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CORPORATE & COMMERCIAL ALERT



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Duty of directors to act with a proper purpose

In *CDH Invest NV v Petrotank South Africa (Pty) Ltd & Others* (483/2018) [2019] ZASCA 53 (1 April 2019), the Supreme Court of Appeal (SCA) held that a round robin resolution approving a resolution to, amongst others, increase the number of authorised shares in Petrotank South Africa (Pty) Ltd (Petrotank) was invalid on the basis that the directors of Petrotank did not exercise their powers to increase Petrotank's authorised shares for a proper purpose.

Duty of directors to act with a proper purpose

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In *CDH Invest NV v Petrotank South Africa (Pty) Ltd & Others* (483/2018) [2019] ZASCA 53 (1 April 2019), the Supreme Court of Appeal (SCA) held that a round robin resolution approving a resolution to, amongst others, increase the number of authorised shares in Petrotank South Africa (Pty) Ltd (Petrotank) was invalid on the basis that the directors of Petrotank did not exercise their powers to increase Petrotank's authorised shares for a proper purpose.

The relevant facts of the case are as follows:

- In 2013, CDH Invest NV (CDH Invest) and Amabubesi Investments (Pty) Ltd (Amabubesi) incorporated Petrotank, a South African company in which CDH Invest and Amabubesi held all the shares in a 60/40 ratio.
- In terms of a shareholders agreement, styled a memorandum of understanding (MOU), Petrotank was to have 100 000 authorised ordinary shares.
- However, Petrotank's memorandum of incorporation (MOI) when it was eventually incorporated, erroneously recorded the number of authorised ordinary shares as 1 000.
- The board of Petrotank comprised of five directors, three of which were nominees of CDH Invest and two of Amabubesi.
- CDH Invest sought an order directing the board of Petrotank to convene a shareholders meeting to consider and pass five resolutions, the last of

which (and the subject of the appeal) being to instruct the board to consider a *pro rata* rights offer of 98 835 ordinary shares.

- Before the rights issue could be considered, the authorised ordinary shares in Petrotank would have to be increased.
- On 25 March 2014, certain directors of Petrotank met and discussed the business of Petrotank. On 28 March 2014, a CDH Invest director that attended the meeting, sent a detailed email to his fellow Petrotank directors setting out the issues discussed at the meeting and noted in conclusion there were more shares in issue than have been authorised. To rectify the position various documents aimed at "*putting the Company on the right side of the Companies Act*" were attached to the email.
- There was no explanation as to how, when or why this breach came to his attention.
- One of the attachments to the email was a round robin resolution in terms of section 74 of the Companies Act, No 71 of 2008 (Companies Act) which contained a resolution to increase Petrotank's number of authorised shares to 1 000 000 ordinary shares and a consequential amendment to the MOI.
- On the same day, an Amabubesi director sent an email to all the directors stating that he will investigate the issue before he signs the documents. Despite the

Duty of directors to act with a proper purpose...*continued*

The court of first instance found that the round robin resolution was invalid on the basis that the three Petrotank directors who signed the resolution had breached their fiduciary duties.

objection, the three CDH Invest directors proceeded to sign the round robin resolution.

- On 4 April 2014, a legal advisor to Amabubesi sent an email to the CDH Invest director that sent the original email with the round robin resolution informing him that the authorised shares be increased to 1 000 000 is incorrect and needed to be amended accordingly. The reason advanced was that the increase of shares should be to 100 000 as agreed in the MOU instead of 1 000 000.
- The two Amabubesi emails were ignored by the CDH Invest directors and the amendment to the MOI duly filed with and accepted by the Companies and Intellectual Property Commission. The filing of the amendment was done by another service provider and not Petrotanks' auditors.

The court of first instance found that the round robin resolution was invalid on the basis that the three Petrotank directors who signed the resolution (CDH Invest nominees on Petrotanks' board) had breached their fiduciary duties. The SCA agreed with the court of first instance and also found that the resolution was invalid. The appeal by CDH Invest failed.

The court of first instance held that the power of directors to increase the authorised shares must be exercised in good faith and in the best interests of the company (a subjective test) and for a proper purpose (an objective test).

The motivation for the resolution was a devious misrepresentation, because it failed to offer any justification for increasing the authorised shares to 1 000 000. The resolution was also irrational as it did not conform to the proclaimed purpose of correcting the error in the MOI. For the same aforementioned reasons, the court of first instance found that the resolution could not have been proposed and passed for a proper purpose.

The SCA considered the important issue of whether a director can exercise its power to increase the authorised shares in a company without restraint and without the need to explain the basis of the decision in a justifiable manner? In answering this question, the SCA analysed the purpose of directors receiving a notice prior to a physical directors' meeting being held or a written resolution being approved and stated that the purpose of a notice is not only to inform directors of the date of the meeting but the reasons thereof.

The notice sent to the directors of Petrotank proclaimed a different reason for the increase in the authorised shares, ie to correct an obvious error in the recordal of the number of authorised shares from 1 000 to 100 000 as agreed to in the MOU, than what was in fact contained in the resolution itself, which was an increase in the authorised shares to 1 000 000.

The SCA held that the justification for the increase did not rationally extend beyond an increase to 100 000 shares. The CDH Invest directors knew that the resolution was contrary to the stated purpose when they signed it, knew it was contrary to

Duty of directors to act with a proper purpose...*continued*

The SCA concluded that the only inference one can draw is that the CDH Invest directors misrepresented the matter to be decided and failed to provide reasons for the actual resolution passed.

the MOU, ignored the contradiction when it was brought to their attention, employed the services of a firm other than Petrotank's auditors in implementing the resolution and never bothered to explain why in correcting a blatant error the authorised shares were increased to 1 000 000 instead of 100 000.

The SCA concluded that the only inference one can draw is that the CDH Invest directors misrepresented the matter to be decided and failed to provide reasons for the actual resolution passed. These actions amounted to a misrepresentation of the real purpose for the increase (to have enough authorised shares to effect

the rights offer) and their conduct did not conform to the standard of good faith required of directors in terms of section 76(3) of the Companies Act. Accordingly, they did not exercise their powers as directors for a proper purpose.

To avoid unfavourable results and possible personal liability, directors must always satisfy themselves that, in exercising their powers pursuant to the Companies Act and/or a company's memorandum of incorporation, they do so for a proper purpose, in the best interests of the company and generally in accordance with the rest of the codified standard of directors' conduct in terms of the Companies Act.

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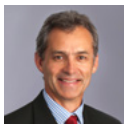


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