

A COMPARISON OF CAPITAL RULES GOVERNING FINANCIAL  
ASSISTANCE BY A COMPANY IN SOUTH AFRICAN AND ENGLISH  
COMPANY LAW

by

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I declare that 'A comparison of capital rules governing financial assistance by a company in South African and English Company law' is my own work and that all the sources that I have used or quoted have been indicated and acknowledged by means of complete references.



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## Summary

The Companies Act of 71 of 2008 makes a number of important changes to the rules relating to capital maintenance. In line with the objectives of the Companies Act of 71 of 2008, section 44 of the Act has removed the prohibition on the provision of financial assistance by a company which was contained under the previous section 38 of the Companies Act 61 of 1973. Despite the repeal of the prohibition, a transaction which involves the provision of financial assistance by a company for the acquisition of or subscription of its own securities still needs to be effected in accordance with the requirements and conditions that are provided under the Act and Memorandum of Incorporation. To explore the new developments, within this study, the provision of financial assistance in terms of section 44 of the Companies Act of 2008 is, therefore, analysed in detail.

On the other hand, the UK Companies Act of 2006 repealed the prohibition on the giving of financial assistance by private companies in most circumstances. It, however, retained the prohibition to public companies only because of the requirements of the Second Company Law Directive (77/91/EEC). This study also explores the rules of financial assistance by a company under the UK Companies Acts in detail.

Though the source of financial assistance by a company both in South Africa and in English Company laws is rooted in the English decision of the *Trevor v Whitworth* case, currently these countries have adopted what is deemed appropriate and significant in their own countries. This study, therefore, examines and compares the rules governing the provision of financial assistance by a company in the company laws of these two countries.

Key Words: solvency and liquidity test; financial assistance by a company; for purpose of or in connection with subscription or purchase of shares or securities; section 44 of the Companies Act of 2008; section 677 of the Companies Act of 2006.

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## Chapter 1: Introduction and general statement of the problem

### 1.1 Introduction

Until recently, the rule prohibiting companies from dissipating funds subscribed for shares, as developed in the English case of *Trevor v Whitworth*<sup>1</sup>, has been considered to be effective in the protection of creditors and minority shareholders of the company.<sup>2</sup> Historically, the capital maintenance rule justified, among other things, the prohibition of share buy-backs, distribution to shareholders out of capital, and the provision of financial assistance by a company for the acquisition of its own securities.<sup>3</sup>

In order to deal with the issues raised in the *Trevor v Whitworth*, the legislature enacted section 38 of the Companies Act 61 of 1973<sup>4</sup> which made provision for the prohibition of financial assistance by a company for the purchase of its own shares.<sup>5</sup> This provision was amended by the insertion of section 3 of the Companies Amendment Act 37 of 1999<sup>6</sup> which created the possibility for companies to provide financial assistance under certain circumstances. This Amendment Act, however, made no substantial change to Section 38 of Companies Act of 1973 other than to add another exception to the prohibition of financial assistance by a company for the acquisition of shares to facilitate buy-backs within a group of companies.<sup>7</sup> In 2006, the legislature enacted the Corporate Laws Amendment Act 24 of 2006<sup>8</sup> with an intention (among others) of further amending section 38 of Companies Act of 1973. Section 9 of the Corporate Laws Amendment Act of 2006 introduced the solvency and liquidity requirement to the general prohibition of financial assistance contained under section 38 of the Companies Act of 1973.<sup>9</sup> Although certain amendments were introduced by these two amending statutes, there have been

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<sup>1</sup> *Trevor v Whitworth* (1887) 12 App Cas 409(HL) 416.

<sup>2</sup> Bhana D 'The company law implications of conferring a power on a subsidiary to acquire the shares of its holding company' 2006 (17) *Stell LR* 232 at 232.

<sup>3</sup> Yeats JL 'The Drafters Dilemma: Some comments on Corporate Laws Amendment Bill 2006', (2006) *SALJ* Vol. 123 601 at 607.

<sup>4</sup> Companies Act 61 of 1973.

<sup>5</sup> Pretorius JT & Delpont PA, *et al Hahlo's South African company law through the cases* (1999) 6<sup>th</sup> ed Juta at 125.

<sup>6</sup> Act 37 of 1999.

<sup>7</sup> Yeats J and Jooste R 'Financial assistance a new approach' 2009 *SALJ* 126 issue 3 566 at 568.

<sup>8</sup> Act 24 of 2006.

<sup>9</sup> Van Der Linde 'The solvency and liquidity approach in the Companies Act 2008' (2009) 2 *TSAR* 224 at 224.



calls for the prohibition of financial assistance to be substituted by solvency and liquidity measures to enable a company to make valid financial assistance.<sup>10</sup>

The introduction of the Companies Act of 2008<sup>11</sup> has reflected a fundamental shift in philosophy and also indicated the apparent death of the capital maintenance rule as a principle underlying company law in South Africa.<sup>12</sup> The Companies Act of 2008 has, among other things, specifically allowed the financial assistance of a company for the purchasing and subscription of company securities. Section 44 of the Companies Act of 2008 provides that a company can provide financial assistance by way of a loan, guarantee, the provision of security, or otherwise to any person for the purpose of, or in connection with, the subscription of any option, or any securities, issued or to be issued by the company or a related or inter-related company, or for the purchase of any securities of the company or a related or inter-related company upon the satisfaction of certain requirements.

By allowing financial assistance, the Companies Act of 2008 does not disregard the interests of third parties and minority shareholders within the company; instead it has allowed financial assistance subject to compliance with certain requirements and conditions as stipulated therein.<sup>13</sup> These requirements and conditions include (among other things) the absence of the prohibition of financial assistance by the Memorandum of Incorporation (MOI) and require that such financial assistance to be made in accordance with the conditions stated in the MOI.<sup>14</sup> Furthermore, the company should, after financial assistance has been granted, ensure that the company satisfies the solvency and liquidity test.<sup>15</sup> These requirements and conditions, therefore, could serve as a means to protect the interests of third parties and minority shareholders against the depletion of the capital of the company.

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<sup>10</sup> Wainer H E 'The Companies Act Changes- Problems and Doubts' (2001) *SALJ* 133 at 133.

<sup>11</sup> The Companies Act of 2008 came into force in May 2011.

<sup>12</sup> Wainer op cit note 10 at 133.

<sup>13</sup> Section 44 (3) & (4) of the Companies Act of 2008.

<sup>14</sup> Section 44(4) of the Companies Act of 2008 as amended by section 30 of Companies Amendment Act of 2011.

<sup>15</sup> Section 44(3) (b) of the Companies Act of 2008.

The origins of the capital maintenance rule under the UK Company laws can be traced back to the decision in *Trevor v Whitworth*,<sup>16</sup> in which the House of Lords laid down the rule making it unlawful for a company to purchase its own shares by using its capital.<sup>17</sup> The origin of the general prohibition against the provision for financial assistance for the acquisition of its own shares, however, has its roots in the Greene Committee Recommendations.<sup>18</sup> It was based on the Greene Committee recommendation that statutory provisions be enacted to prohibit financial assistance by a company for the acquisition of its own shares.<sup>19</sup>

Under the Companies Act of 1985, it was unlawful for an English company, or any of its subsidiaries, to give financial assistance for the purpose of purchasing of company shares.<sup>20</sup> There was, however, an exception to the general prohibition whereby a private company was able to give financial assistance upon completion of the "whitewash" procedure.<sup>21</sup> The "whitewash" procedure, also called the 'gateway procedure', refers to those statutory procedures which are contained in sections 155-158 of the Companies Act of 1985, which allowed private companies to provide financial assistance for the purchasing of its own shares.<sup>22</sup> Due and proper compliance with the procedure was mandatory in order to make a lawful financial assistance.<sup>23</sup> The whitewash procedure required, among other things, that the assistance must be given by a private company for the purpose of an acquisition of shares in itself or its private holding company.<sup>24</sup> It required that the net assets of a company must not be reduced by the financial assistance or, to the extent that they are reduced, the assistance is given out of its distributable profits.<sup>25</sup> In addition, the directors of the company must make a statutory declaration in respect of the company's solvency which must be verified and accompanied by a report from the company's auditors stating that they are not aware of anything to indicate that the directors'

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<sup>16</sup> *Trevor v Whitworth* op cit note 1.

<sup>17</sup> Lowry J 'The prohibition against financial assistance: constructing a rational response' <http://fds.oup.com/www.oup.com/pdf/13/9780199589616.pdf> at 7. (Accessed on November 2012).

<sup>18</sup> Ibid. See also Report of the Company Law Amendment Committee, HMSO Cmd 2675 (1926) para 31.

<sup>19</sup> Ibid.

<sup>20</sup> Section 151 of the UK Companies Act of 1985.

<sup>21</sup> Section 155-158 of the UK Companies Act of 1985.

<sup>22</sup> Roberts C *Financial assistance for the acquisition of shares* 2005 Oxford University Press at 77

<sup>23</sup> Ibid at 58.

<sup>24</sup> Section 155(1) of Companies Act of 1985.

<sup>25</sup> Ibid.

opinions referred to in the statutory declaration are ‘not unreasonable in all the circumstances’.<sup>26</sup> Furthermore, unless it is a wholly-owned subsidiary, in order to comply with the whitewash procedure the shareholders of the company must pass a special resolution in a general meeting authorising the financial assistance.<sup>27</sup> This procedure had no application in public companies as they were not allowed to provide financial assistance for the acquisition of their own or their subsidiaries’ shares.

The provisions of sections 151 to 153 and 155 to 158 of the UK Companies Act of 1985 were repealed, with effect from October 2008, to make provision for financial assistance in respect of private companies. The Companies Act of 2006 has lifted the prohibition of financial assistance by a private company for the acquisition of its shares or those of its holding company.<sup>28</sup> The effect of the repeal of the financial assistance prohibition is that financial assistance transactions by private companies (in respect of the shares of a private company) are no longer unlawful *per se*.<sup>29</sup> The prohibition of financial assistance, however, still continues to apply in respect of a public company or its UK based subsidiaries.<sup>30</sup> This was due to a need to comply with the Second Company Law Directive (77/91/EEC) that prohibited a public company from advancing funds, making loans, or providing security in order for a third party to acquire its shares.<sup>31</sup>

Generally, the prohibition of financial assistance by a company for acquisition of its own shares in South Africa has its origins in the English law, where, as it is stated above, the Greene Committee first drew attention to the potential abuse that could arise from such transactions.<sup>32</sup> The current stance of these two jurisdictions (South Africa and England) on financial assistance, however, exhibits the existence of considerable differences which have necessitated a study of them.

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<sup>26</sup> Sections 155 (6) and 156 of the Companies Act 1985. See also, Roberts op cit note 22 at 82.

<sup>27</sup> Sections 155(4) and 157 of the Companies Act 1985.

<sup>28</sup> Section 682(1) (a) of Companies Act 2006.

<sup>29</sup> The City of London Law Society (CLLS), ‘The implications for leveraged transactions of the repeal of the statutory prohibition of financial assistance by private companies’, Law and Financial Markets Review vol 2 no. 6 (November 2008) at 489.

<sup>30</sup> Dine J & Koustas M *Company law* 6<sup>th</sup>ed Oxford Palgrave Macmillan 2007 at 130.

<sup>31</sup> For a detailed discussion refer to Chapter 3 sub-topic 3.4.2 below.

<sup>32</sup> Yeats J and Jooste R op cit note 7 at 566.

## 1.2 Purpose of the study

The purpose of this study is to conduct a comparative analysis of the provisions for financial assistance by a company for the acquisition of its own securities between South Africa and the United Kingdom. Upon completion of the comparative analysis, special emphasis will be given to the analysis of disparities found in these jurisdictions. Based on the disparities in existence, we will be able to identify the virtues and deficiencies of the South African Company law rules on financial assistance.

## 1.3 Significance of the study

This research is appropriate research for the following three reasons:

Firstly, this research intends to provide an analytical comparison of the laws that regulate financial assistance by a company for a subscription or acquisition of its own securities under the Company Laws of South Africa and England. The issue of financial assistance by a company is a central issue under the modern corporate laws<sup>33</sup>, thus dealing with the manner in which these two countries handle the issue can be helpful (making comparison valuable). This study will foster understanding of the capital maintenance rules on financial assistance and add a wider perspective to its application. Moreover, even though these two countries have shared many similarities in many aspects of the law, they differ fundamentally on the issue of financial assistance by a company to buy its own securities. Such an exercise can identify the similarities and the differences found in these two jurisdictions, thus providing invaluable lessons for South African company law. Comparison with English law is further warranted because of its implementation of the Second Company Law Directive of 1976<sup>34</sup> which applies in respect of public companies with regard to the regulation of provision of financial assistance and represents the position of other member states of the European Union, thus adding a wider perspective.

