



Siber Ink

This copyright protected work from Siber Ink Publishers is licensed under a Creative Commons Attribution Non-Commercial No-Derivatives 3.0 Licence. In essence, you are free to share it with others provided the original source and author(s) are attributed, no commercial use is made of it, and no derivatives are made from it.



You are free:

- to share — to copy, distribute and transmit the work

Under the following conditions:

- Attribution — You must attribute the work in the manner specified by the author or licensor (but not in any way that suggests that they endorse you or your use of the work).
- Non-commercial — You may not use this work for commercial purposes.
- No Derivative Works — You may not alter, transform, or build upon this work.

With the understanding that:

- Waiver — Any of the above conditions can be waived if you get permission from the copyright holder.
- Public Domain — Where the work or any of its elements is in the public domain under applicable law, that status is in no way affected by the license.
- Other Rights — In no way are any of the following rights affected by the license:
 - •Your fair dealing or fair use rights, or other applicable copyright exceptions and limitations;
 - •The author's moral rights;
 - •Rights other persons may have either in the work itself or in how the work is used, such as publicity or privacy rights.

Notice

For any reuse or distribution, you must make clear to others the license terms of this work. The best way to do this is with a link to this web page:

<http://creativecommons.org/licenses/by-nc-nd/2.5/za/>

chapter 2

two essential keys to unlocking the act

The Act contains a host of new rights, obligations, remedies, procedures and sanctions, many of which are innovative, and some of which may even be termed revolutionary. A large number of these innovations are based on two fundamental decisions taken by government. The first, a philosophical decision, was to adopt the 'enlightened shareholder value' model. The second was to forbid the formation of new CCs and, instead, to attempt to ensure that the Act caters for the needs of small businesses at least as well as the CC Act.

These two decisions and their profound impact on the Act are explained below.

2.1 Adoption of the enlightened shareholder value model

As the power and influence of the private sector, in particular the multinational company, has grown, the fundamental philosophical question as to the role of a company in society has become increasingly vexed. During the past 20 to 30 years, strong arguments have increasingly been made, and by and large accepted, that companies should be compelled to care about more than just maximisation of profits for their shareholders. Intense debates on this subject preceding the Act's finalisation saw discussion of different models of a company's (and, therefore, its directors') duties and responsibilities. These debates and models are evidence that company laws are integral to the macro-economic policies of South Africa's various political groupings and, therefore, to the South African economy as a whole. There are three fundamental models:

- The *classic* model holds that a company's duties are essentially to promote and protect the interests of its shareholders only, to the exclusion of all its other stakeholders, including its employees. The 1973 Act was based on this capitalistic model.
- The *pluralist* model sets the interests of stakeholders as an 'end in themselves', requiring a company to continuously balance the interests of all its stakeholders and to prefer the interests of one stakeholder above those of another only where it is in the best interests of the general body of stakeholders to do so. This holistic approach was advocated by the Congress of South African Trade Unions in debates on the Act.

- The *enlightened shareholder value* model, like the classic model, puts the interests of shareholders first, but holds that in pursuing shareholders' best interests in the long term the interests of all other stakeholders, including employees, suppliers and creditors, as well as the environment and the community at large, must be considered. The 'triple bottom line' concept — that it is good for business for companies to be good corporate citizens and to consider social, environmental and economic interests — was favoured by the 2002 King Report on Corporate Governance ('King II'). King III goes somewhat further by recommending that companies strive to achieve the correct balance between their various stakeholder groupings in order to advance the interests of the company. The principles of the King Code are not legally binding except, to some extent, in the case of companies listed on the JSE.

The enlightened shareholder value model has been adopted by the Act, as it has been by most Western countries, including the UK in its 2005 Companies Act. The DTI's stated approach in the 2004 Policy Paper was that, in developing new companies legislation, it would be guided by a legislative framework that

'reflects the recognition that the company is a social as well as an economic institution, and accordingly that the company's pursuit of economic objectives should be constrained by social and environmental imperatives'.

On the face of it, the definition of a 'profit company' in s 1 of the Act as 'a company incorporated for the purposes of financial gain for its shareholders' contradicts this philosophy. It certainly does evidence the fact that the primary duty of the directors of a profit company remains that of maximising profits for its shareholders, but it is equally certain that this duty is severely tempered by a host of other provisions which confer rights on, and impose obligations on companies towards, all their other stakeholders.

