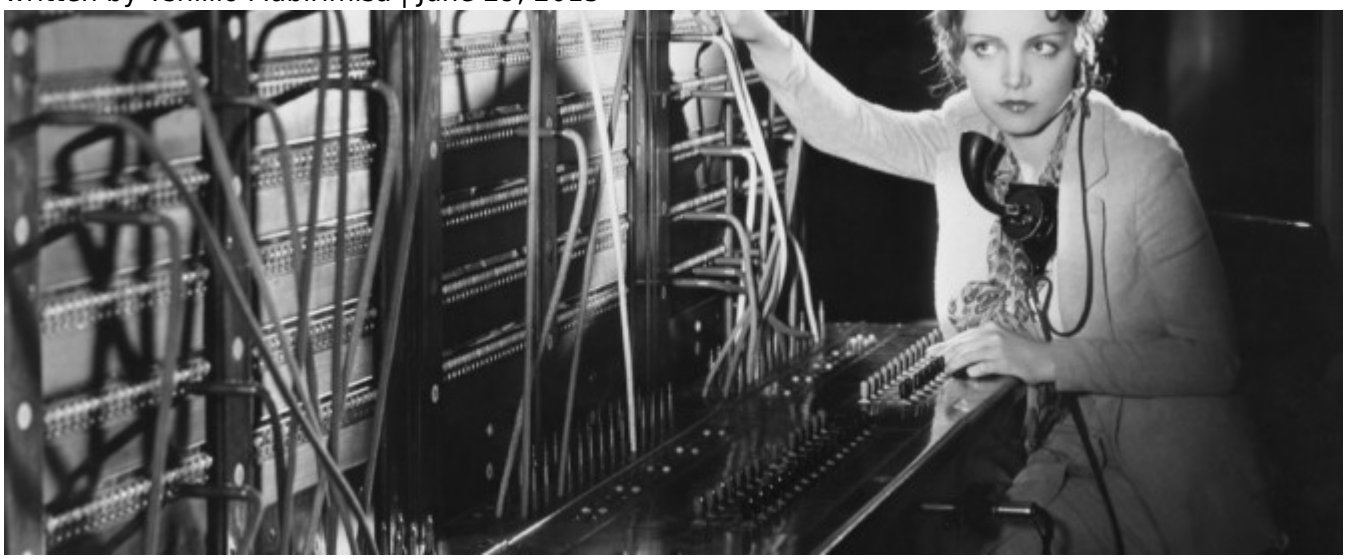
REFORM OF SOUTH AFRICAN COMPANY LAW: SECTION 40 OF THE COMPANIES BILL, 2007

Category: Commercial Law
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"The SA Companies Act has been in existence since 1973 and it is outdated. It contains little on corporate governance, transparency, accountability, modern merger methods and minority shareholder protection."1 It further contains nothing that adequately provides for or encourages private corporate and empowerment groups to conclude Black Economic Empowerment ("BEE") transactions. South African company law is on the move towards reform that will allow those who were previously disadvantaged to be able to meaningfully participate and contribute in the economic development of our country.

"Company law is central to our economy and our prosperity – for wealth creation and social renewal. It can promote enterprise – or it can hold it back. Company law can do so in a number of ways. The corporate finance provisions, if outdated, can disadvantage our companies with respect to their global competitors and constrain their ability to raise capital and compete effectively. Furthermore, ineffective corporate rescue provisions, which may result in creditors receiving lower recoveries, can create disincentives for equity investors, limiting sources of capital for South African businesses."2

Section 38 of the Companies Act 61 of 1973 ("the Act") provides that "no company shall give, whether directly or indirectly, and whether by means of a loan, guarantee, the provision of security or otherwise, any financial assistance for the purpose of or in connection with a purchase or subscription made or to be made by any person of or for any shares of the company, or where the company is a subsidiary company, of its holding company. Any company which contravenes the provisions of this section, and every director or officer of such company, shall be guilty of an offence. "3

The anticipated section 40 of the Companies Bill of 2007 ("the Bill") dealing with financial assistance for the purchase of shares provides that "a company must not give direct or indirect financial assistance to a person for the purpose of, or in connection with, the purchase of a share or option issued or to be issued by the company or a related or inter-related company-

if the company's memorandum of Incorporation expressly prohibits giving such financial assistance, as contemplated in subsection (2)(b); or

in any other circumstances, unless all of the applicable following conditions are satisfied:

Irrespective of the status or category of company concerned, the board must be satisfied that-

immediately after giving the financial assistance, the company would be in compliance with the solvency and liquidity test, and

the terms under which the assistance is proposed to be given are fair and reasonable to the company."4

Section 40 will lift the restriction that a company cannot fund the purchasing of its own shares and will allow financial assistance to be given where the board of directors is satisfied that the liquidity and the solvency tests have been met. From reading the section it is clear that both tests should be satisfied immediately after the giving of such financial assistance.