Secondly, this study will look critically at the capital rules regulating financial assistance for the subscription of company securities under the Companies Act 71 of 2008. It will determine whether the latest amendments made to section 44 of the Companies Act of 2008, as amended by

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<sup>33</sup> Lowry J op cit note 17 at 1.

<sup>34</sup> Directive 77/91/EEC, as amended by Directive 2006/68/EC. see also chapter 3 below

the Companies Amendment Act 2011, addressed the surrounding issues sufficiently. It will also provide solutions and recommendations in the event that the existing provisions are still inadequate. Thirdly, this study aims to instigate observers to engage in this area of the law.

#### **1.4 Scope of the study**

The scope of this study will be limited to the area of financial assistance for the purchasing or subscription of a company's securities as contained in the Companies Act 71 of 2008 (South African company law) and Companies Act of 2006 (English Company Law). Hence, other capital maintenance rules are beyond the scope of this study.

#### **1.5 Methodology**

The Companies Act 71 of 2008, the Companies Amendment Act of 2011, case law, and other relevant pieces of legislation will serve as a primary source on the South African literature. The UK Companies Act of 2006, case law, and other relevant statutes will be used as primary sources for purposes of this research. Recognized Journals, Articles, the writings of well-known authors, and internet websites are used as secondary sources of this study with regard to both jurisdictions.

#### **1.6 Chapter overview**

This paper will consist of five chapters. The first chapter will discuss the preliminaries of this work as has been done above. The second chapter will discuss the evolution of financial assistance by a company for the acquisition of its own shares under South African company law, while the third chapter is devoted to analyzing the English company laws on the same issue. The fourth chapter will be a comparative analysis of the South African and English company laws on financial assistance by a company for the acquisition of its own securities. The fifth chapter will consist of recommendations and solutions.

## Chapter 2: Financial assistance by a company under South African company law

### 2.1 The evolution and development of the concept of financial assistance

A legislative prohibition on the provision of financial assistance by a company for the acquisition of its own shares has been contained in the Company legislation of South Africa since the introduction of section 86bis of the Companies Act 46 of 1926.<sup>35</sup> The latest prohibition was incorporated under section 38 of the Companies Act 61 of 1973 which prohibited a company from giving, whether directly or indirectly, and whether by means of a loan, guarantee, the provision of security, or otherwise, any financial assistance for the purpose of, or in connection with, a purchase or subscription made or to be made by any person of or for any shares of the company, or, where the company is a subsidiary company, of its holding company.<sup>36</sup>

The prohibition of financial assistance under section 38 was intended to be an extension of the rule that a company cannot purchase its own shares, thereby reducing its capital unlawfully by returning assets to shareholders other than as permitted by legislation.<sup>37</sup> The case that established this rule is *Trevor v Whitworth* [1887].<sup>38</sup> According to Yeats and Jooste, the provision of financial assistance gave rise to a concern by the Greene Committee on the potential abuse that could arise from the provision of financial assistance.<sup>39</sup> Yeats and Jooste assert that the Greene Committee considered that such transactions offended 'against the spirit if not the letter of the law which prohibits a company from transacting in its own shares and further that the practice is open to the gravest abuse'.<sup>40</sup> This, therefore, created a need for a statutory provision prohibiting the giving of financial assistance to be incorporated into the South African Companies Act.<sup>41</sup> According to Yeats and Jooste, the prohibition of financial assistance which is contained under section 38 of the Companies Act 61 of 1973 has its roots in England where the Greene Committee first drew attention to the potential abuse.<sup>42</sup>

<sup>35</sup> Yeats J and Jooste R 'Financial assistance a new approach' 2009 *SALJ* 126 issue 3 at 566.

<sup>36</sup> Section 38(1) of the Companies Act 61 of 1973.

<sup>37</sup> Cilliers & Benade *et al Corporate Laws* 3<sup>rd</sup>ed 2000 Butterworths at 329.

<sup>38</sup> Yeats J and Jooste R op cit note 35 at 566, See also *Trevor v Whitworth* (1887) 12 App Cas 409(HL) at 416.

<sup>39</sup> *Ibid*.

<sup>40</sup> *Ibid*; see also the Report of the Company Law Amendment Committee, HMSO Cmd 2675 (1926) para 30.

<sup>41</sup> Pretorius JT & Delpont PA, *et al Hahlo's South African company law through the cases* (1999) 6<sup>th</sup> ed Juta at 125.

<sup>42</sup> Yeats J and Jooste R op cit note 7 at 566.

Prohibition of financial assistance was normally regarded as part of the capital maintenance regime, although transactions involving financial assistance did not in fact diminish the company's share capital. In the view of Cilliers & Benade *et al*, the scope of the prohibition goes much further than being an extension of the rule that a company providing mere financial assistance to a person for the purchase of its own shares does not *per se* reduce its capital.<sup>43</sup> They assert that the company providing the assistance may merely be changing the form of, or encumbering, its assets and, if the borrower is able to meet his obligations with regard to the purchase of the shares, the company's capital remains intact.<sup>44</sup>

According to the Report of the Jenkins Company Law Committee (1962) in England, however, it was observed that abuses are likely to arise where persons who cannot provide necessary funds from their own resources or who typically lack a collateral to raise finance from commercial banks or others on normal commercial terms, gaining control of the company, intended to use the assets of the company to pay for or secure payment of the price of the shares.<sup>45</sup> The Committee pointed out that, if the speculation succeeds the company and, therefore, its creditors and minority shareholders may suffer no loss, although their interests will have been subjected to an illegitimate risk.<sup>46</sup> If it fails, it may be little consolation for creditors and minority shareholders to know that the directors are liable for misfeasance.<sup>47</sup>

The court in *Lewis v Oeanate (Pty) Ltd* referred to, with approval, the *Trevor v Whitworth* case which stated that the purpose of section 38(1) is the protection of creditors of a company who have a right to look to its paid-up capital as the fund intended for the payment of their claims.<sup>48</sup> The court further held that the legislature had the intention of preventing that fund being employed or depleted or exposed to possible risk as a consequence of transactions concluded

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<sup>43</sup> Cilliers & Benade *et al* op cit note 37 at 329.

<sup>44</sup> Ibid.

<sup>45</sup> The Report of the Company Law Committee (Jenkins Report) Cmnd 1749(1962) para 173.

<sup>46</sup> Ibid.

<sup>47</sup> Ibid.

<sup>48</sup> *Lewis v Oeanate (Pty) Ltd* 1992 (4) SA 811(A) at 818.

for the purpose of, or in connection with, the purchase of its shares.<sup>49</sup> The object of the prohibition, therefore, has been considered as protecting the funds of a company by ensuring that persons who acquire shares in a company do so out of their own resources and not by plundering the resources of the company against the interest of third parties and minority shareholders.<sup>50</sup> Having said that, let us investigate the challenges that have emerged from the adoption of the prohibition of financial assistance.

## 2.2 Challenges with section 38 of the Companies Act of 1973

Section 38 of the Companies Act 1973 was found to be amongst the most problematic areas of the Act.<sup>51</sup> According to Cilliers and Benade, the precise content of the concept of the provision of financial assistance for purchase or subscription was the hub of the problem under section 38 of the Companies Act of 1973.<sup>52</sup> The authors pointed out that the widest and most general terms contained under section 38 have created a variety of opinions on its application, particularly in complicated areas of commercial transactions, thereby generating more than its fair share of commercial uncertainty.<sup>53</sup>

The court in *Lipschitz NO v UDC Bank Ltd* held that the prohibition in the section consists of two main elements, one is the giving of financial assistance, and the other is the purpose for which it is given (or the "in connection with" provision).<sup>54</sup> It further held that the two elements are linked to form a single prohibition, although so linked they are fundamentally different in concept.<sup>55</sup>

In the *Lipschitz* case, Miller JA held that the words "financial assistance" have not been comprehensively defined in section 38 of the Companies Act of 1973 or elsewhere in the Companies Act, and, inevitably, problems sometimes arise as to whether what a company has

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<sup>49</sup> Ibid at 819.

<sup>50</sup> Pretorius JT et al op cit note 41 at 125 and 136.

<sup>51</sup> Cilliers & Benade et al op cit note 37 at 329. The authors express the problem under section 38 as '...formidable problem area...'.  
<sup>52</sup> Ibid at 330.

<sup>53</sup> Ibid.

<sup>54</sup> *Lipschitz NO v U D C Bank Ltd* 1979(1) SA 789 (A) at 800.

<sup>55</sup> Ibid



done in a given case constitutes the giving of financial assistance within the meaning of those words as used in section 38 of the Companies Act of 1973.<sup>56</sup> Cilliers and Benade further pointed out that section 38 did not prohibit the giving of financial assistance unless it was established that the assistance was given for the purpose of the purchase or subscription of the company's shares or in connection with such purchase or subscription. As a result, a question arose about whether, in interpreting the prohibition, the words 'in connection with' should be given their literal meaning or not.<sup>57</sup>

On the other hand, the prohibition of financial assistance was considered as restraining commercial transactions. According to Wainer, given the fact that investors and creditors rights can easily be protected by solvency measures, the preclusion of financial assistance appears to be unnecessary.<sup>58</sup> The author stated that the prohibition was also considered as restrictive of the encouragement of commercial activity in view of the harsh consequences of a breach of section 38 and the consequent commercial realities.<sup>59</sup> It must also be pointed out that contravention of section 38 of the Companies Act 61 of 1973 did not merely create criminal liability but invalidated the transaction involved.<sup>60</sup>

### **2.3 Solutions regarding section 38 of the Companies Act of 1973**

Solutions were given to section 38 of the Companies Act of 1973 by courts in various times in different issues. In searching for a guide to a proper answer to the question of whether what a company has done in a given case constitutes the giving of "financial assistance" within the meaning of the section, various tests have been formulated by the courts from time to time.<sup>61</sup> The 'impoverishment test' which begs the question 'has the company become poorer as a result of what it did for the purpose of or in connection with the purchase of shares?' is one of the tests formulated by courts to assist in determining whether a particular transaction amounts to

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<sup>56</sup> Ibid at 799.

<sup>57</sup> Cilliers & Benade et al op cit note 37 at 333.

<sup>58</sup> Wainer H E 'The Companies Act Changes- Problems and Doubts' (2001) 118 *SALJ* 133 at 133.

<sup>59</sup> Ibid.

<sup>60</sup> Pretorius JT & Delport PA *et al* op cit note 41 at 137.

<sup>61</sup> *Lipschitz NO v U D C Bank Ltd* 1979(1) SA 789 (A) at 798.

financial assistance.<sup>62</sup> This test was originally formulated in *Gradwell v Rostra Printers Ltd*<sup>63</sup> and was often used by the courts to determine what should be regarded as financial assistance.<sup>64</sup> The Appellate Division, however, in *Lipschitz v UDC Bank Ltd*<sup>65</sup> specifically warned against the tendency to use the 'impoverishment test' in all circumstances as the only test or even an accurate test to prove financial assistance.<sup>66</sup> Miller JA pointed out that the provision of guarantee or security by a company does not *per se* involve the actual or even probable disbursement or employment of the company's funds.<sup>67</sup> The judge, however, further indicated that, since section 38 of the Companies Act 61 of 1973 expressly provides that the giving of a guarantee or the provision of security constitutes financial assistance, if such guarantee or security was provided by the company and if it were to be established that it was provided for the purpose of or in connection with the purchase of the company's shares, the section would be shown to have been contravened whether or not such guarantee or security actually rendered was likely to render the company poorer.<sup>68</sup>

The Court stated that the 'impoverishment test' might be a very helpful guide and might produce a decisive answer to the question of financial assistance depending primarily on the form which the alleged transaction might have taken.<sup>69</sup> The court, however, strongly challenged the application of the test in many other cases where the test might be entirely irrelevant in deciding whether financial assistance had been provided.<sup>70</sup> In such circumstances, the court pointed out that the company providing financial assistance and the other persons involved in the transactions as well as other circumstances could be relevant in determining whether financial assistance had been given 'for the purpose of or in connection with' the purchase of shares of the company.<sup>71</sup>

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<sup>62</sup> *Lipschitz NO v U D C Bank Ltd* 1979(1) SA 789 (A) at 798. See also Cilliers & Benade, *et al* op cit note 37 at 331.

