DLA CLIFFE DEKKER HOFMEYR

CORPORATE AND COMMERCIAL ALERT

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RECENT CASES HIGHLIGHT MEMORANDA OF INCORPORATION ISSUES AND PERSONAL LIABILITY COMPANIES

Two recent cases decided in relation to the Companies Act, No 71 of 2008 have highlighted important practical issues in company law relating to the constitutional documents of a company and the liability of directors in personal liability companies.

The case of *Verso Financial Services (Pty) Ltd v Burger and others*, case no. 9600/2013 in the Western Cape High Court, Cape Town (judgement handed down on 12 August 2013) is an interesting and telling example of how the lapsing of the two-year 'grace period' for companies' memoranda of incorporation (MOI) and shareholders agreements affects the company's constitutional documents and its shareholders' rights arising from such documents, specifically in the context of director appointments and elections. *MedX (Randburg) (Pty) Ltd v Branfield*, case no. 676/2012 in the Supreme Court of Appeal (judgement handed down on 18 September 2013) dealt with the waiver of directors' liability in the case of personal liability (or so-called 'Inc') companies.

Constitutional documents of a company

The significance of the two-year 'grace period', which commenced on 1 May 2011, was that, subject to certain exceptions, a pre-existing MOI (being the old memorandum and articles of association of a company) prevailed over the Companies Act in the case of any inconsistency between the two, and furthermore a pre-existing shareholders agreement prevailed over both the Companies Act and the pre-existing MOI. Now that the grace period has lapsed, the ranking now is: first the Companies Act, second the MOI and last the shareholders agreement. The reason that the Act and MOI now trump the shareholders agreement is because the default position in s15(7) of the Companies Act will now apply to pre-existing constitutional documents, and that section provides that a shareholders agreement is invalid to the extent that it conflicts with the MOI or the Companies Act.

In the *Verso* case, the reality of this new ranking order hit home for the minority shareholders. In this case, the company and its shareholders were in the process of negotiating a new MOI for purposes of harmonisation with the new Companies Act - a process which has been undertaken and is still underway in a number of companies in South Africa. The company had in place its pre-existing memorandum and articles of association as well as a shareholders agreement which was entered into before the commencement of the new Companies Act. The shareholders agreement contained certain provisions relating to the appointment of directors of the company - more specifically, all directors were to be directly appointed by the respective shareholders. In this regard, it must be appreciated that unlike the previous Companies Act, No 61 of 1973, the new Companies Act envisages three 'modes' of getting directors onto the company's board: they can either be directly appointed by persons named in the MOI (this is where, for instance, a shareholder or creditor simply addresses a letter to the company notifying that it appoints a certain person as director, and that is then sufficient); they can be elected to the board (this entails a nomination and then a majority vote of shareholders); or they can be so-called '*ex officio*' directors meaning that they are board members by virtue of occupying a certain office within the company.

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In the past, in private companies typically all the directors were directly appointed, and this was not a problem under the old Act. But s66(4) of the new Act contains an interesting requirement that at least 50% of directors must, in the case of profit companies, be elected by shareholders. At the risk of oversimplifying what happened in *Verso*, essentially the majority shareholders proceeded to elect additional directors outside the confines of the shareholders agreement. The old articles of the company however provided for the election of all directors, which was not inconsistent with the Act. The minority objected to this conduct of the majority on the basis that the parties were still in negotiations on the new MOI, but the court confirmed that the position now is that the Act and MOI trump any shareholders agreement. Further, the court noted that s66(4)(b), which provides for the election of at least 50% of the directors, is a mandatory and unalterable provision of the Companies Act which cannot be modified in a profit company's MOI. And the right of the shareholders to elect at least 50% of the directors is not qualified or fettered by the fact that negotiations are underway for new constitutional documents. Thus the court decided in favour of the majority.

Without a doubt, the *Verso* case brings to the fore the risks that shareholders expose themselves to if they have not undergone the exercise of harmonising their constitutional documents with the new Companies Act.

Waiver of director liability in 'Inc's'

One of the sub-categories of a private company is a so-called personal liability company, as contemplated in s8(2)(c) read with s19(3) of the Companies Act (the equivalent under the previous Act was the s53(b) company). The personal liability company is an exception to the general premise in company law that directors of a company are not, by their mere holding of that office, liable for the debts and obligations of the company (this fundamental concept of limited liability is codified in s19 of the Companies Act). In a personal liability company, the directors and past directors are jointly and severally liable, together with the company, for any debts and liabilities of the company as are contracted during their respective periods of office. Professional companies such as attorneys are for instance required to use this form of company as it increases accountability of the directors.

The *MedX* case dealt with s53(b) of the previous Companies Act but the same principles would arguably apply to the new Act. That case involved the question of a waiver of the right to pursue the directors for the company's debts. In many instances the question is asked whether a creditor of a personal liability company can waive the statutory right that he has against the directors of the company, and there are arguments both ways around whether public policy would countenance such a waiver. Interestingly in *MedX*, which concerned directors of a medical practice, the core question at hand was not whether such a waiver was permitted in law but rather whether, on the evidence in the specific case, the creditor did in fact waive his rights against the directors. It seems to have been accepted that such a waiver is perfectly competent otherwise, one imagines, the question of evidence as to whether a waiver in fact took place would not have been up for grabs in the first place. However the *MedX* case is a reminder of the fundamental legal principle that a waiver of rights must be clear and unambiguous - there, the full bench of the Johannesburg High Court took the view that there was a waiver whereas the Supreme Court of Appeal disagreed, which highlights the necessity for parties to record such matters expressly and clearly in their agreements.

