DLA CLIFFE DEKKER HOFMEYR

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DE FACTO DIRECTORS

Section 66(7) of the Companies Act, No 71 of 2008 (Act) provides that a person becomes entitled to serve as a director of a company when that person has been appointed or elected in accordance with Part F of Chapter 2 of the Act, or holds an office, title, designation or similar status entitling that person to be an *ex officio* director of the company, subject to subsection 66(5)(a); and has delivered to the company a written consent to serve as its director.

It does however happen that the election or appointment of a director to the board does not comply with the formal and/or procedural requirements of the Act, the company's memorandum of incorporation or any rules of the company.

What then is the status of these irregularly elected or appointed directors? What is the status of decisions taken by the board, who have been 'defectively' elected or appointed directors to the board? Are the board's decisions valid? Void? Voidable?

In terms of s214 of the previous Companies Act, No 61 of 1973 (previous Act) "the acts of a director of a company shall be valid notwithstanding any defect that may afterwards be discovered in his appointment or qualification". In addition the previous Act defined a director to include "any person occupying the position of director or alternate director of a company, by whatever name he may be designated".

Although the Act provides a slightly broader definition of 'director' it does not contain a similar provision to s214 of the previous Act.

S20(7) of the Act codifies the common law Turquand rule and provides that a person dealing with a company in good faith is entitled to presume that the company has complied with all of the formal and procedural requirements in terms of the Act, its memorandum of incorporation and any rules of the company, unless, in the circumstances, the person knew or ought to have known of any failure by the company to comply with any such requirement. However, s20(7) will only find application in respect of third parties, ie persons other than a director, prescribed officer or shareholder of the company.

The categories for ineligible or disqualified directors, in the Act (s69), does not include irregular election or appointment of directors.

Would these irregularly elected or appointed directors be regarded as 'shadow directors', a concept founded in English law, which has been regarded as the equivalent of prescribed officers?

Would they be regarded as '*de facto* directors', which is different to a shadow director in the sense that the de facto director performs the functions of a director, but has not been formally elected or appointed as a director? However, even if our Courts were to classify irregularly appointed directors as prescribed officers or '*de facto* directors', it does not fully address the question of the validity of the decisions taken.

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Although recent case law has seen our Courts dealing with the issue of delinquent directors, our Courts have not yet had to deal with this particular issue under the new Act.

A recent case in the court of Chancery in the state of Delaware in the United States might shed some light on these questions (*Bishop Macram Max Gassis v. Corkery, C.A. 8868-VCG (May 28, 2014)*). The plaintiff challenged his removal as director, inter alia, on the ground that the majority that favoured the amendment to the bylaw of the company which would cause his removal from the board comprised of directors who had not been "validly seated on the board", and that the amendment should therefore be invalidated. In addressing this argument, the court found that even if the three defectively appointed members were invalidly elected, they were 'de facto' directors and thus still capable of taking enforceable actions. Accordingly, the court dismissed the plaintiff's argument and upheld his removal as director.

In the Bishop Macram case it was further remarked that it would be troubling to accept an alternative rule that required the court to call into question all actions taken by a company's board of directors from the occurrence of any procedural irregularity to the time of challenge, which may span the course of several years.

The court referred to *Hockessin Community Center, Inc. v. Swift* (59 A.3d 437 (Del. Ch. 2012) in which a challenge to certain individuals' statuses as directors based on procedural deficiencies in their election was addressed. The court summarised the position as follows:

> *"A [d]e facto director is one who is in possession of and exercising the powers of that office under claim and color of an election, although he is not a director [d] e jure and may be removed by proper proceedings. Where a director assumes office pursuant to an irregular election in violation of the provisions of the corporate charter, he achieves only [d]e facto status which may be successfully attacked by the stockholders"*

Whether our Courts would take the same approach to the Delaware courts, as to the validity of corporate actions taken by a board which comprises directors whose appointment has been subject to some irregularities, remains to be seen. The Act does show some leanings towards US law and therefore that system of law may become increasingly persuasive in our Courts.