<sup>63</sup> 1959(4) SA 419 (A) at 426.

<sup>64</sup> *Lipschitz NO v U D C Bank Ltd* 1979(1) SA 789 (A) at 798.

<sup>65</sup> *Ibid* at 802.

<sup>66</sup> *Ibid* at 798.

<sup>67</sup> *Ibid* at 801.

<sup>68</sup> *Ibid*.

<sup>69</sup> *Ibid* at 802.

<sup>70</sup> *Ibid*.

<sup>71</sup> *Ibid*.

The *Lipschitz* case also dealt with the meaning of the phrases 'in connection with' and 'for the purpose of' under section 38 and attempted to provide the answer.<sup>72</sup> It was held that the "in connection with" provision is an alternative to "for the purpose of", and in the context of the section its connotation cannot be otherwise than profoundly affected by the concept to which it is an alternative.<sup>73</sup> According to Miller JA, therefore, the words "in connection with" appear to have been inserted in order to cover a situation where, although the actual purpose of the company in giving financial assistance might not have been established, its conduct nevertheless stood in such close relationship to the purchase of its shares that, substantially if not precisely, its conduct was similar.<sup>74</sup> The alternative was inserted merely to close possible loopholes but not to create a different type of offence, or a lesser offence, or to prohibit conduct which was not substantially similar to the conduct prohibited by the main provision characterized by the words "for the purpose of".<sup>75</sup> The judge further held that it is not possible to define the exact extent of the 'enlargement of the scope of the prohibition by the addition of the words in question; the facts of each case will determine whether the established "connection" with the purchase of shares constitutes conduct which the Legislature was concerned to prohibit'.<sup>76</sup>

The legislature, on its part, took steps to amend section 38 of the Companies Act 61 of 1973 through section 3 of the Companies Amendment Act 37 of 1999 and section 9 of the Corporate Laws Amendment Act 24 of 2006. The amendment made by Companies Act 37 of 1999 introduced the new exception under section 38(2) (d). This exception had the following effects:

- "A subsidiary may give financial assistance (to its holding company or any other person) in connection with the acquisition by the holding company of its (the holding company's) own shares.
- A holding company may render assistance (to its subsidiary company or to any other person) in connection with the acquisition by the subsidiary of shares in the holding company.

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<sup>72</sup> *Lipschitz v UDC Bank Ltd* 1979 (1) SA 789 (A) 804.

<sup>73</sup> *Ibid* at 805.

<sup>74</sup> *Ibid*.

<sup>75</sup> *Ibid*.

<sup>76</sup> *Ibid*.

- A co-subsiary of a subsidiary acquiring shares in its holding company may give assistance (to the subsidiary or any other person) in connection with the acquisition by the subsidiary of shares in the holding company."<sup>77</sup>

The Corporate Laws Amendment Act of 2006, on the other hand, adopted a more liberal approach than the Companies Amendment Act of 1999 towards financial assistance by inserting a further exception to section 38 of the Companies Act of 1973 to facilitate Black Economic Empowerment.<sup>78</sup> According to Yeats, section 38 of the 1973 Act was considered as an impediment to black economic empowerment (BEE) by preventing even financially strong companies from offering assistance for the purchase of shares to potential BEE partners who did not have the necessary resources to acquire shares independently.<sup>79</sup> The author further pointed out that this amendment was made in order to facilitate shareholder diversification or broad-based black economic empowerment.<sup>80</sup>

Nonetheless, a more radical change to the statutory prohibition was brought about by section 44 of Companies Act 71 of 2008, which introduced a far more fundamental change to the issue of financial assistance. This fundamental change, which is discussed below, can be regarded as one of the solutions provided by the legislature against the challenges brought about by the application of section 38 of the Companies Act 61 of 1973.

#### **2.4 Financial assistance for subscription of securities under section 44 of the Companies Act of 2008**

One of the overall purposes of the Companies Act of 2008 is to create flexibility and simplicity in the maintenance of companies.<sup>81</sup> Accordingly, the Act has lifted the prohibition for providing financial assistance by a company for acquiring its own shares. This fundamental shift in

<sup>77</sup> Van der Linde K 'Financial assistance for the acquisition of shares in accordance with section 85 of the Companies Act- A reply to Delpont (2001) 13 SA Merc LJ 437 at 441.

<sup>78</sup> Yeats J and Jooste R op cit note 35 at 568.

<sup>79</sup> Yeats JL 'The Drafters Dilemma: Some comments on Corporate Laws Amendment Bill 2006', (2006) *SALJ* Vol. 123 at 607.

<sup>80</sup> Ibid.

<sup>81</sup> Section 7(b)(ii) of the Companies Act 71 of 2008. See also The South African company law for the 21<sup>st</sup> Century *Government Gazette* no: 26493 at para 1.2.

philosophy has finally taken the leap and discarded any remnants of the previous Companies Act of 1973.<sup>82</sup> This essentially means that companies are not prohibited from providing financial assistance for the purpose of the acquisition of shares and entering into transactions which are entirely legitimate commercially to facilitate venture capital investment or, socially, to promote wider ownership of the company's shares.

Section 44(2) of the Companies Act of 2008 provides that 'except to the extent that the Memorandum of Incorporation of a company provides otherwise, the board may authorise the company to provide financial assistance by way of a loan, guarantee, the provision of security or otherwise to any person for the purpose of, or in connection with, the subscription of any option, or any securities, issued or to be issued by the company or a related or inter-related company, or for the purchase of any securities of the company or a related or inter-related company, subject to certain conditions and requirements'.<sup>83</sup> Notwithstanding the repeal of the prohibition, a transaction which involves the provision of financial assistance by a company for the acquisition of, or subscription of, its own securities still needs to be effected in accordance with the requirements and conditions that are provided under the Companies Act and Memorandum of Incorporation. Having stated the above, let us now analyse the key terms and concepts together with the conditions and requirements for the provision of financial assistance as well as the consequences of any contravention therein.

## **2.4.1 An analysis of section 44 of the Companies Act 71 of 2008**

### **2.4.1.1 Lack of definition of financial assistance**

Despite the fact that the promulgation of the Companies Act of 2008 was intended to solve the problems inherent in the previous Companies Act, there still exist uncertainties about the new provision which are not yet solved by the Act. Neither section 44 nor the Act provides a definition of the words 'financial assistance'. Section 44(2) of the Act provides that 'financial assistance' includes assistance by way of loans, guarantees, the provision of security, 'or otherwise' as forms of financial assistance that would constitute financial assistance for the

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<sup>82</sup> Delport P A *the New Companies Act Manual* 2009 LexisNexis at 31.

<sup>83</sup> Section 44 (3) to (6) of the Companies Act 71 of 2008.

purpose of the Act.<sup>84</sup> Whilst these are unquestionable forms of financial assistance, the absence of an exhaustive list of forms of financial assistance may create uncertainty. The ambit of the words 'or otherwise' under Section 44(2) is still far from clear, and requires the legislature to provide guidance in this regard.<sup>85</sup> Section 44(1), which should provide the lead in defining the term, has unfortunately failed to do so; rather it contains a negative provision relating to what should not be taken as financial assistance.

As we have discussed above, the Court in the *Lipschitz* case held that the absence of a comprehensive definition of financial assistance within an act may create uncertainty as to whether a given act of a company constituted financial assistance or not.<sup>86</sup> Nonetheless, the question whether financial assistance exists in any given case for the purpose of section 44 of the Companies Act of 2008 will be determined based on the extensive case law that has been built up around the meaning of the words 'or otherwise' in section 38 of the Companies Act of 1973 as it has been discussed above.<sup>87</sup>

#### **2.4.1.2 Lack of clarity with regards the phrase ‘for the purpose of’ or ‘in connection with’**

As we have seen in the previous discussion, and in the previous company legislation a transaction was not prohibited merely because assistance was given but when such assistance was given for the purpose of or in connection with the purchase or subscription of the company’s shares. The absence of the meaning of the concepts, however, created a problem with regard to the application of the prohibition of the financial assistance and this led to courts interpreting the concept as we have seen in the cases discussed above.

Under the current Companies Act, it is simply not enough that financial assistance is given; it must be given for *the purpose of* or *in connection with* the subscription of any option or any

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<sup>84</sup> However, this excludes lending money in the ordinary course of business by a company whose business is the lending of money. See section 44(1) of the Companies Act of 2008.

<sup>85</sup> Yeats J and Jooste R op cit note 37 at 571.

<sup>86</sup> *Lipschitz NO v U D C Bank Ltd* 1979(1) SA 789 (A) at 799.

<sup>87</sup> Yeats J and Jooste R at 571.

securities, issued or to be issued, or for the purchase of any securities of the company or a related or inter-related company.<sup>88</sup> A question may arise as to whether the words 'in connection with' should be given their literal meaning or not. The case law surrounding the meaning of words 'in connection with' in section 38 of the Companies Act of 1973 will presumably continue to apply in determining whether financial assistance made by a company is for the purpose of or in connection with a purchase or subscription of the company's securities in accordance with section 44 of the Companies Act of 2008.<sup>89</sup> The *Lipschitz*<sup>90</sup> decision, discussed above, is the leading authority in this regard.

### 2.4.1.3 Financial assistance for subscription of 'securities' and 'options'

The provisions of section 38 of the Companies Act of 1973 prohibited the giving of financial assistance by a company for the acquisition of 'shares', and then section 44 of the Companies Act of 2008 introduced an inclusive approach by replacing the term 'share' with the term 'securities'. Section 1 of the Companies Act of 2008 defines 'share' as one of the units into which proprietary interest in a profit company is divided. The same section provides that 'securities' means any shares, debentures, or other instruments, irrespective of their form or title, issued or authorised to be issued by a profit company.<sup>91</sup> It can, therefore, be concluded that section 44 of the Companies Act of 2008 casts a much wider net than the provision of section 38 by including various types of commercial instruments that did not previously fall within the ambit of the section.<sup>92</sup>

Section 44(2) regulates not only financial assistance for the subscription of, or purchase of, securities but also the subscription of 'options'. Neither the Companies Act of 2008, however, nor the provision provides what the options are for the purpose of financial assistance.<sup>93</sup> The first assumption, given the intention of the drafters, would be to cover an option to purchase or to

<sup>88</sup> Section 44(2) of the Companies Act of 2008.

<sup>89</sup> Yeats J and Jooste R op cit note 35 at 571.

<sup>90</sup> *Lipschitz v UDC Bank Ltd* at 804-5.

<sup>91</sup> Section 1 of the Companies Act 71 of 2008 as amended by s. 1 (1) (aa) of Act No. 3 of 2011.

<sup>92</sup> Yeats J and Jooste R at 573.

<sup>93</sup> *Ibid* at 574.

subscribe for securities of the company giving the assistance.<sup>94</sup> However, Yeats and Jooste submitted that it is very difficult to restrict the scope of the word as it is wide enough to cover options to acquire any property of the company.<sup>95</sup> The authors are also of the view that case law which was decided under section 38 of the 1973 act may not be helpful in this respect.<sup>96</sup> It would, therefore, have been better had the legislature taken the initiative to clarify the issue of what constitute options for the purpose of financial assistance.

#### **2.4.2 Conditions and requirements embedded in section 44**

As stated above, the Companies Act of 2008 enables companies to give financial assistance for the subscription of their own securities. The ability of companies to provide financial assistance is not an unregulated right. Companies may give financial assistance only if there is due and proper compliance with all of the conditions and requirements provided under section 44 of the Companies Act of 2008. Financial assistance may be granted provided that the Memorandum of Incorporation of the company does not prohibit the granting of financial assistance and that financial assistance is pursuant to an employee share scheme as per section 92 of the Companies Act of 2008 or it is pursuant to a special resolution of the shareholders adopted within the previous two years.<sup>97</sup> Furthermore, the board must be satisfied that the solvency and liquidity test will be satisfied and that the terms under which the assistance is proposed to be given are fair and reasonable to the company.<sup>98</sup>

Hence, if an agreement is concluded in relation to the provision of financial assistance for the subscription or purchase of securities without complying with the conditions and requirements, the agreement would be void.<sup>99</sup> It would, therefore, be worthwhile to elaborate on these requirements and conditions. The two requirements, namely that financial assistance must not be

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<sup>94</sup> Ibid.

<sup>95</sup> Ibid.

<sup>96</sup> Ibid.

<sup>97</sup> Section 44 (2) (3) & (4) of the Companies Act of 2008.

<sup>98</sup> Ibid.