Yaniv Kleitman

CONTACT US

For more information about our Corporate and Commercial practice and services, please contact:

Willem Jacobs
National Practice Head
Director
Corporate and Commercial
T +27 (0)11 562 1555
M +27 (0)83 326 8971
E willem.jacobs@dlacdh.com

David Thompson
Cape Town Regional Practice Head
Director
Corporate and Commercial
T +27 (0)21 481 6335
M +27 (0)82 882 5655
E david.thompson@dlacdh.com

Roelof Bonnet
Director
T +27 (0)11 562 1226
M +27 (0)83 325 2185
E roelof.bonnet@dlacdh.com

Tessa Brewis
Director
T +27 (0)21 481 6324
M +27 (0)83 717 9360
E tessa.brewis@dlacdh.com

Cézanne Britain-Renecke
Director
T +27 (0)21 481 6333
M +27 (0)82 674 1302
E cezanne.britain-renecke@dlacdh.com

Michael Bromley
Director
T +27 (0)21 405 6021
M +27 (0)82 826 3493
E michael.bromley@dlacdh.com

Andrew Curnow
Director
T +27 (0)11 562 1230
M +27 (0)83 728 7215
E andrew.curnow@dlacdh.com

André de Lange
Director
T +27 (0)21 405 6165
M +27 (0)82 781 5858
E andre.delange@dlacdh.com

Chris Ewing
Director
T +27 (0)11 562 1158
M +27 (0)83 325 0588
E chris.ewing@dlacdh.com

Lilia Franca
Director
T +27 (0)11 562 1148
M +27 (0)82 564 1407
E lilia.franca@dlacdh.com

Johan Green
Director
T +27 (0)21 405 6200
M +27 (0)73 304 6663
E johan.green@dlacdh.com

Allan Hannie
Director
T +27 (0)21 405 6010
M +27 (0)82 373 2895
E allan.hannie@dlacdh.com

Peter Hesseling
Director
T +27 (0)21 405 6009
M +27 (0)82 883 3131
E peter.hesseling@dlacdh.com

Quintin Honey
Director
T +27 (0)11 562 1166
M +27 (0)83 652 0151
E quintin.honey@dlacdh.com

Roelf Horn
Director
T +27 (0)21 405 6036
M +27 (0)82 458 3293
E roelf.horn@dlacdh.com

Johan Latsky
Director
T +27 (0)11 562 1149
M +27 (0)82 554 1003
E johan.latsky@dlacdh.com

Banzi Malinga
Director
T +27 (0)11 562 1100
M +27 (0)82 469 5758
E banzi.malinga@dlacdh.com

William Midgley
Director
T +27 (0)11 562 1390
M +27 (0)82 904 1772
E william.midgley@dlacdh.com

Matshipi Mongoai
Director
T +27 (0)11 562 1171
M +27 (0)83 601 7414
E matshipi.mongoai@dlacdh.com

Anita Moolman
Director
T +27 (0)21 405 6122
M +27 (0)72 252 1079
E anita.moolman@dlacdh.com

Jo Neser
Director
T +27 (0)21 481 6329
M +27 (0)82 577 3199
E jo.neser@dlacdh.com

Francis Newham
Director
T +27 (0)21 481 6326
M +27 (0)82 458 7728
E francis.newham@dlacdh.com

Gasant Orrie
Director
T +27 (0)21 405 6044
M +27 (0)83 282 4550
E gasant.orrie@dlacdh.com

Verushca Pillay
Director
T +27 (0)11 562 1800
M +27 (0)82 579 5678
E verushca.pillay@dlacdh.com

David Pinnock
Director
T +27 (0)11 562 1400
M +27 (0)83 675 2110
E david.pinnock@dlacdh.com

Peter Prinsloo
Director
T +27 (0)11 562 1212
M +27 (0)82 739 6284
E peter.prinsloo@dlacdh.com

Allan Reid
Director
T +27 (0)11 562 1222
M +27 (0)82 854 9687
E allan.reid@dlacdh.com

Thina Siwendu
Director
T +27 (0)11 562 1326
M +27 (0)83 345 6679
E thina.siwendu@dlacdh.com

Ben Strauss
Director
T +27 (0)21 405 6063
M +27 (0)72 190 9071
E ben.strauss@dlacdh.com

Roux van der Merwe
Director
T +27 (0)11 562 1199
M +27 (0)82 559 6406
E roux.vandermerwe@dlacdh.com

Charl Williams
Director
T +27 (0)21 405 6037
M +27 (0)82 829 4175
E charl.williams@dlacdh.com

DLA CLIFFE DEKKER HOFMEYR

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BBBEE STATUS: LEVEL THREE CONTRIBUTOR

JOHANNESBURG

1 Protea Place Sandton Johannesburg 2196, Private Bag X40 Benmore 2010 South Africa
Dx 154 Randburg and Dx 42 Johannesburg

T +27 (0)11 562 1000 **F** +27 (0)11 562 1111 **E** jhb@dlacdh.com

CAPE TOWN

11 Buitengracht Street Cape Town 8001, PO Box 695 Cape Town 8000 South Africa
Dx 5 Cape Town
T +27 (0)21 481 6300 **F** +27 (0)21 481 6388 **E** ctn@dlacdh.com

www.cliffedekkerhofmeyr.com

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