisfaction of the test when a payment or transfer is made in consideration for the acquisition of shares.¹²⁶⁴ If the intention is to deviate from this general principle and require an additional consideration of solvency and liquidity,¹²⁶⁵ this should be stated clearly. Further, if it is necessary to cross-refer to the requirements for distributions in general, this should not be set as a prerequisite for the 'decision' to acquire shares. It would be preferable for the 'acquisition' or 'payment' to satisfy the requirements of clause 46.

An acquisition of shares may not be made if, as a result of that acquisition, there will no longer be any shares of the company in issue other than shares held by one or more subsidiaries of the company¹²⁶⁶ or convertible or redeemable shares.¹²⁶⁷ This requirement seems superfluous for two reasons. First, in view of the limitation of ten per cent of each class that may be held by subsidiaries,¹²⁶⁸ it is impossible that a company which indeed has shares other than convertible or redeemable shares could find itself in the position (as a result of an acquisition) where there are no other shareholders of its unconvertible or unredeemable shares. Second, it is required that a company should always have at least one shareholder other than a company that is part of the same group.¹²⁶⁹ If, as has been suggested above,¹²⁷⁰ this provision was adjusted to require such a non-group shareholder to hold at least one share other than a convertible or redeemable share, the partial duplication of the requirement could be avoided by a

¹²⁶² See clause 46(1)(a)(ii).

¹²⁶³ See paragraph 5.8.1 above.

¹²⁶⁴ Payment of consideration for shares is a distribution as envisaged in paragraph (a) of the definition. See paragraph 4.3.1.5 for a discussion of the timing rule applicable to such distributions.

¹²⁶⁵ It would be a step backward compared to the current position as confirmed in *Capitex Bank Ltd v Qorus Holdings Ltd & Others* 2003 (3) SA 302 (W), see paragraph 6.1 above.

¹²⁶⁶ Clause 48(3)(a).

¹²⁶⁷ Clause 48(3)(b).

¹²⁶⁸ Clause 48(2)(b)(i), see paragraph 6.9.6 below.

¹²⁶⁹ Clause 35(3)(b).

¹²⁷⁰ See paragraph 2.9.2 above.

suitable cross-reference.

6.9.2 Authorisation and procedure

The Companies Bill requires neither authorisation in the Memorandum of Incorporation nor a resolution of the general meeting.¹²⁷¹ It is not expressly stated that repurchases should comply with relevant terms and conditions of the company's memorandum of incorporation,¹²⁷² but it can be accepted that repurchases in violation of the memorandum of incorporation will be open to attack by shareholders¹²⁷³ and will expose the directors to liability for breach of their duties.¹²⁷⁴

The idea of dispensing with the requirements of authorisation in the memorandum and a special resolution by the general meeting seems to derive from the MBCA.¹²⁷⁵ The total lack of regulation of the procedure that should be followed in a repurchase also corresponds with the approach under the MBCA.

6.9.3 Liability for unlawful distributions and repurchases under the Companies Bill

Although the Companies Bill regulates the liability for unlawful distributions in a coherent fashion, this will be discussed in the context of liability for unlawful repurchases in order to facilitate comparison with the more comprehensive provisions on liability for unlawful repurchases under the Act. The focus of the Companies Bill is on the liability of directors. The Act expressly provides for director liability in the case of unlawful repurchases but not for unlawful 'payments'. For this reason, the liability provisions of the Companies Bill are best addressed here.

¹²⁷¹ Compare clauses 44(2)(a) and 45(2)(a) which require express authorisation in the memorandum of incorporation for financial assistance for the acquisition of shares or to directors and others.

¹²⁷² As is done in clauses 44(2)(b) and 45(2)(b) in relation to financial assistance.

¹²⁷³ See clause 15(6) which deals with the effect of the memorandum of incorporation.

¹²⁷⁴ The directors would be obliged to comply with such a requirement, see clause 76(3). Liability for non-compliance with the provisions of the memorandum of incorporation is imposed by clause 77(2)(b)(iii). However, clause 77(4) limits the liability of directors in respect of distributions to circumstances where the financial restrictions were not satisfied, see paragraph 6.9.3.1.2 below.

¹²⁷⁵ See Chapter 4 paragraph 4.4.2.

6.9.3.1 Directors

Clause 77 regulates the liability of directors and prescribed officers.¹²⁷⁶ For purposes of this provision the term 'director' has a wider meaning that includes an alternate director, prescribed officer and a member of a board committee or audit committee, irrespective of whether the person is also a member of the company's board.¹²⁷⁷ However, when regard is had to the specific provisions on liability for distributions and repurchases, it seems that only a director in the narrow sense can be held liable because she must have participated in the board resolution authorising the distribution.¹²⁷⁸ The director is liable jointly and severally with any other director who is liable for the same act.¹²⁷⁹

6.9.3.1.1 Requirements

The first requirement for liability is that the director must either have been present at a meeting where the board approved the distribution or must otherwise have participated in the making of the decision.¹²⁸⁰ The Companies Bill provides that board resolutions can be taken otherwise than at a meeting if adopted by a majority of the directors, either by written consent in person or by electronic communication, provided that all the directors received notice of the matter to be decided.¹²⁸¹ It appears that a director who has been notified of a matter to be decided otherwise than at a meeting will have participated in the making of a decision.

It also appears from the cross-references in clause 46(6) and in clause 48(7) to 'approval' of a distribution or acquisition that liability depends on the director's participation in the resolution authorising the distribution or approving the

¹²⁷⁶ The liability of directors for distributions made contrary to clause 46 is regulated in clause 46(6) read with clause 77(3)(e)(vi) while clause 48(7) read with clause 77(3)(e)(vii) deals with the liability in respect of an acquisition of shares contrary to clauses 46 and 48.

¹²⁷⁷ See clause 77(1).

¹²⁷⁸ See clause 46(1)(a)(ii).

¹²⁷⁹ It appears that only other directors can be held liable for the same act. This means that the director will not be jointly and severally liable with shareholders who received the distribution, since their liability does not depend on the same act. The directors will be liable only for the balance not recovered from shareholders, see clause 77(4)(b).

¹²⁸⁰ Clause 46(6)(a) and clause 77(3)(e) read with clause 74. The duplication of the basic requirement of presence at a meeting and failure to vote against the resolution in clause 46(6) and clause 77(3)(e) is unnecessary.

¹²⁸¹ Clause 74.

acquisition that is envisaged, not the resolution acknowledging application of the solvency and liquidity test.¹²⁸² As a result, it seems that a director who did not participate in that resolution but who helped adopt a subsequent resolution in which the board acknowledged that it has applied the solvency and liquidity test, will escape liability. This is clearly undesirable.

The second requirement is that the director must have failed to vote against the resolution despite knowing that the distribution is contrary to the provisions.¹²⁸³ The failure to vote against the resolution applies equally to a meeting and to a decision taken otherwise than at a meeting. A director who fails to note her dissent with a decision taken otherwise than at a meeting, will also be liable.

In terms of the Companies Bill a person is regarded as 'knowing' something not only when she had actual knowledge of it, but also if she was in a position where she reasonably ought to have had actual knowledge, or to have investigated the matter to an extent that could have provided her with actual knowledge, or to have taken measures which, if taken, could reasonably be expected to have provided her with actual knowledge of the matter.¹²⁸⁴

In the case of liability for a distribution, the director should know that the distribution violates clause 46, while knowledge of the violation of either clause 46 or clause 48 is required for liability in respect of an acquisition of shares.

Two additional requirements are imposed for liability under clause 77(3)(e)(vi), that is, liability for a distribution in violation of clause 46. The first of these additional requirements is that the company should not have satisfied the solvency and liquidity test immediately after 'making all of the distribution'.¹²⁸⁵ This requirement introduces an objective *ex post facto* solvency and liquidity test as a prerequisite for liability. It is an important limitation, since it makes little sense to hold directors liable based on an incorrect solvency and liquidity prediction if the company nevertheless happened to be solvent and liquid when the distribution was made. However, it also seems as if liability cannot be imposed in respect of partial implementation of a distribution in violation of the solvency and liquidity

¹²⁸² Even if the reference is rather to the acknowledgement resolution, it is clear that such a resolution also has to deal with the predicted financial situation upon completion of the whole distribution.

¹²⁸³ Clause 46(6)(b) and clause 47(7)(b) read with clause 77(3)(e).

¹²⁸⁴ Clause 1 s v 'knowing, knowingly or knows'.

¹²⁸⁵ Clause 77(4)(a)(i).

requirements, since it is stated that there must be non-compliance with the test after making 'all' of the distribution contemplated in the resolution.

The second additional requirement for liability under clause 77(3)(e)(vi) is that it must have been unreasonable at the time of the 'decision' to conclude that the company would satisfy the solvency and liquidity test after making the relevant distribution.¹²⁸⁶ The reference to the 'decision' rather than to a 'resolution' is unclear, but the different words used may indicate that the reference is to the resolution acknowledging application of the solvency and liquidity test. This also makes sense in the context, because the directors are only required to consider the solvency and liquidity test when making that acknowledgement. The effect of this requirement is to temper the objective solvency and liquidity standard imposed by clause 46(6). Despite actual insolvency or illiquidity, the directors will thus nevertheless be excused if they acted reasonably when making the acknowledgement. Conversely, directors who acted unreasonably when making a declaration will escape liability if the company nevertheless happened to satisfy the requirements at the crucial moment.

As a result of these two further requirements it is clear that although clause 46(6) and clause 77(3)(e)(vi) refer to a distribution contrary to clause 46, it is only in respect of non-compliance with the financial restrictions that the director can incur liability under these provisions.

It is immediately obvious that directors involved in an acquisition of shares in violation of the financial restrictions potentially face wider liability than directors who are being held liable on the basis of an unlawful distribution. Since payment in respect of an acquisition is also a distribution, this bias seems unjustified. Moreover, directors could potentially also be liable for loss or damage caused by non-compliance with any of the other non-financial requirements for share acquisitions.

6.9.3.1.2 Extent of liability

A director is liable for any loss, damages or costs sustained by the company as a direct or indirect consequence of the director's conduct.¹²⁸⁷ Clause 77(3)(e)

¹²⁸⁶ Clause 77(4)(a)(ii).

¹²⁸⁷ Clause 77(3)(e) introductory words.

identifies a number of instances that can result in liability, including unlawful distributions¹²⁸⁸ and unlawful acquisitions of shares.¹²⁸⁹

The discrepancy with regard to the requirements for liability for distributions and acquisitions respectively¹²⁹⁰ is also evident in respect of the extent of liability.

Clause 77(4) limits the liability that can be imposed under clause 77(3)(e)(vi) in respect of distributions violating clause 46 to the difference between the amount by which the value of the distribution exceeded the amount that could have been distributed without causing the company to fail to satisfy the solvency and liquidity test;¹²⁹¹ and the amount, if any, recovered by the company from persons to whom the distribution was made.¹²⁹² This limitation does not apply where clause 77(3)(e)(vii) applies, even if the only problem with the acquisition was that the payment violated the financial restrictions.

There is also uncertainty as to whether clause 77(8), which imposes liability on the director for the costs of all parties in the court proceeding to enforce liability and to restore to the company the amount improperly paid and not recoverable, also applies in instances where clause 77(4) limits the extent of the liability.

6.9.3.2 Shareholder liability

The provisions regarding director liability make mention of amounts recovered from shareholders who received distributions¹²⁹³ or from whom shares were repurchased.¹²⁹⁴ However, the Companies Bill makes no express provision for the liability of shareholders in respect of unlawful distributions or in respect of share acquisitions. This is a departure from the current position under section 90(4) and section 86(2) and (3).¹²⁹⁵

In the absence of specific statutory liability in respect of the receipt of distributions in violation of the requirements, an action for recovery must be based on common-law principles. It appears that invalidity would form the basis for

¹²⁸⁸ Clause 77(3)(e)(vi).

¹²⁸⁹ Clause 77(3)(e)(vii).

¹²⁹⁰ See paragraph 6.9.3.1.1 above.

¹²⁹¹ Clause 77(4)(b)(i).

¹²⁹² Clause 77(4)(b)(ii).

¹²⁹³ Clause 77(4)(b)(ii).

¹²⁹⁴ Clause 48(6).

¹²⁹⁵ See paragraphs 5.6 and 6.4.2 above.

recovery of any distribution. Invalidity could arise due to non-compliance with any of the requirements, not only the solvency and liquidity test. It also appears that shareholders will be liable to restore the unlawful payment to the company regardless of whether they received it in good faith or with knowledge of the non-compliance.

6.9.4 Enforceability of repurchase agreements

An agreement for the acquisition of shares is enforceable, subject to clause 48(2) and clause 48(3).¹²⁹⁶ These clauses set out the power of a company to acquire shares subject to the 'decision' satisfying the requirement of clause 46¹²⁹⁷ and subject to shares other than convertible or redeemable shares remaining in issue to a shareholder other than its subsidiaries.¹²⁹⁸

On the assumption that clause 48(2)(a) succeeds in incorporating the requirements of clause 46,¹²⁹⁹ it appears that non-compliance with any of the requirements for repurchases will render the contract unenforceable. This position is a departure from the current section 88(1) in which non-compliance with the solvency and liquidity test is the only basis for unenforceability.¹³⁰⁰

A contract whereby a subsidiary undertakes to acquire shares in its holding company will be unenforceable if the ten per cent limit will be exceeded or if the holding company will no longer meet the requirement as to shares that must remain in issue. However, since no attempt has been made to incorporate the requirements of clause 46, including the solvency and liquidity requirements into clause 48(2)(b), the acquisition appears enforceable regardless of the financial position of the subsidiary.

A company that is unable to fulfil its obligations in terms of a repurchase agreement can approach the court for relief.¹³⁰¹ If it is just and equitable in view of the financial circumstances of the company the court may make an order ensuring that the person to whom the company is required to make a payment in terms of

¹²⁹⁶ Clause 48(4).

¹²⁹⁷ Clause 48(2)(a).

¹²⁹⁸ Clause 48(3).

¹²⁹⁹ See paragraph 6.9.1 above.

¹³⁰⁰ See paragraph 6.5 above.

¹³⁰¹ Clause 48(5)(a).

the agreement is paid at the earliest possible date compatible with the company satisfying its other financial obligations as they fall due and payable.¹³⁰²

Closer analysis of the order that the court may make reveals that its ultimate object must be to ensure payment without jeopardising the company's ability to satisfy its other financial commitments. This clause is probably not wide enough to cover orders forcing the company to increase the number of shares of a particular class, to reduce the number of shares held by subsidiaries, to issue shares to a shareholder other than one of its subsidiaries, or to instruct the board to consider or reconsider the solvency and liquidity test and acknowledge its application of the test. Such orders may be necessary if the court has to rectify non-compliance with the non-financial requirements of repurchases. However, the provision does not refer to any circumstances other than 'financial circumstances' and 'financial commitments' that should be considered by the court.

It would be preferable to state clearly that enforceability will depend solely on the company's ability to satisfy the solvency and liquidity test. If the intention is indeed to make enforceability dependent on the company's ability to satisfy any of the requirements for repurchases, the court should have more powers as to the order it can make.

The company bears the burden of proving that fulfilment of its obligations will violate the relevant provisions.¹³⁰³

The ranking of claims in respect of unfulfilled repurchases when a company is liquidated is not regulated. It appears that such claims will rank concurrently with the claims of other creditors.¹³⁰⁴ This is also different from the position under the current Act.

If a company has acquired shares contrary to clauses 46 or 48, the company may apply to court to reverse the acquisition. The court may order return of the consideration and the reissuing of the shares.¹³⁰⁵ The use of the conjunctive 'and' implies that the court may not order the one without the other.¹³⁰⁶

¹³⁰² Clause 48(5)(c).

¹³⁰³ Clause 48(5)(b).

¹³⁰⁴ Compare paragraph 5.6 for a discussion of the current position under section 88.

¹³⁰⁵ Clause 48(6).

¹³⁰⁶ Compare paragraph 6.4.2.2 above.

6.9.5 Status of repurchased shares

Shares reacquired by a company as contemplated in clause 48 have the status of shares that have been authorised but not issued.¹³⁰⁷

6.9.6 Acquisitions by subsidiaries

Clause 48(2)(b) authorises a subsidiary to acquire shares in its holding company. Unlike clause 48(2)(a) which expressly makes the 'decision' by a company to acquire its own shares subject to compliance with the requirements of clause 46,¹³⁰⁸ clause 48(2)(b) does not cross-refer to the requirements of clause 46. Although the reasoning behind this apparent inconsistency is unclear, the omission of this requirement in relation to acquisitions by a subsidiary must be welcomed, in view of the difficulties I mentioned.¹³⁰⁹ The requirements for distributions will obviously have to be satisfied when the subsidiary transfers the consideration for the shares.

Two further principles apply to acquisitions by subsidiaries. First, subsidiaries may not together hold more than ten per cent of the number of any class of shares in their holding company.¹³¹⁰ Second, a subsidiary may not vote in respect of any shares it holds in its holding company.¹³¹¹ These provisions are an improvement on the current situation because they apply to any shares held by a subsidiary and not only to shares acquired after the subsidiary became a subsidiary.¹³¹² The limitation of the percentage of each class of shares rather than of the total number of shares in the company is also welcomed.¹³¹³ I will deal with the difficulties that remain below.¹³¹⁴

6.9.7 The redemption or conversion of shares

In terms of the Companies Bill, a company may have shares that are redeemable

¹³⁰⁷ Clause 35(5)(a).

¹³⁰⁸ See clause 48(2)(a) and the discussion in paragraph 6.9.1 above.

¹³⁰⁹ See paragraph 6.9.1 above.

¹³¹⁰ Clause 48(2)(b)(i).

¹³¹¹ Clause 48(2)(b)(ii). This principle is a consequence of rather than a prerequisite for acquisitions.

¹³¹² See paragraph 6.7 above.

¹³¹³ See paragraph 6.7 above.

¹³¹⁴ See paragraph 6.10.9 below for an evaluation.

or convertible at the option of the company, the shareholder or another person at any time, or upon the occurrence of any specified contingency.¹³¹⁵ The consideration may be cash, indebtedness, securities or other property.¹³¹⁶ The inclusion of securities¹³¹⁷ is necessary because the provision also applies to conversions.

The price, amount or other consideration may be specified in the terms of issue of the shares, determined according to a formula or subject to any terms set out in the company's memorandum of incorporation.¹³¹⁸

Redemptions must also comply with the requirements for distributions set out in clause 46, as well as those for the acquisition of shares set out in clause 48.

Conversions are not expressly regarded as distributions and need to comply only with the memorandum of incorporation.¹³¹⁹ This is unfortunate, as a conversion may affect the interests of creditors in the same way as a distribution.¹³²⁰ However, it is possible to regard a conversion as a distribution in appropriate circumstances, for example, as a transfer 'otherwise in respect of any of the shares of that company or of another company within the same group of companies'.¹³²¹ Alternatively, it could qualify as the 'incurrence of a debt or other obligation by a company for the benefit of one or more holders of any of the shares of that company or of another company within the same group of companies'.¹³²² In this instance, although a transfer of shares cannot amount to a distribution,¹³²³ the transfer of a debt security may be regarded as a distribution.

6.10 Evaluation of repurchases

The regulation of share repurchases poses definite challenges because share repurchases involve a distribution to shareholders as well as a reorganisation of

¹³¹⁵ Clause 37(4)(b)(i).

¹³¹⁶ Clause 37(4)(b)(ii).

¹³¹⁷ See the definition of 'security' in s 1 of the Securities Services Act 36 of 2004. The term includes debt instruments.

¹³¹⁸ Clause 37(4)(b)(iii) – (iv).

¹³¹⁹ See clause 37(4)(b).

¹³²⁰ This is why conversions are also regarded as distributions under s 6.03(b) of the MBCA, see Chapter 4 paragraph 4.3.1.

¹³²¹ Clause 1 s v 'distribution' paragraph (a)(iv), see paragraph 7.1.

¹³²² Clause 1 s v 'distribution' paragraph (b), see paragraph 7.1.

¹³²³ See the introductory sentence of the definition of 'distribution' in clause 1.

share capital. From the perspective of creditor protection repurchases require the same response as any other distribution. This also explains why the financial restrictions applicable to repurchases have been evaluated in relation to distributions in general.¹³²⁴ However, shareholders are exposed to unequal treatment which can dilute the value of their shareholdings as well as the balance of power in the company. The focus of this section will thus be on measures safeguarding the interests of shareholders. Nonetheless, an evaluation of all the non-financial requirements applicable to share repurchases as well as the consequences of repurchases is necessary.

6.10.1 Evaluation of power to acquire shares

Section 85 (1) provides for the acquisition of shares by a company. The choice of the term 'acquisition' is unfortunate for three reasons. First, the company has to cancel the shares and thus does not really acquire them. Second, because the term has not been defined, it is not clear whether it will cover instances where shares are 'acquired' by the company for no consideration. Although the financial restrictions in section 85(4) apply only when payment is involved, the authorisation requirements of section 85(1) apply to any acquisition. However, there is no good reason to insist on authorisation in the articles and in a special resolution of the company where an 'acquisition' does not affect the funds of the company or the rights of other shareholders, for example when shares are donated to a company. Third, the term seems wide enough to include the redemption of shares, which is regulated separately but not expressly excluded. This could create the impression that the requirements of section 85 apply in addition to those of section 98. It is unlikely that this was intended, as the authorisation requirements of section 85(1) negate the essential characteristics of redeemable shares. Also, it makes little sense to impose the financial restrictions of section 85(4) in addition to those imposed on redemptions.

