

**CAPITAL MAINTENANCE RULE AND
DISTRIBUTION FOCUSING ON SECTIONS 46
AND 48 OF THE COMPANIES ACT, 2008
(ACT NO, 71 OF 2008)**

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1.1 INTRODUCTION

The House of Lords in *Trevor v Whitworth*¹, set the principle that, a company cannot acquire its own shares. The capital maintenance rule as set in the case, dictated that the shareholders had no legal claim to the return of the capital they contributed². Companies were required to maintain the share capital for the protection of the creditors and the shareholders.

There was a shift in the principle in that section 48(2) (a) of the Companies Act 71 of 2008³, permits a company to acquire its own shares, provided the provisions of section 46 of the Act are met. The dissertation will consider the principles of the capital maintenance rule and the impact thereof on creditors and shareholders.

1.2 RESEARCH ABSTRACT

The main objective of the capital maintenance rules is that the capital of a company must be maintained for the protection of creditors. It was meant to balance the interest of the creditors and the expectation of the shareholders. For the creditors, the capital serves as a security for the debts owed to them.

It is on this basis that there is need to regulate the distribution to shareholders. The capital maintenance rule prohibited the company from acquiring its own shares. It was requirement that for any distribution in that form other than from the profit of the company required a court order. The capital maintenance rule maintained that the issued share capital of a company serves as a security for meeting creditors' claims. This meant that the issued shares capital

¹ (1887) L R. 12 App. Cas. 409, HL.

² See Van der Linde “*The regulation of distribution to the shareholders in the Companies Act 2008*” 2009, TSAR, at 496.

³ “Companies Act”.

could not be reduced, nor paid back to shareholders unless common law or the Act provided otherwise.

The changes to legislation has an effect that the company's capital could be paid out without it being a reduction of capital if authorised by the Companies Act. It was trite that under capital maintenance rule, no dividend could be paid out of capital, a company could not acquire its own shares or shares in its holding company, par value shares could not be issued at a discount except under stringent conditions. The capital maintenance rule was rendered redundant by provisions of the amendments in the Companies Act, 1999.

1.3 RESEARCH PROBLEM

The research will focus on analysing the following issues: -

- i. Critical analysis of the capital maintenance rule under the Companies Act, 2008;
- ii. Protection of the interest of the creditors under the Act;
- iii. Balancing the interest of creditors to those of shareholders;
- iv. The effectiveness of the solvency and liquidity test;
- v. Comparative study, considering the capital maintenance rule, with focus on Canada and Delaware.

1.4 OBJECTIVE OF THE RESEARCH

The main objective of the dissertation is to determine whether the introduction of the solvency and liquidity test as a yard stick for distribution and acquisition of own shares is effective. Further whether the provision of the Companies Act is adequate to protect the interest of the creditors against the expectations of the shareholders.

1.5 METHODOLOGY

The initial focus will be on the history and background of capital maintenance rule. The second focus will be on the provisions of the Companies Act, 2008, in order to assess if the Act provide adequate protection to creditors. Further, the effect of distribution to creditors and the effectiveness of the solvency and liquidity test. Lastly, a comparative study will be conducted

on the legislative position in Canada and Delaware in the USA with regard to the application of the capital maintenance rule.

1.6 STRUCTURE OF RESEARCH

Chapter 1 of the research will provide the introduction to the research. The historical overview of the capital maintenance rule will be contained in chapter 2 of the research. This will be a synopsis of the origin of the capital maintenance rule. Chapter 3 will address the definition of distribution and requirements that must be met before distribution can be effected. The acquisition of own shares/share buy-back will be dealt with in Chapter 4 of the research. The focus will be on the requirements for the share buy-back, the relationship between section 46 and section 48 and the director's liability for non-compliance with the provisions of section 46 and 48. Chapter 5 of the research will address the issue of the solvency and liquidity test, which will entail the requirements for the test and the consequences for non-compliance with the test. The comparative study will be contained in chapters 6 and 7 of the research. The focus will be on the analysis of the application of the capital maintenance rule in Delaware and in Canada. The conclusion and recommendations will be set out in chapter 8.

HISTORICAL OVERVIEW OF CAPITAL MAINTENANCE RULE

2.1 INTRODUCTION

The share capital of the company can be seen as a form of financing of a company. Contribution to the share capital can be by way of subscription to share or in a form of assets. Even though share capital does not have a definition, it can be said from the application that share capital consist of consideration paid to or due to a company in exchange for the shares of the company.⁴ Consideration can be more or less to the share capital. This notion stems from the fact that minimum share capital is not prescribed by legislation. Some companies can have paid up share capital of nil.⁵ The share capital can exceed the consideration if profits are subsequently capitalised or if shareholders contribute capital to the company in other way than in a form of shares.⁶

Share capital is seen as a liability in the accounts of a company, as shareholders do not have a legal claim to the return of the capital they contributed. Van der Linde highlighted three functions of share capital of the company. The first way is to allow the company to obtain funds with which to operate the company's business; the second function is to provide protective cushion for the creditors of the company; and lastly to serve as a proportionate of interests of the shareholders in the company.

As working capital of the company, the share capital's role is negligible. Van der Linde argues that, even if there is a statutory prescribed share capital, the intended purpose is to minimise frivolous incorporations.

On whether share capital can serve as a buffer for creditors there is school of thought that this is deceiving as share capital is an artificial sum.⁷ This is negated by the fact the capital of the company can be lost in the cause of business. It was noted by Van der Linde

⁴ Van der Linde, "*Aspects of the regulation of share capital and distribution to shareholders*", 2008, LLD, UNISA, at 2.

⁵ Van der Linde, *ibid*, at 4

⁶ Van der Linde, *ibid*, at 3

⁷ Van der Linde, *ibid*, at 5

that the creditors can only be protected if the company has retained the contributed funds or applied it to acquire available assets.

Share capital as allocation tool for shareholder, provide shareholders with certain rights within the company, including the right to participate in general meetings of the company, however, the right can be limited by the constitution of the company.⁸

2.2 ORIGIN OF THE CAPITAL MAINTENCE RULE

The capital maintenance rule was founded in English Law. The concept of capital maintenance rule has historically been maintained to ensure that company does not return its issued shares capital to its shareholders unless authorised by the Companies Act.⁹ Cassim indicates that, “the approach adopted in English Law, and other common- law jurisdiction where historically the underlying philosophy has always been that, because of the separate legal personality and limited liability, all companies must be regulated by the state in the interest of the creditors and the investing public”.¹⁰ This was a shift from the American approach which took a dim view that, creditors providing debt financing are capable of protecting themselves through proper contract negotiations.¹¹

Notably, the *Trevor v Whitworth*¹² case laid down the following principle as said by Lord Watson; “ *Paid-up capital may be diminished or lost in the course of the company’s trading: that is a fact which no legislation can prevent; but persons who deal with, and give credit to, a limited company, naturally rely upon the fact that the company is trading with a certain amount of capital already paid, as well as upon the responsibility of its members for the capital remaining at call; and they are entitled to assume that no part of the capital which has been paid into the coffers of the company has subsequently been paid out, except in the legitimate course of its business.*”

⁸ Van der Linde, *ibid*, at 7

⁹ Cassim, “*The Reform of Company Law and the Capital Maintenance Concept*”, 2005, SALJ, at 285

¹⁰ *Ibid*, at 284

¹¹ *Ibid*, at 284

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

The capital maintenance rule gave birth to the following sub-rules, *to wit*, raising of capital; restriction that dividends may not be paid out of capital; prohibition against giving financial assistance for the subscription of company shares and the rule that was derived from the *Trevor v Whitworth*, that the company may not purchase its own shares.¹³

The first sub-rule, relating to the prohibition of payment of dividends out of share capital, meant that the capital fund upon which the creditors relied upon for the satisfaction of their claim should be maintained.¹⁴

The second sub-rule of prohibition of repurchase by a company of its own shares was founded on the premise that, a company could not reduce its capital by repurchase of its shares. This was confirmed by Lord MacNaghton who advanced the following, “...on the principle of limited liability, to purchase its own shares when it is authorised by its article to do so. The consideration of that question, as it appears to me, necessarily involves the broader question whether it is competent for a limited company under any circumstances to invest any portion of its capital in the purchase of a share of its own capital stock, or to return any portion of its capital to any shareholders without following the course which Parliament has prescribed. They cannot draw funds in which others as well as themselves are interested”.¹⁵

From the dictum above, it can be said that, the repurchase of the company of its own share would have been *ultra vires* the company as it was not empowered by the articles of association. This is confirmed by the argument by Cilliers and Benade, that the capital maintenance rule did not develop as an independent rule, and that the rule has its origin from the extension of the *ultra vires* rule. Cilliers and Benade further indicated that the

¹³ Cassim, “*The Reform of Company Law and the Capital Maintenance Concept*”, 2005, SALJ, at 285

¹⁴ Pretorius et al, “*South African Company Law through Cases*”, at 6th edition, Juta & Co Ltd, 1999, at 138

¹⁵ *Trevor v Whitworth*, at 432

capital maintenance rule dictates that the act in respect of the capital must not be *ultra vires* and cannot prefer shareholders above creditors.¹⁶

Lastly, offering financial assistance for acquisition or subscription of company shares was viewed as a contravention of capital maintenance rule. An indirect way for acquiring of own share was by lending money for the acquisition of shares of the company.¹⁷

2.3 DEVELOPMENT OF THE CAPITAL MAINTENANCE RULE IN SOUTH AFRICA

The capital maintenance rule was adopted as part of south African law. The 1926 and 1973 Companies Act were based on English legislation and English Common Law.¹⁸ The capital maintenance rule was applied by South African courts as evidenced by a case of *Cohen, NO v Segal*¹⁹, in which Judge Boshoff J stated that “*Whatever has been paid by a member cannot be returned to him and no part of the corpus of the company can be returned to a member so as to take away from the fund to which the creditors have a right to look as that out of which they are to be paid. The capital may be spent or lost in carrying on the business of the company, but it cannot be reduced except in the manner and with the safeguards provided by the statute*”.

The Companies Act 1973, in its original form, regulated capital maintenance in sections 83-90. It was generally acknowledged that there was a risk as envisaged in the case of *Trevor v Whitworth*, that the capital of the company could be lost in the course of trading by the company. However, the reduction of capital was not allowed, unless sanctioned by the court, and provided for in the article of association.

