

COMPANY LAW MATTERS

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Countdown to the coming into operation of the new Companies Act

The new Companies Act 71 of 2008 (the Act) was given presidential assent on 9 April 2009. Companies now find themselves in a 'hurry up and wait' situation, in anticipation of the next step, which is that the President must fix the date on which the Act will come into operation. The latest indication from the Department of Trade and Industry (the DTI) is that the Act will only come into operation in the latter half of 2010.

The delay can be attributed to a number of factors:

Firstly, the Minister of Trade and Industry can make regulations in respect of various matters including the forms required to be used for purposes of the Act as well as matters relating to the functions of the Take-over Regulation Panel. The DTI is in the process of preparing these regulations, which will have to be published for public comment before they are finalised.

Secondly, in terms of the Act, a number of new institutions must be established, such as the Companies Tribunal, and some existing institutions must be transformed. For example, CIPRO must be transformed into the Companies and Intellectual Property Commission and the Securities Regulation Panel must be changed to the Takeover Regulation Panel.

Furthermore, it is also possible and likely that certain amendments will be made to the Act in order to address certain obvious inconsistencies and to streamline the transition process.

Anyone that manages or advises companies would be wise to use this time to prepare for the transition and acquaint themselves with the provisions of the Act.

The Act moves away from memoranda and articles of association of companies and introduces the concept of a memorandum of incorporation (MOI). All companies will, at no charge, be able to replace their existing memoranda and articles of association with a MOI within the first two years of the Act coming into operation. A number of undesirable consequences could result for companies that fail to effect these changes after the two year period has elapsed.

All companies may also need to revise their shareholder agreements as the Act allows shareholders to enter into agreements with each other concerning any matter relating to the company, provided that the agreement is consistent with the Act.

Companies should consider adopting incidental rules relating to the governance of a company as contemplated in the Act. The tax consequences arising from any changes to the MOI and share capital structure of a company will need to be considered.

It is also likely that some of the JSE listing requirements will have to be amended before the Act comes into force.

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Cliffe Dekker Hofmeyr is fully conversant with the changes to the Act and positioned to offer its clients a comprehensive strategy to prepare for the coming into operation of the Act, tailored to a

client's specific needs.

Tessa Brewis, Senior Associate and Peter Kituri, Candidate Attorney

Board committees in the new Companies Act

It is common practice for directors to delegate their authority to one or more board committees. For some companies it will be a statutory requirement in terms of the Companies Act No 71 of 2008 (the Act) to have an audit committee and a social and ethics committee.

Section 94(2) of the Act makes it compulsory for a public company, state-owned company, or a company that has voluntarily determined to do so, to have an audit committee.

Section 72(4) of the Act provides that certain companies will also be obliged to have a "social and ethics" committee. The Minister may in terms of these provisions prescribe by regulation that a company or category of companies must have such a committee if it is, among other things, *"desirable in the public interest"*. The nature and purpose of this committee is still unclear and will hopefully be clarified when the regulations are published.

A company may (except to the extent that its memorandum of incorporation provides otherwise) appoint any number of committees of directors and delegate its authority to such board committees in terms of section 72. This section is of a general nature and does not prescribe what type of board committees (other than an audit and social and ethics committee) a company must or should have.

As there are no limitations, a board will be entitled to delegate any authority in its discretion to a board committee. In this regard it is stated that a board committee *"has the full authority of the board in respect of a matter referred to it"*.

This does not mean that directors can hide behind board committees, or in any way dissipate the discharge of their duties and responsibilities.

Section 72(3) clearly states that the implementation of board committees alone will *"...not alone satisfy or constitute compliance by a director with the required duty of a director to the company, as set out in section 76"*.

Section 76 in turn contains provisions under the heading *"Standards of directors conduct"*, which creates certain statutory requirements for directors to fulfill their duties towards the company.

An interesting provision is that section 72(2)(a) provides that a board committee (except for an audit committee, which must consist only of directors) may include persons who are not directors of the company. Such a person must, however, not be ineligible or disqualified to be a director and will not be entitled to vote on a matter to be decided by the committee.

The fact that a non-director member will not have any voting rights may make it unattractive to serve on a board committee, especially if the risk of liability to act in such capacity is taken into account. The effect is in any event that the majority of members on a board committee will have to be directors in order to effectively operate and take decisions.

It is important to note that the provisions of sections 75, 76 and 77 of the Act will apply not only to directors, alternate directors or a prescribed officer, but also to all other members of a board committee. This means that board committee members will have the same statutory duties as directors of a company and board committee members will have to act accordingly in order to avoid liability.