I suggest that the term 'acquisition' should be defined and that the acquisition of shares for no consideration should be expressly excluded. The redemption of shares should not be subject to the authorisation requirements for repurchases. However, it is preferable that the same financial restrictions apply to redemptions

¹³²⁴ See paragraph 4.4.1 above.

and repurchases.¹³²⁵

The Companies Bill uses the term 'acquisition' without providing a definition. By implication this includes shares acquired in compliance with a court order. But the Companies Bill also expressly excludes shares surrendered to the company under the proposed appraisal remedy, which appears anomalous. Although the Companies Bill will solve some of the uncertainty regarding the meaning of 'acquisition', I submit that further attention should be given to the inclusion or exclusion of payments made under the appraisal remedy and court orders. An advantage of the Companies Bill is that the redemption of shares is also regarded as an acquisition, so that the same financial restrictions apply to repurchases and redemptions.

The greatest difficulty with the proposals on share acquisitions under the Companies Bill relates to the group concept. The definition of 'distribution' includes payments or transfers to the shareholders of any other company in the same group and is evaluated elsewhere.¹³²⁶ However, when dealing with share acquisitions in particular, clause 48 addresses the acquisition of shares by a subsidiary in its holding company but does not mention other acquisitions within a group. As a result, there is no limit on the extent of shareholding of a company in its co-subsiary, because neither the ten per cent limit of clause 48(2) nor the requirement in clause 48(3) that shares other than convertible or redeemable shares or shares held by one or more subsidiaries must remain in issue, will apply to shares that co-subsiaries hold in each other.¹³²⁷ It appears that the drafters of the Bill have not fully considered the implications of the wider definition of distribution.¹³²⁸ I submit that the acquisition of shares by a subsidiary in a co-subsiary (other than its own subsidiary) should also be regulated expressly if it is indeed the intention behind the wide definition of 'distribution'.¹³²⁹

¹³²⁵ Also see paragraph 6.10.8 below.

¹³²⁶ See paragraph 4.4 above.

¹³²⁷ See also paragraph 2.9.2 above where it was pointed out that the Companies Bill does not contain a general requirement on the minimum issued, as opposed to authorised, shares.

¹³²⁸ The draft Companies Bill of 2007 does not contain this extended definition of 'distribution', with the result that there has not been opportunity for public comments on the idea of a general group extension.

¹³²⁹ See paragraph 6.10.7 below.

6.10.2 Evaluation of financial restrictions

I evaluate the financial restrictions applicable to distributions, including share acquisitions elsewhere.¹³³⁰ I will focus here on the timing aspect in relation to share acquisitions. Although it is clear that the time of payment is decisive under the Act,¹³³¹ the Companies Bill introduces a measure of confusion by requiring that the 'decision' to acquire shares should satisfy the requirements of clause 46.¹³³² This appears to be contrary to the general scheme of the Companies Bill which requires the financial restrictions be satisfied when a distribution, in this case the transfer of money or property, is made.

In general, the requirements of solvency and liquidity are no doubt sensible restrictions on repurchases. But the comparative study revealed a rather interesting exception that merits consideration in South Africa. In California the net proceeds¹³³³ of a life policy or of disability insurance payable to the corporation may be applied to repurchase or redeem the shares of a deceased or disabled shareholder in terms of a prior agreement.¹³³⁴ This exception can play an important role in closely held private companies, in particular because the situation in such companies is recognised as one of the justifications of a share repurchase power. But if the company is unable to pay its debts, this exception will be to the disadvantage of the creditors who are generally entitled to be paid from all the company's property, including the proceeds of a policy. I submit that an exception is warranted, but that only the excess over the total premiums paid should be available for the repurchase. In my view this solution adequately protects the creditors.¹³³⁵

6.10.3 Evaluation of procedure

The Act provides minimum standards of protection to shareholders by requiring

¹³³⁰ See paragraph 4.4.1 above.

¹³³¹ See paragraph 6.2.1 above.

¹³³² See paragraph 6.9.1.1.

¹³³³ That is, the excess over any premiums contributed by the corporation.

¹³³⁴ See Chapter 4 paragraph 3.4.2.5.

¹³³⁵ Provision could be made for the calculation of interest on premiums paid, so that the creditors will also be compensated for the time value of money. However, it should be remembered that premiums paid while the company was not experiencing any financial difficulties could hardly have been paid to the disadvantage of creditors.

authorisation in the articles and a special resolution approving an acquisition.

It appears that the requirement of authorisation in the articles does not add much to the protection of shareholders, as the articles may also be altered by special resolution. The same shareholders who have the power to approve an acquisition will be able to approve the alteration of the articles. It may be difficult for a minority shareholder to prove that the inclusion of a repurchase power in the abstract is not in the best interest of the company. It is more likely that a shareholder will succeed in attacking a special resolution to approve a particular repurchase of shares as amounting to unfairly prejudicial conduct than would be the case with a special resolution to alter the articles and so grant the company the power to acquire its own shares.

The special resolution approving a repurchase offers better protection since specific information about the proposed special resolution will have been disclosed to the shareholders.¹³³⁶ However, in view of the absence of voting restrictions on shareholders who participate in selective repurchases, this protection is compromised.¹³³⁷ The Act also prescribes the procedure to be followed for certain repurchases, but there are anomalies in the regulation of the procedure for the acquisition of unlisted shares.¹³³⁸ When section 87(2) was enacted in 1999, it provided that an offering circular was not required 'if, and to the extent that, the shares are acquired in terms of the special resolution passed in terms of section 85(3)'. While section 85(3) does refer to a general approval, the special resolution authorising the repurchase is passed in terms of section 85(1). The only special resolution referred to in section 85(3) is a resolution which revokes a general approval.

The position after 1999 appeared to be that an offering circular was not required where shares were acquired under a general approval. On the other hand, this was required for every acquisition under a specific approval, even for a specific approval of an acquisition from a particular shareholder. This did not make sense. After all, if the company passed a special resolution which specifically approved an acquisition from a single shareholder, the whole purpose of the resolution was defeated if the company nevertheless had to make offers to (and

¹³³⁶ See s 199(1).

¹³³⁷ See paragraph 6.3.1.2 above.

acquire shares from) all the shareholders. In order to avoid the necessity of sending out an offering circular when a company wanted to acquire shares from a specific named shareholder, it had to resort to an acquisition under a general approval which left the directors free to also acquire further shares as they saw fit.

After the amendment of December 3, 2001, section 87(2)(a) now states that an offering circular is not required where the approval is a specific approval. This means that it is required in the case of a general approval. Prior to the amendment, a general approval in an unlisted company would have afforded the directors a wide discretion, subject to the mandate given, to acquire shares from whomever wanted to sell without resorting to a *pro rata* offer. One context in which such a general power might have been very useful was in relation to employee shareholder schemes where the shares of employees who left the company could be repurchased by the company.

However, because section 87 now obliges the company to send out an offering circular to all shareholders inviting them to offer their shares, the ambit of what can be achieved by way of a general approval has been narrowed down to *pro rata* acquisitions only. While the Companies Amendment Act 35 of 2001, which amended section 87(2)(a), may have solved some anomalies, it created fresh ones.

Although the Act distinguishes between a specific and a general approval, it does not define either concept and gives no indication of when an approval will be general or specific. Would it be possible for the general meeting to manipulate the procedural requirements by simply declaring an approval to be either general or specific, regardless of its terms? Is it possible, for example, to pass a 'specific' approval for company A to acquire 600 class A shares at a price of Rx per share *pro rata* from all its shareholders who are willing to sell? If so, the section 87(2)(a) requirement of an offering circular will not apply and the company can presumably follow its own procedure to give effect to the resolution. Can a resolution authorising the company to, during the course of the financial year, acquire up to 10 per cent of its shares at a price between Rx and Ry per share be either a general or a specific approval? This dilemma is not solved by interpreting the concepts general and specific according to their ordinary meaning, because the

requirement of an offering circular substantially limits the ordinary meaning of a general approval.

I suggest that this problem can be attributed to the legislature's failure to distinguish between the three main types of repurchases which should each be regulated in an appropriate fashion. The three types of share repurchases¹³³⁹ commonly recognised in modern company law are:

- **self-tender or *pro rata* offers:** the company offers to acquire shares from shareholders who are willing to sell - in order to treat shareholders fairly, such repurchases should be made as far as possible on a *pro rata* basis
- **selective repurchases:** the company wishes to acquire shares from one or more identified shareholders who should, due to their interest in the matter, not be allowed to vote - full disclosure of the reasons for the repurchase and the price payable is required
- **general repurchases:** the company is given a general power to acquire shares as and when they become available - this power is given for a fixed period and the volume of shares and the price ranges can be stipulated.

The procedure prescribed by the JSE Limited in fact distinguishes between the three types of repurchases. As a result, a divergence has arisen between the types of repurchases that may be made by listed and unlisted companies and the basic rules that apply to each. On the one hand, unlisted companies do not enjoy the same flexibility under the Act as listed companies do in terms of the JSE Limited rules. On the other hand, the procedural safeguards of the Act can be avoided by unlisted companies while listed companies have to comply with a procedure designed for the specific type of repurchase. Section 87(2)(a) may need further attention to bring it into line with the more sophisticated rules of the JSE Limited. Procedurally the concepts of general and specific repurchases are almost exact opposites, depending on whether they involve unlisted or listed shares. The *JSE Limited Listings Requirements* also exclude the votes of shareholders whose shares are being acquired in a selective repurchase and so reduce the risk of

¹³³⁹ Acquisitions in terms of court orders or minority buy-out rights excluded.

abuse.¹³⁴⁰

The Companies Act should distinguish between the different types of specific approval and regulate each in an appropriate way. Shareholders in unlisted companies are probably exposed to a greater risk of abuse through share repurchases than shareholders in listed companies, and so it is understandable that the current protection of shareholders in selective repurchases is regarded as insufficient.¹³⁴¹

As regards general approvals, it should once again be possible, as was the case in the period between the 1999 and 2001 Companies Amendment Acts, for unlisted companies to give their directors a general mandate to repurchase shares without having to resort to an offering circular. It should be made clear that an offering circular will be required in the case of a self-tender offer only.

The proposed deregulation of repurchases in the Companies Bill is regrettable. Neither authority in the memorandum nor shareholder approval by resolution is required. The risks associated with selective repurchases are not addressed. It appears easy for a company to exclude in its Memorandum of Incorporation the presumption of equality within a class embodied in clause 37(1). Moreover, the fair treatment of different classes of shares in a share repurchase is ignored, although very limited allowance is made for taking into account the liquidation preferences of shares.¹³⁴² While the appraisal remedy proposed in clause 164 will be available if the rights of a class of shares are materially affected by an alteration of the memorandum, an acquisition of shares will not involve such an alteration of the memorandum and will thus not entitle the shareholders to insist on appraisal of their shares. Also, since the directors decide on share repurchases, they may use repurchases to expropriate shareholders.

I submit that the requirements of clauses 46 and 48 and the duties imposed on directors will not adequately protect shareholders against the risks inherent in repurchases, and in particular, coercive or selective repurchases. Shareholders' only recourse will be to rely on the duties of director, to the extent that these duties

¹³⁴⁰ See paragraph 6.3.2.2 above.

¹³⁴¹ See Cassim "New Statutory Provisions" 775; Cassim "Reform of Company Law and Capital Maintenance" 287 – 288. See also Blackman, Jooste & Everingham *Companies Act* 5-45 – 5-47 for a discussion of the risks attendant on repurchases.

¹³⁴² See paragraph 4.3.1.4 above.

are preserved under the Companies Bill. In this regard, a director's duty to exercise powers for a proper purpose is expressly mentioned in the Companies Bill.¹³⁴³ Shareholders could possibly also use the minority oppression remedy.¹³⁴⁴ In view of the generally recognised risks associated with selective repurchases, I submit that shareholders should not have to rely on such remedies, the enforcement of which will necessarily have adverse cost implications. It would be preferable to protect shareholders through appropriate preventative measures.

While the MBCA does not prescribe a procedure for fair treatment of shareholders in repurchases, other legislation such as the Federal Securities Exchange Act of 1934,¹³⁴⁵ as well as established principles of state laws, does regulate this. Most state laws rely on the principle that directors should exercise their powers for a proper purpose.¹³⁴⁶ Also, the existence of fiduciary duties owed by controlling shareholders to minority shareholders in closely held companies is well recognised and applied in the context of selective repurchases. Although South African law also recognises the proper purpose principle,¹³⁴⁷ it may take time for the courts to develop its application in the context of repurchases. Further, the recognition of fiduciary duties of majority shareholders is in its infancy in South Africa and its possible effect on the appropriate procedure for repurchases must still be determined by the courts.

I submit that the protective measures of the New Zealand Companies Act provide a better model for South Africa. In addition to express authorisation in the memorandum, the directors have to resolve that the repurchase is fair to the company as well as the remaining shareholders.¹³⁴⁸ Disclosure of prescribed details to shareholders is essential where selective acquisitions are proposed and, unless the company's constitution expressly provides for non-*pro rata* offers, the written consent of each shareholder is required.¹³⁴⁹

¹³⁴³ See clause 76(3)(a).

¹³⁴⁴ See clause 163.

¹³⁴⁵ 15 USCA ss 78a et seq; see s 13(e) and Rule 13e-4. This applies to listed companies.

¹³⁴⁶ See Chapter 4 paragraph 4.4.3.

¹³⁴⁷ This is confirmed in clause 76(3)(a).

¹³⁴⁸ See Chapter 3 paragraphs 5.3.2 and 5.3.3.

¹³⁴⁹ Chapter 3 paragraph 5.3.2.

6.10.4 Evaluation of liability

Although the company can hold shareholders liable to return the amount of an unlawful payment, either as consideration for the acquisition of shares or otherwise by reason of shareholding, the Act provides for the liability of directors in respect of payments for the acquisition of shares only. It is anomalous to hold directors liable in respect of repurchases but not in respect of other payments, particularly in view of the fact that liability for the former is imposed only for non-compliance with the financial restrictions.

From the perspective of creditor protection, there is no justification for a different approach to director liability for dividend-like payments and for unlawful share repurchase payments. If statutory liability were imposed on directors in respect of non-compliance with the shareholder protection measures, this would recognise the basic difference between repurchases and other distributions.

Difficulties would remain even if section 86 were to apply to all distributions. Firstly, the position of a director who has paid the amount of the unlawful consideration to the company should be regulated. The extent of a director's liability depends on recovery from shareholders and the contribution of co-directors. It was argued that a director who already extinguished this liability to the company should have a direct right of recourse against shareholders. Such a director should also be refunded if the company subsequently recovers payment from a shareholder. Curiously, the current provisions appear to forbid this. It should be made clear that such a director does not lose the right to apply for and receive repayments by shareholders or former shareholders.

Secondly, the court should be given more flexibility as to the kinds of orders it could make when a director, as opposed to a creditor or shareholder, applies for an order against the vendor-shareholder.¹³⁵⁰ In particular the court should be given the power to order that the company issue shares to the shareholder or former shareholder, as is the case under section 86(3).¹³⁵¹ The court should also be entitled to make any other order it deems fit, including an order that the shareholder should make a payment directly to directors who have already restored an unlawful payment to the company. Thirdly, various discrepancies arise

¹³⁵⁰ Compare section 86(3), discussed in paragraph 6.4.2.2 above, with section 96(2), discussed in paragraph 6.4.2.1 above.

from an analysis of section 86(2) when compared with section 86(3), although both provide for recovery from shareholders. There seems to be a difference between the orders a court can make on application of a director under section 86(2) and on application by a creditor or shareholder under section 86(3). It appears that when the application is brought by a director the court can only order the vendor-shareholder to make payment to the company. Although it could be argued that the court has this power in any event,¹³⁵² the obvious differences in the wording of these two provisions are unsatisfactory. The express reference to particular types of orders in the one provision may possibly justify a conclusion that these types of orders cannot be made under a provision that fails to mention them yet mentions other orders.

Shareholders who received an unlawful payment are liable to restore this amount to the company. There is no indication in the Act that *bona fide* vendors are excused, although the court is given a discretion to refuse an order under section 86(3). Cassim criticises the lack of an express provision exonerating a *bona fide* vendor, since the discretion of the court under section 86(3) leaves room for uncertainty.¹³⁵³ However, the authors of Blackman, Jooste & Everingham *Companies Act* point out that a *bona fide* vendor would nevertheless have been preferred above the company's creditors.¹³⁵⁴

I submit that the latter argument is convincing. It also accords with the South African common law, which relies on the principles of unjustified enrichment rather than on the notion of a constructive trustee. Although knowledge on the part of the recipient may influence the specific enrichment action that should be used, recovery from a *bona fide* recipient is possible, which is not the case under the constructive trustee doctrine.¹³⁵⁵

The practical application of the recovery provision will depend on the ability to identify the recipient. It can be problematic to enforce this liability in the case of share repurchases on a stock exchange.¹³⁵⁶ However, the directors will remain

Continued

¹³⁵¹ See paragraph 6.4.2.2 above.

¹³⁵² See Blackman, Jooste & Everingham *Companies Act* 5-76.

¹³⁵³ Cassim "New Statutory Provisions" 771 – 772.

¹³⁵⁴ Blackman, Jooste & Everingham *Companies Act* 5-77.

¹³⁵⁵ See paragraph 5.6 above.

¹³⁵⁶ See Van der Linde "A Company's Purchase of its Own Shares" 69. The anonymity of market purchases may also complicate the application of tax consequences of repurchases. See

Continued

liable for any deficit that is unrecoverable from vendors.

It could be argued that if recovery from shareholders were to be limited to shareholders who knew of the unlawfulness of a payment, the liability of directors would be an adequate safeguard for creditors. However, in large companies, especially listed companies, such reliance may be unwarranted. While the chances of finding knowing shareholders are remote, acquisitions on stock exchanges will usually involve significant amounts of money which the directors may very well be unable to restore.

The Companies Bill constitutes an improvement on the current Act because it expressly regulates the liability of directors for all distributions. Despite references to liability if a distribution is made contrary to the requirements of clause 46 as such,¹³⁵⁷ directors can be liable only for non-compliance with the solvency and liquidity test.¹³⁵⁸ Non-compliance with any of the other requirements will have to be determined according to the general liability principles of the Bill.¹³⁵⁹

As is the current position, creditors are not allowed to institute action against directors in respect of unlawful distributions. The liability of directors is towards the company only. However, in terms of the proposed statutory derivative action, creditors will be able to do so with the permission of the court.¹³⁶⁰ Shareholders and co-directors will also be able to enforce the company's right of recovery.

A director who did not participate in the initial meeting or resolution authorising a distribution, or who voted against the resolution, is exempt from liability even if she was subsequently involved in an acknowledgement resolution that reached an unreasonable conclusion regarding the company's solvency and liquidity. Similarly, no liability can be imposed under clause 77(3)(e)(vi) in respect of distributions in compliance with a court order or pursuant to an existing legal obligation. This may be an oversight and I submit that liability in respect of unreasonable acknowledgements should be regulated along similar lines. There is

Continued

Cathro "Share Buy Backs" 86 – 88 for a discussion of the position in Australia where on-market and off-market repurchases are taxed differently to ensure neutrality between all market purchases. Although in South Africa the company will be able to calculate its liability for STC, the vendor may still account for the receipt of the purchase price as if the sale was made to a third party.

¹³⁵⁷ See clause 46(4)(a) and clause 77(3)(e).

¹³⁵⁸ See clause 77(4).

¹³⁵⁹ See clauses 75 to 77.

¹³⁶⁰ See clause 165(2)(d).

a possibility that a director may nevertheless incur liability for breaching her duty of care and skill under a more general liability clause.¹³⁶¹

The Companies Bill also provides expressly for director liability in respect of share acquisitions.¹³⁶² Clause 77(3)(e)(vii) imposes liability where shares are acquired in violation of clause 48 or clause 46. This implies that either clause 77(3)(e)(vi) or clause 77(3)(e)(vii) could be used when the company makes a distribution in respect of an acquisition of shares contrary to the distribution requirements, since a payment for the acquisition of shares is a 'distribution' and also involves an 'acquisition of shares'. Under paragraph (vii), the director will be exposed to potential liability for a higher amount than would be the case under paragraph (vi).¹³⁶³ This effect seems to have been unintended and could be avoided by removing the reference to clause 46 not only from paragraph (vii) of clause 77(3)(e), but also from clause 48. There seems to be no justification for this divergence when the basic problem is that the company made a distribution while it did not satisfy the solvency and liquidity test.

It is a common trend among the other jurisdictions surveyed to base directors' liability not merely on the actual insolvency or illiquidity of the company but rather on their failure to exercise due diligence, particularly in relation to the financial restrictions. In England directors who signed the solvency declaration in respect of a repurchase out of capital are liable if the company is wound up within one year of the date of the payment, unless they can prove that they had reasonable grounds for forming the opinion set out in the declaration.¹³⁶⁴

In New Zealand three different bases of liability are distinguished, namely signing of a solvency certificate in the absence of reasonable grounds for believing that the company would satisfy the solvency test; failure to take reasonable steps to ensure that the correct procedure is followed and failure to take reasonable steps to prevent a distribution when the director is no longer satisfied that the company would satisfy the solvency test.¹³⁶⁵ In Delaware directors are liable for the wilful or negligent violation of any of the requirements pertaining to

¹³⁶¹ See clause 77(2).

¹³⁶² Clause 48(7) read with clause 77(3)(e)(vii).

¹³⁶³ See paragraph 6.9.4.1 above.

¹³⁶⁴ See Chapter 2 paragraph 6.5.2.

¹³⁶⁵ See Chapter 3 paragraph 6.4.

repurchases or dividends, but a director can escape liability by proving that she did not consent to the distribution and caused her dissent to be noted in the minutes.¹³⁶⁶ Directors who are present at the meeting where a disposition is approved and who fail to vote against the distribution will be liable under Californian law for distributions in violation of the financial restrictions. However, a director cannot be held liable unless she was negligent or acted in bad faith. Under the MBCA directors who voted in favour of or assented to a distribution in violation of either the financial restrictions or the articles of the company are potentially liable if they failed to comply with the standard of conduct for directors. An express provision exonerating directors in respect of reliance on information supplied by others is a feature common to all three the American systems.