The Department of Trade and Industry highlighted the following in the regulations of capital maintenance rule: -

¹⁶ Cilliers and Benade, at 322

¹⁷ Pretorius *et al, ibid*, at 125

¹⁸ Cilliers and Banade, *ibid*, at 19

¹⁹ *Cohen V Segal* 1970 (3) SA 702 (W)

“South African company law has always accepted the principle that a company's share capital is effectively a guarantee fund for its creditors. As such the creditors have had the assurance that the capital of the company, which is the initial safeguard required for the right of limited liability, will not be diminished other than in the ordinary course of business or in accordance with the provisions of the Companies Act. In addition to the Companies Act, various common law principles constitute a further safeguard that companies should not, other than in limited circumstances, reduce their share capital. In this regard mention may be made of the prohibition against the purchase by a company of its own shares as being part of the foregoing common law principles”²⁰

The major shift came with the amendment of the Companies Act in 1999.²¹ The capital maintenance rule was relaxed and South Africa adopted the solvency and liquidity test. With the 1999 amendment, companies were allowed to acquire own shares, make payment out of capital or to pay dividend out of capital, offer financial assistance for acquisition of shares or subscription or to return capital to its members. Even with the amendment to the rule, the company could still not issue shares on discount, not pay interest on share capital and the requirement relating to redeemable preference was remained.²²

The Companies Act, 1999, repealed sections 83-90.²³ The Explanation Memorandum provided the following with regard to the amendment, “... *in the modern company law system companies may reduce capital including the acquisition of own shares ...*”

The Department of Trade and Industry recognised the need to introduce the amendments to the capital maintenance rule and highlighted a concern that ‘South African law has been tardy in its recognition of modern concepts of capital maintenance rule’. The

²⁰ Department of Trade and Industry, “Purchase by a company of its own shares”, Notice 724 of 1998, *Government Gazette* No. 18868 of 8 May 1998

²¹ Companies Amendment Act 37 of 1999

²² Pretorius et al, *ibid*, at 122

²³ Companies Act, 1973

Department acknowledged that, ‘modern notion of capital maintenance is that companies may reduce capital, including the acquisition of their own shares, subject to solvency and liquidity criteria. This has the advantage of affording protection to creditors whilst at the same time giving flexibility to companies to achieve sound commercial objectives’.²⁴

The acquisition of own shares meant that the share capital can be reduced. In the case of par value shares it can be reduced with the par value shares acquired and in case of non-par value shares, a value per share gets to be computed by dividing the total stated share capital in respect of the particular class of shares.²⁵

Jooste argued that, the reduction of share capital, can be regarded as paid-up share capital which had been lost or not represented by available assets. This did not, according to him, amount to capital actually received from shareholder but the share capital and stated capital accounts reflecting the company’s issued share capital.²⁶ In confirmation of his hypothesis, Jooste indicated that section 90 of the Act,²⁷ does not expressly or impliedly permit a reduction of capital. In support, Blackman indicated the following as quoted by Jooste: -

“Section 90 puts an end to the capital maintenance rule. A company may now distribute (make ‘payments’ of) all its net assets to its shareholders. The section draws no distinction between distributions of profits and distributions out of capital; and all such ‘payments’, regardless of whether or not they involve payment out of capital, leave the company’s share capital and its capital accounts unaffected. Thus, s 90 puts an end to the rule that ‘dividends’, in the sense of any payment or benefit given by a company to its shareholders qua shareholders, cannot be paid out of capital. It permits ‘payments’ out of capital without a reduction of the company’s share capital (and, of course, without the consent of the company’s creditors and the confirmation of the court). Hence, what it permits is not the reduction of share capital, but, rather, the payment of capital funds to shareholders without a reduction of share capital. It should be noted

²⁴ Department of Trade and Industry, *ibid*

²⁵ Companies Act, 1973

²⁶ Jooste, “Can share capital be reduced other than by way of buy-back”, 2009, *SALJ*, at 294.

²⁷ Companies Act, 1973

that a reduction of share capital coupled with a distribution of capital funds constituted a return of capital funds to the shareholders concerned. Strictly speaking, s 90 does not authorize a return of capital funds. The shareholders' rights to return of their capital on winding-up remain intact. What s 90 permits the company to do is to make payments to the shareholders out of capital funds.”

Jooste, advocated a view that, with the repeal of sections 83-90, and without specific enactment of a provision regulating reduction of capital, companies cannot technically reduce their capital.²⁸ Van der Linde differed with Jooste's perspective and advanced an argument that, capital can be reduced by section 85²⁹ through share buy-back. She argued that this can be achieved by cancellation of lost capital. A company could acquire its own share without consideration and cancel them to reflect lost capital.³⁰

Another way of acquiring own shares was to lend money for the acquisition of shares of the company or subscription; provided the company satisfied the solvency and liquidity test.³¹ There was an exception under section 38(2)(d), which excluded acquisitions by the company of own shares and provision of assistance to third parties.³²

It can be read from section 90³³ that, as long as the articles allows it, dividend may be paid from profit. The company is not obliged to distribute all its profit by way of dividends and may store it in reserve, however, once declared, dividend must be paid.³⁴

With the amendment in 1999, the company could make payment to the shareholders, either from the revenue profit or capital. The payment would have to comply with the solvency and liquidity test. The share premium account and the capital redemption reserve funds may be paid out as profit available for distribution as dividend and may

²⁸ Jooste, “*Can share capital be reduced other than by way of buy-back*”, 2009, SALJ, at 299-300

²⁹ Companies Amendment Act, 1999

³⁰ Van der Linde, “*Aspects of the regulation of share capital and distributions to shareholders*”, 2008 LLD, UNISA, at 307

³¹ Section 38 of the Amendment Act, 1999

³² Pretorius *et al*, at 125

³³ Companies Amendment Act, 1999

³⁴ Pretorius *et al*, at 138

also be applied in paying unissued shares to be issued to members as fully paid up capitalisation shares.³⁵

The Companies Act, 2008, continued along the same vein by embracing the solvency and liquidity test. Provision has been made under section 48,³⁶ for acquisition by a company of own shares. Financial assistance for subscription of shares has been relaxed, and the assistance³⁷ is now dependant on the fulfilment of certain conditions. Conditions have been imposed on the distribution³⁸ of dividends and issuing of authorised shares on *pro rata* basis. The obligation for the approval of the above mentioned transactions has been put on directors, at the exclusion of the shareholders, with few exceptions wherein the directors might be seen to have personal interest in the transaction. The cushion in form of liabilities of directors for non-compliance with the provisions of the Act has been provided.³⁹

2.4 CONCLUSION

The change in the capital maintenance regime placed South African Law within par of International Law with regard to the approach to the application of the capital maintenance doctrine. The focus on the solvency and liquidity test will provide assurance to the creditors that their interest will be protected. The 1999 amendments which introduced the share buy-back provided the flexibility need for the modern business realm.

³⁵ Pretorius *et al*, at 143

³⁶ Companies Act, 2008

³⁷ Section 45, Companies Act, 2008

³⁸ Section 46, Companies Act, 2008

³⁹ Section 77, Companies Act, 2008

3.1 INTRODUCTION

Shareholders expect a return on share capital invested, however this is uncertain. Van der Linde indicates that the ‘the expectation of shareholders to receive dividend is vivid in contrast with the very remote expectation to receive a share in the net assets of the company’.⁴⁰ She further cautions that, the expectation of shareholders to receive profits of the company during the company’s existence must be balanced against the expectation of creditors to receive payment.⁴¹ A way of ensuring that the interest of the creditors are protected is by imposing conditions that must be met before distribution can be effected. Creditors are not the only party that might be adversely affected by distribution; minority shareholders can be squeezed out by either restricted dividend payment or through selective distribution to certain classes of shares by share repurchase.⁴²

Capital maintenance rule regulated distribution by prohibiting payment of dividend out of share capital. Historically, companies limited themselves to paying dividend out of profit only. The Joint Stock Companies Act of 1844, did not expressly prohibit the payment of dividends out of capital, however it included the power to declare dividends from the profit of the company.⁴³

Prior to 1999, any distribution of funds to shareholders, other than payment from profit required a court order. The regulation of distribution was done to protect the creditors and minority shareholders. According to Jooste, the distribution must be regulated law in order to protect the

⁴⁰ Van der Linde, “*Aspects of the regulation of share capital and distributions to shareholders*”, 2008, LLD, UNISA, at 14

⁴¹ Van der Linde, *ibid*, at 14

⁴² Van der Linde, *ibid*, at 16

⁴³ Van der Linde, *ibid*, at 19

interest of the creditors and minority shareholders, in the light of the abolition of the capital maintenance rule.⁴⁴

Van der Linde, indicated the following with regard to payment to shareholders: -

*“Distribution is a term used to refer to payment to shareholders as a return to share capital. Shareholders have expectation, but not a right, to receive a return on the capital they contributed to the company by sharing in the profit during its existence. They also have residual or reversionary interest in the company’s net assets upon its dissolution, but no right to repayment of their contribution while the company exist. This means that any distribution to shareholders during the existence of a company amounts to gratuitous disposition by the company”*⁴⁵

Prior to the 2008 Companies Act, ‘distribution’ was not defined, and was regulated in a fragmented manner. However, the 1973 Act provided scenarios that can be defined as distribution, namely, payment of interest on share capital; payment for the acquisition of shares, payment by reason of shareholding and payment for redemption of shares.⁴⁶ In short, payment of interest on share capital was only allowed in exceptional circumstances and required a court order.⁴⁷ There was no need to comply with the provision of the solvency and liquidity test for payment of interest on share capital and there was no reduction in the share capital. The acquisition of shares was subject to the solvency and liquidity test and resulted in the reduction of share capital. Payment by reason of shareholding was subject to the solvency and liquidity test, however, did not result in the reduction of share capital. Payment for the redemption of shares could only be made out of distributable profits and the proceed of a further issue of

⁴⁴ Jooste, “*Issues relating to the regulation of distribution by the 2008 Companies Act*” 2009, SALJ, at 627

⁴⁵ Van der Linde, “*Regulation of distributions to shareholders in the Companies Act, 2008*” 2009, TSAR, at 484

⁴⁶ Van der Linde, “*Aspects of the regulation of share capital and distributions to shareholders*”, 2008, LLD, UNISA, at 367

⁴⁷ Section 79 of the Companies Act 1973

shares. There was no financial restriction and the payment did not result in the reduction of paid-up capital reflected on share capital account.⁴⁸

Even if some of the transactions above did not require the application of the solvency and liquidity test, the general rule was that the company could not make payment to the shareholders, if there were reasonable reasons to believe that the company would after the payment be unable to pay its debts as they become due in the ordinary course of business or that the company's total assets would after the payment be less than its total liabilities.⁴⁹

3.2 DEFINITION OF DISTRIBUTION

Distribution was never defined in the Act until the proclamation of the Companies Act, 2008. The definition includes the following concepts, in which distribution might be direct or indirect: -

- Transfer of money or property⁵⁰
- Incurrence of a debt or other obligation⁵¹
- Forgiveness or waiver of a debt or obligation⁵²

The transfer of money or property can be in a form of dividend,⁵³ as payment in lieu of capitalisation,⁵⁴ as consideration for the acquisition contemplated in section 48;⁵⁵ or transfer in respect of the shares of that company or of another company within the same group. There is an exception relating to distribution under the appraisal remedy.⁵⁶

⁴⁸ Van der Linde, *Aspects of the regulation of share capital and distributions to shareholders*, 2008, LLD, UNISA, at 368

⁴⁹ Sections 85(4), section 90(2), Companies Act, 1973

⁵⁰ Section 1, Companies Act, 2008, "distribution", paragraph (a)

⁵¹ Section 1, Companies Act, 2008 "distribution", paragraph (b)

⁵² See section 1, Companies Act, 71 of 2008 "distribution", paragraph (c)

⁵³ s 1 sv "distribution", paragraph (a)(i)

⁵⁴ s 1 sv "distribution", paragraph (a)(ii)

⁵⁵ s 1 sv "distribution", paragraph (a)(iii)

⁵⁶ s 1 sv "distribution", paragraph (a)(iv)

The definition for distribution does not include the distribution made in the event of liquidation. The school of thought on this notion is that in a liquidation, surplus assets gets distributed to shareholders only after the debts of the companies have been paid to creditors.⁵⁷

Considering that under capital maintenance rule, a proper way to pay return on share capital was through payment of dividends, it would have been prudent to define what dividend would entail. Dividend can however be regarded as “any other payment made by the company by means of which it parts with money to its shareholders and can only be made by way of dividing profit”.⁵⁸ Once a dividend is declared, the shareholder become vested with the entitlement for payment even if payment is made at a later date.