The Act has partially codified the common-law fiduciary duties of directors, the most important of which requires that directors 'act in the best interests of the company'. Protagonists of the pluralist approach argued that the Act should spell out exactly what this duty entails and that it should include social and environmental responsibilities. The position taken by government was to embrace the enlightened shareholder value model, but not to legislate on the specifics as to what a director's duty to act in the company's best interests means. Instead, government has chosen to leave it to our courts to determine the ambit of directors' duties through the development of our common law. It also concluded that the manifestation of the enlightened shareholder value model in various new provisions of the Act, particularly those which give stakeholders significant new rights and remedies, coupled with the rights and remedies given to stakeholders by numerous other statutes, provided sufficient protection for them. It decided that this approach, coupled with the self-regulating principles

of the King Code, should encourage companies to comply not just with the letter of the law but with the spirit of good corporate governance.

Protagonists of the pluralist approach also argued that a voluntary self-regulating approach such as the enlightened shareholder value model disregards the fact that companies are legally bound by the Bill of Rights in terms of s 8(2) of the Constitution. Therefore a specific duty should be included for directors to realise and comply with fundamental human rights in the Constitution and the Bill of Rights to the extent that companies are required to do so. This did not happen, but there are nevertheless a number of provisions of the Act which refer to sections of the Constitution. For example, s 7(a) states that one of the purposes of the Act is to ‘promote compliance with the Bill of Rights in the application of company law’.

The adoption of the enlightened shareholder value model has resulted in a host of new provisions being introduced into the Act to give effect to it. It is epitomised in s 7(a), (b)(iii) and (d), which state that two other purposes of the Act are to:

- ‘promote the development of the South African economy by encouraging transparency and high standards of corporate governance as appropriate, given the significant role of enterprises within the social and economic life of the nation’; and
- ‘reaffirm the concept of the company as a means of enhancing economic and social benefits’.

Section 7 is given legal backing by s 5(1), which states that the Act must be interpreted ‘and applied’ in a manner that gives effect to these purposes.

Another important innovation occasioned by this new approach is the obligation of public and certain other companies to have a social and ethics committee.

John F Olson describes the Act’s corporate social responsibility model as follows:

‘Over the past twenty years, corporate governance has seen a surge in interest with regard to corporate responsibilities to society. Often, these interests have not been embedded in statutes but instead have been implemented through guidelines and codes. The Companies Act directly provides a clear framework for the empowerment of stakeholders and includes a directive that companies operate to enhance not only shareholder-profits but also societal welfare. To ensure that these purposes are fulfilled, the South African Government is provided greater power in governance decisions than is typically found in most other general corporate statutes.’¹

¹ ‘South Africa moves to a global model of corporate governance but with important national variations’ in Tshepo H Mongalo (ed) *Modern Company Law for a Competitive South African Economy* (Juta 2010) 219.

The Act also gives significantly greater rights and remedies to stakeholders, including minority shareholders, and thus encourages stakeholder activism. Two of the most striking — even alarming, in some instances — aspects of the Act are:

- the number of remedies it provides, in particular the number of remedies it provides to minority shareholders, employees and directors; and
- the number of methods by which its remedies may be enforced.

In both these respects the Act generally goes further than the companies legislation of other Western countries, including the USA and the UK. Unfortunately this could lead to increased litigation and a fair amount of ‘remedy shopping’.

2.2 Phasing out of the CC and the advent of the ‘new’ small private company

The 1973 Act was designed primarily to cater for the requirements of large companies; it ignored the economic and administrative difficulties faced by the small business. It is for this very reason (ie, to cater for the small business) that the CC Act was enacted as far back as 1984. In stark contrast, the Act attempts to cater for the requirements of companies of all sizes — a ‘one size fits all’ approach.

Government has taken the in principle decision to scrap the CC and instead ‘provide [in the Act] for a company structure that reflects the characteristics of a CC’. It has, however, kept its options open by leaving the CC Act intact for the time being, but on the basis that new CCs are now forbidden — no new CCs may be formed, nor may companies be converted into CCs. It is envisaged that this mechanism will result in CCs becoming obsolete within the next 10 years.

In the 2004 Policy Paper the DTI explained its rationale for the abolition of the CC as follows:

‘[T]he current division between close corporations . . . and . . . companies offers limited opportunities for progression from one form of company to another and has resulted in distrust by financiers of close corporations . . . [I]t is necessary to move away from the largely artificial separation between the different business forms, to recognise only one formal business vehicle and to provide for a simple, easy company formation process.’