<sup>99</sup> Further discussion is found under section 2.4.3 below.



prohibited by the Memorandum of Incorporation<sup>100</sup> and that financial assistance must be given in pursuance of an employee share-scheme in accordance with section 97 of the Companies Act of 2008 are, however, not discussed here in detail.

#### 2.4.2.1 Adoption of a special resolution

In terms of section 44(3) (a) (ii), a company can make valid financial assistance for subscription of its own shares if the particular financial assistance is pursuant to a special resolution of the shareholders, adopted within the previous two years, which approved such assistance either for the specific recipient, or, generally, for a category of potential recipients, and the specific recipient falls within that category.<sup>101</sup> This requirement must be satisfied despite any provision of a company's Memorandum of Incorporation to the contrary.<sup>102</sup> The requirement of adoption of a special resolution is included in the Companies Act of 2008 for the protection of shareholders.<sup>103</sup>

According to Wainer, however, the special resolution of shareholders is required only for the lending company, not for the company whose securities are the subject of the financial assistance.<sup>104</sup> The author submitted that the absence of a special resolution requirement in the company whose securities are the subject of financial assistance would endanger the interests of shareholders of that company.<sup>105</sup> It is, however, my opinion that Wainer's submission may cause unnecessary complexity of procedure in this regard. It will, therefore, suffice if the shareholders of the company providing the assistance approve the transaction through adoption of a special resolution.

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<sup>100</sup> Delport op cit note 82 at 31 described this requirement of the Companies Act of 2008 as 'the Memorandum of Incorporation must expressly permit the company to give such financial assistance'. I, however, respectfully disagree with this idea. The act does not require an express permission of the Memorandum of Incorporation but the absence of prohibition. See Davis D *et al Companies and other Business Structures in South Africa* (2011) 2 ed Oxford South Africa at 83 See also Wainer H E, 'the new Companies Act: peculiarities and anomalies' 2009 SALJ 126 at 817.

<sup>101</sup> Section 44(3) a (ii) of the Companies Act of 2008.

<sup>102</sup> Section 44(3) of the Companies Act of 2008.

<sup>103</sup> Yeats J and Jooste R op cit note 35 at 580.

<sup>104</sup> Wainer H E op cit note 100 at 816.

<sup>105</sup> Ibid.

### 2.4.2.2 The solvency and liquidity requirement

Section 44(3)(b)(1) of the Companies Act of 2008 provides that the board may not authorize any financial assistance unless it is satisfied that, immediately after providing financial assistance, the company would satisfy the solvency and liquidity test.<sup>106</sup> The liquidity and solvency test is included under the Companies Act to be used as a protective measure in a wide range of transactions including the giving of financial assistance affecting the rights of creditors.<sup>107</sup>

In accordance with the provisions of the Act, the effect of financial assistance must be measured ‘immediately after providing financial assistance’.<sup>108</sup> The way in which the solvency and liquidity test is currently formulated, imposes a positive duty on its board in a sense that the board must be ‘satisfied’ that the company will satisfy the test. According to Van der Linde, the Companies Act does not require the board of directors to acknowledge, by resolution, that it has applied the solvency and liquidity test when the test is applied to financial assistance transactions.<sup>109</sup> Yeats J and Jooste R noted that the test in financial assistance is a subjective test in that the board must be satisfied that the company is *actually* solvent and liquid (liquid for the following 12 months) and it is immaterial whether or not the board or reasonable person is satisfied that it is solvent and liquid.<sup>110</sup>

On the other hand, section 4 of the Companies Act of 2008 provides that a company satisfies the solvency and liquidity test at a particular time if, considering all reasonably foreseeable financial circumstances of the company at that time, the assets of the company, as fairly valued, equal or exceed the liabilities of the company, as fairly valued, and it appears that the company will be able to pay its debts as they become due in the ordinary course of business for a period of 12 months after the date on which the test is considered.<sup>111</sup> In applying the solvency and liquidity test, only accounting records that satisfy the requirements of section 28 and financial statements

<sup>106</sup> Section 44(3) (b) of the Companies Act of 2008.

<sup>107</sup> Van Der Linde K ‘The solvency and liquidity approach in the Companies Act 2008’, (2009) TSAR vol.2 at 225.

<sup>108</sup> Section 44(3) (b) (i) of the Companies Act of 2008.

<sup>109</sup> Van der Linde op cit note 107 at 238.

<sup>110</sup> Yeats J and Jooste R op cit note 35 at 587; see also Delpont op cit note 82 at 32.

<sup>111</sup> Section 4(1) of the Companies Act of 2008 as amended by Companies Amendment Act 2011.

that satisfy the requirements of section 29 are used in the computation.<sup>112</sup> The board or any other person applying the solvency and liquidity test to a company must consider a fair valuation of the company's assets and liabilities, including any reasonably foreseeable contingent assets and liabilities, irrespective of whether or not these arise as a result of the proposed transaction and may consider any other valuation of the company's assets and liabilities that is reasonable in the circumstances.<sup>113</sup>

### 2.4.2.3 The requirement of 'fair and reasonable'

In terms of the Companies Act of 2008, the board may not authorize any financial assistance contemplated in section 44(2) unless the board is satisfied that the terms under which the assistance is proposed to be given are fair and reasonable to the company.<sup>114</sup> Neither the Companies Act nor the section defines what is meant by *fair and reasonable* for such purpose. Yeats J and Jooste R discussed various factors in order to determine what constitutes the term *fair and reasonable* under the provisions of section 44.<sup>115</sup> The authors raised a variety of questions. Does the requirement mean that, viewed from a commercial perspective, the transaction, whatever it might be, will benefit the company?<sup>116</sup> Must there be a reasonable *quid pro quo*? Does it simply mean that the company is provided with 'fair and reasonable' security?<sup>117</sup> The authors did, however, not come up with a single conclusion on the issue. It seems, therefore, as if the requirement of *fair and reasonable* would include diverse circumstances which include the security provided for the assistance, the benefit that the company will receive, and the existence of a reasonable *quid pro quo*. The transaction must be in the best interests of the company and be intended to promote the success of the company for the benefit of its members in order to determine whether a certain financial transaction is fair and reasonable to the company.<sup>118</sup> It has been recognised that the requirement contained under section 44(3)(b)(ii) makes the Companies Act of 2008 tougher to negotiate than section 38 of

<sup>112</sup> Section 4(2) (a) of the Companies Act of 2008.

<sup>113</sup> Section 4(2) (b) of the Companies Act of 2008.

<sup>114</sup> Section 44(3) (b) (ii) of the Companies Act of 2008.

<sup>115</sup> Yeats J and Jooste R op cit note 35 at 576.

<sup>116</sup> Ibid at 677.

<sup>117</sup> Ibid.

<sup>118</sup> Ibid at 678.

the Companies Act of 1973 where there was no contravention of the section even if the terms under which the assistance was given were not fair and reasonable to the company.<sup>119</sup>

#### **2.4.2.4 Restrictions or conditions in the Memorandum of Incorporation**

The company may provide a restriction or conditions in its Memorandum of Incorporation for the giving of financial assistance.<sup>120</sup> The conditions or restrictions with respect of the granting of financial assistance stipulated in the Memorandum of Incorporation must be satisfied before any decision is made.<sup>121</sup> These conditions and restrictions are meant to provide better protection for both shareholders and creditors.

#### **2.4.3 Effect of non-compliance with the Companies Act of 2008 and/or the Memorandum of Incorporation**

Section 38 of the Companies Act of 1973 did not provide for the effect of the contravention of the prohibition. This was discussed in the *Lipschitz* case where it was stated that an agreement for the giving of financial assistance in breach of the prohibition is void and unenforceable.<sup>122</sup> The Companies Act of 2008, however, expressly provides that a board's decision or agreement to provide financial assistance is void to the extent that the provision of the assistance is inconsistent either with the Companies Act of 2008, or prohibition, condition, and restriction in respect of financial assistance set out in the Memorandum of Incorporation of the company.<sup>123</sup> The statement, 'to the extent that the provision of that assistance would be inconsistent with' in the section clearly indicates that those elements or provisions of an agreement or resolution which do not contravene the Companies Act of 2008 and the Memorandum of Incorporation will remain valid and enforceable.

If a resolution or an agreement is void in terms of section 44(5) of the Companies Act of 2008, a director of a company is liable to the extent set out in section 77(3)(e)(iv) if the director was present at the meeting when the board approved the resolution or agreement or participated in the

<sup>119</sup> Cassim *et al Contemporary Company Law* (2012) 2<sup>nd</sup>ed at 330.

<sup>120</sup> Section 44(2) of the Companies Act of 2008.

<sup>121</sup> Section 44(4) of the Companies Act of 2008.

<sup>122</sup> *Lipschitz v UDC Bank Ltd* 1979 (1) SA 789 (A) 804-5.

<sup>123</sup> Section 44(5) of the Companies Act of 2008.

making of such a decision in terms of section 74 and failed to vote against the resolution or agreement despite knowing that the provision of financial assistance was inconsistent with section 44 or a prohibition, condition, or requirement set out in the Memorandum of Incorporation.<sup>124</sup> The extent of the liability is the loss, damage, or costs sustained by the company as a result of the directors' failure to vote against the resolution or agreement.<sup>125</sup>

Unlike section 38 of the Companies Act of 1973, section 44 of the Companies Act of 2008 does not make the contravention of the Companies Act of 2008 and/or the MOI a criminal offence. Yeats and Jooste convincingly submitted that, since the threat of potential criminal liability for directors was an effective deterrent, section 44 of the Companies Act of 2008 should have retained the criminal liability of the directors.<sup>126</sup> The interests of the stakeholders of the company would, therefore, have been protected more had the criminal responsibility of directors been maintained under section 44.<sup>127</sup>

## 2.5 Conclusion

In this chapter we have seen the evolution of the rule of financial assistance within the South African context. We have seen how the statutory prohibition of financial assistance has its roots in the English decision of *Trevor v Whitworth* where it was held that the company should maintain its capital for the benefit of creditors. The prohibition has since gone through different developmental stages until its repeal with the coming into effect of the Companies Act of 2008 as amended.

The prohibition of financial assistance was never without its own challenges, which, among others, was the lack of a proper definition of the concept "financial assistance". Court decisions were relied upon to analyse and interpret what the legislature intended by the concept to enable presiding officers to decide whether a particular transaction fell within the definition. The *Lipchitz* and *Gradwell* decision played a role in the shape and form of this provision.

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<sup>124</sup> Section 44(6) of the Companies Act of 2008.

<sup>125</sup> Section 77(3)(e)(iv).

<sup>126</sup> Yeats J and Jooste R op cit note 35at 584.

<sup>127</sup> Ibid.

The lifting of the prohibition by the enactment of section 44 is seen as having brought a fundamental change to the rules of capital maintenance, ending considerable speculation on the classification of financial assistance transactions. Through section 44, the solvency and liquidity test was adopted, in order to ensure that company assets are not depleted by the transaction for the benefit of creditors and other relevant stakeholders. Among other measures introduced to protect the creditors is the condition that restrictions and/or conditions in the MOI have to be complied with. These measures were introduced to address the mischief that section 38 was trying to prevent, which is that the capital of the company has to be maintained for the benefit of the company together with the relevant stakeholders.

The new provision is considered to be a great improvement to the capital maintenance rule which had been part of South African company law for too long. Since this provision is fairly new to the South African company legislation, its effectiveness is yet to be seen.

## Chapter 3: Financial assistance by a company under English company law

### 3.1 Introduction

According to Roberts, the rules regulating financial assistance by a company for the acquisition of its own shares has been in the statute books since the Companies Act of 1928.<sup>128</sup> This statutory rule has gone through successive re-enactments.<sup>129</sup> The current rules of financial assistance by a company are found in seven sections (section 677 to 683) in Part 18 of Chapter 2 of the Companies Act of 2006. The provision of financial assistance for the purchase of the company's own shares has been considered in various UK court decisions. This chapter will, therefore, discuss the capital rule governing financial assistance in the UK company law.

### 3.2 Origin and development of financial assistance by a company

The genesis of the prohibition of financial assistance by a company in English law can be traced back to the decision in *Trevor v Whitworth*.<sup>130</sup> According to Roberts, however, the statutory rules prohibiting financial assistance by a company for the purchase of its own shares is derived from the work of the Greene Committee.<sup>131</sup> The Committee recommended statutory provisions to prohibit a company from providing, directly or indirectly, any financial assistance for the purchasing of its own shares whether in the form of a loan, a guarantee, the provision of security, or otherwise.<sup>132</sup>

The first legislation that introduced the prohibition on financial assistance was enacted in section 16 of the Companies Act of 1928.<sup>133</sup> The first operative statutory prohibition, however, was contained under section 45 of the Companies Act of 1929.<sup>134</sup> This section made it unlawful for a company to give, whether directly or indirectly, and whether by means of a loan, guarantee, the provision of security, or otherwise, any financial assistance for the purchase, or in connection

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<sup>128</sup> Roberts *C Financial assistance for the acquisition of shares* 2005 Oxford University Press at 7.