Under payment *in lieu* of capitalisation share, the company may offer cash payment as the alternative to capitalisation of shares provided the Memorandum of Incorporation (MOI) authorises that. However, the board may not offer the cash payment *in lieu* of awarding capitalisation share if the company would not be able to satisfy the solvency and liquidity test immediately upon the completion of the distribution. In making this determination, the board will have to act in good faith, in the best interest of the company for a proper purpose. Capitalisation is normally done in the event the company does not want to declare any dividend. In that way, there is no payment of money and the transaction amounts to an accounting entry.⁵⁹

Acquisition by a company of its own shares or acquisition by the subsidiary of share in holding company is regulated by section 48. As a principle, the company cannot acquire its shares, as it cannot hold rights against itself.⁶⁰ Further, a company or a subsidiary of a company cannot acquire shares of that company, if after the acquisition there will be no shares to issue. The instance in which the company can be able to do this is if the shareholder relinquishes rights in respect of a share of a company, which can be done for a consideration.

⁵⁷ Van der Linde, “*The regulations of distribution to shareholders in the Companies Act 2008*”, 2009, TSAR, at 486

⁵⁸ Henochsberg on Company Act, 2008, s1, at 14-15

⁵⁹ Henochsberg on Company Act, 2008, s1, paragraph (a) ii, at 14

⁶⁰ Van der Linde, “*The regulations of distribution to shareholders in the Companies Act 2008*”, 2009, TSAR, at 488

With regard to transfer in respect of shares, there is an exclusion of acquisition of shares under appraisal remedy. Section 164 (19)⁶¹ provides that, making of demand, tendering of shares and payment by a company to a shareholder, do not constitute distribution by the company and not subject to the provision regulating distribution. The effect of the exclusion is that it places the shareholders who demand payment under appraisal remedy at the same footing as creditors.⁶²

The incurrance of a debt or obligation as a form of distribution has an effect that the incurrance of the obligation must be ‘in respect of share’ or ‘by reason of shareholding of a shareholder’. The shareholder must be the beneficiary, directly or indirectly in the incurrance of the debt. However, the incurrance must not arise from a pre-existing obligation.⁶³

The last instance of distribution is the forgiveness or waiver of a debt or obligation. For the waiver of debt to qualify as distribution, there must be a link to shareholding. The concern with regard to the definition of distribution as highlighted by Jooste in that, ‘if a company acquires its own shares and the consideration takes a form of a company incurring a debt on behalf of the selling shareholder, or waiver of a debt owed to the company by the selling shareholder, the company does not have to comply with the solvency and liquidity test.⁶⁴ It is recommended by Jooste that, the definition of distribution must be refined to make it unambiguous in that, ‘the transfers in sub-parts (i) to (iv) of part (a) of the definition is also applicable to part (b) and (c). This he argues, will bring the definition in par with the definition of distribution in New Zealand.⁶⁵

Van der Linde,⁶⁶ has raised the following concerns with regard to the definition of distribution:-

⁶¹ Companies Act, 2008

⁶² Van der Linde, “*The regulations of distribution to shareholders in the Companies Act 2008*”, 2009, TSAR, at 489

⁶³ Henochsberg on Company Act, 2008, s1, paragraph (b), at 14

⁶⁴ Jooste, “*Issues relating to the regulations of ‘distributions by the 2008 Companies Act’*”, 2009, SALJ, at 635.

⁶⁵ Jooste, *ibid*, at 634

⁶⁶ Van der Linde, “*The regulations of distribution to shareholders in the Companies Act 2008*”, 2009, TSAR, at 386

- The fact that the definition does not expressly require the incurrence or forgiveness of an obligation ‘in respect of shares’.
- The extension of distribution to group context. The concern is that the group extension makes the requirements for distribution problematic, more specifically the application of the solvency and liquidity test.
- The exclusion of appraisal payments. The exclusion has an impact in that shareholders who insist on being paid for their shares flowing from appraisal remedy, receive payment in preference to creditors.

3.3 REQUIREMENTS FOR DISTRIBUTION

The first requirement for distribution is that, it must be flowing from an existing legal obligation of the company or court order or if the board passes a resolution approving the distribution. This is a deviation from the provisions of section 90 of the Companies Act 1973, which required that such payment be authorized by article of association. There is no specific provision in section 46 making it a requirement for distribution to be authorized by the shareholders. Van der Linde advocate an argument that, the company’s MOI can provide for the shareholders to approve any distribution.⁶⁷ This is line with the notion that section 46 can be altered by providing in the MOI for the authorization by the shareholders. The board will have to comply with the MOI as it imposes higher standard, greater restriction or more onerous requirements than would otherwise apply.⁶⁸

The second requirement in that distribution cannot be effected if ‘it reasonable appears’ that the company would not satisfy the solvency and liquidity test after completing the distribution.⁶⁹ This is in line with the provisions of section 90(2) of the Companies Act, 1973. Van der Linde argues that, the determining factor is the existence of a reason or ground for a specific belief.⁷⁰

⁶⁷ Van der Linde, “*Regulations of distribution to shareholders in the Companies Act 2008*”, 2009, TSAR, at 492

⁶⁸ Henochsberg, Notes, s46, at 197-198

⁶⁹ Section 46(1)(b) of the Companies Act, 2008

⁷⁰ Van der Linde, “*Aspects of the regulation of share capital and distribution to shareholders*”, 2008, LLD, UNISA, at 370

Further, in the application of the solvency and liquidity test as set in section 46 (1) (b), the directors must acknowledge that the solvency and liquidity test has been applied and there must be a reasonable conclusion that the company would satisfy the solvency and liquidity after distribution.⁷¹ Van der Linde is of the view that the resolution will have to be passed even in instances where distribution is pursuant to an existing obligation or court order.⁷²

On the timing of the application, the solvency and liquidity would have to be reapplied if the distribution is not completed within 120 days after the board has made an acknowledgement.⁷³ If the distribution flows from the incurrance of the debt or other obligation of the company, the provision of section 46 will apply as and when the board resolve to incur the debt or the obligation.

For any distribution that arises from the court order, the company may approach the court for the variation of the order if the company will not be able to satisfy the solvency and liquidity requirement. Considering that the court may grant an order that is just an equitable having considered the financial circumstances of the company, it would be odd for the court to issue the order enforcing the original court order or making order which would result in the company not able to satisfy the solvency and liquidity requirements after distribution.

In the event that there is acquisition of share contrary to the provisions of section 46, the company may apply to court for an order reversing the acquisition; provided not more than 2 years has lapsed since the acquisition. The court may in the above mentioned instance, order that a person from whom the shares were acquired return the amount paid by the company and the company may issue the equivalent number of shares of the same class as acquired.⁷⁴

⁷¹ Section 46(1)(c)

⁷² Van der Linde, “*Aspects of the regulation of share capital and distribution to shareholders*”, 2008, LLD, UNISA, at 378

⁷³ s 46(3)

⁷⁴ s 48 (6).

The directors of a company will be held liable for an unlawful distribution. Both sections 46 (6) and 48 (6) of Act 2008, make provision for liability of a director as provided for in section 77 (3) (e) (vii). The director will be held liable if he was present in a meeting or was part in a decision making and failed to vote against the acquisition of shares contrary to the provision of section 46. It follows that for liability to arise, the director must have been present in the meeting when a decision was made or participated in the decision making. Further, the director should have failed to note his dissent against the decision for distribution contrary to the provision of Act. However, liability will not follow if the distribution arose from a court order or for the satisfaction of an existing legal obligation.⁷⁵

With regard to treatment of shares on distribution, section 37(5) (d),⁷⁶ states that the share of a class must be treated equally, unless the MOI, indicates otherwise. The section entitles the shareholders to distribution calculated in any manner, including dividends that may be cumulative, non-cumulative, or partially cumulative, subject to the requirements of sections 46.⁷⁷

3.4 CONCLUSION

The definition of distribution is welcomed, as it provides clarification of what entails distribution. Prior to the amendment, distribution was regulated in a fragmented manner. The change in the regulation of distribution has ensured that it is no longer a requirement to obtain a court order to declare distribution other than from profit. This has made the process less onerous.

The definition however, has seen some criticisms from different scholars. Jooste argues that the definition must be refined to remove and ambiguity and Van der Linde shares the same sentiment more particularly the extension of the distribution to group context.

⁷⁵ Van der Linde “*The regulation of distribution to the shareholders in the Companies Act 2008*” 2009, TSAR, at 496.

⁷⁶ Companies Act, 2008

⁷⁷ Companies Act, 2008

ACQUISITION OF OWN SHARES / SHARE BUY-BACK

4.1 INTRODUCTION

When the Companies Act, 1973, was amended in 1999, it abolished the concept that the companies cannot acquire its own shares. The Companies Amendment Bill, 1999 set forth the following as an objective for the introduction of share buy-back: -

“The principles of capital maintenance have undergone significant changes in almost all countries. The modern notion of capital maintenance is that companies may reduce capital, including the acquisition of their own shares, but subject to solvency and liquidity criteria. This has the advantage of affording protection to creditors whilst at the same time giving flexibility to companies to achieve sound commercial objectives. These aspects of flexibility and achievement of sound commercial objects have become extremely important since South Africa’s re-entry into the global market... One of the accepted defences against the negative action in the international market place is the ability of strong companies to repurchase and cancel their own issued which levels the playing field in relation to those spectators wishing to reduce the value of a company’s shares by indiscriminate market activities. Legislations in most of the EEC, US and other developed markets permits the repurchase of a company’s issued share capital, subject to solvency and liquidity criteria”.