CCs today comprise the overwhelming majority of all limited liability entities in South Africa. They outnumber companies by about eight to one. Given the indisputable popularity and success of the CC as a limited liability vehicle for use, in the main, by small businesses, one of the DTI’s top priorities was to ensure, as best it could, that the ‘new’ small private company, which has effectively replaced the CC, is at least as easy and cheap to create, maintain and administer as a CC in all its facets, yet is as much a private company as any other — not an easy task.

There are two fundamental differences between a private company and a CC:

- A private company issues shares which evidence a person's participation in the equity and control of a private company. A CC does not issue any type of instrument. One merely holds a 'member's interest' in a CC, akin to having an equity participation in a partnership.
- A private company has shareholders and directors. The powers of, and in relation to, a private company are separated between those of its shareholders and those of its directors. A CC has members only, who have absolute power in relation to all aspects of the CC and its business.

The DTI was thus faced with this problem: how do you create a private company which closely resembles a CC without scrapping the essential requirements that a company must have shares and directors?

The burden of a small company having to have shares is not removed by the Act but is alleviated in three ways:

- for the first time, the Act allows directors to be given the power to determine nearly all aspects of the share structure of a company, including the number of, and the rights attached to, a company's authorised and issued shares, as well as the power to buy back the company's shares;
- almost all of the complex provisions of the 1973 Act which placed severe restrictions on the ability to alter a company's share structure have been removed; and
- the provisions of the Act governing shares are far more flexible than those of the 1973 Act.

These innovations simplify and therefore considerably reduce the costs of corporate governance and administrative processes in relation to most aspects of a company's shares.

As far as the division of powers between shareholders and directors is concerned, the DTI's solution was this: allow directors to have the same powers as shareholders, but ensure that control of the company, including control of the composition of the board of directors, remains with the shareholders exclusively at all times. The Act has implemented this solution by giving directors far greater powers than they had under the 1973 Act, but also by

- giving shareholders the overriding right to revoke, restrict or modify most of these new powers at any time simply by amending its constitution, now called its 'Memorandum of Incorporation' ('MOI'); and
- ensuring that the most crucial powers of control of a company are still vested exclusively in its shareholders, namely the power to amend the MOI, to appoint at least 50% of the directors, to remove directors, to issue shares to directors, to implement any fundamental change to the company or its business, and to wind up the company.

Because these increased powers of directors are unprecedented in South African companies legislation, a person reading the Act for the first time is left somewhat confused as to the division of powers of, and in relation to, the company between its shareholders and directors. Until now this division of powers was quite clear-cut. Invariably shareholders alone had the power to determine the make-up of every aspect of the company's shares or other equity instruments. They also usually had the sole right to decide on issues that were outside the ordinary course of conduct of the company's business. Directors, on the other hand, were charged with the duty, and had the power, to manage and control the company's day-to-day business operations, including representing the company in transacting with third parties. The answer to this confusion lies mainly in the use of the phrase 'Except to the extent that a company's Memorandum of Incorporation provides otherwise' (and variations thereof), which forms the precursor to numerous sections of the Act. These sections form part of what are defined in s 1 of the Act as 'alterable' provisions, by which is meant in the present context that any power given to directors in terms of any provision of the Act which embodies these words may be revoked, restricted or modified by shareholders at any time. In other words, shareholders can decide at any time not to give the directors a particular power, but if they do not make that decision, the directors will automatically be vested with the power in question by default. Moreover, and importantly, a positive act by the shareholders is required — their decision must be formally adopted by way of incorporation of it in the MOI pursuant to the passing of a special resolution. If shareholders do not revoke, restrict or modify any of these powers in this manner, they will, by default, give directors the greatest powers the Act allows. This mechanism achieves two crucial goals:

- the powers of shareholders and directors can be either partially or substantially interchanged (or even merged if the shareholders and directors are the same person(s)), resulting in a control structure which is flexible enough to reflect most (but not all) of the characteristics of the control structure of a CC; and
- the MOI of a small company can be a much shorter and far simpler document than that of a large company because its shareholders will not wish to amend any of the 'alterable' provisions of the Act in most cases. In this context, therefore, the MOI of the small company will be the relevant sections of the Act itself. This is essential because the biggest delay in and cost of incorporating a small company would otherwise be the drafting of its MOI.