Under the proposed provisions of the Companies Bill a director who did not participate in the initial meeting or resolution authorising a distribution, or who voted against the resolution, is exempt from liability even if she was subsequently involved in an acknowledgement resolution that reached an unreasonable conclusion regarding the company's solvency and liquidity. The failure to distinguish between the authorisation of a distribution and a resolution acknowledging compliance with the financial restrictions also means that directors cannot be liable when a payment in accordance with existing rights or in compliance with a court order is made in violation of the solvency and liquidity test.

As under the present provisions, creditors are not given the right under the Companies Bill to institute action directly against directors in respect of unlawful distributions. The liability of directors is towards the company only. However, in terms of the proposed statutory derivative action,¹³⁶⁷ shareholders and co-directors will be able to enforce the company's right of recovery. The comparative survey showed that California is the only other jurisdiction that expressly grants creditors and shareholders a general right to enforce the liability of directors in respect of unlawful distributions,¹³⁶⁸ although Delaware allows this in the case of dissolution or insolvency of the company.¹³⁶⁹ It is suggested that the company is the proper claimant and that creditors and shareholders should as a general rule not be

¹³⁶⁶ See Chapter 4 paragraph 2.4.4.

¹³⁶⁷ See clause 166.

¹³⁶⁸ See Chapter 4 paragraph 3.4.5.1.

¹³⁶⁹ See Chapter 4 paragraph 2.4.4.

allowed to proceed against the directors.¹³⁷⁰

Although the Companies Bill refers to recovery from shareholders, it does not expressly regulate this aspect. It appears that only the company will be able to enforce liability against the shareholders. The directors are not given any direct recourse against shareholders, although the extent of their liability depends on the amounts recovered from shareholders. I submit that this is not a serious problem, as the directors can recover these amounts through the company. Also, the proposed statutory derivative action can be used by directors, shareholders, registered trade unions and, with the permission of the court, any other person including a creditor.

The effect of the Companies Bill is that unlawful distributions can be recovered from shareholders even if they received the distribution in good faith and without knowledge of the violation.

In view of criticism against this wide liability of shareholders, a consideration of this issue in other jurisdictions is warranted. Although the finer detail differs, shareholders are exempted from liability on the basis of good faith or ignorance of the impropriety of the distribution in New Zealand, California and under the MBCA.¹³⁷¹ With regard to the USA the effect of the Uniform Fraudulent Transfer Act, which allows a creditor to recover a distribution from a shareholder if it left the corporation insolvent or with unreasonably small capital offsets this more lenient treatment.¹³⁷²

In England shareholders from whom shares were acquired out of capital, have no defence and are automatically liable to return the consideration if the company is wound up within one year of the payment. However, in respect of distributions otherwise than in terms of a share repurchase it must be shown that a shareholder knew or had reasonable cause to believe that a distribution was made in contravention of the provisions in order to hold her liable to return a distribution.¹³⁷³

The decision whether to hold shareholders liable despite their good faith is

¹³⁷⁰ See paragraph 7.13 and the provision entitled 'Liability for distributions in violation of solvency and liquidity test.

¹³⁷¹ See Chapter 2 paragraph 6.4.2; Chapter 4 paragraphs 3.4.6.2 and 4.4.6.

¹³⁷² See Chapter 4 paragraph 4.6.2 where it is also explained that this remedy is not restricted to insolvency proceedings.

¹³⁷³ See Chapter 2 paragraph 5.6.

ultimately based on a policy judgment in which the interests of creditors and shareholders are accorded relative weight. However, factors such as the upheaval that would be caused if recovery is sought from a large number of anonymous shareholders of listed shares, the duplicate liability of directors and the possible reliance on insolvency measures to impeach unlawful distributions also come into play. I suggest that the simplest solution is to hold shareholders liable regardless of whether they received a distribution in good faith. Practical difficulties in enforcing such recovery should not obscure the basic principle that ultimately, creditors enjoy preference in respect of the repayment of their debts.

6.10.5 Evaluation of enforceability

A contract for the repurchase of shares is enforceable, except to the extent that the company cannot perform without breaching the financial restrictions. If the company is wound up before the vendor-shareholder has been paid in full, the claim in respect of consideration will be ranked in priority to the other shareholders of the class who have not sold their shares to the company. This is a rather exceptional provision since it amounts to a statutory subordination of the claims of certain creditors (shareholder-vendors) to the claims of certain shareholders (those of classes enjoying priority over the class of shares acquired by the company). While the interests of preference shareholders are not taken into account in the application of the financial restrictions,¹³⁷⁴ they thus become relevant once the company has been wound up. It is also significant that the vendor-shareholders enjoy priority over the remaining shareholders of their own class.¹³⁷⁵

An almost identical arrangement regarding enforceability and the ranking of claims in respect of unfulfilled share repurchase contracts is found in England and in New Zealand.¹³⁷⁶ It is also notable that claims in respect of share repurchases and redemptions are treated in the same way.¹³⁷⁷ Currently the Act does not regulate the ranking of a claim in respect of an obligation to redeem shares, which is clearly undesirable.

¹³⁷⁴ See paragraph 4.1.3 above.

¹³⁷⁵ See paragraph 6.5 above.

¹³⁷⁶ See Chapter 2 paragraph 6.5 and Chapter 3 paragraph 6.5.

¹³⁷⁷ See Chapter 2 paragraph 6.5 and Chapter 3 paragraph 6.5.

The proposals of the Companies Bill with regard to the enforceability of repurchase agreements are unsatisfactory. Although an attempt appears to have been made at distinguishing between financial inability and other reasons why the company alleges that it cannot fulfill its obligation, and the orders the court may make in each instance, it has been foiled by inaccurate or overly broad cross referencing.¹³⁷⁸ The cost and time implications of obliging a company that already finds itself in financial difficulties to approach the court for relief, apparently regardless of whether or not the vendor-shareholder is pressing for payment, are also ill-considered. The rationale for forcing the company to bring an application in the event of non-compliance with certain requirements while making an application optional when certain other requirements have not been met is also not clear.

As regards the general enforceability of distributions the Companies Bill enjoins a company to proceed with a distribution on the basis of an acknowledgement by the directors that the company satisfies the financial restrictions. Enforceability of the distribution does not depend on the actual solvency and liquidity of the company at the time of enforcement, but rather on whether the directors have made an acknowledgement within the relevant period. This appears to conflict with the requirement in clause 46(1)(b) that it should reasonably appear that the company will satisfy the solvency and liquidity test immediately after completing the distribution. If enforceability depends purely on the board's acknowledgement, clause 46(1)(b) does not have any effect and clause 46(1)(c), which deals with the acknowledgement could have stood by itself. The purpose of this provision may have been to prevent the company from assigning the contract or to release the vendor-shareholder from liability.¹³⁷⁹ If this was the intention, I suggest that a distinction should be drawn between the moment the agreement becomes binding and the actual enforceability of payment.

If the board has considered the solvency and liquidity test for purposes of making an acknowledgement and concludes that the test is not satisfied, it has to approach the court for an order varying its original order,¹³⁸⁰ only in the case of a distribution in compliance with a court order and apparently not in any other

¹³⁷⁸ See paragraph 6.7.5 above.

¹³⁷⁹ See Chapter 2 paragraph 6.3.2.

¹³⁸⁰ See paragraph 5.8.2 above.

case.¹³⁸¹

The ranking of an unpaid claim in respect of a repurchase in a subsequent winding-up of the company is not addressed. It seems that such claims would rank concurrently with the claims of other creditors.

I make suggestions for the improvement of this provision.¹³⁸²

6.10.6 Evaluation of status of shares

The Act and the Companies Bill adopt the solution that shares should be cancelled when they are acquired by the company.¹³⁸³ However, it is uncertain exactly when shares are 'acquired' by the company. In New Zealand it is expressly provided that a company acquires shares when, but for the deemed cancellation, the company's name would have been entered into the register of shareholders.¹³⁸⁴ Apart from the fact that this provision appears to address the problem that in view of the cancellation the company never really 'acquires' the shares, it does not seem to take the matter much further. It does not appear necessary to include a similar regulation of this aspect in the South African Companies Act. Consistent use of terminology such as 'acquire', 'complete' and 'pay' and careful cross-referencing would be an improvement.

It is not certain how the acquisition of uncertificated shares should be handled. Under section 91A(4) the account of the transferee has to be credited in the subregister. Presumably the shares will be cancelled once they are entered into the name of the company's account in the subregister. Whether this satisfies the requirement that they should be cancelled 'forthwith' is debatable.

While many problems are associated with treasury shares,¹³⁸⁵ they are allowed in Delaware and to a limited extent in England and New Zealand.¹³⁸⁶ In South Africa shares held by a subsidiary in its holding company are an indirect form of treasury shares. If South Africa were to introduce treasury shares the disposal of such shares may have to be regulated, in addition to extending the

¹³⁸¹ Except if the distribution is in respect of an acquisition of shares, in which case the procedure outlined in the preceding paragraph applies.

¹³⁸² See Chapter 6 paragraph 7.16.

¹³⁸³ See paragraphs 6.6 and 6.9.6 above.

¹³⁸⁴ See Chapter 3 paragraph 6.6.

¹³⁸⁵ See Chapter 1 paragraph 1.

¹³⁸⁶ See Chapter 2 paragraph 6.6, Chapter 3 paragraph 6.6 and Chapter 4 paragraph 2.6.6.

voting restrictions currently in section 39 to treasury shares.¹³⁸⁷ Obviously it would be necessary to consider the cumulative effect of shares held through subsidiaries and in treasury. In England crossholdings are generally not allowed.¹³⁸⁸ Also, the distinction between listed and unlisted companies and the opportunities for the regulation of disposal of treasury shares should be borne in mind. Tax implications are another relevant factor. However, I think that the notion of treasury shares is conceptually flawed.

6.10.7 Evaluation of acquisitions by a subsidiary

The main advantage of using a subsidiary to acquire shares in a holding company rather than having the holding company acquire its own shares, is that secondary tax on companies (STC) will not be payable.¹³⁸⁹ A repurchase and cancellation of a share will amount to a distribution and is classified as a dividend for purposes of STC. However, when the subsidiary acquires shares in its holding company the shares are not cancelled and the purchase is not regarded as a dividend. It is uncertain whether this incentive will fall away when STC is abolished as the principles for the taxation of dividends have not yet been formulated.

Crossholding of shares can lead to various abuses and has been criticised by various academics and by South African courts.¹³⁹⁰

The protection against these abuses in the Act and in the Companies Bill is found in the imposition of the ten per cent limit on crossholdings and the neutralisation of voting rights.¹³⁹¹ The Companies Bill will rectify the rather obvious inadequacies of the Act in this regard.¹³⁹² It makes it clear that the ten per cent limit applies in respect of shares held by subsidiaries and plainly states that the voting rights may not be exercised.

However, as is the case under the Act, the Bill does not regulate the consequences of subsidiaries holding more than ten per cent of the shares of a

¹³⁸⁷ See Chapter 5 paragraph 6.10.6.

¹³⁸⁸ See paragraph 6.7 below.

¹³⁸⁹ See Wainer "Problems and Doubts" 138; Cassim "New Statutory Provisions" 779 – 780.

¹³⁹⁰ See Blackman, Jooste & Everingham *Companies Act* 5-102; Wainer "Problems and Doubts" 138 – 139; Delport "Company Groups" 125; *The Unisec Group Ltd & Others v Sage Holdings Ltd* 1986 (3) SA 259 (T) at 265 – 266.

¹³⁹¹ See paragraphs 6.7 and 6.9.7 above.

¹³⁹² See paragraph 6.7 above.

particular class. Various events subsequent to an acquisition could cause this limit to be exceeded, including the exercise of appraisal rights by other shareholders of the class, the issue of capitalisation shares, a selective repurchase of shares, or the acquisition of a further subsidiary that already holds shares in the holding company. It may not be easy to predict relatively small or temporary infractions of the limit.¹³⁹³ There may be difficulties in taking timeous preventative action, for example difficulty in finding a purchaser for the shares or inability by the holding company to implement a selective repurchase of the shares held by its subsidiaries. A rule similar to that found in the English Companies Act that allows twelve months to rectify the limit in respect of treasury shares, should be considered.¹³⁹⁴ Although this provision applies to direct treasury shares, it should be easy to adapt it to shares held by subsidiaries.

However, in view of the risk of abuse associated with crossholdings and the eminent demise of the tax advantages, it might be preferable to prohibit a subsidiary from acquiring shares in its holding company or in any co-subsidiary that holds shares in it.¹³⁹⁵ This will eliminate the problem of dividend round-tripping and the considerable risk posed to minority shareholders of partially owned subsidiaries.¹³⁹⁶

6.10.8 Evaluation of redemption of shares

The Act provides different procedures and requirements for the repurchase of shares and the redemption of shares. These diverging rules for redemption and repurchase of shares should not be retained. In particular the same financial restrictions should apply to both options. This problem is addressed by the Companies Bill which does not distinguish between repurchases and redemptions in this regard. In all the other systems investigated, repurchases and redemptions are subject to the same financial restrictions.

It makes sense to distinguish between redemptions at the option of the company and other redemptions as far as the procedural issues are concerned.

¹³⁹³ An example would be where it is uncertain how many shareholders will elect a cash payment in lieu of an issue of capitalisation shares.

¹³⁹⁴ See Chapter 2 paragraph 5.7.

¹³⁹⁵ See Chapter 6 paragraph 6.7.

¹³⁹⁶ See Blackman, Jooste & Everingham *Companies Act* 5-102.

An example of this is found in New Zealand where the procedural requirements for redemptions at the option of the company are the same as those for repurchases.¹³⁹⁷ The Companies Bill appears to succeed in drawing such a distinction. The provision regulating distributions expressly refers to existing legal obligations.¹³⁹⁸ In such a case board authorisation is not required, but an acknowledgement of solvency and liquidity must nevertheless be made. It can be assumed that a redemption at the option of the company is regarded as a distribution which is subject to authorisation by the board. Although this difference may seem insignificant, it may lead to opposing results as far as the liability of directors is concerned, because this liability is made dependent on participation in the original authorisation of the distribution.¹³⁹⁹

I think the legislation should expressly state that redeemable shares may be repurchased prior to the redemption date.¹⁴⁰⁰

¹³⁹⁷ See Chapter 3 paragraph 6.8.

¹³⁹⁸ Clause 46(1)(a).

¹³⁹⁹ See paragraph 6.10.4 above.

¹⁴⁰⁰ See Chapter 2 paragraph 6.8.

CHAPTER 6

CONCLUSION

1 INTRODUCTION

This final chapter commences with a summary of the different aspects of the regulation of share capital, capital contributions and distributions that were considered, followed by a conclusion and list of key recommendations. I then make more specific recommendations through proposed statutory provisions for the regulation of share capital and distributions. Although I have suggested improvements to particular provisions of the current Act in my criticisms of the current position, my proposals envisage a more complete overhaul of this area. For this purpose I will use the Companies Bill, which also aims to reform this area, as a point of departure where appropriate. In doing so, I hope that this thesis can make a contribution to the review process which is already in an advanced stage. This chapter and thesis concludes with a final analysis of the regulation of share capital structure, contributions and distributions and its impact on creditors and shareholders.

2 STRUCTURE OF SHARE CAPITAL

The analysis of South African law commenced with a discussion of the share capital structure established by the Companies Act.¹ The provisions dealing with authorised capital, issued capital, kinds of shares, share capital accounts, undistributable reserves, variation and reduction of share capital and loss of capital were identified as the components of this capital structure.

2.1 Authorised capital

The requirement that a company state its authorised capital in its memorandum of association, and amend this memorandum whenever the authorised capital is increased or decreased, is a clear indication of the importance of share capital in

¹ See Chapter 5 paragraph 2.

the scheme of the Act.²

Although the authorised capital determines the fee payable to the Registrar, the main function of authorised capital is to protect existing shareholders against dilution of their equity interests through the issue of shares beyond the stipulated limit. Authorised capital is a preventive measure operating on a structural level.

All the systems surveyed offer protection to shareholders against dilution of their interests when further shares are issued, but the methods of implementation and levels of protection differ. Apart from authorised capital, restrictions on the issue of shares, including pre-emptive rights, also provide protection.³

The decision to rely on the concept of authorised capital does not depend on or correlate with the type of financial restrictions a system prescribes for distributions.⁴ Some capital maintenance systems use authorised capital while others do not. Similarly, authorised capital is used in some solvency and liquidity systems, but not in others. Examples of each combination can be found in the jurisdictions analysed.⁵ The existence or not of strong pre-emptive rights on share issues is a good indication of whether reliance is placed on authorised capital in a system. Similarly, systems that do not have authorised capital tend to require shareholder approval for all or certain share issues.

In South Africa, authorised capital can be increased by special resolution, while shareholder approval by ordinary resolution is a general requirement for the issue of shares. Issues to directors must be approved by special resolution. Pre-emptive rights in relation to issues of further shares apply to listed companies.⁶ The Corporate Laws Amendment Act of 2006 extends existing pre-emptive rights on the transfer of shares to certain further share issues, but this amendment is problematic in several respects.⁷

The Companies Bill proposes to retain authorised capital and the requirement of a special resolution for an increase, although the power to

² See Chapter 5 paragraph 2.1.

³ See Chapter 5 paragraph 2.9.1.

⁴ See Chapter 5 paragraph 2.9.1.

⁵ See Chapter 2 paragraph 2.1; Chapter 3 paragraph 2; Chapter 4 paragraphs 2.2.1, 3.2.1 and 4.2.1. Also see Chapter 5 paragraph 2.9.1.

⁶ See Chapter 5 paragraph 2.1.

⁷ See Chapter 5 paragraph 2.1.

authorise further shares can be delegated to the board.⁸ It does away with shareholder approval as a general prerequisite for the issue of shares, but extends the special resolution requirement to include both issues to directors and substantial further issues. It also introduces pre-emptive rights on further share issues as the default option for private companies.

Pre-emptive rights afford more protection to minority shareholders than the requirement of a special resolution for the increase of authorised capital, coupled with an ordinary resolution for the actual issue of shares.⁹ This is because the right of minority shareholders to subscribe for further shares cannot be overridden by a majority vote. But shareholders who do not have additional funds to invest in the company will not enjoy the benefit of pre-emptive rights. The extent of the pre-emptive rights and the ease with which they may be excluded also have an influence on the level of protection enjoyed by shareholders.

While pre-emptive rights offer excellent protection to minority shareholders, they can also unduly restrict the company's ability to issue shares as consideration for assets, especially in the course of a merger or acquisition. This explains why pre-emptive rights are often made applicable to cash issues only.¹⁰ The potential abuse of non-cash issues to effect a dilution of shareholder interests can be addressed in other ways, for example strict regulation of non-cash consideration or a requirement of shareholder approval by ordinary or special resolution. It is difficult to explain why the Companies Bill provides for pre-emptive rights in respect of cash and non-cash issues alike, but excludes them when future consideration in any form is involved.¹¹ In my discussion of these proposed provisions, I warn that this distinction can be abused.

I suggest that pre-emptive rights should be the default option for both private and public companies in order to protect shareholders against dilution of their shareholdings. In private companies there is the additional consideration of a closed circle of shareholders. For this reason, existing shareholders in private companies should be given the opportunity to take up shares that their fellow

⁸ See Chapter 5 paragraph 2.8.1.

⁹ See Chapter 5 paragraph 2.9.1.

¹⁰ See Chapter 2 paragraph 2.1 and Chapter 4 paragraph 4.2.1.

¹¹ See Chapter 5 paragraph 2.8.1.

shareholders decline to subscribe for.¹² I think my proposal will achieve an appropriate balance between shareholder protection and the company's ability to issue further shares to raise capital or fund beneficial transactions.

A shareholder approval requirement targeting specific kinds of issues that have a greater potential for abuse is preferable to a general approval requirement, as it allows more flexibility. The Companies Bill proposal on substantial further issues¹³ is welcomed in principle, although I have criticised the threshold of 30 per cent, as well as its application where the company has more than one class of shares.¹⁴

In view of the limited application of the shareholder approval requirement and the proposed pre-emptive rights, I propose that the notion of authorised capital should be retained.¹⁵ However, it should be recognised that this concept is a remnant of the *ultra vires* doctrine and that persons who subscribe for unauthorised shares may be adversely affected should the issue not be ratified. For this reason, directors should also be made personally liable to the persons who offered to take up shares.¹⁶ At the same time the provisions on shareholder approval and pre-emptive rights should be improved.¹⁷

2.2 Minimum share capital

A statutory prescribed minimum capital, such as found in England for public companies, can offer some protection to creditors. But the specified amount is necessarily arbitrary. It is generally accepted that a minimum capital requirement can achieve little more than discourage frivolous incorporations.¹⁸

Although the Act does not prescribe a minimum issued or paid-up capital

¹² See paragraph 8.5 below and the proposed provision entitled 'Pre-emptive right to be offered and to subscribe shares'.

¹³ See Chapter 5 paragraph 2.8.1.

¹⁴ See Chapter 5 paragraph 2.8.1.

¹⁵ The proposed provision appears in paragraph 8.2 below and is entitled 'Authorisation for shares'.

¹⁶ See paragraph 8.5 below and subclause 3(e) of the proposed provision entitled 'Issue of shares'.

¹⁷ See the proposed provisions entitled 'Shareholder approval for issue of shares in certain circumstances' and 'Pre-emptive rights to be offered and to subscribe shares' in paragraph 8.2 below.