Share buy-back was regulated by section 85 of the Companies Amendment Act, 1999. Section 85 (1), provided for a company to acquire its own shares, as long as such acquisition was authorised by an article of association and was approved by special resolution.⁷⁸ If the article of association did not authorise the share buy-back, such transaction was regarded as *ultra vires* the company.

⁷⁸ Companies Amendment Act 1999

The approval by special resolution meant that the shareholders had to approve the share buy-back. This was due to the fact that acquisition of a company's own shares can be unfair towards either the vendor-shareholder or the non-selling shareholders. This was because approval by special resolution or agreement of the vendor shareholders was not required unless the vendor shareholders held sufficient shares to block special resolution.⁷⁹ Blackman indicated the following as quoted by Van der Linde, 'that the company has a duty not to unfairly discriminate between shareholders for reasons that such act may constitutes fraud on minority'.⁸⁰

The provisions of section 85 (1) were confirmed by the Courts in the case of *Capitex Bank Ltd v Qorus Holdings Ltd and Others*,⁸¹ wherein Judge Malan J indicated that "*section 85(1) in so many words as a general proposition allows a company to approve the acquisition of its own shares subject only to two internal requirements, viz, that the acquisition be authorised by the articles and that approval be given by way of special resolution. This effectively repeals one of the three sub-rules of the common-law rule that a company maintain its capital ... The general power given to all companies is inconsistent with the unexpressed rule of the common law that a company may not purchase its own shares*".

Considering that share buy-back required an approval, it was laid down in section 85 (2) that the approval can either be a general approval or a specific approval for a particular acquisition.⁸² The general approval remains valid until the next annual general meeting of the company, unless revoked earlier by special resolution. Another requirements for share buy-back was the introduction by section 85 (4),⁸³ of the solvency and liquidity test. A company could not acquire its own shares if there is a reasonable ground for believing that, after acquisition, it would not be able to pay its debts in the ordinary course of its own business and that its liabilities would exceed its fairly valued assets. The test was meant to ensure that the interests of creditors are protected.

⁷⁹ Van der Linde, "*Aspects of the regulation of share capital and distributions to shareholders*", LLD, UNISA, at 437

⁸⁰ Van der Linde, *Ibid*, 437

⁸¹ *Capitex v Qorus Holdings Ltd and Other* 2003 (3) SA 302 (W)

⁸² Section 85 (4), Companies Amendment Act, 1999

⁸³ Section 85 (4), Companies Amendment Act, 1999.

Section 85 (9), introduces a safety net to the effect that a company may not acquire its own shares, if as a result of such acquisition there would be no longer be any shares in issue other than convertible or redeemable shares.⁸⁴

This was a departure from the principle set out in *Trevor v Whitworth*, to the effect that a company cannot not acquire its own shares. Lord Watson⁸⁵ stated that, “*a company could not legally either resell the shares, as this would be ultra vires, or cancel them, as this would be reduction of capital*”.

Blackman advanced the following justification for share repurchase, as quoted by Cassim⁸⁶: -

- Share repurchases are useful where a company has an employee share incentive scheme because they enable the company to purchase employees’ shares when they leave their employment;
- Share repurchase can be usefully utilised to buy dissenting shareholders;
- Share repurchases enable a company to return surplus funds to shareholders who can then make other more profitable investments;
- Share repurchases can be used to maintain or achieve what is perceived to be a desirable debt-equity ratio;
- Share repurchase provides a means to avert a hostile takeover.

4.2 REQUIREMENTS FOR SHARE BUY-BACK

In terms of section 48, the directors of the company can authorise the acquisition by a company of its own shares. It is no longer a requirement for the acquisition to be authorised by the articles of association nor the shareholders’ approval by special resolution.

Van der Linde argued that, even if it is not a requirement for the memorandum of incorporation to authorise repurchases, nothing prevents the regulation of repurchases in a memorandum of incorporation. She indicates further that, the repurchase provisions do not expressly state that

⁸⁴ Section 85(9), Companies Amendment Act, 1999

⁸⁵ *Trevor v Whitworth*, at 428

⁸⁶ FHI Cassim, *et al*, *Contemporary Company Law*, Juta & Co Ltd, 2011, at 296

repurchases should comply with the relevant terms and conditions of the company's memorandum of incorporation, but it can be accepted that repurchases in violation of the memorandum of incorporation will be open to attack by shareholders. The directors are obliged to comply with the provisions of the memorandum of incorporation, and will be liable to the company if the company suffers loss or damage as a result of the non-compliance with the memorandum of incorporation. A director will also be liable to a shareholder who suffers damage as a result of such non-compliance, but only if the director acted fraudulently or with gross negligence and the conduct has not been ratified by special resolution".⁸⁷ Cassim however, advanced a contrary view and indicated that section 48 is an unalterable provision and that there is nothing in section 48 that indicates that the section may be negated, restricted, limited, qualified, extended or otherwise altered in substance or effect by the company's memorandum of incorporation.⁸⁸ However, the dilemma can be negated by providing in the memorandum of incorporation for a special resolution to take place in all transaction for share buy-back.

With regard to acquisition of shares by subsidiary, the board of directors of subsidiary may approved the acquisition of share in the holding company.⁸⁹ Until the amendment of the Companies Act in 1999, there was a prohibition for the subsidiary to acquire share in the holding company. The acquisition of shares by subsidiary has been limited in that the subsidiary cannot acquire more than 10% in aggregate of the number of issued shares of the holding company. Further, any shares so acquired will not have any voting right attached to them.⁹⁰ The acquisition of share by the subsidiary in the holding company does not require a special resolution by the shareholders as contemplated in section 48(8). The advantage of allowing the subsidiary to acquire share in the holding company is that the secondary tax on company (STC), will not be payable. This is because repurchase and cancellation of shares amounts to a distribution and is classified as a dividend for purposes of STC. However, when

⁸⁷ Van der Linder, "*Share repurchases and the protection of shareholders*", 2010, TSAR, at 303

⁸⁸ FHI Cassim, *et al*, "*Contemporary Company Law*", Juta & Co Ltd, 2011, at 303

⁸⁹ Section 48 (2) (b)

⁹⁰ Section 48 (2) (b) (i) and (ii)

the subsidiary acquires shares in its holding company the shares are not cancelled and the purchase is not regarded as a dividend.⁹¹

Further, the company cannot acquire shares if as a result of that acquisition, there would be no shares left to issue, other than shares held by one or more subsidiaries of the company or convertible or redeemable shares. There is school of thought that argues that the requirement is superfluous considering that, it is impossible that a company which indeed has shares other than convertible or redeemable shares could find itself in the position where there are no other shareholders of its unconvertible or unredeemable shares and that it is required that a company should always have at least one shareholder other than a company that is part of the same group.⁹² Another argument introduced to counter effect the argument is that there is nothing in the Act that prohibits a company from reacquiring some of its ordinary shares and thereafter convert the remaining ordinary shares into redeemable shares.⁹³

Where the shares are acquired by the director or a prescribed officer, the acquisition must be approved by shareholders through a special resolution.⁹⁴ The intention of the provision is meant to curb abuse of power by directors. This is the only exception in which the shareholders are involved in the approval of share buy-back by a company. The Companies Act, 1973, made provision for the offer to be made to all shareholders when in an offer to acquire shares. There is no distinction in the Act between the general and selective offers and no special safeguards have been enacted, aimed at the potential mischief inherent in selective offers.⁹⁵

In terms of section 48 (8) (b), in the event that the share buy-back, if considered alone or together with a series of integrated transaction, will amount to more than 5%, of the issued shares, then the provision of section 114 and section 115 of the Companies Act, 2008, must be applied. If the acquisition relates to more than 5% of the shares, the transaction then falls within

⁹¹ Van der Linde, “*Aspects of the regulation of share capital and distributions to shareholders*” 2008, LLD, UNISA, at 505

⁹² Van der Linde, *Ibid*, at 505

⁹³ Henochsberg *on Companies Act, 2008*, s 48, subsection 3, at 2017-208

⁹⁴ Section 48 (8) (a)

⁹⁵ FHI Cassim, *et al*, “*Contemporary Company Law*”, Juta & Co Ltd, 2011, at 303

the ambit of affected transactions or scheme of arrangement. If the company is regulated company, a compliance certificate must be obtained or an exemption must be granted by the Take-Over Regulation Panel.

The cross referencing to section 114⁹⁶ is meant to address the conflict with regard to the involvement of the shareholders in the approval of the affected transaction. A special resolution must be passed in the event that the share buy-back becomes an affected transaction. The difference is meant to address the casual or once-off share buy-back in terms of section 48, whereas section 114 requirements are meant to address the fundamental changes to the company's capital structure.⁹⁷

Lastly, considering that share buy-back is regarded as distribution, the acquisition must comply with section 46, requiring the satisfaction of the solvency and liquidity requirements. The only concern as raised by Van der Linde and Cassim,⁹⁸ is that it is not clear whether a separate decision to acquire shares is envisaged or whether the 'decision' refers to authorisation of distribution by the board under section 46. Where there is an agreement for the share buy-back that is enforceable against the company and the company falls foul of the solvency and liquidity test, the company can approach the court to show that it will be in breach of the solvency and liquidity test and the court may order otherwise if it will be just and equitable.⁹⁹

4.3 DIRECTORS' LIABILITY

The director's liability is derived from common law. In terms of common law, the director, must exercise his or her powers and perform his or her functions in good faith and for a proper purpose; in the best interest of the company; and with the degree of care, skill and diligence

⁹⁶ Companies Act, 2008

⁹⁷ FHI Cassim, et al, "*Contemporary Company Law*", Juta & Co Ltd, 2011, at 304

⁹⁸ Van der Linde, "*The regulation of distribution to shareholders in the Companies Act 2008*", 2009, TSAR, at 492 and FHI Cassim, et al, "*Contemporary Company Law*", Juta & Co Ltd, 2011, at 300.