<sup>129</sup> *Ibid.*

<sup>130</sup> *Trevor v Whitworth* (1887) 12 App Cas 409(HL) 416.

<sup>131</sup> Roberts *op cit* note 128 at 37.

<sup>132</sup> Report of the Company Law Amendment Committee, HMSO Cmd 2675 (1926) at para 31.

<sup>133</sup> Roberts *op cit* note 128 at 9 where the author stated that except sections 53 and 92, the Companies Act 1928 came in to force on 1 November 1929 and was repealed by the 1929 Companies Act.

<sup>134</sup> *Ibid.*

with a purchase made or to be made by any person, of any shares in the company.<sup>135</sup> The provisions of section 45 of the Companies Act of 1929 imposed liability of a fine to the company and every officer who was in default of this provision.<sup>136</sup> According to Roberts, it is hard to determine whether this section has, in fact, prevented, reduced, or narrowed the practice of financial assistance because the prohibition contained in section 45 was found to be too complex to interpret.<sup>137</sup> The author is of the view that the aim of this provision was in fact not achieved and failed properly to handle the abuses that it had sought to limit or eliminate.<sup>138</sup>

The Companies Act of 1929 was amended by the Companies Act of 1948. The prohibition contained under section 45 of the Companies Act of 1929 was applied only with regards to the purchasing of shares to the exclusion of subscriptions. Section 54 of the Companies Act of 1948, however, extended the prohibition to apply to cases of subscriptions in addition to the purchase of shares. It also extended the application of the prohibition to apply to financial assistance by a subsidiary company.<sup>139</sup>

Amendments to section 54 of the Companies Act of 1948 were introduced by the Companies Act of 1980. Section 54 of the Companies Act 1948 was, however, replaced by section 42 to 44 (inclusive) of the Companies Act of 1981. The Companies Act of 1981 introduced a scheme whereby a solvent private company could make valid financial assistance subject to certain stringent restrictions.<sup>140</sup> According to Roberts, the adoption of European Economic Union Second Company Law Directive (77/91/EEC) was the rationale for the relaxation of the prohibition for solvent private companies under the Companies Act of 1981.<sup>141</sup> In terms of Article 23(1) of the Directive, a public company 'may not advance funds, nor make loans, nor provide security, with a view to the acquisition of its shares by a third party'. It, therefore,

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<sup>135</sup> Section 45 (1) of the Companies Act 1929.

<sup>136</sup> Section 45 (3) of the Companies Act 1929.

<sup>137</sup> Roberts op cit note 128 at 10.

<sup>138</sup> Ibid.

<sup>139</sup> Section 54 of the Companies Act 1948.

<sup>140</sup> According to Roberts, firstly all directors of the solvent private company had to make a statutory declaration in the prescribed form. Secondly, the auditors of the private company had to provide a report addressed to the directors. Thirdly, the provision of financial assistance had to be approved by a special resolution of the members of the company in general. Fourthly, the company was obliged to deliver to the Registrar of Companies a copy of the declaration together with the auditor's report. Fifthly, there were important timing requirements imposed by section 43 (9) of the Companies Act 1981 which had to be complied with. See Roberts op cit note 128 at 21. See further sections 43 & 44 of the Companies Act of 1981.

<sup>141</sup> Roberts op cit note 128 at 20.



became possible for the UK government to introduce certain exceptions for solvent private companies.<sup>142</sup> Accordingly, section 43 and 44 of the Companies Act 1981 provided a detailed important condition to be complied with before valid financial assistance by a company could be effected. It was, therefore, the Companies Act of 1981 which introduced the so-called 'whitewash' or 'gateway' procedure into the UK Companies Act.<sup>143</sup> The solvency and liquidity test was one of the important requirements introduced by section 43 of the Companies Act of 1981.

To discuss some of the other provisions of the Companies Act of 1981 from a bird's eye view, there were certain exemptions on which both private and public companies could rely. For instance, companies were not prohibited from giving financial assistance if the company's principal purpose in giving the assistance was not to reduce or discharge any liability incurred by a person for the purpose of the acquisition of any shares in the company or its holding company or the reduction or discharge of any such liability but was an incidental part of some larger purpose of the company and the assistance was given in good faith and in the interests of the company.<sup>144</sup> There was no prohibition from providing financial assistance if the lending of money was part of the ordinary business of the company.<sup>145</sup> The prohibition also did not apply where the provision of assistance was in accordance with an employee share scheme of money for the acquisition of fully paid shares.<sup>146</sup>

The Companies Act of 1981 provisions were re-enacted with some amendments under the Companies Act of 1985. The Companies Act 1985 comprised sections 151-158. Section 151 of the Companies Act of 1985 prohibited both private and public companies from providing financial assistance. According to Griffin, this provision sought to protect creditors and shareholders of the companies from potential financial abuses in respect of the acquisition of company shares.<sup>147</sup>

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<sup>142</sup> Ibid.

<sup>143</sup> Ibid at 6.

<sup>144</sup> Section 42 (4) of the Companies Act 1981.

<sup>145</sup> Section 42 (6) (a) of the Companies Act 1981.

<sup>146</sup> Section 42 (6)(b) of the Companies Act 1981.

<sup>147</sup> Griffin *S Company law: fundamental principles* 4<sup>th</sup>ed , Harlow England, 2006 at 169.

This act maintained the “whitewash” procedure as a means whereby the solvent private companies could make a valid financial assistance. The main features of the procedure included the making of a statutory declaration by the directors regarding the solvency of the company, which was to be supported by an auditor’s certificate, a special resolution by the shareholders of the company approving the financial assistance, and certain requirements as to the timing of providing financial assistance under section 155 of the Companies Act of 1985.<sup>148</sup> According to Roberts, sections 155-158 were an expression of an important concept that ‘the financial assistance may only be given if the company has net assets which are not thereby reduced, or to the extent that they are reduced, the assistance is provided out of distributable profits’.<sup>149</sup> Public companies, however, were not allowed to provide financial assistance except in respect of those exemptions provided under section 153 of the Companies Act of 1985. This was mainly because Article 23 of the Second Company Law Directive (77/91/EEC) required the United Kingdom to maintain a prohibition on financial assistance by public companies, subject to limited exceptions.

The frequent amendments to financial assistance provisions under UK company legislation continued until the enactment of the Companies Act of 2006 which brought about a fundamental change within the regime of financial assistance. These changes and the relevant provisions of the Companies Act of 2006 will be discussed in this chapter. In view of this, let us look at the challenges and solutions that existed before the enactment of the Companies Act of 2006 in relation to financial assistance in brief.

### **3.3 Challenges and solutions regarding the prohibition of financial assistance**

Ever since the introduction of financial assistance into the UK Company legislation, there have been enormous challenges associated with its application. Owing to the enormous number of the challenges, however, this discussion will deal with only a handful of them. The first problem that is raised in relation to the prohibition of financial assistance was discussed by the Jenkins Committee which took a view that transactions involving financial assistance did not necessarily offend against the rule that a limited company may not buy its own shares.<sup>150</sup> The Committee discussed the issue of financial assistance as it was contained in section 54 of the Companies Act

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<sup>148</sup> Sections 155-158 of the Companies Act.

<sup>149</sup> Roberts op cit note 128 at 20.

<sup>150</sup> The Report of the Company Law Committee- the Jenkins Committee Comnd 1749(1926) paras 173.

of 1948. It noted that a company which lends money to a person to buy its shares simply changes the form of its assets, and, if the borrower is able to repay the loan, the company's capital remains intact.<sup>151</sup> Where the assurance given by the purchaser is improper and the company suffers loss, the directors who are parties to the transaction will be liable for misfeasance.<sup>152</sup> The Committee, therefore, deemed the underlying purpose of the statutory prohibition to be aimed at preventing abuses which inevitably arose when provisions of financial assistance by a company are made.<sup>153</sup>

The legislative provisions setting out the prohibition of financial assistance were considered by some writers as 'notoriously difficult' to interpret, which caused uncertainty in that area of the law.<sup>154</sup> For instance, section 54 of the Companies Act of 1948 was criticized for its imprecise drafting which resulted in prohibiting innocent transactions.<sup>155</sup> Sections 152 of the Companies Act of 1985 provided a definition for 'financial assistance'. According to Roberts, however, the statutory definition of financial assistance was not helpful because it did not define the term and could not be taken to be an all-embracing and extensive definition of the phrase 'financial assistance'.<sup>156</sup> In *Charterhouse Investment Trust Ltd v tempest Diesels Ltd*<sup>157</sup> the court held that there is no definition of 'giving financial assistance' in the section, although some examples were given to indicate what is meant by the phrase 'financial assistance'.<sup>158</sup> It was further held that the words have no technical meaning, and their frame of reference is the language of ordinary commerce given that the section is a penal one and should not be strained to cover transactions which are not fairly within it. In order to determine whether a transaction could be described as 'financial assistance', one must examine the commercial realities of the transaction and decide whether it can properly be described as the giving of financial assistance by the company.<sup>159</sup>

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<sup>151</sup> Ibid.

<sup>152</sup> Ibid.

<sup>153</sup> Ibid.

<sup>154</sup> Roberts op cit note 128 at 89.

<sup>155</sup> Roberts op cit note 128 at 12.

<sup>156</sup> Ibid at 30.

<sup>157</sup> (1986) BCLC1 at 10.

<sup>158</sup> Ibid at 10f (ChD).

<sup>159</sup> Ibid see also *Robert Chaston v SWP Group plc* (2003)1 BCLC 675(CA) at 32.

Almost all the UK Company legislation prohibited financial assistance when it was given for the purpose of the acquisition of shares. For the prohibition of financial assistance to be applicable, it must be for the purpose of acquisition or for the purpose of reducing or discharging any liability so incurred.<sup>160</sup> There was, however, no definition in the legislation to determine whether the assistance was given for the purpose of the acquisition or not.<sup>161</sup> The court in *Chaston v SWP Group Plc* stated that there must be a link, and the link which section 151 of the Companies Act of 1985 required is that the financial assistance must be 'for the purpose of' the acquisition.<sup>162</sup> It further held that the purpose, and the only purpose, of the financial assistance 'is and remains that of enabling the shares to be acquired and the financial or commercial advantages flowing from the acquisition, whilst they may form the reason for forming the purpose of providing assistance, are a by-product of it rather than an independent purpose of which the assistance can properly be considered to be an incident'.<sup>163</sup>

In addition to the potential width of the general prohibition, there were also problems regarding the application of the general exemptions.<sup>164</sup> Concepts of purpose, larger purpose, principal purpose, and good faith in the interest of the company were included without any definition under section 153(1) and (2) of the Companies Act of 1985. In considering both the concepts of the principal purpose for the assistance, and whether or not it was incidental to a larger purpose, the House of Lords in the *Brady v Brady* case decided that the commercial advantages flowing from the transaction are reasons and these reasons may be excellent but they cannot constitute a "larger purpose" of which the provision of assistance is merely an incident.<sup>165</sup> It further held that the financial or commercial advantages flowing from the acquisition, whilst they may form the reason for forming the purpose of providing assistance, are a by-product of it rather than an independent purpose for which the assistance can properly be considered to be an incident.<sup>166</sup> As

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<sup>160</sup> Section 151(a) & (2) of the Companies Act 1985.

<sup>161</sup> Roberts op cit note 128 at 72. See also Lowry J 'The prohibition against financial assistance: constructing a rational response' <http://fds.oup.com/www.oup.com/pdf/13/9780199589616.pdf> at 14. (Accessed on November 2012).

<sup>162</sup> *Chaston v SWP Group Plc* (2003)1 BCLC 675(CA) at 45.

<sup>163</sup> Ibid at 48.

<sup>164</sup> Sealy L S *Sealy's cases and materials in company law* 9<sup>th</sup>ed Oxford University Press c2010 at 492.

<sup>165</sup> *Brady v Brady* (1989) AC 755 (HL) at 780.