Cézanne Britain and Standré Bezuidenhout

TRP RULING HIGHLIGHTS PYRAMID COMPANIES AND ISSUES AROUND "CONTROL"

A recent ruling of the Takeover Regulation Panel (TRP) in the matter of *Alert Steel Holdings Limited and Capitalworks Private Equity Fund* (26 June 2014) (available at the TRP's website under "Rulings") has highlighted the need for acquirers of pyramid private companies to be wary of the applicability of the takeover laws (particularly those provisions relating to mandatory offers) contained in Parts B and C of Chapter 5 of the Companies Act, No 71 of 2008 (Companies Act). The ruling also emphasises the point that for the requirement of a mandatory offer to arise, there must be an actual acquisition of securities and a change of control as contemplated in s123 of the Companies Act.

The case concerned a so-called 'pyramid' structure of companies. A 'pyramid' is defined in the Takeover Regulations, reg 81, as "the ultimate controlling juristic person, or any intermediate juristic person that, directly or indirectly, holds at least the specified percentage of a controlled company and after applying consolidation accounting principles (irrespective of whether consolidation principles should be applied or not) either (i) derives more than 75% of its total attributable income from that controlled company, or (ii) the attributable net assets in that controlled company represent more than 75% of the total attributable net group assets of the pyramid".

The 'specified percentage' referred to in the definition of 'pyramid' is 35%. Where there is a change of control (and 'control' is also a 35% threshold for this purpose) in the pyramid, there must be a mandatory offer made to the minority shareholders of the regulated company which is controlled by the pyramid (reg 85). Reg 85 provides as follows:

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"(1) If a change in control takes place in a pyramid or intermediate pyramid, the offeror must make an offer or offers to—

> *(a) holders of securities of the pyramid or intermediate pyramid, if any is a regulated company; and*
>
> *(b) holders of securities of the controlled company, excluding securities held by the pyramid or intermediate pyramid.*

(2) The principles governing mandatory offers and comparable offers apply to offers required by this regulation."

'Regulated companies' are public companies, state-owned companies or private companies where more than 10% of the voting securities were transferred amongst unrelated persons in the previous 24 months.

The potential snag with pyramid companies is that s123 of the Companies Act (which regulates mandatory offers) does not refer at all to the triggering of mandatory offers in the underlying companies of a pyramid structure. It is dealt with solely in the Takeover Regulations, and can thus be easily overlooked. What is also very important is that in Alert Steel the TRP ruled that it is not a requirement that the (top) pyramid company should also be a 'regulated company' for reg 85 to apply; what is of relevance is whether the controlled company below the pyramid is a regulated company. Thus the scenario could easily be overlooked where control is obtained over a private, unregulated company but because certain subsidiaries of the target company happen to be regulated (and also happen to have minority shareholders), the acquirer at pyramid level will be required, by virtue of reg 85, to offer to buy out all the remaining shareholders in the (regulated) subsidiary. That is something which may come as a total surprise to an acquirer who would not have thought of the Takeover Regulations at all, given that the actual target company is not regulated.

Therefore, acquirers of private companies should at all times enquire whether any companies below in the group structure of the target are, firstly, regulated, and secondly whether the group structure meets the definition of a 'pyramid' as contained in reg 81. If so, they should at all times be mindful of the potential mandatory offer requirements which are triggered when they cross the 'bright line' of 35% in the pyramid.

The Alert Steel ruling also confirmed the principle, as was expounded some time ago in the Supreme Court of Appeal case of *Sefalana Employee Benefits Organisation v Haslam and others* 2000 (2) SA 415 (SCA), that the mandatory offer provisions are concerned only with <u>actual</u> changes of control. In Alert Steel, the subscription for shares in the pyramid company turned out to be void and of no effect, and therefore there was no actual change of control at the pyramid level. This is similar to Sefalana where a purchase of shares (which, if effected, would have caused the purchaser to cross the 35% threshold that triggers a mandatory offer) was cancelled, with the consequence that the purchaser never actually took transfer of the shares. The court held that no mandatory offer was required, and this same line of reasoning was followed by the TRP in Alert Steel. Therefore, even though the TRP held that reg 85 was certainly capable of application to the set of facts in Alert Steel, in the end a mandatory offer was not required because there was no actual change of control at the pyramid level.

Yaniv Kleitman

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BOARD'S POWER TO REFUSE A TRANSFER OF SHARES: *SITRUS VISSER CASE*

To be categorised as a private company there must be a provision in the company's memorandum of incorporation (MOI) which restricts the transferability of the securities of the company and which prohibits the company from offering its securities to the public (s8 of the Companies Act, No 71 of 2008 (Companies Act). A common restriction that is found in private companies' MOIs is that the board of directors of the company may refuse to register a transfer of any securities of the company, and without giving reasons therefor. For example in Table B of Schedule 1 to the previous Companies Act, 1973, which table sets out a standard form articles of association for private companies, there is an article that provides that "The directors shall have power to refuse to register the transfer of any shares without giving reasons therefor."