⁹⁹ Section 48 (7)

that may reasonably be expected of a person carrying out the same functions and having the general knowledge, skill and experience of that particular director.¹⁰⁰

Considering that share repurchase was prohibited until the 1999 amendment, there were limited instances wherein the director could be seen to have breached the duty of implementing repurchase in an unlawful manner. The principle as laid down in *Trevor v Whitworth*, was to the effect that if a company was involved in a repurchase transaction, the company could recover the purchase price from the shareholder on the basis that the agreement was *ultra vires* and void.¹⁰¹

Under the 1999, Companies Amendment Act, the director of the company could be held personally liable for non-compliance with the solvency and liquidity requirements if the director ‘allowed’ the company to acquire shares contrary to the provisions of the Act.¹⁰² The directors could be held jointly and severally liable for the amount of the unlawful payment which has not been recovered from the shareholders.¹⁰³ The directors could apply to court for relief from liability in terms of section 248.¹⁰⁴ In terms of section 248, the court can grant the director relief if the director acted honestly and reasonable. The financial restrictions imposed an objective test, and liability depended on the director’s knowledge of the unlawfulness of the payment.¹⁰⁵

With regard to liability of the directors, Van der Linde argues contrary to Cassim in that according to Van der Linde, it was irrelevant under the Companies Act 1973, whether a directors voted against the repurchase at the time when the company’s financial position could

¹⁰⁰ *CyberScene Ltd and others v iKiosk Internet and Information (Pty) Ltd*, 2000 (3) SA 806 (C), the court confirmed that a director stands in a fiduciary relationship to the company of which he or she is a director, even if he or she is a non-executive director.

¹⁰¹ Van der Linde, “*The regulation of distribution to shareholders in the Companies Act 2008*”, 2009, TSAR, at 452

¹⁰² Section 85 (4) of the Companies Act, 1973

¹⁰³ Section 86 (1) of the Companies Act, 1973

¹⁰⁴ Companies Act 1973

¹⁰⁵ Van der Linde, “*The regulation of distribution to shareholders in the Companies Act 2008*”, 2009, TSAR, at 456

have allowed the company to acquire shares.¹⁰⁶ The director, according to Van der Linde has a duty to prevent the making of payment contrary to the provision of section 85(4).¹⁰⁷ Section 86 (2),¹⁰⁸ provided reprieve to the directors, in that they could apply to court for an order against the shareholders compelling them to refund the unlawful payment.

Under the Companies Act 2008, the liability of the director for any unlawful acquisition is regulated by section 48 (7), read with section 77. For liability to follow, the directors must have been present at a meeting where the board approved the acquisition or participated in the decision-making.¹⁰⁹ ‘Participated’ include a situation wherein a director was notified of the meeting to approve the acquisition. Van der Linde is of the view that a director who adopted the subsequent resolution approving the acquisition would escape liability.¹¹⁰

Another requirement for liability is that the director should have failed to vote against the resolution for the acquisition of shares, knowing that the acquisition is contrary to section 46.¹¹¹ ‘Knowing’ include, knowing something not only when the director had actual knowledge of it, but also if the director was in a position where he reasonably ought to have had actual knowledge, or to have investigated the matter to an extent that could have provided him with actual knowledge, or to have taken measures which, if taken, could reasonably be expected to have provided him with actual knowledge of the matter.¹¹² The definition is too broad and it would be interesting for the courts to determine the extent at which the person is deemed to have known what he should have known.

Considering that section 48 refers to section 77,¹¹³ the implication is that the director will also be liable under common law. In terms of common law, the liability for breach of fiduciary duty

¹⁰⁶ Van der Linde, “*The regulation of distribution to shareholders in the Companies Act 2008*”, 2009, TSAR, at 456

¹⁰⁷ Companies Act, 1973

¹⁰⁸ Companies Act, 1973

¹⁰⁹ Section 48(7) (a)

¹¹⁰ Van der Linde, “*The regulation of distribution to shareholders in the Companies Act 2008*”, 2009, TSAR, at 481

¹¹¹ Section 48(7) (b)

¹¹² Section 1, definitions, “knowing”

¹¹³ Companies Act, 2008

is *sui generis* and not based on delict or contract. The director could escape liability if he can evoke the business judgement rule. The business judgment as set in section 76(4) indicates that the director who would have satisfied the requirements if: -

“(i) the director has taken reasonably diligent steps to become informed about the matter;

(ii) either-

(aa) the director had no material personal financial interest in the subject matter of the decision, and had no reasonable basis to know that any related person had a personal financial interest in the matter; or

(bb) the director complied with the requirements of section 75 with respect to any interest contemplated in subparagraph (aa);³⁶ and

(iii) the director made a decision, or supported the decision of a committee or the board, with regard to that matter, and the director had a rational basis for believing, and did believe, that the decision was in the best interests of the company”

Finally, there is possible of further liability as set in section 20(6),¹¹⁴ relating to the power of the shareholders to claim any damage against any person who intentionally, fraudulently or due to gross negligence causes the company to do anything inconsistent with the provision of the Companies Act or a limitation, restriction or qualification.

4.4 RELATIONSHIP BETWEEN SECTION 46 AND SECTION 48

Section 48 (2)¹¹⁵ provides authority for the company to acquire its own share, however, such acquisition is dependent on the satisfaction of the requirements of section 46. Section 46 regulates ‘distribution’ and share buy-back is also defined as distribution. It is for this reason that there are school of thought that is not necessary to refer to section 46.

¹¹⁴ Companies Act, 2008

¹¹⁵ Companies Act, 2008

Further, another concern is that the provisions of section 46 sets out the requirements for distribution and not for a decision. The conundrum is that the ‘distribution pursuant to a decision’ is the one that will have a negative impact and not a ‘decision’.¹¹⁶

4.5 NON APPLICABILITY OF SECTION 48

Section 48 of the Companies Act, 2008, does not apply to the shareholder’s appraisal right envisaged in section 164 or redemption by the company of the redeemable securities. Section 164 is activated when right of a shareholder, as derived from the memorandum of incorporation is violated by an amendment to the memorandum of incorporation with a result that his rights are materially adversely affected.¹¹⁷ The section can also be evoked in the event of fundamental transactions. The shareholder can demand that the company pay him the fair value for all shares he holds in the company. The payment will only be done instances wherein the shareholder has objected to the envisaged transaction, his class of shares are adversely affected by the amendment and has voted against the resolution.¹¹⁸ Section 164¹¹⁹ does not constitute an acquisition for the purpose of section 48.¹²⁰

With regard to redemption, the share buy-back and redemption involves return to a company of shares the company had issued to shareholders. In the share redemption, a company acquires shares in accordance with a contract contained in the memorandum of incorporation.¹²¹ According to Cassim, the redemption by the company of any redeemable securities in accordance with terms and condition of those securities is not treated as an acquisition by the company.¹²²

¹¹⁶ FHI Cassim, et al, “*Contemporary Company Law*”, Juta & Co Ltd, 2011, at 300

¹¹⁷ Section 64 (2) of the Companies Act, 2008

¹¹⁸ Section 64(5)

¹¹⁹ Companies Act, 2008

¹²⁰ FHI Cassim, et al, “*Contemporary Company Law*”, Juta & Co Ltd, 2011, at 300

¹²¹ FHI Cassim, et al, “*Contemporary Company Law*”, Juta & Co Ltd, 2011, at 298

¹²² FHI Cassim, et al, *Ibid*, at 298

4.6 CONCLUSION

The provisions of section 48 provides adequate protection to creditors, as the solvency and the liquidity test must be applied for any acquisition by the company of its own shares. Even though the approval of the shareholder is not required for the purpose of the acquisition, the liability imposed on the directors will ensure that the directors act in good faith and to the best interest of the company. Further, the shareholders can bring the derivative action against the directors against any unlawful acquisition.

5.1 INTRODUCTION

The 1999 Amendment Act gave birth to the solvency and liquidity test. The explanatory memorandum introduces the solvency and liquidity test and this was presented as the objective for the amendment: - “in order to promote efficiency, par value shares and nominal value should be replaced with a capital maintenance regime based on solvency and liquidity”¹²³

However, Van der Linde argues that the assertion in the objective of the Bill is inaccurate. According to her, the capital maintenance based on liquidity will not qualify as a capital maintenance regime but as a completely alternative system of regulating distribution by a company to its shareholders.¹²⁴

The initial provision that regulated solvency and liquidity were section 85(4) and section 90(2).¹²⁵ In terms of the provision, the company could not make any payment to the shareholders if there was a reasonable ground of believing that the company would after the payment be unable to pay its debts as they become due in the ordinary course of business and that the consolidated assets of the company fairly valued, will exceed the consolidated liabilities of the company.

Van der Linde argues that, the actual solvency and liquidity of the company was not relevant. If the company is indeed insolvent or unable to pay its debts, payment would in theory be lawful provided there were no reasonable grounds for believing that this was the case.¹²⁶ Considering the provision for ‘reasonable ground for believing’, it can be said that the standard

¹²³ Explanatory Memorandum, Companies Bill 2008, Company Finance

¹²⁴ Van der Linde, “*The Solvency and Liquidity approach in the Companies Act 2008*”, 2009, TSAR, at 224

¹²⁵ Companies Amendment Act, 1999

¹²⁶ Van der Linde, “*Aspects of the regulation of share capital and distributions to shareholders*”, 2008, LLD, UNISA, at 370

is objective. The reasonableness of the director's decision is considered when determining whether the director should be exonerated from liability. This is considered in the light that the creditors will be concerned with whether the company was actually solvent following the payment, not whether the director would expect the company to be solvent, nor whether the accountants could make it look solvent.¹²⁷

Van der Linde indicates that the meaning of the word 'believe', shows that the existence of grounds for suspecting that the company may not satisfy the criteria is not sufficient reason to prevent the company from making payment. She suggests that the requisite belief can only be made if it appears more likely that not that the company is insolvent or unable to pay its debts.¹²⁸ Both sections 85(4) (a) and 90(2) (a),¹²⁹ does not provide for how long after the payment should the company remain able to pay its debts. The time period is only regulated for the JSE Listed companies.¹³⁰ Van der Linde does not agree with Cassim on the interpretation of the time limit within which the test must be satisfied. According to Cassim, the test must be satisfied when at the time when the contract is entered into and subsequently when the payment is made, however, Van der Linde argues that the test must be applied at the time of execution of the contract.¹³¹

Sections 85(4)(b), and 90(2)(b),¹³² regulated the solvency test. The test required that there must be a reason to believe that the 'consolidated assets if the company fairly valued would after the payment be less than the consolidated liabilities of the company'. If a holding company acquires its own shares, the consolidated financial position of the group is taken into account for the solvency test, but not if the shares are acquired by the subsidiary company.¹³³

¹²⁷ R S Bradstreet, "Should Creditors rely on the solvency and liquidity threshold for protection? A South Africa case study", 2012, SALJ at 748

¹²⁸ Van der Linder, "Aspects of the regulation of share capital and distributions to shareholders", 2008, LLD, UNISA, at 370

¹²⁹ Companies Act, 1973

¹³⁰ Van der Linde, *ibid*, at 373

¹³¹ Van der Linde, *ibid*, at 373-374

¹³² Companies Act, 1973

¹³³ P A Delpont, "Company Groups and the Acquisition of Shares", 2001, Mercantile L.J, at 123