¹⁸ See Chapter 2 paragraph 2.2.

expressed in monetary terms, each subscriber to the memorandum of incorporation has to take up at least one share.¹⁹ The requirements for the issue of a certificate to commence business recognise by implication that a company may fund its operations through debt rather than rely on its issued capital.²⁰ The minimum issued share capital is not required for the sake of creditors, but to ensure that the company can function.²¹ It can do no harm to make it a statutory requirement that a company should at all times have at least one share in issue that confers the right to vote and to receive the net assets of the company on its dissolution. I suggest that it is better to state this as a general requirement from the outset than to prescribe which shares should remain in issue following an acquisition of shares as is currently done in the Act.²²

The Companies Bill requires that there should always be at least one share in issue to at least one person other than a company that is part of the same group of companies to which the company belongs.²³ However, the proposed provision is badly drafted. Apart from the fact that the provision will in effect prohibit the shares of a 'wholly owned' subsidiary from being held exclusively by the holding company and its subsidiaries, there is no qualification as to the nature of the one share that must be issued. As the provision is currently drafted, the one issued share need not be a voting share that entitles its holder to receive the net assets on liquidation. This is undesirable and I suggest that the proposed provision on issued capital must be aligned with the provision regarding authorised capital.²⁴ The status of shares acquired by the company should be dealt with in the provision dealing with authorised capital. A properly drafted provision will provide certainty and also allow simplification of the share acquisition provisions, so I will make suggestions for the improvement of this provision.²⁵

¹⁹ See Chapter 5 paragraph 2.2.

²⁰ See Chapter 5 paragraph 2.2.

²¹ See Chapter 5 paragraph 2.9.2.

²² See Chapter 5 paragraphs 2.9.2 and 6.3.2.

²³ See Chapter 5 paragraph 2.8.2.

²⁴ See clause 37(3)(b), discussed in Chapter 5 paragraph 2.8.2.

²⁵ See paragraph 8.4 below and the provision entitled 'Requirement to have shareholders'. My proposed provision is based on the example in the MBCA.

2.3 Kinds of shares

Par value and no par value shares were analysed in detail.²⁶ Although the Companies Act allows both these types of shares, par value shares are more popular. I argued that the legal consequences of these two types of shares depend on the way in which they are regulated rather than on the intrinsic difference between them, namely the existence or not of a par value.²⁷

I explain that under the Act par value shares are more flexible because the company can apportion the issue price between the share capital account, representing the nominal value, and the share premium account, representing the premium.²⁸ Although the stated capital account can be equated with the issued share capital account plus the share premium account of a company, the opportunities for applying the stated capital account are more restricted than the share premium account.²⁹ The requirement that the full issue price of no par value shares should be reflected in a stated capital account possibly explains the unpopularity of these shares in South Africa. This feature distinguishes South African no par value shares from no par value shares found in the other jurisdictions.

I also argue that sections 81 and 82, the two provisions protecting holders of par value and no par value shares respectively against a dilution in the value of their shareholdings, afford holders of no par value shares more protection, and limit the freedom of directors to decide on an issue price to a greater extent, than is the case with par value shares.³⁰

The par value of shares is used in the Companies Act in the determination of voting rights and public companies may deviate from this principle to a limited extent only. I observe that the Act does not provide for the allocation of voting rights between holders of par value shares and of no par value shares in circumstances where both types of shares carry voting rights in the same

²⁶ See Chapter 5 paragraph 2.3

²⁷ See Chapter 5 paragraph 2.3.2.

²⁸ See Chapter 5 paragraph 2.3.1.

²⁹ See Chapter 5 paragraph 2.3.1.3.

³⁰ See Chapter 5 paragraph 2.3.1.4 and see also paragraph 3.5.3.

company.³¹ I also illustrate that the correct application to no par value shares of certain provisions granting members the right to call a meeting or demand a poll depending on the percentage of capital or of issued share capital they hold is uncertain.

Despite the legislature's attempt at ensuring a degree of neutrality, several anomalies and inconsistencies can be attributed to this dual system.³²

Delaware is the only other jurisdiction surveyed that provides for a dual system of par and no par value shares.³³ While the capital maintenance or legal capital doctrine still applies in Delaware, its regulation of how the consideration received for par and no par value shares should be reflected in share capital and reserve accounts differs from South African law in important respects.³⁴ In Delaware it is not required that the full consideration received for no par value shares should be reflected as stated capital.³⁵ Share premiums are also not regulated, although the board of directors has the discretion to reflect any portion of a premium as share capital.³⁶

No par value shares are used to the exclusion of par value shares in each of the jurisdictions surveyed that have abolished the capital maintenance doctrine, namely New Zealand,³⁷ California³⁸ and states following the MBCA.³⁹ These systems are also characterised by the absence of regulation of share capital accounts in which the contributions of shareholders are reflected.

The South African experience since 1999 indicates that it is indeed possible to have a system based on solvency and liquidity in a par value share environment characterised by the regulation of share capital accounts. However, this experience also illustrates that many of the provisions traditionally associated

³¹ See Chapter 5 paragraph 2.3.1.5.

³² See Chapter 5 paragraph 2.3.2.

³³ See Chapter 4 paragraph 2.2.3.

³⁴ See Chapter 4 paragraph 2.7.

³⁵ See Chapter 4 paragraph 2.2.4 and Chapter 5 paragraph 2.4.2.

³⁶ See Chapter 4 paragraph 2.2.4.

³⁷ See Chapter 3 paragraph 2.

³⁸ See Chapter 4 paragraph 3.2.3.

³⁹ See Chapter 4 paragraph 4.2.3.

with the par value concept serve no useful purpose in such a system.⁴⁰

Although the choice between par value and no par value shares does not affect the protection of creditors, the kind of shares used in a company may be relevant for shareholders. The dual system is complicated and its implications uncertain. Par value shares appear to apportion shareholder interests in a predictable fashion, but the practice of fixing a low par value and issuing shares at a premium can be used to overcome this apparent proportionality. I submit that companies should be allowed considerable freedom in determining the relative voting and distribution rights of different classes of shares. However, this should be done in a transparent fashion and not through the manipulation of par values and premiums.⁴¹

I recommend that only no par value shares should be used in South Africa and that existing par value shares should be phased out. This is in line with the system of compulsory no par value shares proposed in the Companies Bill.⁴²

2.4 Share capital and reserve accounts

Share capital accounts and reserve accounts are closely regulated in the Act. The nominal value of issued par value shares must be reflected in a share capital account and any premium in a share premium account.⁴³ The stated capital account must reflect the full proceeds of an issue of no par value shares.⁴⁴

The imposition of restrictions on the application of share premiums is one of the most problematic aspects of the capital structure of companies in South Africa. Although the Act purports to treat share premiums as if they constitute share capital, it nevertheless allows the application of the share premium account in instances where ordinary share capital cannot be applied. Following the abolition of the capital maintenance principle, the share capital of a company has little significance from the point of view of creditors. It is equally insignificant from

⁴⁰ See Chapter 5 paragraphs 2.3.2 and 2.4.3.5.

⁴¹ See Chapter 5 paragraph 2.9.3.

⁴² See Chapter 5 paragraph 2.8.3. See also paragraph 8.1 below and the proposed provision entitled 'Legal nature of company shares'.

⁴³ See Chapter 5 paragraphs 2.4.1 and 2.4.3.

⁴⁴ See Chapter 5 paragraph 2.4.2.

the perspective of shareholder rights. This is because despite some legislative attempts to identify premiums with the shareholders who contributed them, shareholder rights are generally determined without reference to share premiums.⁴⁵

Besides South Africa, England is the only jurisdiction surveyed to regulate share premium accounts.⁴⁶ I argue that the regulation of share premium accounts must be reconsidered.⁴⁷ If par value shares and share premium accounts are retained, consideration will have to be given to the introduction of merger relief as has been done in England.⁴⁸ However, the retention of only no par value shares will avoid the problem of share premium accounts altogether.⁴⁹

Together with the share premium account, the share capital and stated capital accounts previously played an important role in the application of the common-law principle that share capital had to be maintained. I explained that although these accounts are no longer relevant for the financial restrictions applicable to distributions, the Companies Act still comprehensively regulates the keeping of share capital accounts and carefully circumscribes when they may or should be adjusted.⁵⁰ In view of the new philosophy of subjecting distributions to solvency and liquidity these prescriptions are unnecessary from the creditors' perspective. However, shareholders still have an interest in the share capital accounts as these indicate the relative entitlements of shareholders to distributions and other membership rights.⁵¹

Companies should be free to arrange the way in which the rights of shareholders in respect of contributed capital should be reflected. With the exception of England, this is currently the position in all the other jurisdictions that have been surveyed and is also in line with the proposals of the Companies Bill.

⁴⁵ See Chapter 5 paragraph 2.4.3.4.3.

⁴⁶ See Chapter 2 paragraph 2.4.3.

⁴⁷ See Chapter 5 paragraph 2.4.3.4.3.

⁴⁸ See Chapter 2 paragraph 2.4.3.

⁴⁹ See Chapter 5 paragraph 2.4.3.5.

⁵⁰ See Chapter 5 paragraph 2.4.

⁵¹ See Chapter 5 paragraph 2.9.4.

2.5 The variation of share capital

I analyse the rules on the variation of share capital.⁵² Share capital can be increased or decreased,⁵³ shares can be consolidated or subdivided⁵⁴ and par value shares can be converted into no par value shares or *vice versa*.⁵⁵ I illustrate that in most of these instances there are uncertainties and anomalies pertaining to the calculation of the prescribed fee on authorised capital.⁵⁶ The main objection against these variation provisions is that they are unnecessarily complex to the extent that they form part of the regulation of share capital and reserve accounts. I have already criticised these aspects.⁵⁷

The Companies Bill also contains a provision regarding the variation of share capital. Unlike the current provision which regulates the consequences of variations in considerable detail, the clause enables a company by special resolution to amend its capital or to delegate certain powers in this regard to the board of directors.⁵⁸ Although the appraisal remedy will be available in respect of certain variations of share capital, it appears that an increase in authorised capital will not qualify, even if new classes are created with priority over existing classes of shares. Shareholders will have to rely on the other protection measures against dilution of shareholder interests, namely pre-emptive rights and shareholder approval for certain issues.⁵⁹

I support the proposals of the Companies Bill with regard to variation of capital, although I recommend that they should be contained in a separate section.⁶⁰

⁵² See Chapter 5 paragraph 2.5.

⁵³ See Chapter 5 paragraph 2.5.1.

⁵⁴ See Chapter 5 paragraph 2.5.2.

⁵⁵ See Chapter 5 paragraph 2.5.3.

⁵⁶ See Chapter 5 paragraphs 2.5.1 – 2.5.3.3.

⁵⁷ See paragraph 2.4 above.

⁵⁸ See Chapter 5 paragraph 2.8.5.

⁵⁹ See paragraph 2.1 above.

⁶⁰ See paragraph 8.3 below and the provision entitled 'Variation of share capital'.

2.6 The reduction of issued capital

I assert that despite the repeal of the capital reduction provisions,⁶¹ companies can still achieve reductions of share capital through the acquisition of shares under section 85, redemption of shares under section 98 or the repurchase of shares in terms of a court order under section 252.⁶²

I suggest that most, if not all, of the kinds of reductions that were previously possible under the repealed provisions, are still possible through the creative combination of share acquisitions, including acquisitions without consideration, variations of capital and the issue of capitalisation shares out of reserves.⁶³ Although these methods may appear to be more cumbersome than the direct reduction of share capital under the previous provisions, I argue that this inconvenience must be balanced against the requirement for court approval under the repealed provisions.⁶⁴

In my view the reduction of capital through the acquisition of shares adequately protects the interests of creditors when compared to the protection they enjoyed under the repealed capital reduction provisions.⁶⁵ However, minority shareholders are worse off because share repurchases that may affect their rights disproportionately can be forced on them by a special resolution without their consent, and, unlike disproportionate reductions of capital under the repealed provisions, will not be subjected to scrutiny by a court.⁶⁶

When considering the interpretation of remaining references in the Act to the reduction of capital,⁶⁷ I suggest that these references should be understood as references to reductions by way of the acquisition of shares resulting in adjustments to the share capital accounts. I raised but rejected the possibility that references to the reduction of capital can by implication refer to applications of the

⁶¹ See Chapter 5 paragraph 2.6.

⁶² See Chapter 5 paragraph 2.6.2

⁶³ See Chapter 5 paragraph 2.6.3.

⁶⁴ See Chapter 5 paragraph 2.6.3.

⁶⁵ See Chapter 5 paragraph 2.6.4.

⁶⁶ See Chapter 5 paragraph 2.6.4.

⁶⁷ See Chapter 5 paragraph 2.6.5.

share premium account and capital redemption reserve fund.⁶⁸

I recommend that existing references in the Act to the reduction of capital should, depending on the context, be replaced with direct references to the acquisition of shares or adjustments of capital accounts consequent upon such acquisitions.⁶⁹ This proposal is of an interim nature as it applies only to the current Companies Act.

In the comparative study, separate reduction of capital provisions were found only in systems that retained the capital maintenance principle.⁷⁰ In these systems companies may need to reduce the formal capital yardstick to enable them to continue making distributions to shareholders. This is unnecessary if distributions depend on solvency and liquidity only.

2.7 Loss of capital

One of the grounds for winding-up of a company is that it has lost 75 per cent of its share capital or that this capital has become useless for its business. For purposes of this provision, share capital will be regarded as lost if the company's net assets are less than the amount of its share capital. While the retention of this ground does not make sense from the perspective of creditor protection, I argue that because shareholders have a residual interest in the capital they invested, loss of capital should remain a ground for winding-up.⁷¹

I think this legitimate interest of the shareholders, rather than creditor protection, also underlies the requirement in England that a meeting of shareholders should be convened in the event of a substantial loss of capital.⁷²

3 CAPITAL CONTRIBUTIONS

A shareholder's capital contribution to a company consists of the consideration given in respect of the issue of shares. My analysis of the regulation of consideration reveals that common-law principles were enhanced and also

⁶⁸ See Chapter 5 paragraph 2.6.5.

⁶⁹ See Chapter 5 paragraph 2.6.5.

⁷⁰ See Chapter 5 paragraph 2.9.6.

⁷¹ See Chapter 5 paragraph 2.7.

⁷² See Chapter 2 paragraph 2.7.

eroded by statutory provisions.⁷³

I deal with the consequences of non-compliance with the requirements before considering the different aspects of the size, form and timing of capital contributions. An allotment and issue in violation of the requirements is void, although the court may validate the irregular creation, allotment or issue of shares.⁷⁴ This seems to be unnecessarily rigid. The solution adopted in England, namely to hold the allottee liable to pay the full consideration in cash immediately,⁷⁵ may also not be suitable in every case. I think a distinction should be made between the consequences of different types of non-compliance.

The Companies Bill proposes to relax the regulation of the size, form and timing of capital contributions.⁷⁶ Although it is stated that shares will be fully paid once the company has received the consideration 'approved' by the directors,⁷⁷ there is uncertainty about the legal consequences for the subscriber if directors do not conform to the required standards of conduct.⁷⁸ It should be made clear whether or not a subscriber will become liable for the difference between the initial determination and the amount that should reasonably have been determined. In Delaware and California the directors' determination is conclusive, except if fraud is involved.⁷⁹ The MBCA does not provide a fraud exception and simply makes the determination conclusive.⁸⁰ Directors can nevertheless be held liable for breach of their duties. It is recommended that South Africa should follow the example of the MBCA.⁸¹ Allottees should not be liable for more than they undertook to contribute.

⁷³ See Chapter 5 paragraph 3.

⁷⁴ See Chapter 5 paragraphs 3.2 and 3.4.

⁷⁵ See Chapter 2 paragraphs 3.2 and 3.4.

⁷⁶ See Chapter 5 paragraphs 3.6.1 – 3.6.4.

⁷⁷ Except if future consideration is involved, see chapter 5 paragraph 3.6.4.

⁷⁸ See Chapter 5 paragraphs 3.6.1 and 3.7.1.

⁷⁹ See Chapter 4 paragraphs 2.3.1 and 3.3.1.

⁸⁰ See Chapter 4 paragraph 4.3.1.

⁸¹ See paragraph 8.6 below and subclause (5) of the proposed provision entitled 'Consideration for shares'.

3.1 Size of capital contribution

The minimum consideration payable for the issue of shares depends on whether or not the shares have a par value.⁸² The consideration for par value shares must be at least equal in value to their nominal value. This is because the common-law rule against the issue of shares at a discount still applies in South Africa. This is one of a number of instances where the legislature retains the rules regarding the formation of share capital despite its reforms of the distribution rules.⁸³ Although there is no common-law rule regarding minimum consideration for no par value shares, there is a statutory limitation on the minimum issue price where further shares of an existing class are being issued.⁸⁴

In England and Delaware, the other jurisdictions surveyed that have par value shares, the consideration is also required to equal or exceed the par value of the shares. England no longer allows an exception to this rule.⁸⁵ In Delaware shares may be issued below par if approved by shareholders, but creditors are entitled to hold the subscriber liable for the discount.⁸⁶ The South African exception in section 81 is unique because it makes an issue at a discount valid also against creditors.

Despite some similarities between section 81, which provides for the issue of par value shares at a discount,⁸⁷ and section 82, which regulates the minimum price at which no par value shares may be issued,⁸⁸ these two provisions serve different purposes.⁸⁹ While both provisions aim to protect existing shareholders against the uncontrolled dilution in the value of their shareholdings, section 81 in addition caters for the interests of creditors and future shareholders. Unfortunately neither of these provisions is effective in preventing the uncontrolled dilution of shareholder value, because the interest of shareholders relates to the current

⁸² See Chapter 5 paragraph 3.1.

⁸³ See Chapter 5 paragraph 3.1.

⁸⁴ See Chapter 5 paragraph 3.1.2

⁸⁵ See Chapter 2 paragraph 3.1.

⁸⁶ See Chapter 4 paragraph 2.3.1.

⁸⁷ See Chapter 5 paragraph 3.1.1.

⁸⁸ See Chapter 5 paragraph 3.1.2.

⁸⁹ See Chapter 5 paragraph 3.7.1.

value of their shares rather than the consideration they initially paid for their shares.

The Companies Bill provides that shares must be issued for adequate consideration.⁹⁰ This is a flexible concept that allows directors to take into account the company's current financial situation as well as market conditions. I suggest that the present value of existing shares is a factor the directors have to take into account in determining the adequacy of the consideration. Directors will also be personally liable for loss caused to the company by a determination in breach of the standard of conduct expected from them.⁹¹ For this reason I submit that it is unnecessary to impose specific restrictions on the minimum price at which further shares may be issued.

I recommend that the requirement of adequate consideration, as proposed in the Companies Bill, should be introduced, but extended so that a determination will also be required if non-cash consideration is later substituted for the initial consideration.⁹²

3.2 Form of capital contribution

I discuss the acceptable forms of consideration for shares⁹³ and illustrate that in South Africa the types of acceptable consideration are curtailed by the requirement that the company should actually have received the consideration prior to allotment and issue.⁹⁴

While the comparative study shows that future consideration is often subjected to stricter regulation and that in a number of jurisdictions future services may not be accepted as consideration,⁹⁵ it also appears that South Africa attaches harsher consequences to non-compliance with these rules. An issue and allotment for an improper consideration, for example future services, will be void

⁹⁰ Clause 40(4)(a), see Chapter 5 paragraph 3.6.1.

⁹¹ Clause 40(3) read with clause 77(2)(a) – (b), see Chapter 5 paragraph 3.6.1.

⁹² See paragraph 8.6 and the provision entitled 'Consideration for shares', especially subclause (4).

⁹³ See Chapter 5 paragraph 3.2.

⁹⁴ See Chapter 5 paragraph 3.4.

⁹⁵ See Chapter 2 paragraph 3.2 (England); Chapter 4 paragraph 2.3.2 (Delaware) and paragraph 3.3.2 (California).

in South Africa while in England, for example, the allotment will be valid and the subscriber will be liable to pay the consideration in cash.⁹⁶

The Companies Bill states that shares may be issued for any consideration.⁹⁷ Although I welcome this approach, I criticise the definition of consideration which includes things irrespective of their apparent or intrinsic value.⁹⁸ In my view a new Companies Act should not contain a definition of consideration.

Although the Act provides for the issue of capitalisation shares there is still a debate about the consideration aspect.⁹⁹ Capitalisation shares are expressly regulated as an exception to the consideration requirement in England, New Zealand and under the MBCA. I suggest that South Africa needs a similar exception to accommodate capitalisation issues. The express recognition that shares may be issued otherwise than for consideration is a positive feature of the Companies Bill.¹⁰⁰ Treating capitalisation issues and conversions as exceptions to the rule obviates the need to resort to artificial explanations of consideration.¹⁰¹

The proposed regulation of capitalisation shares in the Companies Bill must be commended.¹⁰² In addition to addressing the consideration aspect, the implications of offering cash alternatives are also expressly regulated.¹⁰³

3.3 The regulation of non-cash capital contributions

Although consideration for shares may be paid in cash or kind, the imposition of additional formalities in respect of non-cash consideration is common.¹⁰⁴ South African law requires disclosure of particulars regarding non-cash consideration,

⁹⁶ See Chapter 2 paragraph 3.2.

⁹⁷ See Chapter 5 paragraph 3.6.2.

⁹⁸ See Chapter 5 paragraph 3.7.2.

⁹⁹ See Chapter 5 paragraph 3.2.1.

¹⁰⁰ In terms of clause 40(1)(b) shares may be issued in terms of conversion rights pertaining to previously issued securities of the company, while clause 40(1)(c) provides that shares may be issued as capitalisation shares. See also Chapter 5 paragraph 3.6.2.

¹⁰¹ See Chapter 5 paragraph 3.2.1.

¹⁰² See Chapter 5 paragraph 3.7.2.1.

¹⁰³ Clause 47(3)(b), see Chapter 5 paragraph 4.3.