<sup>166</sup> Ibid.

a result, according to Jason, the House of Lords in *Brady v Brady* severely restricted the efficacy and ambit of the exemptions contained under sections 153(1) and (2).<sup>167</sup>

The legal consequence following the breach of prohibition of financial assistance was one source of dispute. In early decisions, such as *Spink (Bournemouth) Ltd v Spink*<sup>168</sup>, it was held that the legal consequences of the breach of section 45 of the Companies Act of 1929 was that the company was liable for a fine but that the contract between the vendor and purchaser was valid.<sup>169</sup> In *Selangor United Rubber Estates Ltd v Craddock (No 3)*<sup>170</sup>, however, it was held that a loan by a company in breach of prohibition of financial assistance would be void.<sup>171</sup> As has been stated above, various legislative amendments have been effected to answer some of the challenges regarding the prohibition of financial assistance. The Companies Act of 2006 is another step towards the same purpose. In view of the above, capital rules governing financial assistance by a company under this legislation are discussed below.

### **3.4 Financial assistance for acquisition of shares under the Companies Act of 2006**

#### **3.4.1 Definition of financial assistance**

The provisions of section 677 of the Companies Act of 2006 provide for the meaning of financial assistance and they provide that “financial assistance” includes, amongst other things, financial assistance given by way of a gift, guarantee, security, or indemnity (other than an indemnity in respect of the indemnifier's own neglect or default), or by way of release or waiver, by way of a loan, or any other agreement under which any of the obligations of the person giving the assistance are to be fulfilled at a time when, in accordance with the agreement any obligation of another party to the agreement, remain unfulfilled, or by way of novation of, or the assignment of, rights arising under a loan or such other agreement, or any other financial assistance given by a company where the net assets of the company are reduced to a material extent by the giving of

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<sup>167</sup> Ellis J G ‘Financial assistance by a company for the acquisition of its shares: a more liberal regime?’ International Company and Commercial Law Review 1997 vol 8 286-289 at 287 (Westlaw database); See also Roberts op cit note 128 at 72.

<sup>168</sup> (1936) Ch 544.

<sup>169</sup> *Victor Battery Co Ltd v Curry's Ltd* (1946) Ch 242 it was held that a secured debenture issued by a company in breach of the prohibition of financial assistance was valid and enforceable against the company.

<sup>170</sup> (1968) 1 WLR 1555 at 1656H-1659F.

<sup>171</sup> Ibid at 1656H-1659F as quoted by Roberts op cit note 128 at 13.

the assistance or the company, has no net assets.<sup>172</sup> This definition, like the previous Companies Act, does not provide a comprehensive definition of financial assistance. The relevant case law, therefore, decided under the predecessors to Companies Act of 2006 remains pertinent to the interpretation of the definition of financial assistance.<sup>173</sup>

### **3.4.2 Financial assistance by public company for acquisition of shares in itself and in its private holding company**

The financial assistance provisions of the 1985 Act which prohibit a public company from giving financial assistance have been maintained in the Companies Act of 2006. A public company (and its subsidiaries) is still prohibited from giving financial assistance for the purpose of the acquisition of its shares or those of a parent company. This is mainly due to a need to comply with the Second Company Law Directive (77/91/EEC) that prohibits a public company from advancing funds, making loans, or providing security in order for a third party to acquire its shares.<sup>174</sup> The Second Company Law Directive, among other things, does have a role in coordinating national provisions of Member States on the formation of public limited liability companies and the maintenance and alteration of their capital.<sup>175</sup> The Directive laid down the conditions needed to ensure that the capital of the company is maintained in the interest of creditors.<sup>176</sup> The prohibition contained under the Directive was among those rules provided in the interests of creditors. Hence, public companies were required to comply with the rules of financial assistance for such purpose. It must be noted that the Second Company Law Directive has been amended by Directive 2006/68/EC of the European Parliament and of the Council of 6 September 2006 amending Council Directive 77/91/EEC which gives member states the option to relax, in part, the prohibition on public companies giving financial assistance.<sup>177</sup> Directive 2006/68/EC relaxes the prohibition in relation to advance loans and security with a view to the acquisition of a company's shares by a third party.<sup>178</sup> According to Lowry J, however, complex

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<sup>172</sup> Section 677 of the Companies Act of 2006.

<sup>173</sup> Sealy op cit note 164 at 497.

<sup>174</sup> Ibid at 491.

<sup>175</sup> The Second Company Law Directive (77/91/EEC) preamble.

<sup>176</sup> Ibid

<sup>177</sup> Directive 2006/68/EC of the European Parliament and of the Council of 6 September 2006 amending Council Directive 77/91/EEC as regards the formation of public limited liability companies and the maintenance and alteration of their capital.

<sup>178</sup> Ibid

procedural requirements were also introduced, including the need to obtain a shareholders' resolution authorizing the board to engage the company in financial assistance within the limits of the distributable reserves, and such a resolution was required for each transaction or arrangement entered into.<sup>179</sup> It is understood that the UK government did not intend to take this position of the Directive to be included under the Companies Act of 2006.<sup>180</sup> According to Lowry J, the Department of Trade and Industry considered the procedure to be complex and onerous and, therefore, unlikely to be utilized by companies.<sup>181</sup>

Where a person is acquiring, or proposing to acquire, shares in a public company or its private holding company, it is unlawful for that company, or a company that is a subsidiary of that company<sup>182</sup>, to give financial assistance directly or indirectly for the purpose of the acquisition before, or at the same time as, the acquisition takes place.<sup>183</sup> This prohibition, however, does not have application where the company's principal purpose in giving the assistance is not to give it for the purpose of any such acquisition, or the giving of the assistance for that purpose is only an incidental part of some larger purpose of the company, and the assistance is given in good faith in the interests of the company.<sup>184</sup> Like its predecessors, neither the Companies Act of 2006 nor the section provides a definition of the phrases "the company's principal purpose", larger purpose of the company, and "in good faith in the interests of the company". The interpretation of these phrases will, therefore, be dependent upon case law decided under previous legislation.

It is moreover, not lawful for a company, or a company that is a subsidiary of that company, to give financial assistance directly or indirectly for the purpose of reducing or discharging the liability of a person who has acquired shares in a company and incurred liability by himself or another person for the purpose of the acquisition, if, at the time the assistance is given, the

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<sup>179</sup> Lowry J, op cit note 161 at 22.

<sup>180</sup> Ibid.

<sup>181</sup> Ibid.

<sup>182</sup> This does not include a subsidiary which is a foreign company. This is mainly because S678 of the Companies Act of 2006 gives statutory effect to the decision in *Arab Bank Plc v Mercantile Holdings Ltd* [1994] 2 All ER 74 that the prohibition on financial assistance does not apply to the giving of such assistance by a subsidiary incorporated overseas. This is achieved by the definition of 'company' in s1 of the Act making it clear that, unless the context otherwise requires, 'company' means a company which is formed and registered under the Act or a former UK Companies Act. See Sealy, L. S., op cit note 164 at 490.

<sup>183</sup> Section 678(1) and 679 (1) of the Companies Act of 2006.

<sup>184</sup> Section 678(2) and 679(2) of the Companies Act of 2006.



company in which the shares were acquired is a public company.<sup>185</sup> This prohibition, however, does not have application if the company's principal purpose in giving the assistance is not to reduce or discharge any liability incurred by a person for the purpose of the acquisition of shares in the company or its holding company (including its private holding), or the reduction or discharge of any such liability, is only an incidental part of some larger purpose of the company and the assistance is given in good faith in the interests of the company.<sup>186</sup> The absence of a definition for the concepts of "the company's principal purpose", "larger purpose of the company", and "in good faith in the interests of the company" is also felt here. As we have stated above, the interpretation of these phrases will, therefore, be dependent upon case law, which includes the *Brady*<sup>187</sup> case.

The Companies Act of 2006 has certain exceptions for public companies, to the effect that, if a public company intends to make a valid financial assistance, the board has to ensure that its net assets are not reduced by the giving of the assistance, or, to the extent that those assets are so reduced, the assistance is provided out of distributable profits.<sup>188</sup> The transactions to which this exception applies, however, are only where the lending of money is part of the ordinary business of the company, the lending of money is the ordinary course of the company's business, financial assistance is for the purposes of an employees' share scheme, for the provision of financial assistance for *bona fide* employees or former employees or their spouses or civil partners, widows, widowers, or surviving civil partners, or minor children or step-children, loans to persons (other than directors) employed in good faith by the company with a view to enabling those persons to acquire fully paid shares in the company or its holding company to be held by them by way of beneficial ownership.<sup>189</sup>

### 3.4.3 Legal consequence of breaching the prohibition of financial assistance

The only statutory sanction for contravention of the prohibition of financial assistance is that an offence is committed by the company and every officer of the company who is in default.<sup>190</sup>

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<sup>185</sup> Section 678(3) and 679(3) of the Companies Act of 2006.

<sup>186</sup> Section 678(4) and 679(4) of the Companies Act of 2006.

<sup>187</sup> *Brady v Brady* (1989) AC 755 (HL).

<sup>188</sup> Section 682(1)(b) of the Companies Act of 2006.

<sup>189</sup> Section 682(3) of the Companies Act of 2006.

<sup>190</sup> Section 680 of the Companies Act of 2006.



According to Roberts, it is well established that a transaction which contravenes the prohibition is void and unenforceable as between the parties by the reason of illegality.<sup>191</sup> The director who has participated in the breach is under breach of fiduciary duty.<sup>192</sup> These directors may also be subjected to the proceedings to disqualify them from acting as directors.<sup>193</sup>

### 3.5 Conclusion

In this chapter we have seen the origin and development of the provision of financial assistance within the UK context. We have discussed the evolution of this provision together with the embedded prohibition from the Companies Act of 1926 until its elimination with the coming into effect of the Companies Act of 2006.

We have discussed the influence that the *Trevor v Whitworth* case had on the provision of financial assistance. It is through this case, together with the Greene Committee, that the total prohibition of financial assistance was endorsed. This was effected with the intention of ensuring that the assets of the company are not depleted by transactions that are similar to the provision of financial assistance. We have also seen the influence of Directive 77/91/EEC on the prohibition of financial assistance in public limited companies in a bid to ensure the protection of creditors' interests.

We have discussed the challenges encountered during the reign of the previous company legislation and the attempts made by various court decisions in a bid to resolve the *impasse*. We have discovered that the definition of 'financial assistance' is still elusive, and that we can safely conclude that only time will tell whether the legislature will at some point succeed in providing a definition.

We concluded with the discussion about the provision of possible liability of breach of any of the provisions governing financial assistance. We have seen that the legislature imposes criminal liability on both the company officer and the company for contraventions of the relevant provisions.

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<sup>191</sup> Roberts op cit note 128 at 63.

<sup>192</sup> Ibid at 64 the author also referred *Belmont Finance Corp v William Furniture(No.2) Ltd* (1980) 1 All ER 393 (CA).

<sup>193</sup> Ibid.

## Chapter 4: Comparison of capital rules governing financial assistance by a company in South Africa and England

### 4.1 Introduction

The inception of the financial assistance provision into the company legislation of the two countries, namely South Africa and United Kingdom, has seen the provision of financial assistance by a company for the purchase of its own shares going through a series of developments prior to the assumption of the current position. Though the *Trevor v Whitworth*<sup>194</sup> case and the Greene Committee Recommendations were considered to be the cornerstone of the rules governing financial assistance, each country has its own court decisions and legislative amendments which have developed and contributed to the current shape of financial assistance. It is through these decisions and amendments that we discover certain similarities and differences inherent in each jurisdiction.

The historical background and the current legal position relating to the capital rules governing financial assistance by a company in each jurisdiction has been discussed quite extensively in the previous chapters. To avoid unnecessary repetition, therefore, reference will be made to the differences that have been found to exist and also the lessons that each country could adopt from each other.

### 4.2 The definition of financial assistance

It has been stated that ‘financial assistance’ is not a term capable of precise legal definition, and it has been held that it is clearly unwise for the legislature to lay down a precise definition thereof.<sup>195</sup> In *Anglo Petroleum Ltd and another v TFB (Mortgages) Ltd [2008] 1 BCLC 185*, Toulon LJ asserted that the absence of a clear definition of ‘financial assistance’ could give rise

<sup>194</sup> *Trevor v Whitworth* (1887) 12 App Cas 409(HL) 416.