5.2 ANALYSIS OF THE SOLVENCY AND LIQUIDITY

The Companies Act, 2008 continued with the same vein by incorporating the solvency and liquidity test in section 4 of the Act. The solvency and liquidity test acts as a prerequisite for the regulation of distribution, provision of financial assistance to the directors and acquisition of own share by company. The elements of the solvency and liquidity test are that the assets of the company, as fair 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.¹³⁴

The solvency test entails that the assets of the company should exceed the liabilities after distribution or payment and this means payment or distribution must be made from the net assets.¹³⁵ This is regarded as solvency in the bankruptcy sense and is determined by way of balance sheet test.¹³⁶ The solvency element does not require that it should ‘appear’ that the assets ‘will’ exceed the liabilities, but it is presented objectively with reference to a particular point in time.¹³⁷ Comparatively, the solvency requirement in South Africa is regarded as lenient and out of step with international trend more particularly because the test must be satisfied after the distribution. There is no provision for solvency margin except in situation where preference of shareholders has to be considered.¹³⁸

The liquidity element relates to the company’s ability to pay the debts as they become due.¹³⁹ The test is normally referred to as the “equity insolvency”, “equity solvency” and “equity test”.¹⁴⁰ With regard to the liquidity test, the first approach has to be a balance sheet test based on the current assets and liabilities and the second approach relates to cash flow analysis. This entails the cash flow predictions which takes into the current assets and the future income of

¹³⁴ Section 4(1) (a) and (b) of the Companies Act, 2008

¹³⁵ Van der Linde, “*The Solvency and Liquidity approach in the Companies Act 2008*”, 2009, TSAR, at 225

¹³⁶ Van der Linde, *Ibid*, at 225

¹³⁷ Van der Linde, *Ibid*, at 227

¹³⁸ Van Der Linde, *Ibid*, at 228

¹³⁹ Section 4(1) (b)

¹⁴⁰ Van der Linde, “*The Solvency and Liquidity approach in the Companies Act 2008*”, 2009, TSAR, at 225

and credit of the company. Further, the current liabilities and prospective liabilities must be considered.¹⁴¹

Van der Linde advances an argument that the difference between the solvency test and the capital maintenance test is that the latter requires a margin over solvency which is equal to the share capital of the company. The satisfaction of the capital maintenance test implies that a simple solvency test must be satisfied. However, the solvency element is satisfied if a company makes distribution according to the capital maintenance principles, which does not require that the company be able to pay its debts as they become due in the ordinary course of business. It is for this reason that some jurisdiction applies the liquidity or equity solvency test in addition to the maintenance rule.¹⁴²

The solvency element allows the creditors to enjoy preference over shareholders upon dissolution of the company and the equity element on the other hand deals with the expectations of the creditors to be paid on time and for the company to be able to pay its debts as they become due.¹⁴³

5.3 REQUIREMENTS FOR THE SOLVENCY AND LIQUIDITY TEST

In applying the solvency and liquidity test, the company must take into account any financial information which relates to the accounting record that are compiled in terms of section 28 of the Act and financial statements as set out in section 29 of the Act.¹⁴⁴ Further, there must be a fair valuation of the company's assets and liabilities, including any foreseeable contingent assets and liabilities and any other evaluation done in respect of the assets of the company.¹⁴⁵

¹⁴¹ Van der Linde, *Ibid*, at 226

¹⁴² Van der Linde, “*The Solvency and Liquidity approach in the Companies Act 2008*”, 2009, TSAR, at, 226

¹⁴³ Van der Linde, *Ibid*, at 226

¹⁴⁴ Section 4(2) (a)

¹⁴⁵ Section 4(2) (b)

Van der Linde argues that, it might be difficult to rely exclusively on recorded financial information when applying the liquidity test, she advances a recommendation that, the liquidity test should be based on the financial information contained in the company's records and statements, as well as foreseeable circumstances that may affect the company's liabilities to pay its debts.¹⁴⁶ The concern with the consideration of contingent assets and liabilities is that, there is no requirement in terms of accounting standards and international financial reporting standards, for the inclusion of such information in the financial statement.¹⁴⁷

If distribution relates to transfer of money or property, the preferential liquidation right of shareholders should not be considered as a liability of the company.¹⁴⁸ The wording of the section is confusing as it has two negatives and this might imply that the consideration of the preferential liquidation right should be considered.¹⁴⁹ The preferential liquidation right of preference shareholders are relevant for the solvency element and not liquidity element due to the fact that the liquidation rights cannot be regarded as a debt due in the ordinary course of business.¹⁵⁰

Another requirement relates to the timing of the application of the test. With regard to distribution, the solvency and liquidity test must be completed for a period of 12 months following the distribution.¹⁵¹ A further timing relates to the fact that the solvency and liquidity test should be considered when the company intends to make the distribution.¹⁵² However, the test should be satisfied after the completion of distribution.¹⁵³ Different transactions requires different timing with regard to the application of the solvency and liquidity test. The solvency and liquidity test must be applied immediately after providing financial assistance or after

¹⁴⁶ Van der Linde, "*The Solvency and Liquidity approach in the Companies Act 2008*", 2009, TSAR, at 230

¹⁴⁷ Van der Linde, *Ibid*, at 232

¹⁴⁸ Section 4(2) (c)

¹⁴⁹ Van der Linde, "*The Solvency and Liquidity approach in the Companies Act 2008*", 2009, TSAR, at 232

¹⁵⁰ Van der Linde, *Ibid*, at 232

¹⁵¹ Section 4(1)(b)

¹⁵² Section 46(1)(b)

¹⁵³ Van der Linde, "*The Solvency and Liquidity approach in the Companies Act 2008*", 2009, TSAR, at 233

completion of the amalgamation or merger.¹⁵⁴ Where distribution relates to the incurrence of a debt, the solvency and liquidity test must be considered when authorisation by the board occurs and not when the debt or obligation is satisfied.¹⁵⁵ Distribution relating to payment of dividend need to satisfy the 120-day rule. Payment of dividends must be made within 120 days from date of authorisation.¹⁵⁶ In the event that distribution does not take place within 120 days, the board of directors have to apply the solvency and liquidity test again as well as acknowledge that distribution can proceed.¹⁵⁷

5.4 CONSEQUENCES FOR NON-COMPLIANCE WITH THE SOLVENCY AND LIQUIDITY TEST.

Acquisition by the company of own shares contrary to the provisions of section 46 renders the acquisition voidable.¹⁵⁸ This can be ascertained from the provisions of section 48(6), which provides for the company to apply to court for the reversal of the acquisition; provided 2 years has not lapsed since the acquisition. Further, section 218(1), provides that, “nothing in the Act, renders void an agreement, resolution or provision of an agreement, resolution, Memorandum of Incorporation or rules of a company that is prohibited, void, voidable or may be declared unlawful in terms of this Act, unless a court declares that agreement, resolution or provision to be void”.¹⁵⁹

With the reversal of the transaction by the court, the court may order that a person from whom the shares were acquired return the amount paid by the company and the company to issue to that person an equivalent number of shares of the same class acquired.¹⁶⁰

However, section 46 of the Act does not contain a similar provision contained in section 48 of the Act relating to reversal of transaction. Comparatively, section 90 of the Companies Act

¹⁵⁴ Van der Linde, *Ibid*, at 233

¹⁵⁵ Section 46(4)

¹⁵⁶ Section 46(3)

¹⁵⁷ Section 46(3)(b)

¹⁵⁸ R Jooste, “*Issues relating to the Regulations of Distribution by the 2008 Companies Act*”, 2009, SALJ, at 645

¹⁵⁹ R Jooste, *Ibid*, 645

¹⁶⁰ Section 48(6) (a) and(b)

1973, provided for the shareholder to repay any dividend received contrary to the provisions of section 90 of the Companies Act, 1973.¹⁶¹

With regard to a third party who innocently received distribution contrary to the provisions of section 46, Jooste advances an argument that, such third party cannot even rely on section 20(7), relating to statutory Turquand rule to protect his interest.¹⁶²

Liability of director will follow if the director was present at the meeting when the board approved the distribution and acquisition contrary to the provisions of section 46 and section 48. The liability of directors for breach of section 46 and section 48, is for loss, damages and costs sustained by the company as result of direct or indirect consequence of the voidness of the resolution of the agreement.¹⁶³

7.5 CONCLUSION

The analysis of the solvency and liquidity test indicates that the solvency and liquidity test provides protection to creditors more than what the capital maintenance rule did. The concern relates to the ability of the directors of the company to be able to apply the liquidity and solvency test, more particularly the need to make future assessments on the liabilities of the company. This requirement provides room for directors to make erroneous solvency and liquidity determination.

¹⁶¹ R Jooste, “*Issues relating to the Regulations of Distribution by the 2008 Companies Act*”, 2009, SALJ, at 646

¹⁶² R Jooste, *Ibid*, at 647

¹⁶³ R Jooste, *Ibid*, at 647

CAPITAL MAINTENANCE RULE IN DELAWARE

6.1. INTRODUCTION

In the United State of America (USA) different state have adopted difference laws regulating corporations. Many states within the USA have adopted the Model Business Corporation Act, 1996 (MBCA).¹⁶⁴ Delaware is one of the states that have not adopted the MBCA and corporations in Delaware are regulated in terms of Delaware General Corporation Law (DGCL). Historically, prior to 1811, corporation could not form a corporation without legislative authority.¹⁶⁵ In 1875, New Jersey, was the first State to proclaim a general corporation statute which was copied by Delaware as is.¹⁶⁶ Over the year there was demise in the legal capital rule and new relaxed rules emerged.