When amendments similar to Section 40 were proposed for European company law, Ellis Ferran, a reader in corporate law and financial assistance from the University of Cambridge, in his article titled "Simplification of European Company Law on Financial Assistance" suggested that adopting the proposed amendments "is likely to be a largely pointless exercise. Barring truly exceptional circumstances, no company is ever likely to want to take advantage of the proposed gateway procedure because it is time-consuming, costly, runs the risk of transaction-disrupting minority shareholder actions and exposes directors to excessive personal risks."5

"Directors have a duty to consider any contingent liabilities that may arise including any liability that may result from giving the assistance. The directors should take fiduciary responsibility to ensure that they are not acting recklessly when recommending to the shareholders that the company provides financial assistance."6

In dealing with the purpose of the Bill, Section 6 mentions the purpose to be to promote the development of companies within all sectors of the economy and in particular among South Africans who have historically been excluded from active participation in economic organization, management and productivity.7 Section 40 "will make it easier for private corporations and empowerment groups to conclude more BEE transactions in a financial system which is not adequately geared towards financing empowerment."8

The explanatory memorandum to the bill states that the amendments to section 38 of the Act have been made with the intention to facilitate BEE transactions. Section 40 itself does not refer to BEE transactions per se therefore leaving room for other transactions provided that the solvency and liquidity tests are met.

BEE should not be the primary motivating factor for reformation of our company law. The reform should be encouraged by a necessity to reform our company law legislation to enable it to stand the test of how businesses are run today. It should be done to persuade and facilitate South Africans to participate in the economy of their country and to keep our law up to date with international trends. We live in a dynamic society where laws need to be updated as often as it becomes necessary to align them with the needs of our society. It is definitely time to introduce a statute that caters for the majority of our people and the South African experience as a whole, and to complete the reform that was being gradually introduced by the numerous amendments to the Act.

Section 40 demonstrates clearly the third growth objective of the NEDLAC consultations, namely corporate efficiency. This objective stipulates that company law should shift from a capital maintenance regime based on par value, to one based on solvency and liquidity.9 "The new section hopes to move the test from the preservation of capital to a solvency test which is in line with international trends and has been applied in South Africa for share buy-back schemes."10

The liquidity test aims at protecting the company's capital and constitutes an efficient contractual instrument for facilitating the entrepreneurial activities of a company11. The solvency test aims at giving a better view of the commercial prospects of a company but it suffers by being able to provide only for a limited time horizon and giving wide discretionary powers to the directors. This makes the solvency test particularly problematic when long-term obligations have to be addressed. In the end, a combination of the liquidity and the solvency test seem to be the reasonable solution12.

"The new regime will allow a company to lend money to a BEE buyer to purchase its shares as long as it is solvent and liquid at the time. It will also allow a company in certain circumstances to stand as surety for, or provide guarantees and perhaps collateral to, third parties to borrow from banks or to use its own balance sheet for loans to a BEE partner which will provide a much simpler source of finance."13

"The delay in implementing the crucial change is creating uncertainty around the way black empowerment and private equity deals should be structured. The Section 38 amendment is likely to reduce transaction costs and mitigate some risks as there will no longer be a need to devise intricate funding structures to deal with the current restrictions."14 So long as the company is solvent and the shareholders approve of the transaction, the delay and failure to implement the new section on financial assistance for the purchase of shares means that deals are being structured in an unnecessarily complicated way.15

The chief-director of policy and legislation at the Department of Trade and Industry Mr Fungai Sibanda said that most of the amendment gazetted from the Corporate Law Amendment Bill, related to audit requirements and could not be implemented until the creation of a reporting council and an investigation panel. He suggested that the new sections could be promulgated by the end of August 200716, this has not happened as yet.

The amendment is intended to encourage shareholder diversification and in particular BEE. A BEE company will be able to buy shares in a company conducting an existing operation or business.17 Finally we will have a statutory provision allowing "BEE groups with the necessary skills and expertise and who are able to add value to the company to be able to acquire equity without to rely on outside institutions or vendor finance."18

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[1] http://www.fm.co.za/cgi-bin/pp-print.pl
[2] Keynote address by Tshediso Matona, Director-general: Trade and Industry, conference on South African Company law for the 21st century, Pretoria,19 March 2007 at page 3
[3] Extracts from Section 38 of the Companies' Act 61 of 1973
[4] Section 40 of the Companies Bill of 2007 at page 96-97
[5] http://www.journals.cambridge.org/action/displayabstract?frompage=online&aid=291888
[6] http://www.routledge.co.za/routmod/modules/news
[7] Corporate law Amendment Bill of 2006.
[8] Financing Empowerment-The implications of section 38 of the Companies Act, Heidi Miller and Mzi Mgudlwa of Sonnenberg Hoffman Galombik at page 3
[9] Explanatory memorandum to the Corporate Laws Amendment Bill of 2006, page 4
[10] http://www.routledges.co.za/routmod/modules/news
[11] http://journals.cambridge.org/action/displayAbstract?frompage=online&aid=260139
[12] http://journals.cambridge.org/action/displayAbstract?frompage=online&aid=447724
[13] http://www.derebus.org.za/nxt/gateway.dll/4rnla/185za?f=templates$fn=...
[14] http://www.wwb.co.za/wwb/en/page48?oid=9995&sn=Detail%20popup
[15] http://www.wwb.co.za/wwb/en/page48?oid=9995&sn=Detail%20popup

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[17] http://www.cliffedekker.co.za/asndmsg/newsview.asp?PG=24&I=84666
[18] http://www.routledges.co.za/routmod/modules/news