<sup>195</sup> *Anglo Petroleum Ltd and another v TFB (Mortgages) Ltd [2008] 1 BCLC 185* para 26. See also *Lipschitz NO v U D C Bank Ltd* 1979(1) SA 789 (A) at 805.

to uncertainties and had the potential to catch transactions which might be considered innocuous.<sup>196</sup>

In view of this, the Companies Act of 2008 also does not provide a definition of the concept 'financial assistance'. In an attempt to determine the meaning of 'financial assistance', section 44(1) of the Companies Act of 2008 provides that financial assistance does not include lending money in the ordinary course of business by a company whose primary business is the lending of money but includes a loan, guarantee, the provision of security, or otherwise.<sup>197</sup> It could, therefore, be concluded from this definition that the Companies Act of 2008 does not provide an exhaustive definition regarding the subject, which was the case even under the operation of section 38 of the Companies Act of 1973.

The UK Companies Act 2006, like its South African equivalent, does not contain a comprehensive definition for the concept of 'financial assistance'. Section 677 of the Companies Act 2006, however, provides detailed examples of what could be referred to as financial assistance.<sup>198</sup>

Jooste notes that, although the cases decided under the operation of section 38 of the Companies Act of 1973 will certainly remain relevant and applicable (in the determination of the definition of financial assistance), South African courts should also look to the foreign jurisdictions from which certain of the new terms and concepts have been drawn as an aid to their proper interpretation.<sup>199</sup> For instance, the cases that were decided under the English courts pointed out that the commercial realities of the transaction must be applied in order to determine the existence of financial assistance.<sup>200</sup> The South African courts are, therefore, still reliant upon previously decided cases in order to establish guidelines about what constitutes financial assistance. Davis cautions that, even though the *Lipschitz* decision has attempted to provide guidance regarding this issue, courts are still finding it difficult to apply the principles laid down

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<sup>196</sup> Ibid, see also *Lipschitz NO v U D C Bank Ltd* 1979(1) SA 789 (A) at 799.

<sup>197</sup> Ibid.

<sup>198</sup> Section 677 of the UK Companies Act of 2006.

<sup>199</sup> Cassim FHI *et al Contemporary Company Law* (2012) 2<sup>nd</sup> ed Juta at 315.

<sup>200</sup> *Charterhouse Investment Trust Ltd v tempest Diesels Ltd* (1986) BCLC1at 10; *Robert Chaston v SWP Group plc* [2003] 1 BCLC 675 at paragraph 32.

in the case, as is evidenced in the *Gardner v Margo*.<sup>201</sup> Having said the above, it is my opinion that the UK position appears to be more thorough in this regard than its South African counterpart.

### **4.3 The Meaning of securities**

The provision of section 44 of the Companies Act of 2008 regulates financial assistance by a company for the subscription of or purchase of 'securities' and 'options'. As explained in chapter two, the term 'securities' is much wider than the term 'shares' as it includes notes, shares, derivative instruments, and debentures.<sup>202</sup> Section 677 and 678 of the UK Companies Act 2006 makes reference only to financial assistance by a company for the acquisition of 'shares' to the exclusion of other instruments that could fulfil a purpose similar to shares. It is my opinion, therefore, that the use of the word 'securities' in section 44 of the Companies Act of 2008 is preferable to the term 'shares', as it is much wider in its scope of operation.

### **4.4 Circumstances in which financial assistance is prohibited and permitted**

One of the noteworthy differences between the South African and UK Company laws lies in the circumstances in which financial assistance is permitted and prohibited. The first point of difference is found in how these two jurisdictions apply the laws of financial assistance in various types of companies. The Companies Act of 2008 does not distinguish between a private and public company insofar as the provision for financial assistance is concerned.<sup>203</sup> Section 44 of the Companies Act of 2008 clearly provides that, except to the extent that the MOI provides otherwise, the board may authorise 'a company' to provide valid financial assistance for the purpose of subscription of securities or options by complying with the requirements and conditions provided in the MOI and the Companies Act of 2008.<sup>204</sup> There is no difference between various kinds of companies insofar as financial assistance is concerned.

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<sup>201</sup> Davis D *et al Companies and other Business Structures in South Africa* (2011) 2<sup>nd</sup> ed Oxford South Africa at 84; also refer to the *Gardner and another v Margo* 2006 (6) SA 33 (SCA) at 49.

<sup>202</sup> Section 1 of the Companies Act of 2008 on the definition of the word 'securities'.

<sup>203</sup> Section 10 (2) (a) of the Companies Act of 2008 restrict the application of section 44 regarding non-profit companies.

<sup>204</sup> Section 44(2) of the Companies Act 71 of 2008.

The UK Companies Act 2006, on the other hand, distinguishes between a private and public company. As we have discussed in chapter three, the Companies Act 2006 does not prohibit a private company from providing financial assistance except for the purpose of the acquisition of shares of a public parent company.<sup>205</sup> The Companies Act 2006 prohibits a public company from providing financial assistance save for certain exemptions.<sup>206</sup> This is in compliance with Directive 2006/68/EC which stipulates that financial assistance by a public company must be allowed subject to certain safeguards intended to protect the interests of creditors and third parties.<sup>207</sup> The current, generally accepted principle regarding the provision of financial assistance by a public company is not the prohibition of financial assistance but the setting of controlling mechanisms to guard against any prejudice to creditors and minority shareholders. In view of the above, it is my opinion that section 44 of the South African Companies Act is more tenable than sections 678 and 679 of the UK companies Act.

#### **4.5 Provision of financial Assistance in the MOI**

In terms of the provisions of section 44 of the Companies Act 71 of 2008, a company is allowed to provide financial assistance upon compliance with the requirements and conditions which are stipulated both in the act and in the Memorandum of Incorporation (if any).<sup>208</sup> The provisions of section 44 allow the board to include restrictions and conditions for providing financial assistance in the MOI.<sup>209</sup> As a result, a company should comply not only with the Companies Act of 2008 but also with the restrictions and conditions of MOI (if any) to make financial assistance for the purpose of the acquisition of shares.<sup>210</sup>

The UK Companies Act 2006, on the other hand, is silent on whether the company's articles of association can provide a restriction and/or conditions for the company to provide financial

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<sup>205</sup> Section 678(1) of the Companies Act of 2006.

<sup>206</sup> Sections 678(2) & (4) and 679(2) (4) of the UK Companies Act of 2006.

<sup>207</sup> Directive 2006/68/EC of the European Parliament and of the Council of 6 September 2006 amending Council Directive 77/91/EEC as regards the formation of public limited liability companies and the maintenance and alteration of capital.

<sup>208</sup> Section 44 of the Companies Act 71 of 2008.

<sup>209</sup> Ibid section 44(4).

<sup>210</sup> Ibid.

assistance. It could, thus, be interpreted that the Companies Act of 2006 does not expect the board to include a provision for financial assistance in its articles of association. It could also be concluded that, under the UK company law, private companies are expected to comply only with the relevant provisions of the Companies Act of 2006 governing financial assistance and are free from conditions and restrictions that could be contained in their articles of association.

#### **4.6 The solvency and liquidity test**

The requirements that a public company must comply with in order to exploit the exceptions under the UK Companies Act of 2006 provide the other area of difference with Companies Act 71 of 2008. Section 682 of the Companies Act 2006 stipulates that a public company is allowed to make valid financial assistance if the company has net assets that are not reduced by the giving of the assistance, or, to the extent that those assets are so reduced, the assistance is provided out of distributable profits.<sup>211</sup> This requirement is comparable to the solvency and liquidity requirement that is employed by the Companies Act 71 of 2008, which stipulates that, after providing financial assistance, the company should satisfy the solvency and liquidity test.<sup>212</sup> Section 682(3) of the Companies Act 2006 provides that, for the purpose of the exemption, “net assets” are the amount by which the aggregate of the company’s assets exceeds the aggregate of its liabilities.<sup>213</sup> The transactions to which this section applies are limited to those provided under section 682(2) (a)-(d) and include transactions where the lending of money is part of the ordinary business of the company, the lending of money is the ordinary course of the company’s business, and the provision by the company, in good faith in the interests of the company or its holding company, of financial assistance for the purposes of an employees’ share scheme.<sup>214</sup> On the other hand, the Companies Act 71 of 2008 requires the directors of the company to apply the solvency and liquidity test for all kinds of financial assistance transactions. In South African Companies Act, therefore, the application of the solvency and liquidity test is not restricted for certain transactions unlike the English Companies Act. There is also a significant difference in the way these two requirements apply.

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<sup>211</sup> Section 682 of the Companies Act of 2006.

<sup>212</sup> Sections 4 and 44(3) (b) (i)-(ii) of the Companies Act 71 of 2008.

<sup>213</sup> Section 682 (3) of the Companies Act of 2006.

<sup>214</sup> Section 682(2) of the Companies Act of 2006.

#### 4.7 The consequences of breach of any of the provisions governing financial assistance

The liability of a director in accordance with the Companies Act 71 of 2008 is stipulated in section 44(6) and 77(3) (e) (iv) of the Companies Act 71 of 2008. The provisions of section 44(6) stipulate that, if a director was present at the meeting, or participated in the making of a decision in terms of section 74, and failed to vote against the provision of financial assistance for the acquisition of securities of the company, despite knowing that the provision of financial assistance was inconsistent with section 44 or the MOI, the director concerned shall be liable to the extent set out in section 77(3) (e) (iv).<sup>215</sup> The liability of directors is limited to the loss, damage, or costs sustained by the company as a result of the directors' failure to vote against the resolution or agreement.<sup>216</sup>

In addition, the provisions of section 44 do not impose criminal sanctions against the director and the company for failure to comply with its provisions; section 22 of the Companies Act of 2008, however, makes provision for criminal liability against the company if it is found that the affairs of the company were conducted recklessly, with gross negligence, and with the intent to defraud any person or for fraudulent purpose.<sup>217</sup> It is unclear whether this provision will be invoked if it is found that the company has not breached the provisions of section 44 nor is it clear whether failure to comply with the provisions of section 44 could be classified as fraudulent and reckless trading in terms of section 22.

The provisions of section 680 of the UK Companies Act, on the other hand, provides that, if a company contravenes the provisions of section 678 or 679, an offence is committed by the company and every officer of the company who is in default.<sup>218</sup> This position differs from the provisions of section 44(6) and 77 (3) (e) (iv) of the Companies Act of 2008 where a director is liable for breaching his statutory fiduciary duty.<sup>219</sup>

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<sup>215</sup> Section 44(6) read with section 77(3) (e) (iv) of the Companies Act 71 of 2008.

<sup>216</sup> Section 77(3) (e) (iv) of the Companies Act of 2008.

<sup>217</sup> Section 22 of the Companies Act 71 of 2008.

<sup>218</sup> Section 680 of the UK Companies Act.

<sup>219</sup> Section 44(6) of the Companies Act 71 of 2008.

It has been submitted that, although the decriminalization of the companies' legislation is appropriate in other areas of corporate law, the potential criminal liability for both the directors and company was an effective deterrent and should have been retained under the Companies Act of 2008 for the enforcement of provisions such as section 44.<sup>220</sup> Section 171(1) of the Companies Act of 2008 provides that the Companies and Intellectual Property Commission, or the Executive Director of the Takeover Regulation Panel, may issue a compliance notice in the prescribed form to any person whom the Commission or Executive Director, as the case may be, on reasonable grounds believes has contravened this Act or assented to, was implicated in, or directly or indirectly benefited from, a contravention of this Act, unless the alleged contravention could otherwise be addressed in terms of this Act by an application to a court or to the Companies Tribunal.<sup>221</sup>

If a person to whom a compliance notice has been issued fails to comply with the notice, the Commission or the Executive Director, as the case may be, may either apply to a court for the imposition of an administrative fine or refer the matter to the National Prosecuting Authority for prosecution as an offence in terms of section 214 (3), but may not do both in respect of any particular compliance notice.<sup>222</sup> Section 214(3) of the Companies Act of 2008 further provides that it is an offence to fail to satisfy a compliance notice issued in terms of this Act, but no person may be prosecuted for such an offence in respect of a particular compliance notice if the Commission or Panel, as the case may be, has applied to a court in terms of section 171 (7) (a) for the imposition of an administrative fine in respect of that person's failure to comply with that notice.<sup>223</sup> A court, on application by the Commission or Panel, may impose an administrative fine only for failure to comply with a compliance notice, as contemplated in section 171 (7), not exceeding the greater of 10% of the respondent's turnover for the period during which the

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<sup>220</sup> See a detailed discussion in chapter 2 paragraph 2.4.3.

<sup>221</sup> Section 171(1) (a)-(b) of the Companies Act 71 of 2008.

<sup>222</sup> Section 171 (7) of the Companies Act 71 of 2008.