In Delaware, the authorized capital of the corporation must be stated in its certificate of incorporation.¹⁶⁷ However, the DGCL does not require a minimum capital to be stated by the corporation. §151, of the DGCL, states that the stock can be issued with or without par value. Further, a stock of any class may be issued subject to redemption at the option of the corporation, the shareholders or the occurrence of a specified event.¹⁶⁸

The directors of the corporation can by resolution, determine that only part of the consideration to be received by the corporation for stock issues to be capital.¹⁶⁹ In case of a corporation with par value share, the amount to be determine as capital, must be at least equal to the aggregate of the issued shares and where the corporation has no par value share, the total capital must be

¹⁶⁴ Van der Linde, “*Aspect of Regulation of Share Capital and Distributions to shareholders*”, 2008, LLD, UNISA, at 78

¹⁶⁵ Richard Booth, “*Capital Requirements in the United States Corporation Law*”, 2005 Maryland Legal Studies Research Paper No. 2005-64, at 3

¹⁶⁶ Ibid, 4

¹⁶⁷ Van Der Linder, Ibid, 78

¹⁶⁸ § 151 (b) of the DGCL

¹⁶⁹ § 154 of the DGCL

in excess of the aggregate par value of the issued shares.¹⁷⁰ The corporation may by resolution increase the capital by transferring to the capital account, a portion of the net assets in excess of the amount determined as capital.¹⁷¹ However, the nonstock corporation shall have zero capital.¹⁷²

6.2 DISTRIBUTION

Distribution is regulated in a fragmented way in Delaware. There is no central definition of distribution.¹⁷³ The general rule in Delaware is that repurchases, redemptions and dividends may be made of surplus, to ensure that the state capital remains intact. Section 160 of DGCL provides for the corporation to purchase, redeem, receive, take or otherwise acquire, own and hold, sell, lend, exchange, transfer or otherwise dispose of, pledge, use and otherwise deal in and with its own shares. The ensuing condition for the purchase is that the such transaction cannot cause any impairment of the capital of the corporation.¹⁷⁴ Even with the non-impairment rule, distribution can be done out of capital, however, the reduction of capital must take place at the same time.¹⁷⁵

The directors of the corporation have the discretion to declare a dividend, as long as the article of incorporation provides for payment of dividend.¹⁷⁶ Payment of dividend may be declared out of surplus and if there is no surplus from the net profit of the corporation. Dividend that is paid out of profit in that current year is regarded as ‘nimble dividends’.¹⁷⁷ If the corporation has surplus as at time of the anticipated payment of dividend, the shareholders can demand that payment of dividend be effected.¹⁷⁸

¹⁷⁰ § 154 of the DGCL

¹⁷¹ § 154 of the DGCL

¹⁷² § 154 of the DGCL

¹⁷³ Van der Linde, “*Aspect of Regulation of Share Capital and Distributions to shareholders*”, 2008, LLD, UNISA, at 172

¹⁷⁴ § 160 (1) of the DGCL

¹⁷⁵ Van der Linde, “*Aspect of Regulation of Share Capital and Distributions to shareholders*”, 2008, LLD, UNISA, at 172

¹⁷⁶ § 170 (a) of the DGCL

¹⁷⁷ Van der Linde, “*Aspect of Regulation of Share Capital and Distributions to shareholders*”, 2008, LLD, UNISA, at 169

¹⁷⁸ Van der Linde, *ibid*, at 169

If the corporation's capital has been diminished by a devaluation of assets or by losses or otherwise, to an amount less than the aggregate amount of capital represented by the issued and outstanding stock of all classes having a preference upon the distribution of assets, the directors may not declare and pay dividends out of current profits without first making good the deficiency in the amount of capital represented by the preferred shares.¹⁷⁹ This rule protects the interests of preference shareholders by ensuring that the corporation cannot distribute dividends to its ordinary shareholders if its assets are insufficient cover the amount of its preferred shareholders.¹⁸⁰

Payment may be paid in cash, property or shares of the corporation. In case of payment from shares of the corporation, the amount must be designated as capital in respect of the share being declared as dividend. In the case of the par value share, this amount must be equal to the aggregate par value of the shares.¹⁸¹

Considering that distribution has an effect of reducing capital and in all instances where there is reduction of capital, the solvency test must be satisfied.¹⁸²

SHARE BUY-BACK CONCEPT

Section 160(a) of DGCL, empowered corporations to purchase, redeem, receive, take or otherwise acquire, own and hold, sell, lend exchange, transfer or otherwise dispose of pledge, use and otherwise deal in and with own shares. This was however dependent on the requirement that the corporation could not purchase or redeem its own capital stock for cash or other property when the capital of the corporation is impaired or if the transaction could cause an impairment of the capital of the corporation.¹⁸³ There is no specific definition of repurchase under the DGCL, however this include any acquisition by the corporation for consideration

¹⁷⁹ Van der Linde, *ibid* at 176

¹⁸⁰ van der Linder, *ibid*, at 177

¹⁸¹ Van der Linde, *ibid*, at 177

¹⁸² Van der Linde, *Ibid*, at 177

¹⁸³ § 160 (1) of the DGCL

and exclude redemptions.¹⁸⁴ Even though there is no specific provision regulating procedure for repurchase, the court in Delaware has distinguished between selective repurchases or discriminatory tender offers and *pro rata* self-tender-offer.¹⁸⁵ The procedure for repurchase has not been formulated in any Delaware corporation statute. There is no requirement for approval by the shareholders nor is there a requirement for proportionate repurchase and it is for this reason that there is no *pro rata* offer to all stock holders of a particular class.¹⁸⁶

The courts have formulated the proper purpose doctrine to ensure protection of corporations. The proper purpose for the repurchase must be for the best interest of the corporation.¹⁸⁷ This would exclude any repurchase that benefit the directors in their position. The exclusion to the proper purpose doctrine applies in the circumstances wherein shares are purchased from a single shareholder believed to be a threat to the corporation.¹⁸⁸ The proper purpose doctrine is also applied to curb any abuse of selective or non-proportionate repurchase.¹⁸⁹

The repurchased shares are regarded as issued and the corporation hold them as treasury shares. The treasury shares redeemed or purchased may be sold and the directors have discretion to determine the price and this could be below par value. Further, the shares held as treasury shares will not have any voting right nor will they be considered for the purpose of determining a quorum.¹⁹⁰ The alternative for holding shares as treasury, it to retire them or cancel them.¹⁹¹

A subsidiary may acquire shares in the holding corporation without complying with any restrictions. This can be deduced from the fact that the statute does not specifically exclude the

¹⁸⁴ Van Der Linde, “*Aspect of Regulation of Share Capital and Distributions to shareholders*”, 2008, LLD, UNISA, at 179

¹⁸⁵ Van Der Linde, *ibid*, at 179

¹⁸⁶ Van der Linde, *ibid*, at 180

¹⁸⁷ Van der Linde, *ibid*, at 181

¹⁸⁸ Van der Linde, *ibid*, at 181

¹⁸⁹ Van der Linde, *ibid*, at 181

¹⁹⁰ Van der Linde, *ibid*, at 183

¹⁹¹ Van der Linde, *ibid*, at 183

acquisition and the fact the legislation exclude the voting rights of shares held by another corporation of which the other corporation is the holding corporation.¹⁹²

APPLICATION OF SOLVENCY AND LIQUIDITY TEST

The solvency and liquidity test is applied differently in Delaware. The DGCL provide for the solvency test as regulated by §244(b). §244(b), provides that the corporation cannot effect the reduction of capital unless the assets of the corporation remaining after such reduction shall be sufficient to pay any debts of the corporation for which the payment has not been otherwise provided.

Distribution contrary to the solvency test requirement might result in the directors being held liable for breach of fiduciary duty. The directors who willfully and negligently violate the distribution and payment of dividend, shall be held jointly and severally liable to the corporation and the creditors in case of insolvency, to the full amount of the dividend unlawfully paid, or for the full amount unlawfully paid for purchase or redemption.¹⁹³ Payment will include interest from such time the liability occurred. Liability extend for a period of six years after the transgressing of § 160 and § 173.¹⁹⁴ The director who was absent or submitted a dissenting vote on the resolution may be exonerated from liability.¹⁹⁵

Stockholders who received the dividend or payment for the sale of redemption of their stock with knowledge of the contravention of § 160 and § 173, will be held liable.¹⁹⁶ Creditors are not entitled bring any action against stockholders for unlawful distribution, however, can institute action against the directors of the corporation in the event of insolvency.¹⁹⁷

¹⁹² Van der Linde, *ibid*, at 183

¹⁹³ § 174 of the DGCL

¹⁹⁴ § 174, DGCL

¹⁹⁵ § 174, DGCL

¹⁹⁶ Van der Linde, *ibid*, at 175

¹⁹⁷ Van der Linde, *ibid*, at 175

CONCLUSION

There are certain provisions on the regulation of capital maintenance in Delaware that are in contrast to South African law, in that: -

- Liability is extended for a longer period (six years).
- Shareholders are liable to refund the money paid from acquisition.
- Only shareholders who received dividend or payment for the sale of their stock with knowledge of the unlawfulness of the payment are liable.
- There is provision for a “proper purpose” doctrine.

THE CAPITAL MAINTENANCE RULE IN CANADA

7.1 INTRODUCTION

The reform in Canadian corporate law occurred in 1970. Prior to that corporation were established under the ‘letters patent statute and English model registration statute’.¹⁹⁸ The shift came in with the development of Canada Business Corporation Act of 1975 (CBCA). Most of the states in Canada adopted the CBCA.¹⁹⁹ The development of CBCA resulted in the abandonment of the patent model and the English model which were regarded as outdated.²⁰⁰

The following was said by Dickerson with regard to the support for the reform: -²⁰¹

“...they deal with the internal affairs of the organisation, the content of the articles of incorporation, the rights of the shareholders, the powers and liabilities of the directors, the authorised number and variety of the share, the holding of meetings restrictions on corporate finance, such as the withdrawal of funds by way of dividends and share repurchases”

7.2 DISTRIBUTION

Payment of dividend was not a point of concern in Canada during the sixteenth and seventeenth century, when capital raising and profit distribution was allowed under each voyage or venture.²⁰²

Payment of dividend originated as a result for the need to regulate distribution of corporate earnings.²⁰³ Historically, the focus was on permanent capital structure and partial retention of

¹⁹⁸ Welling, “*Corporate Law in Canada: The Governing Principles*” Scribblers Publishing, 2006, at 44

¹⁹⁹ Welling, at 44

²⁰⁰ Welling, at 55

²⁰¹ Welling, at 56

²⁰² Welling, at 626

²⁰³ Welling, at 626

earnings in corporation and this imposed an obligation on the directors to determine the amount and time at which profit can be distributed.²⁰⁴

Some Canadian statutes have addressed the issue of payment of dividends by providing for statutory enactment that allowed for payment of dividends of shares. Other states have imposed an obligation on corporation to provide for one class of shares that has rights attached to it for payment of dividend.²⁰⁵

Welling argues that some Canadian statutes like CBCA, make mention of dividend which create an assumption that dividend can be paid.²⁰⁶ Generally, payment of dividends is not guaranteed. Shareholder could not require corporation to pay a dividend. The power to declare dividend was bestowed on board of directors and had to be provided for in the corporate's constitution.²⁰⁷ The requirement was, when deciding to pay the dividend, the directors must satisfy themselves that paying the proposed dividend will be in the best interest of the corporation.²⁰⁸ The decision by board of directors is fiduciary in nature. The limitation on the power to declare a dividend is that such decision must be exercised in good faith and in the best interest of the corporation.²⁰⁹ This flows from the common law duties of the directors.