¹⁰⁴ See Chapter 2 paragraph 3.3, Chapter 3 paragraph 3.3, Chapter 4 paragraph 3.3.3 and paragraph 4.3.3.

but valuation is required only in order to reflect the consideration in the share capital and, where applicable, reserve accounts of the company.¹⁰⁵ The consequence of a discrepancy between the value of non-cash consideration and the issue price is the subject of conflicting views,¹⁰⁶ but I argue that these opposing views can be reconciled by drawing a distinction between the effects of such a discrepancy on the consideration due to the company on the one hand and on the share capital accounts on the other hand.¹⁰⁷

The valuation provisions do not achieve neutrality between par and no par value shares, as the requirements in respect of no par value shares have a slightly wider application, prescribe the procedure in more detail, and cannot be avoided by recording a value.¹⁰⁸

In comparison with most of the other jurisdictions surveyed, the South African regulation of non-cash consideration is lenient. In England and in Delaware, the two systems surveyed that still rely on the maintenance of share capital, the solutions are, respectively, to require independent valuation in respect of shares in public companies¹⁰⁹ and to impose shareholder liability for watered shares.¹¹⁰ In contrast, the general approach in systems based on solvency and liquidity is to protect the company and the shareholders by obliging the directors to determine that fair value was given for the shares.¹¹¹ Nevertheless, additional precautions are prescribed in respect of non-cash consideration in California,¹¹² in New Zealand,¹¹³ and in respect of substantial non-cash issues under the MBCA.¹¹⁴

South African law is stricter than some jurisdictions in its classification of

¹⁰⁵ See Chapter 5 paragraph 3.3.

¹⁰⁶ See Chapter 5 paragraph 3.3.1.

¹⁰⁷ See Chapter 5 paragraph 3.3.1.

¹⁰⁸ See paragraph 3.3.

¹⁰⁹ See Chapter 2 paragraph 3.3. The disclosure requirement for private companies is similar to the South African position that applies to all companies having a share capital.

¹¹⁰ See Chapter 4 paragraph 2.3.1.

¹¹¹ See Chapter 3 paragraph 3.3; Chapter 4 paragraphs 3.3.3 and 4.3.3. See also Chapter 5 paragraph 3.7.3.

¹¹² See Chapter 4 paragraph 3.3.3.

¹¹³ See Chapter 3 paragraph 3.3.

¹¹⁴ See Chapter 4 paragraph 4.3.3.

what constitutes cash. Cheques and promissory notes are not regarded as cash and so are subject to the increased regulation applicable to non-cash consideration.¹¹⁵ I recommend that a definition of cash consideration, based on the example in the English Companies Act,¹¹⁶ should be inserted into the Act to allow common forms of payment such as cheques and promissory notes to be treated as cash rather than as non-cash consideration.¹¹⁷

Under the Companies Bill there are no additional requirements for non-cash consideration. I criticise this lack of additional protection measures for existing shareholders when non-cash consideration is accepted by the board and suggest that particulars of non-cash consideration should be disclosed to shareholders.¹¹⁸ This will enable them to take appropriate action against directors who accept inadequate consideration. The provision I recommend appears below.¹¹⁹

3.4 Timing of capital contribution

The time when a capital contribution has to be made is of interest to the company as well as to existing shareholders.¹²⁰ A company may not allot and issue shares unless it has received the full issue price or other consideration for those shares.¹²¹ The primary effect of this requirement is that the issue of unpaid or partly paid shares is not allowed in South Africa, but this rule also curtails the nature of the consideration that may be accepted.¹²²

All the other systems I include in my comparative study allow unpaid or partly paid shares and regulate their legal consequences in varying degrees of detail.¹²³ Provision is usually made for the forfeiting of shares to the company should the shareholder default in paying up the outstanding amounts when due.

¹¹⁵ See Chapter 5 paragraph 3.2.

¹¹⁶ CA 1985 s 738(2); CA 2006 s 583(3), see Chapter 2 paragraph 3.2.

¹¹⁷ See Chapter 5 paragraph 3.7.2. See the proposed definition of 'cash' in paragraph 8.6 below.

¹¹⁸ See Chapter 5 paragraph 3.7.3.

¹¹⁹ See paragraph 8.6 and subclause (3) of the provision entitled 'Consideration for shares'.

¹²⁰ See Chapter 5 paragraph 3.7.4.

¹²¹ See Chapter 5 paragraph 3.4.

¹²² See Chapter 5 paragraph 3.7.4.

¹²³ See Chapter 2 paragraph 3.4, Chapter 3 paragraph 3.4, Chapter 4 paragraphs 2.3.4, 3.3.4 and 4.3.4 and the summary in Chapter 5 paragraph 3.7.4.

Restrictions on the transfer of unpaid or partly paid shares are also common. Where transfer is not restricted, the liability of the transferor and the position of the transferee are usually regulated. Delaware and California regulate the participation of unpaid or partly paid shares in more detail and afford partly paid shares dividend rights in proportion to the amount paid up on them.¹²⁴

The Companies Bill allows unpaid or partly paid shares and regulates their implications in detail.¹²⁵ The basic principle is that shares are regarded as paid up to the extent that consideration has been received by the company.¹²⁶ The transfer of unpaid or partly paid shares is restricted as such shares have to be placed in trust in the hands of a third party and will be transferred to the shareholder when paid. The Companies Bill sets out the default participation rights pertaining to shares placed in escrow and their entitlement to distributions, but these aspects can be changed in an escrow agreement.¹²⁷

Unpaid or partly paid shares should be welcomed as they will provide additional flexibility in the area of corporate finance. The proposed regulation follows a cautious approach, but nevertheless allows deviation from certain elements of the scheme, for example with respect to voting and distribution rights. These shares can potentially play an important role in black economic empowerment transactions.

Although I support the proposed provisions, I recommend that provision should be made for an adequacy determination by the board where unpaid or partly paid shares were issued for cash consideration, but the company later agrees to accept future non-cash consideration when a further payment is due.¹²⁸ This situation is not covered by the current formulation of clause 40(5) as the shares will not originally have been issued for consideration in the form of an agreement for future services, benefits or payments. I also recommend, and include a proposal, that the familiar concept of a trust should be used instead of

¹²⁴ See Chapter 4 paragraphs 2.3.4 and 3.3.4.

¹²⁵ See Chapter 5 paragraph 3.6.4.

¹²⁶ Companies Bill, 2008 clause 40(4).

¹²⁷ See Chapter 5 paragraphs 3.6.4 and 3.7.4.

¹²⁸ See Chapter 5 paragraphs 3.6.4 and 3.7.4.

'escrow'.¹²⁹

3.5 The regulation of commissions

I discuss the regulation of commission in respect of subscribing or procuring subscriptions for shares briefly. I observe that the relevant section is one of the very few provisions of the Act expressly limiting the application of funds representing issued share capital.¹³⁰ There is some uncertainty about the interpretation of the provision, and I suggest that the correct approach is to regard the provision as an exhaustive regulation of commissions, regardless of whether the commission is paid out of share capital or other funds.¹³¹

The Companies Bill does not regulate the payment of commission, as this is unnecessary in view of the deregulation of share capital and share capital accounts.

4 DISTRIBUTIONS

The Companies Act does not contain an inclusive definition of 'distribution'. However, the following payments that are regulated in the Companies Act are essentially distributions:¹³²

- payments to shareholders for the acquisition of their shares by the company
- payments to shareholders on the redemption of their shares
- payments to shareholders as interest on their shares
- payments to shareholders by reason of their shareholding.

Each of these distributions is regulated by separate provisions of the Act.¹³³ Different financial restrictions apply. The first and last of the above distributions

¹²⁹ See paragraph 8.7 below and the subclause (4) of the provision entitled 'Consideration for shares'.

¹³⁰ See Chapter 5 paragraph 3.5.

¹³¹ See Chapter 5 paragraph 3.5.

¹³² See Chapter 5 paragraph 4.

¹³³ See Chapter 5 paragraph 4.

are subject to the solvency and liquidity of the company, following the extensive amendments brought about by the Companies Amendment Act of 1999.¹³⁴ The second and third distributions, which were expressly regulated in the Act prior to these amendments, continue to be regulated as specific exceptions to the capital maintenance principle.¹³⁵ This fragmentation creates anomalies.¹³⁶

In contrast, the Companies Bill contains a comprehensive definition of the concept 'distribution'.¹³⁷ Three main methods of making distributions are identified, namely:

- a transfer of money or property
- the incurrance of an obligation
- the forgiveness or waiver of an obligation

As well as setting out these methods, the definition provides a list of examples of distributions and also expressly excludes certain transactions from the ambit of the definition.¹³⁸

I identify some similarities between the proposed definition in the Companies Bill and the definitions of the New Zealand Companies Act and the MBCA. I note that the third method, which is not mentioned expressly in these other two definitions, will be useful as it covers the waiver of a claim for outstanding consideration on unpaid or partly paid shares.¹³⁹

I criticise certain aspects of the proposed definition. First, I assert that the indiscriminate extension of the definition to the group context is undesirable. The extension may have the undesirable consequence of affecting transactions which are clearly not in the nature of distributions, for example the acquisition by a holding company of further shares in its subsidiary.¹⁴⁰

Despite an analysis of comprehensive definitions of 'distribution' in other

¹³⁴ See Chapter 5 paragraphs 4, 5 and 6.

¹³⁵ See Chapter 5 paragraphs 5.7 and 6.8.

¹³⁶ See Chapter 5 paragraph 4.4.

¹³⁷ See Chapter 5 paragraph 4.3.

¹³⁸ See Chapter 5 paragraph 4.3.

¹³⁹ See Chapter 5 paragraph 4.3.

¹⁴⁰ See Chapter 5 paragraph 4.3.

jurisdictions no precedent can be found for a general extension to all companies within a group. The Californian definition expressly includes distributions by a subsidiary,¹⁴¹ while one of the purposes of the inclusion of an indirect transfer in the MBCA definition is to regulate aspects of repurchases by a subsidiary.¹⁴²

I recommend that the definition of 'distribution' should be restricted to distributions by a company to its own shareholders, whether directly or indirectly.¹⁴³ In addition, the acquisition by a subsidiary of shares in its holding company should be expressly regulated, preferably in a separate provision.¹⁴⁴ In my view the notion of an indirect distribution sufficiently covers any other group transactions that may amount to distributions.

A second criticism I raise against the proposed definition is that it does not expressly require the distribution to be 'in respect of' or 'by reason of' the shareholding of the shareholder, except in one of the specific examples of a distribution.¹⁴⁵ I propose that such a qualification should be inserted.¹⁴⁶

Third, with reference to the express exclusion of appraisal payments from the definition, I criticise the incoherent regulation of appraisal payments and payments for shares in terms of a court order.¹⁴⁷ I submit that the interests of creditors should enjoy priority over those of dissenting shareholders. Payments under the proposed appraisal remedy should be subject to the financial restrictions just like payments to shareholders in terms of a court order.¹⁴⁸

4.1 Financial restrictions for distributions

Although the Act does not subject all distributions to the same financial restrictions, the solvency and liquidity test can be described as the general rule because it applies to the most common forms of distributions, namely 'payments'

¹⁴¹ See Chapter 4 paragraph 3.4.1.

¹⁴² See Chapter 4 paragraph 4.4.1.

¹⁴³ See also paragraph 8.8 below.

¹⁴⁴ See also paragraph 8.14 below.

¹⁴⁵ See Chapter 5 paragraph 4.4.

¹⁴⁶ See paragraph 8.8 and subparagraphs (b) – (c) of the recommended definition of 'distribution'.

¹⁴⁷ See Chapter 5 paragraph 4.4.

¹⁴⁸ See paragraph 8.8 and the recommended definition of 'distribution'.

and share repurchases. In both instances payment may not be made if there are reasonable grounds for believing that after the payment the company's liabilities will exceed its assets or that it will not be able to pay its debts as they become due in the ordinary course of business.

I observe that the way in which the solvency and liquidity test is formulated imposes a negative rather than a positive duty on the company.¹⁴⁹ This is because payment is allowed in principle, unless there are reasonable grounds to believe that the company is insolvent or will be unable to pay its debts.

The other jurisdictions that subject distributions to a solvency and liquidity test all impose a positive duty on the company or its directors to enquire into the financial position of the company when making a distribution.¹⁵⁰ The positive action that will be required of directors in relation to the resolution acknowledging application of the solvency and liquidity test is an improvement, provided that the acknowledgement is not used as the final determinant of enforceability of a distribution.¹⁵¹

I have already criticised the proposed inclusion in the solvency element of the 'consolidated assets of the company' where the company making the distribution is a member of a group of companies.¹⁵² It appears from the context that the intention was to refer to the consolidated assets of a group of companies. However, the group aspect is taken too far, especially if the subsidiary is partially owned and its financial affairs not integrated with those of the holding company.¹⁵³ The difficulties are aggravated by the wide definition of distribution in the group context. I recommend that both the definition and the financial restrictions should be reconsidered.

4.1.1 Reasonable grounds for believing

The existence or not of reasonable grounds to believe that a certain state of

¹⁴⁹ See Chapter 5 paragraph 4.1.1.

¹⁵⁰ For the position in England see Chapter 2 paragraph 6.2.2; for New Zealand see Chapter 3 paragraph 4.3; for California see Chapter 4 paragraph 3.4.2; for the MBCA see Chapter 4 paragraph 4.4.2.

¹⁵¹ See paragraph 6.5 below.

¹⁵² See Chapter 5 paragraph 4.3.1.2.

¹⁵³ See Chapter 5 paragraph 4.3.1.2.

affairs will exist immediately after payment, must be objectively assessed in applying the financial restrictions of the Act.¹⁵⁴ Under the Companies Bill, the validity of a distribution will also not depend on actual solvency and liquidity but on the reasonably foreseeable financial circumstances of the company.¹⁵⁵

I submit that the validity or lawfulness of a distribution should depend on whether the company in fact satisfies the financial restrictions when it makes the distribution. If the requirements are not met, the amount of the distribution should be recoverable from the recipient shareholders. The liability of directors, on the other hand, should depend on their conduct when applying the test.¹⁵⁶

A distinction between the lawfulness and recoverability of a distribution and the liability of directors is also made in England,¹⁵⁷ New Zealand and under the MBCA. I make suggestions regarding the solvency and liquidity test as well as the liability provision.¹⁵⁸

4.1.2 The liquidity element

All the systems that have abolished capital maintenance include a liquidity element as part of the financial restrictions for distributions. But there are subtle differences between the various jurisdictions. A time period may be specified as is the case in England where a solvency declaration is required for certain distributions from capital.¹⁵⁹ However, in all the other systems, including South Africa, no time period is prescribed.¹⁶⁰ The Companies Bill proposes to introduce a 12 month period.¹⁶¹ While a specific limitation can provide directors with more certainty when they have to make a statutory declaration as required under the Companies Bill, I advise against introducing a specific time period. Creditors of

¹⁵⁴ See Chapter 5 paragraph 4.4.1.1.

¹⁵⁵ See Chapter 5 paragraph 4.3.1.1.

¹⁵⁶ See Chapter 5 paragraph 4.4.1.1.

¹⁵⁷ See Chapter 2 paragraph

¹⁵⁸ See paragraph 8.10 below for the proposed solvency and liquidity test. See paragraph 8.11 regarding liability.

¹⁵⁹ See Chapter 2 paragraph 6.2.2. Although England still applies the capital maintenance doctrine, a repurchase from capital is one of the exceptions to that principle.

¹⁶⁰ Although the *JSE Limited Listings Requirements* prescribe a 12-month period, see chapter 5 paragraph 4.1.2.

¹⁶¹ See Chapter 5 paragraph 4.3.1.3.

companies with clearly foreseeable longer-term commitments may be disadvantaged by a 12 month limit, especially when extraordinary distributions are being made. The ordinary course of business of different companies may reasonably require a shorter- or longer-term projection to be made.

I also propose that claims in respect of distributions that are enforceable subject to solvency and liquidity should be excluded expressly as they are not due in the ordinary course of business.¹⁶²

4.1.3 The solvency element

A solvency element is an integral part of the financial restrictions of all the jurisdictions that have adopted alternatives to the capital maintenance or legal capital doctrine. In comparison with solvency requirements applicable in other jurisdictions, the South African balance sheet test is relatively lenient because it does not provide for any margin over solvency.¹⁶³ In most of the systems surveyed there is a margin equal to the liquidation preferences of preferent shareholders. While the purpose is to protect preferent shareholders, creditors benefit at the same time. It is also obvious that the South African financial restrictions are out of step with international trends in the protection of preference shareholders.¹⁶⁴ I recommend that the liquidation preferences of preferred classes of shareholders should be taken into account under the solvency element as a default option, unless the company's constitution expressly provides otherwise. I do not agree with the approach in the Companies Bill which requires express provision to be made for the protection of preferent shareholders.

The manner in which the solvency of a company must be determined is not prescribed in the Act. In New Zealand¹⁶⁵ and under the MBCA,¹⁶⁶ approved and audited financial statements must be used. This is also proposed in the Companies Bill, although the specific provision is somewhat ambiguous.¹⁶⁷ While

¹⁶² See paragraph 8.10 and subclause (2) of the provision there.

¹⁶³ See Chapter 5 paragraph 4.4.1.3.

¹⁶⁴ See Chapter 5 paragraph 4.4.1.3.

¹⁶⁵ See Chapter 3 paragraph 4.2.

¹⁶⁶ See Chapter 4 paragraph 4.4.2.

¹⁶⁷ See Chapter 5 paragraph 4.3.1.4.

it is a good idea to consider the information in properly prepared accounts, the validity of a distribution should ultimately depend on the actual solvency of the company at the time the distribution is made. Directors who know that the company has suffered a loss since the time reflected in the financial statements should also not be able to escape liability. I will recommend a provision clarifying this issue.¹⁶⁸

4.1.4 The timing for the application of the financial restrictions

The solvency and liquidity test must be satisfied at the time when payment, in the sense of an actual transfer of money or property, takes place.¹⁶⁹

Among the solvency and liquidity jurisdictions surveyed, South Africa is the only one consistently to apply the financial restrictions at the time of actual payment or transfer.¹⁷⁰ The date of authorisation is used for all distributions in New Zealand¹⁷¹ and for certain distributions in California and the MBCA.¹⁷² The time of application of the test also has an influence on the status of the shareholder's claim in respect of the distribution.

As a result of the inclusion of the incurring of a debt or obligation in the definition of 'distribution', the Companies Bill also introduces a specific timing rule stating that the distribution takes effect when the incurring of an obligation or debt is authorised.¹⁷³

The general rule is that a distribution may not be made unless it appears that the company will satisfy the solvency and liquidity test 'immediately after completing the proposed distribution'.¹⁷⁴ When the company intends to 'make' a 'proposed' distribution, the board must pass a resolution acknowledging its satisfaction that the company will comply with the test. However, the 120 day rule which has become necessary as a result of the requirement of a formal

¹⁶⁸ See paragraph 8.11 and subclause (1)(b) of the proposed provision entitled 'Liability for distributions in violation of solvency and liquidity test'.

¹⁶⁹ See Chapter 5 paragraph 4.2.

¹⁷⁰ See Chapter 5 paragraph 4.4.2.

¹⁷¹ See Chapter 3 paragraph 4.3.

¹⁷² See Chapter 4 paragraphs 3.4.3 and 4.4.3.

¹⁷³ See Chapter 5 paragraph 4.3.1.5.

¹⁷⁴ See Chapter 5 paragraph 4.3.1.5.

acknowledgement by the directors, detracts from this principle.¹⁷⁵ I recommend that the 120 day rule should be relevant for the formal acknowledgement by directors only, but that the actual enforceability of the distribution should not depend on it.¹⁷⁶

I submit that a company should be prohibited from proceeding with a distribution if the directors are no longer satisfied that the company's financial situation allows it.¹⁷⁷

5 DIVIDENDS AND OTHER PAYMENTS BY REASON OF SHAREHOLDING

Section 90 allows the distribution of the net assets of a company and so has abolished the capital maintenance doctrine.¹⁷⁸ Although the solvency test in section 90(2)(a) is less restrictive than the common-law test for dividends, the liquidity test added a new dimension to the financial restrictions in comparison with the common law.¹⁷⁹

The definition of 'payment' includes dividends in the narrow as well as in the wide sense. However, it is uncertain to what extent common-law rules as well as existing arrangements in company articles pertaining to 'dividends' apply to 'payments', particularly when a payment would not have been lawful at common law.¹⁸⁰ This uncertainty may have a negative impact on preference shareholders in particular. To solve this problem I recommend a statutory definition of 'dividend', similar to the one in the New Zealand Companies Act of 1993, coupled with a proportionality requirement.¹⁸¹

The common-law position of shareholders following the declaration of a dividend has been affected by the new financial restrictions.¹⁸² Because the

¹⁷⁵ See Chapter 5 paragraph 4.3.1.6. See also paragraph 6.5 below on the problem with enforceability.

¹⁷⁶ See paragraph 8.9 and subclauses (2) – (4) of the proposed provision entitled 'Making of distributions'.

¹⁷⁷ For the suggested procedure and burden of proof, see subclauses (4) – (5) of the proposed provision entitled 'Making of distributions' in paragraph 8.9 below.

¹⁷⁸ See Chapter 5 paragraph 5.

¹⁷⁹ See Chapter 5 paragraph 5.2.

¹⁸⁰ See Chapter 5 paragraph 5.1.2.

¹⁸¹ See paragraph 8.12 below.