<sup>223</sup> Ibid, see also section 214(3) where it is stipulated that a person convicted of an offence in terms of section 214(3), is liable to a fine or to imprisonment for a period not exceeding 12 months, or to both a fine and imprisonment. (See section 216 of the Companies Act 71 of 2008).



company failed to comply with the compliance notice and subject to the maximum of R1 million.<sup>224</sup>

It has been submitted that, commercially, the potential gain to be made by a company or individuals where financial assistance is provided in contravention of the Companies Act of 2008 and/or the Memorandum of Incorporation may well exceed the maximum administrative fine.<sup>225</sup> Hence, the imposition of the administrative fine might not deter the company or the directors from violating the rules of financial assistance under the Companies Act of 2008 and the Memorandum of Incorporation. In this regard, therefore, it could be concluded that the Companies Act of 2006 is more determined than the Companies Act of 2008 to protect the interest of creditors and those shareholders who do not accept the provision of particular financial assistance.

#### **4.8 Conclusion**

As it has been stated above, each country has developed immensely insofar as the provisions of the rules of financial assistance are concerned. It is clear, however, that, even though the rules of financial assistance emanated from the same principle, currently both South Africa and the United Kingdom follow what is deemed appropriate and significant in their own countries.

In this chapter we have seen that a total prohibition of financial assistance by a company is no longer relevant in both jurisdictions, and that each jurisdiction has managed to modify the application of financial assistance to suit its own scope of operation. We have seen that the concept of financial assistance is still not defined in both jurisdictions, owing to the fact that it is a concept which is not definable. We have also seen that the mischief that the provision for financial assistance attempts to cater for in both jurisdictions is the protection of the assets of the company for the benefit of shareholders and creditors.

This chapter has attempted to investigate the differences inherent in the application of financial assistance in both jurisdictions. We have seen how public companies in the UK are still prohibited from providing financial assistance for the purchase of its shares, in compliance with

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<sup>224</sup> Sections 175(1) and (5) of the Companies Act 71 of 2008; see also regulation 163 of the Companies Regulation, 2011.

<sup>225</sup> Cassim *et al* op cit note 199, at 333.

Directive 2006/ 68/EC, while in South Africa section 44 has lifted the total prohibition in relation to both private and public companies.

Secondly, we have seen how the South African Companies Act requires compliance with restrictions and conditions stipulated by the Companies Act of 2008 and the Memorandum of Incorporation, while the UK Companies Act requires compliance only with the Companies Act of 2006.

Thirdly, we have noted how both jurisdictions deal with the provision of ensuring that, after financial assistance has been affected, the company's assets should not be depleted by the transaction. Section 44(3)(b)(1) stipulates that the board must be satisfied that, immediately after financial assistance, the company must satisfy the solvency and liquidity test. The UK Companies Act applies a similar measure only in respect of public companies as stipulated in section 682(1)(b)(i) (ii).

Lastly, we have seen that the UK imposes criminal penalties on both the company and every officer of the company who is in default of the provisions governing financial assistance. In South Africa, the provisions of section 77(8) (a)&(b) stipulate that a director will be liable to restore to the company any amount improperly paid by the company as a consequence of the impugned act.

## Chapter 5: Conclusion and Recommendations

### 5.1 Conclusion

In this paper we have described the evolution and developments of the rules of financial assistance within the South African and English Company laws context. We have seen that the English decision of *Trevor v Whitworth* serves as a root for a statutory prohibition of financial assistance in both countries. Various court decisions and pieces of legislation have played a major role in the development of the rules of financial assistance in both countries.

In this paper we have, furthermore, seen that, though the two countries have shared the same source of court decision, each country has adopted what is deemed appropriate and significant in its own country. As a result we have witnessed significant differences between the rules of financial assistance of these two countries.

This paper has attempted to investigate the challenges in relation to section 38 of the Companies Act of 1973. It has also attempted to indicate the solutions that were deemed to be helpful during the application of section 38 of the Companies Act of 1973. This was explored mainly because the key concepts in section 38 of the 1973 Companies Act were retained in section 44 of the Companies Act of 2008. We have seen that section 44 of the Companies Act of 2008 introduced a new philosophy by avoiding the prohibition of financial assistance under the Company laws of South Africa. It introduced various mechanisms for protecting the interests of creditors and stake holders including minority share holders. We have discussed section 44 of the Companies Act of 2008 in detail.

We have also discussed the rules of financial assistance under the English Companies Acts. We have seen that various court decisions and successive amendments have regulated the rules of financial assistance. Attempts have been made to discover the challenges and solutions that existed under the previous legislative enactments. We have also discussed the new rules of financial assistance under the Companies Act of 2006.

Attempts have been made to compare the financial rules of South Africa and England. We have witnessed that there are significant differences between these two countries. Among others, we have seen that, under the Companies Act of 1985, there was a prohibition of financial assistance for both private and public companies, although private companies were allowed to make a valid financial assistance in exceptional circumstances. The introduction of the Companies Act of 2006, however, avoided the prohibition of a private company from providing financial assistance. The Companies Act 2006 retained the prohibition regarding public companies because of the influence of Directive 77/91/EEC. The rules of financial assistance contained under section 44 of the Companies Act of 2008, however, apply to every company having a share capital, whether it is a public company or a private company.

Generally, it is the writer's opinion that the current position of the South African Companies Act of 2008 regarding the rules of financial assistance is more commendable than its UK equal. There are, however, some instances which may indirectly take away the successes of the rules of financial assistance under the Companies Act of 2008.

Firstly, section 38 of the previous Companies Act of 1973 prohibited a company from giving, whether directly or indirectly, whether by means of a loan, guarantee, the provision of security or otherwise, any financial assistance for the purpose of, or in connection with, a purchase or subscription made or to be made by any person of or for any shares of the company, or, where the company is a subsidiary company, of its holding company. Nothing was stated under section 38 as to what constituted 'financial assistance' within the meaning of the section.<sup>226</sup> Authors such as Cilliers and Benade point out that the widest and most general terms contained under section 38 have created a variety of opinion on its application, particularly in complicated areas of commercial transaction, and thereby have generated more than a fair share of commercial uncertainty.<sup>227</sup> Section 44 of the Companies Act of 2008, like its predecessor, does not provide a definition of 'financial assistance'. It merely contains, in the first subsection, a negative provision relating to what should not be taken as financial assistance.

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<sup>226</sup> Cassim FHI *et al Contemporary Company Law* (2012) 2<sup>nd</sup> ed Juta at 316.

<sup>227</sup> Cilliers & Benade *et al Corporate Laws* 3<sup>rd</sup> ed 2000 Butterworths at 330.

Notwithstanding the repeal of the prohibition of financial assistance under the Companies Act of 2008, a transaction which involves the provision of financial assistance by a company for the acquisition of, or subscription of, its own securities still needs to be made in accordance with the requirements and conditions that are provided under the Companies Act of 2008 and the Memorandum of Incorporation. Although financial assistance is, therefore, not prohibited by the Companies Act of 2008, the various conditions and requirements that need to be satisfied in order to make valid assistance requires clarity about whether a certain act constitutes 'financial assistance' or not. As a result, it is the writer's opinion that the legislature failed to provide adequate guidelines as to what constitutes financial assistance under section 44 of the Companies Act of 2008. The Legislature should at least have included a number of examples of financial assistance like section 677 (1) of Companies Act of 2006 which defines financial assistance as financial assistance given by way of gift, by way of guarantee, security, or indemnity (other than an indemnity in respect of the indemnifier's own neglect or default), or by way of release or waiver.

Secondly, section 44(3) (b) (ii) of the Companies Act of 2008, among other things, provides that the board of directors may not authorise any financial assistance unless it is satisfied that 'the terms under which the assistance is proposed to be given are fair and reasonable to the company'. Neither the Companies Act of 2008 nor the section, however, defines what is meant by 'fair and reasonable' for such purpose. Authors such as Richard Jooste raised various questions as to what this requirement means and from what perspective it must be viewed.<sup>228</sup> The absence of clarity on the requirement of section 44(3) (b) (ii) may, therefore, create uncertainty which ultimately hinders the effectiveness of the rules under the Companies Act of 2008.

Thirdly, section 44 of the Companies Act of 2008 contains no criminal liability provision unlike section 680 of the Companies Act 2006. It has been submitted that the decriminalisation of company's legislation in many respect is an appropriate and positive development made by the legislature.<sup>229</sup> The threat of potential criminal liability for directors, however, was an effective deterrent in certain contexts, and the criminal liability provision should have been retained for the purpose of sections such as section 44. It is unclear whether this provision will be invoked if

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<sup>228</sup> Cassim *et al* op cit note 226 at 330.

<sup>229</sup> Ibid at 333.

it is found that the company has not breached the provisions of section 44 nor is it clear whether failure to comply with the provisions of section 44 could be classified as fraudulent and reckless trading in terms of section 22. The absence of criminal liability may, therefore, create challenges insofar as compliance with both the Companies Act of 2008 and the Memorandum of Incorporation is concerned.

## 5.2 Recommendations

Based on the above conclusions the writer recommends the following:

Firstly, as it was pointed out above, there is no definition of 'financial assistance' under the Companies Act of 2008. The absence of a clear definition, however, means that the section can give rise to uncertainties as discussed above. The writer, therefore, recommends that the legislature, in subsequent amendments to the Companies Act of 2008, should include a definition of 'financial assistance'. The writer, therefore, proposes the following definition of 'financial assistance' and recommends the amendment of section 44(1) only of the Companies Act of 2008. The writer has adopted this definition from the Companies Act 2006, and it is designed to fit into other provisions of section 44 of the Companies Act of 2008.

44. Financial assistance for subscription of securities.

- (1) In this section “financial assistance” means any financial assistance given by a company including:
- (a) financial assistance given by way of gift;
  - (b) financial assistance given:
    - (i) by way of guarantee, security or indemnity (other than an indemnity in respect of the indemnifier’s own neglect or default); or
    - (ii) by way of release or waiver;
  - (c) financial assistance given:
    - (i) by way of a loan or any other agreement under which any of the obligations of the person giving the assistance are to be fulfilled at a time when, in accordance with the agreement, any obligation of another party to the agreement remains

unfulfilled. But this does not include lending money in the ordinary course of business by a company whose primary business is the lending of money; or  
(ii) by way of the novation of, or the assignment of, rights arising under, a loan or such other agreement.

Secondly, the legislature's intention with respect of the requirement contained under section 44(3)(b)(ii), which provides that the board may not authorize any financial assistance contemplated in section 44(2) unless the board is satisfied that the terms under which the assistance is proposed to be given are fair and reasonable to the company, needs to be clarified. In order to better understand what the requirement of "fair and reasonable" entails, it would be ideal to consider issues such as whether the security provided for the assistance is sufficient, whether the company will derive any benefit, and whether there exists a reasonable *quid pro quo*. This essentially means that the transaction must be in the best interests of the company, and it must also promote the success of the company for the benefit of its members. If this is not, however, the intention of the legislature then I would recommend that this requirement should be clarified in the subsequent amendments to the Companies Act of 2008. The legislature, therefore, in the subsequent amendment to the Companies Act of 2008, should clarify the requirement by providing a definition or description under section 2 or section 44 (3) of the Companies Act of 2008.

Thirdly, the Companies Act 71 of 2008 does not provide for a criminal liability provision regarding the director and the company. The potential criminal liability of directors and the company would be a deterrent against the contravention of the Companies Act 71 of 2008. Hence, the writer would recommend that the legislature in subsequent amendments to the Companies Act should include the criminal liability provision for the contravention of the conditions and requirements set out under the Act and/or the Memorandum of Incorporation.

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TO WHOM IT MAY CONCERN

This is to certify that I have completed the English Editing of the thesis to be submitted in accordance with the requirements for the degree of Master of Laws with specialisation in Commercial Law the University of South Africa.

The dissertation is entitled

A COMPARISON OF CAPITAL RULES GOVERNING FINANCIAL ASSISTANCE BY A COMPANY IN SOUTH  
AFRICAN AND ENGLISH COMPANY LAW

by

ANDARGIE, ABYOTE ABEBE

I am qualified to have done such editing, being in possession of an Bachelor's degree in English from Rhodes University, Grahamstown, an Honours Degree in English and a HED with English as prime teaching subject from the University of South Africa, and having taught English to Matriculation, First Year University Level, GCSE and A level in both South Africa and the United Kingdom of Great Britain for over 40 years, as well as having been Senior (English) Associate Editor of a national magazine for two years.

I trust that this declaration is satisfactory.



DAVID JOHN SWANEPOEL