In dealing with payment of dividend, the Canadian courts were divided on whether payment of dividend can be categorised as a gift. The judge in the case of tax case of *Gestion Yvan Drouin v Canada* (2000) 12 BLR 3d 21 (Tax CC), indicated that, "dividends payment was not gratuitous because the corporation had received 'consideration' in the form of capital contribution by the shareholder".²¹⁰ However, it was noted that the judge didn't suggest that corporation is legally bound to pay dividends, because if there was a legal obligation, that would be debt capital and this would be a violation of corporate capital structure.²¹¹ The

²⁰⁴ Welling, at 626

²⁰⁵ Welling, at 627

²⁰⁶ Welling Footnote 97, at 627

²⁰⁷ Welling, at 627

²⁰⁸ Welling, at 628

²⁰⁹ Welling, at 628

²¹⁰ Welling, Footnote 104, at 628

²¹¹ Welling, at 628

Supreme Court of Canada on the other hand indicated that, dividend is, in effect, a gift from the corporation to its shareholders and the following was emphasised:- ²¹²

“...this means that dividends should be seen to be a narrow, legalistic view: corporate gifts...permissible only to the extent that the directors think that it will serve the corporate entity’s best interest, as they then perceive those interests; beyond this, the declaration of any dividend, like any other unauthorized gift of corporate, is a breach of directors’ duty”.

Once a corporation declares a dividend, it becomes a debt payable by corporation to the shareholders. Most Canadian corporate statutes provide for payment of dividends in a form of money or property.²¹³ Section 43 (1) of CBCA²¹⁴ provides that “A corporation may pay dividends by issuing fully paid shares of corporation and, subject to section 42, a corporation may pay a dividend in money or property”.

Another way of paying dividends was done by issuing shares of the corporation. This must however, conform to statutes and requirements for payment of dividends. Consequently, ‘the stated capital account is adjusted to reflect the market price of the newly issued shares.’²¹⁵ however, this must be statutorily and constitutionally authorized.²¹⁶

The tax implication on the dividends payment is that inter-corporate dividends are tax exempt whereas dividend paid to individual shareholders attracts tax.²¹⁷ Another consideration to be made relate to share equality. The general rule is that, unless specified otherwise in the corporate constitution, all shares carry equal right to dividends.²¹⁸

²¹² Welling, at 628

²¹³ Welling, at 629

²¹⁴ Canadian Business Corporation Act, 1975

²¹⁵ Welling, at 630

²¹⁶ Welling, at 630

²¹⁷ Welling, at 630

²¹⁸ Welling, at 632

There is an exception with regard to payment of dividends. The solvency rule may inhibit payment of dividends.²¹⁹

7.3 SHARE BUY-BACK CONCEPT

The 1970 reform brought a lot of major changes within the Canadian corporation environment. The CBCA does regulate the acquisition of own shares by corporation and subsidiary. Section 30 (1)²²⁰ prohibit corporation from holding shares in itself or in its holding body corporate. Further, it prohibits the subsidiary bodies corporate from acquiring shares of the corporation.²²¹

The Act imposes an obligation on the corporation to cause the subsidiary body corporate that hold shares of the corporation to sell or otherwise dispose of those shares within five years from the date the body corporate became a subsidiary of the corporation.²²² This is means to ensure that the provisions of section 30(1) of the CBCA are complied with.

There is an exception to the provisions of section 30 (1) CBCA, in that the corporation is allowed hold shares in itself if that is done in a capacity of a personal representative. However, neither the corporation nor the subsidiary can have beneficial interest in the shares.²²³ Further, the corporation may hold share in itself or in its holding body corporate if the purpose thereof is to provide security in the transaction entered into in the ordinary cause of business that included the lending of money.²²⁴

The purchase or acquisition by corporation of its own shares is further regulated by section 34 of the CBCA. There are limitations in that, the corporation cannot make any payment to purchase or otherwise acquire shares issued by it if there are reasonable grounds for believing that the corporation is, or would after the payment be, unable to pay its liabilities as they

²¹⁹ Welling, at 634

²²⁰ Canadian Business Corporation Act, 1975

²²¹ Section 30(1) of the CBCA

²²² Section 30(2)

²²³ Section 31(1)

²²⁴ Section 31(2)

become due; or the realizable value of the corporation's assets would after the payment be less than the aggregate of its liabilities and stated capital of all classes.²²⁵

The corporation can acquire shares in itself in other forms. The corporation can if authorized by its article, acquire shares to settle or compromise a debt or claim asserted by or against the corporation; to eliminate fractional shares; or fulfil the terms of a non-assignable agreement under which the corporation has an option or is obliged to purchase shares owned by a director, an officer or an employee of the corporation.²²⁶ Further, a corporation may purchase or otherwise acquire shares issued by it to satisfy the claim of a shareholder who dissents under section 190; or comply with an order under section 241.²²⁷

With regard to the redemption of shares, the corporation may, if authorized by the articles and has met certain requirements as set out in the CBCA, purchase or redeem any redeemable shares issued by it at prices not exceeding the redemption price thereof stated in the articles or calculated according to a formula stated in the articles.²²⁸ This is however subject to the corporation satisfying the solvency requirements.²²⁹

It must be noted that, once the shares are acquired or redeemed, such shares are cancelled to the become authorized unissued shares.²³⁰

7.4 APPLICATION OF THE SOLVENCY AND LIQUIDITY TEST

For payment of dividend to be compliant, the corporation should believe that the corporation is or would after the payment be able to pay its liabilities as they become due or the realizable value of the corporation 's assets would thereby be less than the aggregate of its liabilities and

²²⁵ Section 34(1) – (2)

²²⁶ Section 35(1)

²²⁷ Section 35(2)

²²⁸ Section 36(1)

²²⁹ Section 36(2)

²³⁰ Section 37(5)

stated capital of all classes.²³¹ The first part of the test relates to cash-flow. This means that the directors need to assess and predict how the cash flow with regard to payment of debts would be like at the time at which the dividends are paid.²³² The second part of the test is an estimation of the value of the assets of the corporation.²³³ The concern is that for most corporation is might be difficult to predict the realizable value of their capital assets on a day- to- day basis.²³⁴

Liability follows directors who authorize payment of dividends contrary to the provisions of the CBCA. Section 118(2) (c)²³⁵ impose joint and several liability to directors who consent to resolution authorizing payment of dividend contrary section 42. The question is whether the innocent shareholders should be obliged to repay the dividends received from irregular payment. Section 118(4) and (5),²³⁶ provide limited recovery from the shareholders who received the dividend. The obligation is on the directors to pursue the shareholders.

The enforcement of repayment of money paid to the shareholders is only available as provided for in the statute. The statute grants the judge, discretion to order or withhold any contribution that seem appropriate.²³⁷

With regard to acquisition of own shares, the corporation will be prevented from making any payment for the acquisition of shares if there is a reasonable ground that the corporation at the time of payment or after payment, be unable to meet its liabilities as they become due. This entail assessing the liquidity of the corporation. The solvency part of the test requires that the realizable value of the corporation's assets would after the payment be less than the aggregate of its liabilities and its stated capital of all classes.²³⁸ This is a subject valuation and the concern is that the directors may not be able to make this determination, more particular considering that the company can have both tangible and intangible assets.

²³¹ Section 42

²³² Welling, at 642

²³³ Welling, at 642

²³⁴ Welling, at 642

²³⁵ CBCA

²³⁶ CBCA

²³⁷ Welling, at 645

²³⁸ Section 32

With regard to redemption of shares, the solvency requirements are slight different to those relating to the acquisition of own shares. The test requires in addition to the aggregate liabilities, the corporation consider the aggregate of the amount required for payment on a redemption or in a liquidation of all shares the holders of which have the right to be paid before the holders of the shares to be purchased or acquired, to the extent that the amount has not been included in the liabilities.²³⁹

7.5 CONCLUSION

The regulations of distribution and acquisition of own shares in South African Law is more structures even though it has its own flaws. The application of the solvency and liquidity is slightly different in Canada. The corporation only considers the solvency element of the test and not the liquidity element of the test. As with South Africa, liability is imposed to directors for contravention of the provision of the Act with regard to unlawful payment of dividends. Share buy-back is only allowed in limited circumstances, like in a capacity of a personal representative or if providing security.

²³⁹ Section 37(2)

CONCLUSION AND RECOMMENDATIONS

8.1 CONCLUSION

The objective of the study was to determine if the new era of regulation of the capital maintenance rule provides protection to both creditors and shareholders equally. Further, to determine how the capital maintenance rule is applied internationally, focusing on Delaware and Canada. Having considered the provisions of the maintenance rule as applied historically and the requirements as set out in the provisions of the Companies Act, 2008, it can be said that the rule has undergone a radical overhaul.

Even with the remnant of the capital maintenance rule still lingering, there has been a major overhaul of the capital maintenance principle over the years. The current provisions as contained in the Companies Act, 2008, do have some anomalies. There are certain school of thought as advocated by Van der Linde, that, the solvency and liquidity test over-protects the creditors. The best option would have been to balance the interest of the creditors to those of shareholders. The shareholders have been left with limited protection, more particularly considering the power given to the board of directors with regard to the reduction of capital of the company. Further, unlike the Companies Act, 1973, there is no provision to inform the shareholders of the envisaged distribution or acquisition, save for the acquisition affecting directors and inter-related parties. The imposition of liability to directors meant to offset their powers, might be challenging in that liability will only follow directors who participated in the authorisation of distribution and for implementing distribution contrary to the provisions of the section 46 and section 48 of the Companies Act, 2008.

The MOI provisions which could have provided cushion to limit the powers of the directors. Of major concern is that the scholars are divided on whether the authority of directors can be curtailed by an insertion in the MOI. This relates to whether the provisions of section 46 and section 48 of the Companies Act, 2008, are an alterable provision or not.

Defining ‘distribution’ in section 1 of the Companies Act, 2008, has benefits, however, there are issues that must be addressed within the definition itself. The application of distribution to the group of companies can result in some undesirable results. It is not clear whether distribution is ‘in respect of the shareholding and this need to be clarified. The exclusion of the of acquisition of shares under the appraisal remedy can result in minority shareholders being preferred and further payment will have to be done for the shares irrespective of the financial position of the company.

Internationally, Delaware applies the non-impairment rule and the ‘proper purpose doctrine’ for the regulating distribution and share buy-back. This concept is non-existent in South African legislations. Further, the application of the solvency and liquidity test in Delaware is different as the corporations only applies the solvency test. Solvency test in Delaware is regulated in the Bankruptcy Code and the application of the test in capital reduction evolved from case law.

Canadian law also highlights some challenges in defining the solvency of the corporation, unlike South Africa wherein guideline is provided for the books of account that must be considered in determining the solvency of the company, Canada does not have the similar provision. Companies have to consider both tangible and intangible assets in assessing the solvency of the company.

8.2 RECOMMENDATIONS

- The solvency and liquidity test must also be applied in payment under the appraisal remedy. The directors must be allowed to approach the court to stay any payment in the event such payment will result in a company falling foul of the solvency and liquidity test.
- The definition of ‘distribution’ needs to be clarified to address the anomalies indicated above.
- The redemption of shares must also be included in the definition and regulation of distribution, more particularly, redemption at the option of the company.

- Shareholders should be involved in certain instances more particularly considering that, capital reduction has an effect of changing ownership of the company.

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