A question which often arises in this context is, to what extent does the board have an unfettered discretion to refuse the transfer? Do the directors have to furnish reasons for their refusal, and is such a clause still in line with modern notions of public policy having regard to the general point of departure that a shareholder's shares are his private property and he may deal with and dispose of same freely? Obviously a concern here is that the board is given very wide powers to approve or decline the entry of a new shareholder to the company, which powers it could potentially use for self-interested purposes. These precise issues arose in the recent unreported Cape Town High Court case of *Visser Sitrus (Pty) Ltd v Goede Hoop Sitrus (Pty) Ltd* case no. 15854/2013 (19 June 2014).

In the Visser Sitrus case, the MOI of the target company (Goede Hoop Sitrus or GHS) contained a clause that provided that:

> *"no shareholder may transfer the registered or beneficial ownership of any Ordinary Shares in the Company to any other party without first complying with the requirements for transfer as set out in the Act and in this MOI and obtaining the approval of the board for such transfer. The board may, at any time, decline to register any transfer of Ordinary Shares in the securities register of the Company without giving any reason therefor and the directors shall be deemed to have so declined until they have resolved to register the transfer."*

One of the shareholders of GHS, Visser Sitrus (VS), wished to sell its shares to an entity that was in the process of consolidating control over GHS, and the board was not pleased with this situation. The board accordingly refused the transfer without giving reasons for its decision. Naturally VS challenged this in court, but was unsuccessful. The court made the following points:

- This type of clause, namely that GHS's board has a discretion whether or not to approve a registration of transfer and does not have to provide reasons for refusal, is a common restriction on transfers of shares in the articles/MOI of private companies. Company legislation in South Africa, in keeping with Commonwealth corporate legislation, has always required a private company's constitution to restrict the transfer of the company's shares. This requirement has been retained in s8(2)(b)(ii) of the Companies Act (which, notably, refers to 'securities' and not 'shares' – securities includes shares but also a number of other instruments issued by profit companies such as debentures and bonds).
- To the court's knowledge, the validity of such a clause has never been challenged, and counsel informed the court they had found no authority to that effect.
- It has always been held that a board's discretion must be exercised in what the directors *bona fide* consider to be the best interests of the company, not for an improper or collateral purpose. It is simply inherent in the nature of a fiduciary power. This is in essence an important 'check-and-balance' on the exercise of the board's discretion to refuse registration of the transfer of shares.
- Recent cases in the UK have dealt with this standard power of directors and confirmed its nature and validity.
- There is no general duty on a person holding a fiduciary position to give reasons for his actions to those to whom their duties are owed. The duty of a fiduciary to render an account is a duty to disclose <u>what</u> he has done in the course of his administration, not <u>why</u> he has done it.
- Accordingly, the court did not see anything

> repugnant about a clause in an MOI stating that the board does not need to give reasons for its decision on a request to register a share transfer. Many powers are typically entrusted by the MOI to the directors, and the administration of corporations would become unwieldy if directors were bound on request to provide reasons for their decisions.

Therefore, despite VS's counsel's argument that such a clause is out of step with modern notions of company law, the court held that such a clause is still perfectly valid and enforceable. If a shareholder believes that the board is acting mala fide or with a collateral purpose in refusing to register the transfer (and is therefore breaching its fiduciary duties under s76 of the Companies Act), then a basis needs to be laid out for such an argument, and a court would certainly intervene and grant an appropriate remedy if a breach of fiduciary duty is proven.

Shareholders of private companies should accordingly at all times be fully appreciative of the scope and impact of this commonly occurring clause. In the process of negotiating and drafting MOIs (and shareholders agreements, for that matter) in any given circumstances, it should certainly be considered whether such a clause ought to be modified or watered down in any way. For example, consider whether the board should be required to furnish reasons for its refusal, or set out defined parameters in the MOI within which the board may exercise its discretion, or perhaps do away with the clause completely and rely entirely on other types of restrictions on the transferability of securities. The issue is that a selling shareholder may well jump through all the hoops of an onerous pre-emptive rights clause, for example, and then find itself very much at the mercy of the board of directors when it finally wants to transfer its shares to a third party purchaser.

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