Johan Coetzee, Director

Wider powers (and duties) for audit committees

The concept of audit committees is not new to South African company law - the obligation to appoint an audit committee was brought into the Companies Act No 61 of 1973 (the current Act) by way of the introduction of section 269A during 2006. According to the current Act, a "widely held" company is obliged to have an audit committee.

The same obligation is repeated in section 94 of the Companies Act No 71 of 2008 (the new Act), but the wording of the relevant section differs in some important respects from the current Act.

Section 94(2) of the new Act makes it compulsory for a public company, state-owned company, or company that has voluntarily determined to do so, to have an audit committee. The first important difference is that an audit committee is no longer appointed by the board of directors, but by the company at each annual general meeting.

The fact that the shareholders will appoint the audit committee inadvertently leads to the question as to whether or not the audit committee is still a board committee in the normal sense. This seems to differ from a normal board committee as envisaged in section 72 of the new Act, which provides that the board may delegate any of its authority to any number of committees of directors.

It could be argued that if shareholders appoint an audit committee, it will create another statutory governance structure in a company, which could in certain instances restrict and overlap with the powers of the board of directors. It should be remembered that audit committee members may only consist of directors. A director who is an audit committee member will have additional powers and corresponding additional duties to take into account.

The following changes contained in the new Act are highlighted:

- The somewhat confusing concept of a "widely held" company is not retained in the new Companies Act - the well-known concept of a public company is used again.
- An audit committee must consist of three non-executive directors (compared to the current requirement of two non-executive directors who "*must act independently*").
- The concept of a non-executive director is extended to exclude any prescribed officer or full-time executive employee of the company and a material supplier of the company.

- The concept of an independent director as seen in the current Act is also substituted for the concept that a director may not be "*related*" to any such person.

The definition of "*related*" in respect of an individual includes marriage or living together in a relationship similar to marriage, separated by no more than two degrees of natural or adopted sanguinity or affinity and if that individual directly or indirectly controls another juristic person.

The Minister may further prescribe minimum qualification requirements for members of an audit committee. These requirements would ensure that the committee taken as a whole comprises persons with adequate relevant knowledge and experience to equip the audit committee to perform its functions.

Some of the duties of an audit committee have also been amplified, namely:

- it must not only determine which non-audit services the auditors may provide, but also those that the auditors may not provide;
- the annual audit committee report must also include comments on the financial statements, accounting practices and internal financial control of the company;
- it may make submissions to the board on any matter concerning the accounting policies, financial control, records and reporting; and
- some of the other functions the audit committee must perform include the implementation of policies in respect of risk management, control and governance processes within the company. These duties are examples of where there may be an overlap and possible conflict with board duties. Will the risk committee have to report to the audit committee, or will it still be a normal board committee with delegated powers reporting to the board?

The responsibilities of audit committees have been substantially increased in terms of King III (this will be discussed more comprehensively in a future article). Examples of these additional responsibilities are financial reporting, IT risk and assurance activities.

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It is clear that the additional powers for audit committee members will also lead to additional duties. The real debate will be where the actual powers of the directors will rest and how and if there will be a power play between the board and the audit committee.

It will nevertheless be a daunting task for any director who is also a member of an audit committee to comply with his duties in order to avoid liability.

Johan Coetzee, Director

Court's interpretation of "disposal" is hunky-dory

Does section 228 of the Companies Act 61 of 1973 impose a requirement on a company to procure the consent of its shareholders by special resolution when mortgaging its main asset?

In *The Standard Bank of South Africa Ltd v Hunkydory Investments 188 (Pty) Ltd and others*, case no 15427/08, Acting Judge Owen Rodgers had to decide whether the registration of a mortgage bond over a company's main assets constituted an act whereby the company "disposes of" the whole or the greater part of its assets within the meaning of section 228(1) of the Companies Act.

In short, Standard Bank sought summary judgment against the defendant on the strength of four mortgage bonds. In a last-gasp attempt to escape liability under these four mortgage bonds, the defendant argued that the mortgage bonds were not binding on it because the passing of the bonds constituted disposals as contemplated in section 228 of the Companies Act and because shareholder resolutions as required by that section were not procured.

Section 228(1) states that -

"[n]otwithstanding anything contained in its memorandum and articles, the directors of a company shall not have the power, save by special resolution of its members, to dispose of -

- (a) the whole or the greater part of the undertaking of the company; or*
- (b) the whole or the greater part of the assets of the company."* (emphasis added)

The term "dispose" or "disposal" is not defined in the Companies Act.

The Court considered numerous arguments in rejecting the defendant's contention that the mortgaging of an asset constitutes a disposal for the purposes of section 228.