¹⁸² See Chapter 5 paragraph 5.4.

financial restrictions apply at the time of actual payment, the shareholder will obtain a contingent claim when the dividend is declared. The position is similar to that in respect of unpaid consideration for the acquisition of shares, although the enforceability of section 90 payments is not regulated by statute.¹⁸³

The failure to impose express statutory liability on directors for unlawful payments under section 90 is out of step with the position that obtains to repurchases. It is also out of step with international trends.¹⁸⁴ I recommend that the liability of directors and shareholders should be regulated in the same way as in respect of unlawful repurchases.¹⁸⁵

The additional procedural requirements applicable to repurchases in comparison with payments under section 90 are justified by the fact that the latter do not involve the alteration or subrogation of the rights of the shareholders. I assert that payments under section 90 have to comply with the principle of equality or proportionality in their effect on shareholders unless the company's articles provide otherwise.

The proposals of the Companies Bill will contribute to solving this dilemma, because the Bill contains a comprehensive definition of 'distribution' and provides for equal rights within a class unless the memorandum expressly provides otherwise.¹⁸⁶ The memorandum must also set out the rights and preferences of each class of shares in respect of 'distributions' rather than 'dividends'.¹⁸⁷ When the model provisions for a memorandum of incorporation are drafted, it might be a good idea for them to provide for a distinction in formalities between 'regular' distributions out of profits and other distributions like returns of capital or non-cash distributions, as this will alert shareholders to distributions in respect of which there may be an increased risk of repayment.¹⁸⁸

¹⁸³ See Chapter 5 paragraph 6.5. See also paragraph 7.10 and subclauses (4) – (5) of the proposed provision entitled 'Making of distributions' in paragraph 8.9 below.

¹⁸⁴ See Chapter 3 paragraph 4.6; Chapter 4 paragraphs 2.4.4, 3.4.5 and 4.4.6.

¹⁸⁵ See paragraph 8.11 below and the proposed provision entitled 'Liability for distributions in violation of solvency and liquidity test.'

¹⁸⁶ See Chapter 5 paragraph 5.8.

¹⁸⁷ See Chapter 5 paragraph 2.8.1.

¹⁸⁸ This could resemble the arrangements in the *JSE Limited Listings Requirements* regarding section 90-payments where shareholder approval is required, see Chapter 5 paragraph 5.9.

6 SHARE REPURCHASES

Although the term share repurchase is generally used to describe a transaction under section 85, the section applies to the ‘acquisition’ by a company of its own shares.¹⁸⁹

6.1 Power to acquire shares

The meaning of the word ‘acquisition’ in section 85 is not defined.¹⁹⁰ This raises questions about the proper application of sections 85 to 88 to acquisitions that were possible at common law or in terms of the Act prior to the 1999 amendments. These include acquisitions for no consideration, redemptions of redeemable preference shares and the acquisition of shares in compliance with a court order under section 252. I regard the possibility that such acquisitions may have become subject to regulation under section 85 as untenable. I conclude that the legislature probably did not intend to subject such acquisitions to the requirements of sections 85 to 88, but suggest that this uncertainty should be cleared up by expressly excluding these other acquisitions from the ambit of the general repurchase or acquisition provision.

The Companies Bill also does not define ‘acquisition’ of shares. Although redemptions and acquisitions under court orders are clearly regarded as distributions, there are conflicting indications in the Companies Bill as to whether they are also acquisitions.¹⁹¹ On the other hand, the ‘surrender’ of shares under the appraisal remedy is neither a distribution nor an acquisition. The Companies Bill is also silent on the acquisition by a company of its own shares for no consideration.

I think that a definition of ‘acquisition’ is necessary.¹⁹² The effect of the definition on related provisions like those regulating the status of acquired shares should also be considered.¹⁹³

I also recommend that the repurchase by a subsidiary of shares in its holding

¹⁸⁹ See Chapter 5 paragraphs 6.1 and 6.1.1.

¹⁹⁰ See Chapter 5 paragraph 6.1.1.

¹⁹¹ See Chapter 5 paragraph 6.9

¹⁹² See paragraph 8.13 and the suggested definition of ‘acquisition’.

¹⁹³ See paragraph 8.3 below and the proposed provision entitled ‘Status of reacquired shares’.

company or in a co-subsiary should be regulated in a separate provision.¹⁹⁴

6.2 Financial restrictions for repurchases

The main function of the common-law prohibition against the purchase by a company of its own shares is to protect the creditors of the company against the diminution of the company's capital.¹⁹⁵ One of the primary objectives in regulating share repurchases is to find an alternative protection mechanism for creditors. The approach adopted in the Companies Act is to protect creditors through the financial restrictions of solvency and liquidity.¹⁹⁶

Although a prohibition against repurchases is commonly associated with the capital maintenance doctrine, share repurchases are nevertheless allowed in both the systems surveyed that still rely on capital maintenance. In England, shares may be repurchased upon the same terms as redemptions or, in the case of private companies, even from capital.¹⁹⁷ Delaware allows repurchases out of profits or as part of a reduction of capital.¹⁹⁸

While most of the requirements of section 85 apply to acquisitions in general, the financial restrictions of solvency and liquidity apply only when the acquisition involves a payment by the company. Although the concept of a payment is not defined for purposes of section 85(4), the provision refers to payment 'in whatever form'. It appears from the context that consideration in the form of money or property is envisaged.¹⁹⁹ This wider interpretation of 'payment' is also in line with the definition of payment in section 90(3) of the Act.

I raise the possibility of an exception to facilitate the acquisition of shares of deceased or disabled shareholders out of the proceeds of an insurance policy payable to a company,²⁰⁰ and recommend a provision based on the example in

¹⁹⁴ See paragraph 8.14 below.

¹⁹⁵ See Chapter 1 paragraph 2.

¹⁹⁶ See Chapter 5 paragraph 6.2.

¹⁹⁷ See Chapter 2 paragraphs 6.2.1 and 6.2.2.

¹⁹⁸ See Chapter 4 paragraph 2.6.2.

¹⁹⁹ See Chapter 5 paragraph 6.2.

²⁰⁰ See Chapter 5 paragraph 6.10.2.

California.²⁰¹

6.3 Procedure and other requirements

While compliance with the financial restrictions protects the interests of creditors, the procedural aspects of share repurchases can safeguard shareholders against abuse of the repurchase power. Two main approaches emerged from the comparative study. On the one hand Commonwealth jurisdictions tend to prescribe the procedure by statute, focusing on proper authorisation and disclosure. Jurisdictions in the USA on the other hand, prefer to base shareholder protection on general principles focusing on directors' fiduciary duties, although abuses associated with particular types of repurchases, such as greenmail, are regulated at federal level.

South Africa opted for the statutory regulation of the procedure, but it is sometimes difficult to establish which requirements apply to a particular acquisition of shares.²⁰²

The procedures for repurchases of listed and unlisted shares diverge in important respects.²⁰³ The more extensive regulation in respect of listed shares offers better protection to shareholders and is in line with the international trend of distinguishing between repurchases on the basis of the risk they entail from a shareholder protection perspective.²⁰⁴

The Companies Act makes provision for a *pro rata* or self-tender offer procedure. It prescribes the information that must be disclosed to shareholders when they are invited to offer their shares to the company and obliges the company to acquire shares as far as possible on a *pro rata* basis if more shares are offered.²⁰⁵

I assert that minority shareholders are not adequately protected against selective repurchases. Despite an attempt by the legislature to correct an earlier

²⁰¹ See paragraph 7.16 and the subclause (9) of the proposed provision entitled 'Company acquiring its own shares'.

²⁰² See Chapter 5 paragraph 6.10.3.

²⁰³ See Chapter 5 paragraphs 6.3.2.1 and 6.3.2.2.

²⁰⁴ See Chapter 5 paragraph 6.10.3.

²⁰⁵ See Chapter 5 paragraph 6.3.2.1.

error with regard to when the *pro rata* offer procedure should be followed, the procedure with its onerous disclosure and liability provisions can be avoided by manipulating the kind of approval.²⁰⁶ Also, minority shareholders can be coerced into selling their shares back to the company if the required majority gives a specific approval. While the Act apparently does not exclude coercive repurchases, the *JSE Limited Listings Requirements* clearly require that as a general rule shareholders be given a free choice, even in the case of odd-lot offers.²⁰⁷

The Companies Bill proposes to relax the procedure and contains no prescriptions on the steps that should be followed.²⁰⁸ I argue that specific attention should be given to the protection of shareholders in selective repurchases. The legislation should draw a proper distinction between different kinds of acquisitions and clearly state the procedural requirements applicable to each. A distinction between self-tender offers, selective repurchases and general repurchases is necessary. The opportunity of manipulating the procedure to the detriment of minority shareholders should be eliminated.

An interesting question I consider is whether, in view of the similarities between share repurchases and reductions of capital,²⁰⁹ the common-law principles on fair treatment of shareholders in a reduction of capital will also be applicable to share repurchases.²¹⁰ I conclude that it is best to avoid any doubt in this regard by providing statutory protection.²¹¹

6.3.1 Authorisation and procedural steps

Together with authorisation in the articles, approval by special resolution constitutes the main protection mechanism for shareholders.²¹² I argue that the requirement of authority in the articles does not enhance the protection of

²⁰⁶ See Chapter 5 paragraph 6.3.1.3.

²⁰⁷ See Chapter 5 paragraph 6.3.2.2.

²⁰⁸ See Chapter 5 paragraph 6.9.2.

²⁰⁹ See Chapter 5 paragraph 2.6.

²¹⁰ See Chapter 5 paragraph 6.3.

²¹¹ See paragraph 8.14 and the provision entitled 'Company acquiring its own shares'.

²¹² See Chapter 5 paragraphs 6.3.1.2 and 6.10.3.

shareholders because the articles can be altered by the same majority that can pass the special resolution approving a repurchase.²¹³

Although the Companies Bill proposes that a repurchase of shares must be authorised by the board of directors,²¹⁴ it does not prescribe any authorisation or approval of distributions by the general meeting. I submit that the requirements of clauses 46 and 48 and the duties imposed on directors will not adequately protect shareholders against the risks inherent in repurchases, and in particular, selective repurchases.²¹⁵

The comparative analysis reveals that approval by special resolution is a requirement for off-market share repurchases in England while an ordinary resolution is sufficient for market repurchases.²¹⁶ In New Zealand shareholder approval is not required for *pro rata* offers to all shareholders, but for selective offers either the written consent of all shareholders or express permission in the company's constitution is required.²¹⁷ Shareholder approval is not required in Delaware, California or under the MBCA.²¹⁸ I explain that procedural aspects of repurchases are regulated at federal level in the USA, in certain instances also in respect of unregistered securities.²¹⁹ The courts in the USA have over the years also had the opportunity of developing the application of general principles of company law to the share repurchase situation.

In view of the concern regarding the fairness of share repurchases to minority shareholders, I propose that selective repurchases should be subject to shareholder approval by special resolution, after full disclosure.²²⁰ The votes of the vendor-shareholders should be excluded. It should also be made clear that shareholders cannot be coerced into selling their shares to the company, except under a scheme of arrangement.

²¹³ See Chapter 5 paragraph 6.10.3.

²¹⁴ See Chapter 5 paragraph 8.7.4 for criticism of the formulation of the clause .

²¹⁵ See Chapter 5 paragraph 6.10.3.

²¹⁶ See Chapter 2 paragraph 6.3.1.

²¹⁷ See Chapter 3 paragraph 6.3.2. In addition, shareholders are given the right to object in court.

²¹⁸ See Chapter 4 paragraphs 2.6.3, 3.6.3 and 4.6.3.

²¹⁹ The equivalent of unlisted securities in South Africa.

²²⁰ See paragraph 8.14 and subclause (1)(a) of the provision entitled 'Company acquiring its own shares'.

Although selective repurchases have a greater potential for abuse, proportionate repurchases in a specific class of shareholders can also result in unfair treatment among different classes. Shareholder approval should be prescribed also for proportionate acquisitions or self-tender offers, as an alternative to authorisation in the company's constitution.²²¹ This could be an ordinary resolution, but the interests of classes of shareholders that do not generally confer the right to vote should be taken into account. It should be made clear that preference shareholders will have voting rights when their class of shares or the shares of any class ranking behind them with regard to the return of capital are being repurchased.²²²

The legislature's attempt at protecting shareholders by providing for a *pro rata* tender offer procedure has been unsuccessful because the prescribed procedure can be avoided by simply designating the approval as a specific approval. At the same time poor legal drafting has resulted in removing the flexibility of a general repurchase authority.

The *JSE Limited Listings Requirements* are more effective in protecting shareholders. The distinction it makes between different kinds of repurchases facilitates the imposition of appropriate shareholder protection mechanisms while flexibility is nevertheless retained.

I criticise the complete freedom of procedure allowed by the Companies Bill. While this approach is also found in state legislation in America, it is qualified there by the existence of general principles that have been developed over years. In the absence of well-developed common-law principles on fair treatment of shareholders in a repurchase, I recommend that South Africa enacts statutory protection. I think that the New Zealand principles applicable to selective repurchases provide a suitable example.²²³ Accordingly, I propose specific disclosure requirements in addition to shareholder approval.²²⁴

²²¹ See paragraph 8.14 below and subclause (1)(b) of the provision entitled 'Company acquiring its own shares'.

²²² This should be done in the provision on voting rights.

²²³ See Chapter 3 paragraph 6.3.2

²²⁴ See paragraph 8.14 below and subclause (1)(b) of the provision entitled 'Company acquiring its own shares'.

6.3.2 Other formalities

When shares have been acquired, the Registrar must be notified. This rule applies to listed and unlisted shares alike.²²⁵ The JSE Limited prescribes various additional formalities, including announcements of acquisitions made.²²⁶ However, in view of the proposed deregulation of share capital accounts, I submit that notifying the Registrar is unnecessary, but that shareholders of all companies should also be informed when the directors have acquired shares in terms of a general repurchase power.²²⁷

6.3.3 Adjustments to capital accounts

Although it appears obvious that a company must adjust its share capital accounts when it cancels the shares it acquired, the Act expressly regulates the adjustment of share capital accounts.²²⁸ I point out that similar adjustments are not expressly required for an acquisition through the redemption of shares. When the court orders a repurchase of shares by a company under section 252 it has the power to direct the reduction of the company's share capital as a consequence of the acquisition, although the exact adjustments that may be required are not prescribed.

I identify several uncertainties and anomalies regarding the application of the statutory non-distributable reserves to provide for a premium on the repurchase of shares.²²⁹ But, in view of the proposal to abolish par value shares and deregulate share capital accounts, specific recommendations in this regard are unnecessary.

6.4 Liability for unlawful repurchases

Holding directors accountable for unlawful distributions and providing for the

²²⁵ See Chapter 5 paragraph 6.3.2.

²²⁶ See Chapter 5 paragraph 6.3.2.2.

²²⁷ See Chapter 5 paragraph 6.3.2.1. The problem regarding general repurchases will obviously have to be sorted out first. For proposals in this regard, see paragraph 8.14 below and subclause (8) of the provision 'Company acquiring its own shares'.

²²⁸ See Chapter 5 paragraph 6.3.3.

²²⁹ See Chapter 5 paragraph 6.3.4.

recovery from shareholders of amounts they received in violation of the financial restrictions is an integral part of the regulation of repurchases as well as other distributions. I discuss the issue under share repurchases because the provisions of the Act in this regard are more comprehensive than is the case with section 90 payments.²³⁰

6.4.1 Directors

Directors who allow a company to make a payment for the acquisition of its shares at a time when there is reason to believe that the company is insolvent or unable to pay its debts are jointly and severally liable to restore the amount to the company to the extent that it has not been recovered.²³¹

The basis of liability is that the director 'allowed' an unlawful payment and I assert that a director must at least be aware of the payment and of the adverse financial position of the company before liability can arise.²³² The director will also have to have neglected her duty to prevent the unlawful payment. Although it is difficult to think of circumstances where a director who is *prima facie* liable will nevertheless be able to prove the requirements for relief by the court, this possibility is expressly preserved by the liability provision.²³³

The Act does not provide for liability of directors in respect of non-compliance with the authorisation and other procedural requirements for repurchases. Also, the Act does not provide for director liability when section 90-payments are made in violation of the financial restrictions. Such liability will be determined in terms of the common law. The Companies Bill provides for statutory liability of directors regardless of the type of distribution involved, but once again in respect of non-compliance with the financial restrictions only.²³⁴

It is a common trend in the jurisdictions surveyed to base directors' liability not merely on the actual insolvency or illiquidity of the company but rather on their failure to exercise due diligence when considering the financial position of the

²³⁰ See Chapter 5 paragraph 6.4.

²³¹ See Chapter 5 paragraph 6.4.1.

²³² See Chapter 5 paragraph 6.4.1.1.

²³³ See Chapter 5 paragraph 6.4.1.1.

²³⁴ See Chapter 5 paragraph 6.9.4.1.

company. I criticise the proposals of the Companies Bill which consider only the participation of directors at the time of authorisation of a distribution.²³⁵ I submit that liability should be imposed for implementing a distribution in violation of the financial restrictions.

The extent of a director's liability depends on recovery from shareholders and the contribution of co-directors. I argue that a director who has already extinguished this liability to the company should have a direct right of recourse against shareholders. Such a director must also be refunded if the company subsequently recovers payment from a shareholder.²³⁶ The current provisions appear not to allow this.

6.4.2 Shareholders

The Companies Act provides that directors who are liable for an unlawful payment can institute proceedings to compel a vendor-shareholder to restore the payment to the company.²³⁷ Creditors can also seek a court order against the shareholder or former shareholder for the return of the consideration to the company.²³⁸

The options available to the court are set out in some detail in relation to proceedings brought by creditors, but not by directors.²³⁹ I think that this discrepancy should be addressed by the legislature. Unfortunately there have not been any reported cases to indicate how a court will exercise its discretion when asked to make an order against shareholders.

The Act does not provide exceptions to the liability of shareholders and it can be assumed that they will be liable regardless of their good faith. This approach corresponds with the treatment of dispositions without value, which includes distributions to shareholders, under the insolvency legislation.²⁴⁰

I explain that in New Zealand, California and under the MBCA shareholders are not liable under companies legislation if they were unaware of the violation of

²³⁵ See Chapter 5 paragraph 6.9.4.1.2.

²³⁶ See Chapter 5 paragraph 6.4.1.3.

²³⁷ See Chapter 5 paragraph 6.4.2.1.

²³⁸ See Chapter 5 paragraph 6.4.2.2.

²³⁹ See Chapter 5 paragraph 6.10.4.

²⁴⁰ See Chapter 5 paragraph 6.4.2.

the financial restrictions or acted in good faith, although they may have to restore the payment under insolvency law or fraudulent conveyance law.²⁴¹

The Companies Bill does not expressly regulate the liability of shareholders for distributions in violation of the financial restrictions. Liability is implied by the reference in the director liability provisions to the amount that may have been recovered from shareholders.²⁴² The intention appears to be that shareholders will be liable even if they received the consideration in good faith. Such an approach obviously creates uncertainty for shareholders, but it is suggested that the scale should be tipped in favour of creditor rights. If a large group of shareholders who received a distribution in good faith are allowed to retain the unlawful payment, thereby increasing the potential liability of a few directors, the chances of successful recovery may be compromised.²⁴³ Despite the practical difficulties that may arise from the recovery of distributions, I recommend that shareholders should be liable in respect of any distribution received in violation of the financial restrictions.²⁴⁴

6.5 Enforceability of contracts for the acquisition of own shares

A contract for the repurchase of shares is enforceable, except to the extent that the company cannot perform without breaching the financial restrictions. In a subsequent liquidation the claim will rank before the claims to the return of capital of remaining shareholders of that class, but after the claims of creditors and preferent shareholders.²⁴⁵ This arrangement was seen as exceptional in view of the fact that the interests of preferent shareholders are not taken into account when distributions are made during the existence of the company.²⁴⁶ My only criticism against this rule is that it does not also apply to redemptions.

²⁴¹ See Chapter 5 paragraph 6.10.4.

²⁴² See Chapter 5 paragraph 6.9.3.2.

²⁴³ See Chapter 5 paragraph 6.10.4.

²⁴⁴ See paragraph 8.11 and subclause (3) of the provision entitled 'Liability for acquisitions in violation of solvency and liquidity test.'

²⁴⁵ See Chapter 5 paragraph 6.5.

²⁴⁶ See Chapter 5 paragraph 6.10.5.

I criticise the proposals of the Companies Bill on enforceability and identify four difficulties.²⁴⁷ First, there is tension between the provisions dealing with the basic requirements for distributions, the acknowledgement by directors, and the enforceability of distributions. I argue that the requirement that a distribution must be fully carried out once the directors have made an acknowledgement cannot be reconciled with the basic requirements for distributions. Second, the Companies Bill does not deal with the ranking of an unpaid distribution, and in particular a claim in respect of a share repurchase agreement, in an ensuing liquidation. Third, I view the requirement that the company is obliged to approach the court for relief in certain circumstances as unnecessary. Fourth, the Companies Bill allows a company to resist the enforcement of repurchases on certain non-financial grounds that are within its own control or that it can rectify. I make several suggestions for the regulation of the enforceability of share repurchase contracts.²⁴⁸

6.6 The status of repurchased shares

With regard to the requirement that shares acquired by the company should be cancelled 'forthwith', I assert that the cancellation will coincide with the moment when the shares are no longer held by the shareholder. This means that the company will not acquire its own shares in a literal sense.

The peremptory cancellation of shares acquired by a company under section 85 means that the shares cannot be held as treasury shares.²⁴⁹

There are many problems and risks associated with treasury shares, not least of which are serious conceptual difficulties.²⁵⁰ However, treasury shares are allowed in Delaware and to a limited extent in England and New Zealand. The risks are addressed in considerable detail in the English legislation and regulatory scheme.²⁵¹

²⁴⁷ See Chapter 5 paragraph 6.9.4.

²⁴⁸ See paragraph 8.14 and subclauses (2) – (6) of the provision entitled 'Company acquiring its own shares'.

²⁴⁹ See Chapter 5 paragraph 6.6.