There are over 50 'alterable' provisions in the Act.

The default or 'alterable' provisions mechanism alone does not, however, enable the small company to effectively adopt the applicable sections of the Act as its MOI because the MOI must deal with more than just the respective

powers of its shareholders and directors. It must also deal with other matters, the most important of which is corporate governance — the governance of meetings and decisions of shareholders and directors. To cater for the small company once again, the sections of the Act which deal with these governance matters are far more comprehensive and detailed than the corresponding provisions of the 1973 Act. In fact, the 1973 Act was silent on most of these matters; they were generally dealt with in the Articles of Association ('the Articles'). The main sections of the Act to which this reasoning has been applied are ss 58–65 (meetings and resolutions of shareholders) and ss 66–73 (constitution, powers and meetings of the board). Many of these sections also have considerable flexibility to cater for the numerous forms of governance structures which a small or medium-sized company may wish to adopt. For example, s 65 allows the MOI to require a higher percentage than 50,1% of voting rights to approve an ordinary resolution and/or a different (ie, a higher or lower) percentage than 75% of voting rights to approve a special resolution, but there must always be a margin of at least 10% between these two percentages.

The combined effect of the 'alterable' provisions mechanism and the detailed governance sections of the Act is that the small company's MOI can be a simple, short document which effectively states that the company adopts the applicable sections of the Act as its MOI. This will simplify, cheapen and accelerate the formation and registration procedure for a small company considerably. The MOIs of public and medium to large private companies will be lengthy documents. Five standard form 'short' and 'long' MOIs for profit and NPCs are contained in Forms CoR 15.1A and B (profit companies) and Forms CoR 15.1C, D and E (NPCs) which are annexures to the Regulations.

The 'alterable' provisions approach to accommodating the small company has met with criticism. Critics are particularly concerned that it could severely prejudice the rights of minority shareholders in large unlisted companies and thus have a detrimental effect on the private equity market. This criticism has merit because, unfortunately and ironically, an unintended consequence of the 'alterable' provisions mechanism is that minority shareholders in medium and large unlisted companies could be left with fewer protections against the majority shareholders or the board, or both, than they had under the 1973 Act. They argue that the Act now enables the rights of minority shareholders to be significantly eroded because it requires them to have an unrealistic knowledge of the company's MOI in order to safeguard certain of their powers and rights as shareholders which they hitherto took for granted — and which, in the case of large companies, even the authors of the Act would agree, they should be fully entitled to take for granted. This leaves the Act open to abuse by unscrupulous majority shareholders and their nominated directors except for listed companies because their MOIs must comply with the Listings Requirements and the JSE has already amended its Listing Requirements to the effect that most of the

new powers given to directors must be excluded from a listed company's MOI. In other words, what may be good for the small company may be very bad for the medium and large unlisted company. Some critics have even expressed concern that the uncertainty surrounding this issue could discourage foreign investment in South African unlisted companies. Some examples:

- Under the 1973 Act a company had to have a specified number of authorised shares. This obligation protected shareholders because directors could not issue shares in excess of the number of authorised shares without shareholder approval. The Act now empowers the directors to increase or reduce the number of authorised shares without shareholder approval, unless the MOI provides otherwise. If the MOI does not, this shareholder protection is lost.
- Under the 1973 Act a company could not issue shares without shareholder approval. The Act now gives the directors the power to issue shares without shareholder approval up to a maximum of 30% of the voting power of all shares of that class of share. Minority shareholders of unlisted public companies do not have pre-emptive rights over these shares (i.e., the right to acquire these shares before they may be issued to any third party). These minority shareholders thus have no protection in relation to share issues up to this 30% level, unless the MOI provides otherwise.

Countering a possible erosion of minority shareholders' rights are some groundbreaking, powerful new remedies available to aggrieved minority shareholders and other stakeholders. Hopefully these will prove to be an effective deterrent to abuse by directors, who have these extraordinary powers.

There are also some 'unalterable' provisions of the Act which limit the powers of directors. They constitute the fundamental or 'core' provisions upon which the rest of the Act is based. They usually commence with the words 'Despite anything to the contrary in a company's Memorandum of Incorporation'.

What is abundantly clear from the above is that the MOI of an unlisted company, whether it be a public or a private company, is now a crucial document that investors, creditors and other stakeholders must carefully review as a matter of course in order to ascertain, among other things, whether or not the 'customary' rights and powers of shareholders remain intact.