The Court stated that in all instances where a company borrows money, the company's assets are exposed to risk of attachment and disposal by judicial sale.

The transaction, which exposes the company's assets to the risk of forced sale is therefore the borrowing of money, and not the mortgage *per se*. Further, a bond would not (and could not) set out the terms of the potential future disposal of the property. In a forced sale it is the sheriff who sells the property, not the mortgagor.

Acting Judge Owen Rodgers' interpretation of section 228 would seem to be valid. The crux of the matter must be that the transaction that exposes the company's assets to the risk of forced sale is the borrowing of money, and not the mortgage *per se*. The borrowing of money is typically a function of the directors who should be free to do so, subject to any limitations imposed by the company's articles of association.

While the *Hunkydory* case deals only with the registration of mortgage bonds over a company's assets, there is no reason not to extend the *ratio* of the case to other transactions where money is borrowed or the lender acquires security, such as cessions and pledges *in securitatem debiti*.

When the new Companies Act 71 of 2008 comes into effect, section 112 (section 228's successor) will regulate a company's disposal of all or the greater part of its assets or undertaking. It is interesting to note that section 112 also refers to a "disposal" of a company's assets, and the term "disposal" is also not defined in the new act. It is therefore likely that the reasoning in *Hunkydory* would also apply to the provisions of section 112.

Werner Mennen, Associate

Does the Conventional Penalties Act affect the enforceability of Involuntary Transfer (Haircut) Provisions in a Shareholders Agreement?

It is often provided in a shareholders agreement that on the occurrence of certain "Trigger Events" (for example, the death, disability, or insolvency of a particular shareholder, or on the breach of the particular shareholders' agreement by a shareholder), that a shareholder will be compelled to forfeit a certain portion of the fair market value of his shares in the company, depending on the nature of the particular Trigger Event. Such provisions are popularly referred to as "haircut" provisions. The question arises as to whether or not such haircut clauses fall within the ambit of the Conventional Penalties Act, 15 of 1962 (the Act).

Prior to the promulgation of the Act, the common law regarded a penalty clause as *prima facie* unenforceable. The law as it was has been replaced by the provisions of the Act with the consequence that, subject to the provisions of the Act, any stipulation for a penalty or for liquidated damages flowing from breach of a contractual obligation may be enforced in any competent court. The Act states that if it appears to a court that such penalty is out of proportion to the prejudice suffered by the creditor by reason of the act or omission in respect of which the penalty was stipulated, the court may reduce the penalty to such extent as it may consider equitable in the circumstances.

The first question to be answered is whether or not the haircut provisions fall within the definition of a "penalty stipulation" as contemplated within the Act. Based on the wording of section 1(1) of the Act and as confirmed by several court decisions (for example, *Parekh v Shah Jehan Cinemas (Pty) Ltd and Others* 1982 (3) SA 618 (D), *De Klerk v Old Mutual Insurance Company Limited* 1990 (3) SA 34 (E) and *Sun Packaging (Pty) Ltd v Vreulink* 1996 (4) SA 176 (A)), it is a requirement that the liability of the debtor to pay, to deliver or to perform derives from breach of contract. Therefore, in order for the Act to apply, a party cannot simply be exercising its rights under a contract - there must be a breach of contract as a result of which a certain penalty may be enforced.

A further requirement of what constitutes a penalty, is that it must be intended "to operate *in terrorem*, i.e. as a penalty in the common

law sense". The effect hereof is that a particular consequence (such as a forced offer of shares for sale) in the event of a breach of contract is not automatically a penalty. The court needs to look at all the circumstances in order to determine whether the provision was imposed with the intention of it being a penalty. In addition, the intention must be to operate "*in terrorem*".

It is questionable whether standard haircut provisions will be seen as a penalty and fall under the provisions of the Act. These provisions are usually not included in order to strike terror into the shareholder to ensure that he will comply with contractual provisions in respect of various other contracts.

In many instances, haircut provisions are introduced to ensure efficient working of the shareholders' relationship - other shareholders normally agree to become shareholders with particular parties because those parties will bring something of value to the relationship. If such shareholders do something or fail to do something that goes to the very heart of expectations that were created and those expectations are disappointed, it is questionable whether a Trigger Event in such circumstances is a penalty provision.

This does not mean that there is no risk of a successful challenge and all concerned should be alive to that risk. However, even if such haircut provisions are found to constitute a penalty, that is not the end of the matter. To get any relief, the shareholder will have to show that the extent of the haircut is disproportionate to the prejudice suffered by the company and other shareholders. Prejudice in this context is not confined to financial prejudice.

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