²⁵⁰ See Chapter 5 paragraph 6.10.6.

²⁵¹ See Chapter 2 paragraph 6.6.

It is my opinion that treasury shares should not be allowed in South Africa.²⁵²

6.7 Acquisitions by a subsidiary

The South African regulation of acquisitions by subsidiaries occupies a middle ground between the complete prohibitions in England and New Zealand and the absence of any restrictions in the American systems.

I criticise several aspects of the regulation of acquisitions by subsidiaries of shares in their holding companies. The main problem is that the provisions do not distinguish between the acquisition of shares on the one hand and the holding of shares on the other.²⁵³ Legislative intervention is necessary in order to exclude the voting rights of any shares a subsidiary holds in its holding company. Clarity is also needed with regard to the proper application of the ten per cent limit and whether the subsidiary, the holding company, or both should comply with the requirements for repurchases, like authorisation and the financial restrictions.²⁵⁴ It should also be stated whether subsidiaries can subscribe for shares in their holding companies.

The Companies Bill avoids the confusion between the acquisition and the holding of shares, but does not state whether the subsidiary, the holding company, or both, should comply with the requirements.²⁵⁵ It also does not regulate the consequences should the ten per cent limit be exceeded.

The difficulties alluded to can be solved by prescribing exactly how the requirements should apply when a subsidiary is acquiring shares in its holding company. It is better to do this in a separate provision rather than in the same provision that regulates the acquisition of own shares.

However, the question whether cross-holdings should be allowed at all needs to be considered first. The comparative study shows that the acquisition of shares by a subsidiary in its holding company is prohibited in New Zealand and in England. The main objection against cross-holdings is the depletion in apparent capital. Apart from this, there is the risk of dividend round-tripping and

²⁵² See paragraph 8.2 and subclause (6) of the provision entitled 'Authorisation of shares'.

²⁵³ See Chapter 5 paragraph 6.7.

²⁵⁴ See Chapter 5 paragraph 6.10.7.

²⁵⁵ See Chapter 5 paragraph 6.9.6.

manipulation of share prices. When a subsidiary purchases the shares of its holding company it can dilute the value of the interests of the remaining shareholders in the holding company. If the subsidiary is not wholly-owned, its own minority shareholders may be disadvantaged. These objections also apply to the acquisition by a subsidiary of shares in any co-subsiary which holds shares in itself.

I recommend that a subsidiary should not be allowed to acquire shares in its holding company or in any co-subsiary which holds shares in it.²⁵⁶

However, if this is allowed, it should be made clear that the subsidiary as well as the holding company should satisfy the financial restrictions. The repurchase should also be approved by the shareholders of the holding company and, if it is a selective repurchase, the vendor-shareholders should not be allowed to vote. Unless the subsidiary is wholly-owned, the repurchase should be approved by its shareholders except the holding company, its subsidiaries, and any vendor-shareholder of the holding company who also holds shares in the subsidiary. Provision should be made for the disposal or cancellation of shares held in excess of the ten per cent limit.

Although I support an outright prohibition on cross-holdings, some recommendations regarding repurchases by subsidiaries are set out below as an alternative.²⁵⁷

6.8 The redemption of shares

I observe that the redemption of shares in South Africa is still regulated in the same manner as under the capital maintenance doctrine.²⁵⁸ In systems based on solvency and liquidity the redemption of shares is included in the definition of distribution and subjected to the same financial restrictions. I recommend that the diverging rules for redemption and repurchase of shares should not be retained.²⁵⁹ In particular, the same financial restrictions should apply to both options. It also makes sense to distinguish between redemptions at the option of

²⁵⁶ See Chapter 5 paragraph 6.10.7.

²⁵⁷ See paragraph 8.14 and the proposed provision entitled 'Acquisition of shares by subsidiary'.

²⁵⁸ See Chapter 5 paragraph 6.8.

²⁵⁹ See Chapter 5 paragraph 6.10.8.

the company and other redemptions as far as the procedural issues are concerned. An example of this is found in New Zealand where the procedural requirements for redemptions at the option of the company are the same as those for repurchases.²⁶⁰ I also recommend that the power to repurchase redeemable shares prior to the redemption date should be regulated expressly, as is the case in England and Delaware.²⁶¹

Under the Companies Bill redemptions are treated as a specific form of acquisition of own shares, the only difference between the redemption and repurchase of shares being that the former will take place in terms of an existing legal obligation of the company while the latter must be authorised by the board.²⁶² Presumably redemption at the option of the company will be regarded as a distribution that has to be authorised by the directors. I suggest that this issue should be addressed expressly.²⁶³

7 CONCLUSIONS AND KEY RECOMMENDATIONS

A complex body of provisions rigidly regulate the composition and adjustment of share capital accounts and so-called non-distributable reserve accounts. This complexity can be attributed mainly to the co-existence of par value and no par value shares. The fact that the relevant provisions are scattered throughout the Companies Act is a contributing factor.

Despite their complexity, the rules regarding the formation of share capital do not afford creditors significant protection. While these accounts previously formed the basis of the regulation of distributions to shareholders, this is no longer the case. These rules can be justified only with regard to their impact on shareholders.

Shareholders have a direct interest in the proper apportioning of their relative rights. The share capital accounts can play an important role in this regard.

²⁶⁰ See Chapter 3 paragraph 6.8.

²⁶¹ See paragraph 8.14 below and subclause 1(a) of the provision entitled 'Company acquiring its own shares'. For the position in England, see Chapter 2 paragraph 6.8 and in Delaware, Chapter 4 paragraph 2.6.2.

²⁶² See Chapter 5 paragraph 6.9.7.

²⁶³ The suggested distinction is embodied in paragraphs (c) and (d) of subclause (1) of the provision entitled 'Company acquiring its own shares'.

However, due to the very limited correlation between statutory undistributable reserves and the interests of specific shareholders, these accounts are of little relevance to shareholders.

Shareholders also have an interest in the preservation of shareholder value and voting power and can expect some protection against the dilution of their shareholding when further shares are issued. However, the current protection mechanisms that ignore market value are ineffective. Alternative measures of protecting shareholders can be more flexible and efficient than the current provisions. I mention pre-emptive rights and shareholder approval for certain share issues. These measures can supplement the protection offered by the regulation of share capital and capital contributions.

Although the capital invested in a company and the returns on it belong to the company, the shareholders expect a return on the capital contribution they made. Distributions to shareholders are regulated because they can endanger the effectiveness of the hierarchy among creditors and shareholders. Distributions also highlight problems of equal treatment of shareholders of the same class and fairness among different classes of shareholders.

The protection of creditors is achieved by the imposition of financial restrictions. Provided a company remains solvent and able to pay its debts as they become due, the interests of creditors are safe. Shareholders with preferent rights can also be protected by financial restrictions that take into account these preferential rights. South African law lags behind important jurisdictions in providing protection to preferent shareholders.

While there is a basic principle of equality or proportionality among shareholders, it is not always practical to adhere to it when distributions are made. Flexibility should be allowed, but subject to proper safeguards to protect shareholders. The protective measures employed are based on the consent of shareholders, either through authorisation in the company's constitution or through resolutions, enhanced by disclosure and fiduciary duties.

I conclude that:

- Companies should be required to state their authorised capital.
- It should be required that a company should always have at least one issued share that has the right to vote on any matter that arises for

decision at a general meeting, and at least one share that has the right to share in distributions without restriction. This can be the same share.

- Shares should not have a par value.
- The composition and adjustment of share capital accounts should not be regulated by the Companies Act.
- The minimum capital contribution in respect of shares should not be prescribed, but directors should be required to declare that the agreed consideration is fair to the company.
- There should be maximum flexibility regarding the size, form and timing of capital contributions.
- Particulars of non-cash capital contributions should be disclosed to shareholders.
- The concept 'distribution' should be properly defined.
- Distributions should be subject to compliance with a solvency and liquidity test
- Distributions should in principle be proportionate and any exceptions to this principle should be expressly sanctioned.
- The preferential liquidation rights of shareholders should be regarded as liabilities whenever distributions are made to lower ranking classes.
- Any selective distributions within a class of shares should be subject to specific shareholder approval, following proper disclosure, and the voting rights of the recipient shareholders should be excluded.

8 PROPOSED PROVISIONS

I set out a number of proposed provisions, preceded by short explanations for each group of provisions. As I do not number these provisions, cross-referencing between sections is not possible. However, the relationship between different provisions should be reasonably clear. I have adopted terminology from the Companies Bill, for example 'Memorandum of Incorporation', and these provisions are designed to fit into the broad framework of the Companies Bill.

8.1 Kinds of shares

Shares should not have a par value. In this regard I propose the following provision, based on clause 35(1), (2) and (6) of the Companies Bill. Clause 35 deals with a number of issues, some of which apply to shares in general, some to authorised shares and others to issued shares. This may make it difficult to find specific provisions. I also propose that the transferability of shares should expressly be made subject to compliance with the memorandum of association. Existing par value shares should be converted with preservation of their rights.²⁶⁴

Legal nature of company shares

- (1) A share issued by a company is movable property, transferable in any manner provided for or recognised by this Act or other legislation and in accordance with the Memorandum of Incorporation.
- (2) A share does not have a nominal or par value, subject to subsection (3).
- (3) Par value shares in existence at the date of commencement of this Act retain their par value pending their conversion into shares without par value, as far as possible preserving their relative rights and preferences, in accordance with regulations issued by the Minister.

8.2 Authorised capital

A company should set out its authorised share capital in its Memorandum of Incorporation which should be altered whenever it varies its share capital.²⁶⁵ The following proposed provision is based on clause s 36, 35(4), 35(5) and 37(3) of the Companies Bill.

Authorisation of shares

- (1) A company's Memorandum of Incorporation must set out the classes of shares, and the number of shares of each class, that the company is authorised to issue;

²⁶⁴ See paragraph 2.3 above.

²⁶⁵ See paragraph 2.1 above.

- (2) Any reference by a company on a letterhead, invoice or other trading document to the number of authorised shares shall be qualified by stating the number of issued shares and the extent to which they have been paid up.

Rights associated with shares

- (1) If a company's Memorandum of Incorporation has established -
- (a) only 1 class of shares –
 - (i) those shares confer the right to vote on every matter that may be decided by shareholders of the company; and
 - (ii) those shares entitle their holders to receive the net assets of the company upon its liquidation; or
 - (b) more than 1 class of shares, the Memorandum of Incorporation must provide that –
 - (i) at least 1 of those classes of shares has voting rights that may be exercised on any particular matter that may be submitted for a decision to shareholders of the company; and
 - (ii) the holders of at least 1 of those classes of shares, which may be the same class or classes as contemplated in the paragraph (b)(i), are entitled to receive the net assets of the company upon its liquidation.
- (2) Subject to paragraph (b) of this subsection a company's Memorandum of Incorporation
- (a) must set out, with respect to each class of shares –
 - (i) a distinguishing designation for that class; and
 - (ii) the preferences, rights, limitations and other terms associated with that class, subject to paragraph (d);
 - (b) may authorise a number of unclassified shares, which are subject to classification by the board in accordance with subsection (3)(c); and
 - (c) may set out a class of shares -

-
- (i) without specifying the associated preferences, rights, limitations or other terms of that class;
 - (ii) for which the board must determine the associated preferences, rights, limitations or other terms; and
 - (iii) which must not be issued until the board has determined the associated preferences, rights, limitations or other terms, as contemplated in sub-paragraph (ii).

8.3 Variation of share capital

Provision should be made for the variation of share capital, but these provisions should be less complex than those in the current section 75 which also regulates share capital accounts. Companies should be afforded maximum freedom to order their internal affairs. However, since the authorised capital is stated in the Memorandum of Incorporation, any variation of capital must be reflected in an appropriate alteration of the Memorandum.²⁶⁶ The following proposed provision is based on clause 36(2) – (4).

Variation of share capital

- (1) The authorisation and classification of shares, the numbers of authorised shares of each class, and the preferences, rights, limitations and other terms associated with each class of shares, as set out in a company's Memorandum of Incorporation, may be changed only by –
 - (a) an amendment of the Memorandum of Incorporation by special resolution of the shareholders; or
 - (b) by the board, acting in terms of an express authority granted in the Memorandum of Incorporation as contemplated in subsection (2).
- (2) A company's Memorandum of Incorporation may authorise the board absolutely or subject to express limits, to –
 - (a) increase or decrease the number of authorised shares of any class of shares;

²⁶⁶ See paragraph 2.5 above.

- (b) re-classify any classified shares that have been authorised but not issued;
 - (c) classify any unclassified shares that have been authorised but not issued; or
 - (d) determine the preferences, rights, limitations or other terms of shares in a class for which the board must determine the terms.
- (3) If the board of a company acts pursuant to its authority contemplated in subsection (2), the company must file a Notice of Amendment of its Memorandum of Incorporation, setting out the changes effected by the board.

Status of reacquired shares

Shares of a company that have been issued and subsequently –

- (a) acquired by that company, whether for consideration or in any other way; or
- (b) surrendered to that company in the exercise of appraisal rights

have the same status as shares that have been authorised but not issued.

8.4 Minimum issued capital

The minimum issued capital should be prescribed to make it clear that there should always be at least one share in issue with residual rights. I also recommend that companies should not be allowed to issue shares to themselves or to their subsidiaries.²⁶⁷ The following proposed provision is based to an extent on clause s 35(3) and 37(3).

Requirement to have shareholders

- (1) At all times a company should have in issue
 - (a) at least one share that confers the right to vote on every matter that may be decided by shareholders of the company and

²⁶⁷ See paragraph 2.2 above.

(b) at least one share, which could be the same share referred to in paragraph (a), that entitles its holder to receive the net assets of the company upon its liquidation.²⁶⁸

(2) A company may not issue shares to itself or to its subsidiary.

8.5 Protection against dilution of shareholder interests.

The expectation of shareholders that their relative interests in the company will not be exposed to unreasonable dilution is accommodated by regulating the power of directors to issue shares. This is done through restricting the number of shares in accordance with the memorandum, by prescribing shareholder approval for certain share issues and by giving the existing shareholders pre-emptive rights. The proposed provisions are based on clause s 38, 39 and 41 of the Companies Bill. In line with the criticisms expressed, directors should also be liable to persons who subscribed for unauthorised shares if the issue is not authorised retroactively, and the threshold for substantial further issues should be reduced and refined. Pre-emptive rights should apply to all companies unless excluded or limited by the memorandum. In private companies the default option should be that the shares that are not subscribed for by a particular shareholder should be allotted to remaining shareholders under a top-up provision.²⁶⁹

Issue of shares

(1) The board of a company may resolve to issue shares of the company at any time, but only within the classes, and to the extent, that the shares have been authorised by or in terms of the company's Memorandum of Incorporation.

(2) If a company issues shares -

(a) that have not been authorised in accordance with its Memorandum of Incorporation; or

²⁶⁸ It is suggested that it is unnecessary to specify that the share should not be redeemable or convertible. If the company has no other qualifying share in issue, this provision will prevent it from converting or redeeming all the relevant shares unless it first issued at least one new qualifying share. In view of the restrictions applicable to crossholdings by subsidiaries it is unnecessary to address this issue in the minimum issued share capital provision.

²⁶⁹ See paragraph 2.1 above.

- (b) in excess of the number of authorised shares of any particular class;
- (2) the issue of those shares may be retroactively authorised.
- (3) If a resolution seeking to retroactively authorise an issue of shares, as contemplated in subsection (2), is not adopted when it is put to a vote –
 - (a) the share issue is a nullity to the extent that it exceeds any authorisation;
 - (b) the company must return to any person the fair value of the consideration received by the company in respect of that share issue to the extent that it is nullified;
 - (c) any certificate evidencing a share so issued and nullified, and any entry in a securities register in respect of such an issue, is void; and
 - (d) a director of the company is liable to the extent set out in this Act in relation to violation of the solvency and liquidity test if the director -
 - (i) was present at a meeting when the board approved the issue of any unauthorised shares, or participated in the making of such a decision; and
 - (ii) failed to vote against the issue of those shares, despite knowing that the shares had not been; and
 - (e) a director who is liable to the company in terms of subsection (d) is also personally liable to the person who purported to subscribe for the shares for any loss, damages or costs sustained as a result of the invalidity.

Shareholder approval for issue of shares in certain cases

- (1) Subject to subsection (2), an issue of shares, securities convertible into shares, or rights exercisable for shares must be approved by a special resolution of the shareholders of a company, if the shares, securities or rights are issued to –
 - (a) a director, future director, prescribed officer, or future prescribed officer of the company;

-
- (b) a person related or inter-related to the company, or to a director, future director, prescribed officer, or future prescribed officer of the company;
or
 - (c) a nominee of a person contemplated in paragraph (a) or (b).
 - (2) Subsection (1) does not apply if the issue of shares, securities or rights is -
 - (a) under an agreement underwriting the shares, securities or rights;
 - (b) in the exercise of a pre-emptive right to be offered and to subscribe shares;
 - (c) in proportion to existing holdings, and on the same terms and conditions as have been offered to all the shareholders of the company or to all the shareholders of the class or classes of shares being issued;
 - (d) pursuant to an employee share scheme; or
 - (e) pursuant to an offer to the public.
 - (3) An issue of shares, securities convertible into shares, or rights exercisable for shares in a transaction, or a series of integrated transactions, requires approval of the shareholders by special resolution if the voting power of the shares that are issued or issuable as a result of the transaction or series of integrated transactions will reduce the voting power enjoyed by the existing shares immediately before the transaction or series of transactions by more than 20%.
 - (4) In subsection (3) -
 - (a) for purposes of determining the voting power of shares issued and issuable as a result of a transaction or series of integrated transactions, the voting power of shares is the greater of -
 - (i) the voting power of the shares to be issued; or
 - (ii) the voting power of the shares that would be issued after giving effect to the conversion of convertible shares and other securities and the exercise of rights to be issued;
 - (b) a series of transactions is integrated if –

- (i) consummation of one transaction is made contingent on consummation of one or more of the other transactions; or
 - (ii) the transactions are entered into within a 12 month period, and involve the same parties, or related persons; and –
 - (aa) involve the acquisition or disposal of an interest in one particular company or asset; or
 - (bb) taken together, lead to substantial involvement in a business activity that did not previously form part of the company's principal activity.
- (5) A director of a company is liable to the extent set out in this Act in relation to the issue of securities if the director -
 - (a) was present at a meeting when the board approved the issue of any securities as contemplated in this section, or participated in the making of such a decision; and
 - (b) failed to vote against the issue of those securities, despite knowing that the issue of those securities was inconsistent with this section.
- (6) In this section, 'future director' or 'future prescribed officer' does not include a person who becomes a director or prescribed officer of the company more than 6 months after acquiring a particular option or right.

Pre-emptive right to be offered and to subscribe shares

- (1) This section applies with respect to any issue of shares by a company, other than -
 - (a) shares issued in terms of options or conversion rights; or
 - (b) shares issued otherwise than for cash; or
 - (c) shares issued as capitalisation shares.
- (2) If a company proposes to issue any shares, other than as contemplated in subsection (1)(a) to (c), each shareholder of that company has a right, before any other person who is not a shareholder of that company, to be offered and, within a reasonable time to subscribe for, a percentage of the shares to be

issued equal to the voting power of that shareholder's general voting rights immediately before the offer was made.

- (3) A company's Memorandum of Incorporation may extend,²⁷⁰ limit, negate or restrict the right set out in subsection (2), with respect to any or all classes of shares of that company.
- (4) Except to the extent that a company's Memorandum of Incorporation provides otherwise –
- (a) in exercising a right in terms of subsection (2), a shareholder may subscribe fewer shares than the shareholder would be entitled to subscribe under that subsection;
 - (b) shareholders in a private company must be invited to subscribe for more shares in excess of their proportionate entitlement on the understanding that shareholders who indicate their willingness to take up excess shares will be entitled to be allotted shares not taken up by remaining shareholders
 - (c) where two or more shareholders have, in terms of subsection 4(b) indicated their willingness to take up excess shares that become available as a result of shareholders not taking up their rights, such shares must be allotted to them in the same proportion as their voting rights stand in relation to each other, provided that a shareholder may not be allotted more than the maximum number of shares for which he or she subscribed
 - (d) shares not subscribed by shareholders under subsection (2) or (4) may be offered to any other person.

8.6 Consideration for shares

The consideration for shares must be determined by the board.²⁷¹ I support clause 40 of the Companies Bill, although I recommend that the board should also be required to disclose particulars regarding any non-cash consideration it

²⁷⁰ The Companies Bill does not provide for an extension of pre-emptive rights.

²⁷¹ See paragraph 3.1 above.

accepts.²⁷² I propose a definition of cash consideration. I also recommend that a provision should be inserted to regulate the subsequent variation of the subscription contract. I propose that unpaid or partly paid shares should be allowed and support the proposals of the Companies Bill in this regard,²⁷³ although I think the provisions should be contained in a separate section and not in the same provision that regulates the nature of consideration. This will make it easier to identify the provisions that are relevant to a specific share issue.

As regards the board determination of adequacy I regard a further determination as necessary if cash is accepted in lieu of previously agreed upon non-cash consideration. This is because the board is not required to fix the cash value of the consideration. It may also mean that an increase in the value of non-cash consideration subsequent to the issue of the shares cannot be diverted from the company through agreeing on alternative consideration.

Definition of cash consideration

'Cash' includes promissory notes and any other undertaking to pay cash to the company in the future and the release of a liability of the company for a liquidated sum

Consideration for shares

- (1) The board of a company may issue authorised shares only -
 - (a) for adequate consideration to the company, as determined by the board;
 - (b) in terms of conversion rights associated with previously issued securities of the company; or
 - (c) as capitalisation shares.
- (2) Before a company issues any particular shares, the board must determine the consideration for which, and the terms on which, those shares will be issued.
- (3) If the board agrees to issue shares for consideration otherwise than in cash, full particulars of the consideration and of the terms on which the shares will be issued must be made available for inspection by shareholders at the company's registered office.

²⁷² See paragraph 3.3 above.

²⁷³ See paragraph 3.4 above.

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- (4) If, subsequent to the issue of shares the board agrees to accept consideration different from the consideration determined prior to the issue of those shares
- (a) the board must determine that the alternative consideration is at least equal to the present value of the consideration previously agreed upon, and
 - (b) if the alternative consideration is consideration otherwise than in cash, disclose particulars of that consideration as prescribed in subsection (3).
- (5) A determination by the board of a company in terms of subsection (2) as to the adequacy of consideration for any shares may be challenged on the basis of a breach of the standards of conduct for directors, but such a challenge will have no effect on the validity of the issue or on the amount of consideration for which the shareholder is liable.

Time when shares are issued

- (1) Subject to subsection (2) when a company has received the consideration approved by its board for the issuance of any shares –
- (a) those shares are fully paid; and
 - (b) the company must issue those shares and cause the name of the holder to be entered on the company's securities register.
- (2) If the consideration for any shares that are issued or to be issued is in the form of an instrument that is not negotiable by the company at the time the shares are to be issued, or is in the form of an agreement for future services, future benefits or future payment by the subscribing party, -
- (a) the consideration for those shares is deemed to have been received by the company at any time only to the extent -
 - (i) that the instrument is negotiable by the company; or
 - (ii) that the subscribing party to the agreement has fulfilled its obligations in terms of the agreement; and
 - (b) upon receiving the instrument or entering into the agreement, the company must –

- (i) issue the shares immediately; and
 - (ii) cause the issued shares to be transferred to a third party, to be held in trust and later transferred to the subscribing party in accordance with the conditions of a trust deed.
- (3) Except to the extent that a trust deed contemplated in subsection (5)(b) provides otherwise –
 - (a) voting rights, and appraisal rights set out in section 164, associated with shares that have been issued but are in trust may not be exercised;
 - (b) any pre-emptive rights associated with shares that have been issued but are in trust may be exercised only to the extent that the instrument has become negotiable by the company or the subscribing party has fulfilled its obligations under the agreement;
 - (c) any distribution with respect to shares that have been issued but are in trust –
 - (i) must be paid or credited by the company to the subscribing party to the extent that the instrument has become negotiable by the company or the subscribing party has fulfilled its obligations under the agreement; and
 - (ii) may be credited against the remaining value at that time of any services still to be performed by the subscribing party, any future payment remaining due, or the benefits still to be received by the company; and
 - (d) shares that have been issued but are in trust -
 - (i) may not be transferred by or at the direction of the subscribing party unless the company has expressly consented to the transfer in advance;
 - (ii) may be transferred to the subscribing party on a quarterly basis, to the extent that the instrument has become negotiable by the company or the subscribing party has fulfilled its obligations under the agreement;

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- (iii) must be transferred to the subscribing party when the instrument has become negotiable by the company, or upon satisfaction of all of the subscribing party's obligations in terms of the agreement; and
 - (iv) to the extent that the instrument is dishonoured after becoming negotiable, or that the subscribing party has failed to fulfil its obligations under the agreement, must be returned to the company and cancelled, on demand by the company.
- (4) A company may not make a demand contemplated in subsection (6)(d)(iv) unless –
- (a) a negotiable instrument is dishonoured after becoming negotiable by the company; or
 - (b) in the case of an agreement, the subscribing party has failed to fulfil any obligation in terms of the agreement for a period of at least 40 business days after the date on which the obligation was due to be fulfilled.

8.7 Capitalisation shares

I am in favour of express regulation of capitalisation shares, clarifying that their issue is not subject to the requirements regarding consideration for shares and support the regulation of capitalisation shares in the Companies Bill.²⁷⁴

8.8 Definition of distribution

I recommend that a new Companies Act should contain a comprehensive definition of the concept distribution. Although the acquisition of shares by a subsidiary in its holding company can have the effect of a distribution, it should be regulated in a separate provision to provide clarity as to how the requirements should be applied to such distributions.²⁷⁵ I also recommend that appraisal payments should be regarded as distributions. The proposed definition of the Companies Bill is wide enough to include such payments and the authorisation

²⁷⁴ See paragraph 3.2 above.

²⁷⁵ See paragraph 4 above.

provision covers them as payments under an existing legal obligation. It will be easy to remove the express exclusion. I propose the following definition.

Definition of distribution

“distribution” means a direct or indirect –

- (a) transfer by a company of money or other property of the company, other than its own shares, to or for the benefit of 1 or more holders of any of the shares of that company, whether –
 - (i) in the form of a dividend;
 - (ii) as a payment in lieu of a capitalisation share;
 - (iii) as consideration for the acquisition by the company of any of its shares.
- (b) incurrence of a debt or other obligation by a company for the benefit of 1 or more holders of any of the shares of that company in respect of his or her shareholding; or
- (c) forgiveness or waiver by a company of a debt or other obligation owed to the company by 1 or more holders of any of the shares of that company in respect of his or her shareholding,

but does not include any such action taken upon the final liquidation of the company.

8.9 Making of distributions

The making, as opposed to the authorisation of, distributions should be subject to compliance with the solvency and liquidity test.²⁷⁶ This requirement will necessarily also apply to the acquisition of shares for consideration. A distinction should nevertheless be made between the decision to make a distribution and the ultimate validity of the actual distribution.²⁷⁷ The words ‘it reasonably appears’ in (a) obliges the company to take into account objectively determinable facts while the phrase ‘reasonably concluded’ in (b) requires the board to objectively assess the circumstances. However, there is a subjective element in the fact that the

²⁷⁶ See paragraphs 5.2.1 and 5.2.4 above.

²⁷⁷ See Chapter 5 paragraph 4.4.1.1.

reasonableness of the conclusions reached by the company and the board will depend on information available to them.

I also propose that the effective date of a distribution should be specified in order to fix the time for application of the solvency and liquidity test and the enforceability of the distribution.²⁷⁸ I submit that it is unnecessary to require express board authorisation for distributions, although it should be a requirement for the acquisition of own shares.²⁷⁹ I propose the following provision.

Making of distributions

- (1) A company must not make any proposed distribution unless -
 - (a) it reasonably appears that the company will satisfy the solvency and liquidity test immediately after completing the proposed distribution; and
 - (b) the board of the company, by resolution, has acknowledged that it has applied the solvency and liquidity test and reasonably concluded that the company will satisfy the solvency and liquidity test immediately after completing the proposed distribution.
- (2) When more than 120 business days have lapsed since an acknowledgement required by subsection (1)(b), the company may not proceed with or continue the distribution unless the board has reconsidered the solvency and liquidity test with respect to the intended implementation²⁸⁰ of the original resolution, order or obligation; and has, by resolution, acknowledged that it has applied the solvency and liquidity test and reasonably concluded that the company will satisfy the solvency and liquidity test immediately after the proposed implementation.
- (3) When, after having adopted a resolution contemplated in subsection 1(b), the board is no longer satisfied that the company will satisfy the solvency and liquidity test, it shall retract the resolution and not proceed or continue with the distribution.

²⁷⁸ See paragraph 5.2.4 above.

²⁷⁹ See paragraph 8.14 below.

²⁸⁰ The word 'implementation' is preferable to 'distribution'.

Effective date of distribution

- (1) If a distribution takes the form of a transfer of money or assets as contemplated in paragraph (a) of the definition of 'distribution', its effective date is the date of actual transfer of the money or assets.
- (2) If a distribution takes the form of the incurrence of a debt or other obligation by the company, its effective date is
 - (a) where satisfaction of the debt or obligation is conditional upon the solvency and liquidity of the company, the date of each action taken in satisfaction of that debt or obligation,
 - (b) in every other case, the date of incurrence of the debt.
- (3) If a distribution takes the form of the forgiveness or waiver of a debt or obligation as contemplated in paragraph (c) of the definition of 'distribution', its effective date is the date on which the liability of the shareholder is extinguished.

Enforceability of dividends

- (1) When the board has authorised a distribution by way of dividend the shareholder acquires an enforceable claim against the company, subject to subsection (2).
- (2) An obligation of a company to pay a dividend cannot be enforced against that company to the extent that the company is unable to fulfil that obligation without violating the solvency and liquidity test.

8.10 Solvency and liquidity test

The solvency and liquidity test must be formulated objectively with reference to the actual financial position of the company. However, since the liquidity element requires a prediction to be made, it is still necessary to refer to foreseeable circumstances. This does not change the test into a subjective test, as the circumstances must be reasonably foreseeable. I suggest that the requirement that it should 'reasonably appear' that the test will be satisfied, should be

restricted to the provision regulating the ‘making’ of a distribution.²⁸¹ This will facilitate a distinction between an improper decision to make a distribution and an improper distribution as such. The distinction is necessary for purposes of the regulation of liability of directors and shareholders respectively.²⁸² The proposed provision is as follows.

Solvency and liquidity test

- (1) A company satisfies the solvency and liquidity test if,
 - (a) the assets of the company, fairly valued, equal or exceed the liabilities of the company; and
 - (b) 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 its business.
- (2) Unless the Memorandum of Incorporation of the company provides otherwise, any amount that would be required, if the company were to be liquidated at the time of the distribution, to satisfy the preferential rights upon liquidation of shareholders whose preferential rights upon liquidation are superior to the preferential rights upon liquidation of those receiving the distribution, must be regarded as liabilities.

8.11 Liability for distributions in violation of solvency and liquidity test

The liability of shareholders and directors in respect of distributions in violation of the solvency and liquidity test should be regulated expressly. In my view it is unnecessary to provide separately for liability of directors in respect of unlawful agreements to acquire shares. They will be liable in respect of an unlawful distribution if the financial restrictions have not been met. In respect of non-compliance with the further requirements for share repurchases, they will be liable for breaching their duties to the company.²⁸³ The following provision is proposed.

²⁸¹ See the proposed provision in paragraph 8.9 above.

²⁸² See paragraphs 5.2.2 – 5.2.4 above.

²⁸³ See paragraphs 5.4 – 5.4.2 above.

Liability for distributions in violation of solvency and liquidity test

- (1) A director of a company is liable to restore to the company the amount of any distribution made in violation of the solvency and liquidity test, to the extent that it has not been recovered from shareholders, if that director
 - (a) was present at the meeting and failed to vote against the adoption of a resolution by the board in which it acknowledged that it has applied the solvency and liquidity test and reasonably concluded that the company will satisfy the solvency and liquidity test, while it was unreasonable to reach that conclusion; or
 - (b) was aware that the company was about to make, or proceed with, a distribution in circumstances where it was unreasonable to have remained satisfied of the company's solvency and liquidity, and failed to take reasonable steps to prevent the making of the distribution.
- (2) A director who is liable under this section is liable jointly and severally with any other directors who are so liable.²⁸⁴
- (3) A shareholder or former shareholder who received a distribution made in violation of the solvency and liquidity test is liable to restore to the company the amount of the distribution.
- (4) A director who is liable under this section is entitled to institute proceedings against a shareholder to recover the amount of the distribution on behalf of the company or, to the extent that the director has already restored the amount of the distribution to the company, on behalf of that director personally.

8.12 Regulation of dividends

A definition of dividend should be contained in the Companies Act in order to facilitate distinction between proportionate and non-proportionate distributions.²⁸⁵

My proposed definition and the further regulation are based on the example in the

²⁸⁴ It is unnecessary to provide for recovery of a contribution from co-directors, as this is covered by the general principles of joint liability.

²⁸⁵ See paragraph 6 above.

New Zealand Companies Act.²⁸⁶ The following provision is proposed.

Dividends

- (1) A dividend includes any distribution by a company other than a payment in respect of an acquisition by it of its own shares or a payment in lieu of a capitalisation share.
- (2) Unless expressly permitted by the Memorandum of Incorporation of a company, and subject to the provisions regarding shares that have not been paid up in full, every holder of 1 or more shares of the class in respect of which a particular distribution is made is entitled to a distribution in respect of each share held.

8.13 Definition of acquisition

A definition of 'acquisition' should be contained in the Companies Act to make it clear that the requirements of the Act apply only where consideration is involved. Acquisitions for no consideration, including the cancellation of partly-paid shares in the event of default, are not subject to the requirements that apply to repurchases. Acquisitions in compliance with court orders and the 'surrender' of shares under the proposed appraisal remedy should both be regarded as acquisitions to ensure consistency.²⁸⁷ I propose the following definition.

Definition of acquisition of own shares

'acquisition of own shares' includes any acquisition by a company of its own shares for consideration, whether by way of a repurchase or redemption or in compliance with a court order or in terms of the appraisal remedy, but does not include an acquisition for no consideration, a rescission of the issuance of shares or a cancellation of partly-paid shares.

8.14 Power to acquire shares

The requirements for the acquisition of shares by a company and by its subsidiary

²⁸⁶ Although the New Zealand Companies Act of 1993 also expressly excludes financial assistance while the Bill does not regard this as a distribution in the first place. An alternative is to leave out the definition and insert a provision on 'proportionality of distributions' which will have the same effect for distributions otherwise than acquisitions. In view of the proposed provision regarding rights and preferences, provision for selective repurchases is actually required – it will have to be allowed by the memorandum.

²⁸⁷ See paragraph 5.1 above.

should be separated. This will clarify application of the financial restrictions and other requirements and eliminate the spectre of a group concept in relation to distributions. Selective repurchases should be subject to shareholder approval by special resolution, after full disclosure. It should also be made clear that shareholders cannot be coerced into selling their shares to the company. For this reason the authorisation should not be for the acquisition of shares as such, but to make an 'offer' for the acquisition of shares, except of course in the case of a redemption of shares.²⁸⁸ My proposal is the following.

Company acquiring its own shares

- (1) A company may acquire its own shares, including redeemable shares
 - (a) in terms of a resolution of the board, approved by an ordinary resolution of all the shareholders whose interests are affected, to make an offer to acquire the shares proportionately from all the holders of that class who are willing to dispose of them, provided that shares may not be acquired at a price higher than the price at which they are then redeemable;
 - (b) in terms of a resolution of the board, which has been approved by the general meeting by special resolution, excluding the votes of the shareholders to which the offer will be made, after full disclosure of the reasons for and the terms of the offer, to make an offer to acquire its own shares from one or more specific shareholders who are willing to dispose of them;
 - (c) pursuant to an existing legal obligation of the company, a court order or in terms of the appraisal remedy;²⁸⁹
 - (d) pursuant to a resolution of the board to redeem shares that are subject to redemption at the option of the company, or
 - (e) pursuant to a general power given to the board by special resolution of the general meeting, by offering to acquire a maximum of 10% of the

²⁸⁸ See paragraphs 5.3.1-5.3.3 and 5.7 above.

²⁸⁹ The redemption of shares otherwise than at the option of the company will resort under this paragraph.

issued shares of any class of shares, upon the terms set out, and at a price within the range specified in, the special resolution.

- (2) An agreement with a company providing for the acquisition by the company of shares issued by it is enforceable against the company, subject to subsection (3).
- (3) An obligation of a company to acquire its shares, whether in terms of an agreement, court order, under the appraisal remedy or otherwise, cannot be enforced against that company to the extent that the company is unable to fulfil that obligation without violating the solvency and liquidity test.
- (4) If, in proceedings to enforce an obligation to acquire its shares, a company alleges that, as a result of the operation of subsection (3), it is unable to fulfil its obligation to acquire its shares the company has the burden of proving that fulfilment of its obligation would put it in breach of the solvency and liquidity test.
- (5) If a company pays consideration for the acquisition of its own shares in violation of the solvency and liquidity test, the payment of the consideration and the transfer of the shares are invalid and restitution must take place, provided that the contract will remain enforceable subject to the solvency and liquidity of the company.
- (6) Until a company has fully performed an obligation to acquire its shares, shareholders whose shares are being acquired retain the status of claimants entitled to be paid as soon as the company is able to do so without infringing the solvency and liquidity test or, on liquidation, to be ranked subordinate to creditors and to shareholders whose claims are in priority to the claims of the class of shares being acquired, but in priority to the claims of the other shareholders.
- (7) A general power envisaged in subsection 1(e) may be revoked or varied by special resolution of the general meeting and, unless revoked earlier, will be valid only until the next annual general meeting of the company.
- (8) When the board has acquired shares pursuant to a general power envisaged in subsection 1(e), it has to disclose particulars of the exercise of that power to the next general meeting of that company.

- (9) A company may acquire the shares of a deceased or disabled shareholder from the net proceeds of a life policy or disability policy even if the company does not comply with the solvency and liquidity test.

Acquisition of shares by subsidiary

- (1) Subject to subsection (2) a subsidiary may acquire shares of its holding company²⁹⁰
- (a) in terms of a resolution of its board and the board of its holding company to make an offer to acquire the shares proportionately from all the holders of that class who are willing to dispose of them;
- (b) in terms of a resolution of its board and the board of its holding company, which has been approved by the general meeting of the holding company by special resolution,²⁹¹ to make an offer to acquire shares from one or more specific shareholders of the holding company who are willing to dispose of them;
- (c) provided that payment in respect of the acquisition may be made only if both the subsidiary and the holding company satisfy the solvency and liquidity test.
- (2) Not more than 10% in aggregate of the number of issued shares of any class of shares of a holding company may be held by or for the benefit of the subsidiaries of that company.
- (3) No voting rights attaching to shares may be exercised by or on behalf of a subsidiary in respect of the shares it holds in its holding company.
- (4) If, by reason of the cancellation of shares, a company becoming a subsidiary of a holding company, or for any other reason, it appears that subsidiaries taken together hold more than 10% in the aggregate of the number of issued shares of any class of shares of the holding company, the excess over 10% shall be disposed of, or the percentage otherwise reduced to 10%, within 120

²⁹⁰ It is unnecessary to provide for court orders, the appraisal remedy or existing legal obligations as these do not arise in the context. It is also unnecessary to provide for a general repurchase power in respect of shares of the holding company.

²⁹¹ Since the effect of a disproportionate repurchase will be felt by the shareholders of the holding company, it is they who should approve a selective offer.

business days, failing which the excess shares will be deemed to have been surrendered to the holding company in proportion to the number of shares held by each subsidiary.

- (5) An agreement in terms of which a subsidiary agrees to acquire shares in its holding company is enforceable against the subsidiary company, subject to subsection (6).
- (6) An obligation of a subsidiary to acquire shares of its holding company cannot be enforced against the subsidiary to the extent that the subsidiary is unable to fulfil that obligation without violating the solvency and liquidity test or while its holding company does not satisfy the solvency and liquidity test.
- (7) If, in proceedings to enforce an obligation to acquire its shares, a subsidiary company alleges that, as a result of the operation of subsection (6), it cannot fulfil its obligation to acquire shares in its holding company, it has the burden of proving that fact.
- (8) If a company pays consideration for the acquisition of shares in violation of the solvency and liquidity test, the payment of the consideration and the transfer of the shares are invalid and restitution must take place, provided that the contract will remain enforceable subject to the solvency and liquidity of the company.
- (9) Until a subsidiary company has fully performed an obligation to acquire shares in its holding company, shareholders whose shares are being acquired retain the status of claimants entitled to be paid as soon as the company is able to do so without infringing the solvency and liquidity test or, on liquidation, to be ranked subordinate to creditors of the subsidiary.²⁹²
- (10) The directors of the holding company and of the subsidiary are jointly and severally liable to restore the amount of the consideration to the subsidiary company, to the extent that it cannot be recovered from the shareholders.

²⁹² It does not make sense to provide for the ranking of this claim in priority to remaining holders of the same class upon liquidation of the subsidiary, as the other shareholders do not have a claim against the subsidiary in respect of its net assets.

9 FINAL ANALYSIS

The notion of limited liability entails that shareholders stand to lose only their capital contribution to the company. As the owners of the company, the shareholders are expected to bear the risk of its failure. But in addition to the ultimate return of their investment when the company is dissolved, shareholders expect to receive a return on their investment during the life of the company. Their expectations have to be balanced against the prior right of creditors to the satisfaction of their claims. The capital maintenance doctrine responds to this challenge by allowing distributions to shareholders on condition that their initial contribution is left intact in the interest of creditors. The functioning of this theory relies on the accurate determination of what constitutes capital and what does not. This is a relatively complex exercise which, depending on the size of the capital, may not be worth the effort.

Over the past three decades the capital maintenance doctrine has been replaced in a number of jurisdictions by alternative financial restrictions on distributions to shareholders. In 1999 South Africa also started making the transition from the capital maintenance doctrine to a system where most distributions depend on the solvency and liquidity of the company. The amendments created certain anomalies and uncertainties, primarily due to the fact that the provisions on share capital structure and consideration for the issue of shares were not revised. The requirements for certain types of distributions that are expressly regulated in the Act have not been harmonised with the new requirements for share repurchases and payments to shareholders, resulting in undesirable fragmentation.

The financial restrictions of solvency and liquidity provide creditors with adequate protection. The solvency element ensures that the priority of creditors is not endangered, while the liquidity element addresses the expectation of creditors to receive payment when due.

The rules governing the share capital of a company, which have become irrelevant to creditors, remain important to shareholders. Shareholders have an interest in the preservation of their relative equity interests in the company, on which their rights to vote and to share in returns on and of capital depend. These interests can be affected by reorganisations of capital and by disproportionate

contributions and distributions. While it is fairly easy to provide protection to creditors, addressing shareholder interests involves more complex issues.

Although the relationship between shareholders as set out in the constitution of the company is regarded as contractual in nature, the legislation plays an important role by ensuring minimum protection and providing default arrangements. The regulation of capital structure, capital contributions and distributions to shareholders all are important facets of shareholder protection. The real challenge is to find an appropriate balance between shareholder protection and commercial flexibility.

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