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CORPORATE & COMMERCIAL ALERT

IN THIS ISSUE

B-BBEE practice note issued by the DTIC brings clarity on the rules for discretionary collective enterprises

On 18 May 2021, the Minister of Trade, Industry and Competition published a practice note, in terms of the Broad-Based Black Economic Empowerment Act 53 of 2003, as amended (B-BBEE Act), on the rules for entities such as broad-based ownership schemes (BBOs), employee share ownership programmes (ESOPs), trade unions, not-for-profit companies, co-operatives and trusts (together referred to as discretionary collective enterprises (DCEs)) for purposes of B-BBEE measurement and recognition. The practice note aims to address the misalignment in the manner in which, amongst others, the B-BBEE Commission, verification agencies and B-BBEE advisors have been interpreting the treatment of DCEs in terms of B-BBEE legislation, in particular when it comes to ownership recognition.



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In 2018, the B-BBEE Commission published detailed guidelines on *"Understanding The Use of Trusts In B-BBEE Ownership Initiatives"*.

The guidelines addressed not only trust structures but also BBOSs and ESOPs. The guidelines sought to apply additional interpretative principles to DCEs for purposes of B-BBEE ownership recognition under the B-BBEE Codes than are contained in the B-BBEE Codes themselves. The practice note has clarified the legal position in relation to several matters set out in the guidelines, which we discuss in detail below.

Recognition of the use of trusts to facilitate B-BBEE ownership

While the B-BBEE Commission recognised that trusts can be used to facilitate B-BBEE ownership and that the B-BBEE Codes have rules that must be applied, it noted that the transaction in question must still meet the requirements for recognition of ownership, which comprises of exercisable voting rights, economic interests and net value in the hands of black people as a result of direct or indirect participation in the measured entity. The B-BBEE Commission did not differentiate between the legal nature of companies and trusts and appears to have concluded that, in order for a trust to contribute to B-BBEE ownership recognition (for purposes of complying with the objective of the B-BBEE Act to increase the effective ownership by black people in the economy), its beneficiaries would in effect have to have rights similar to those of shareholders of companies. As a result, the B-BBEE Commission then introduced several consequential provisions in the guidelines that it suggested would need to be in place in order for black ownership to be validly claimed via a trust, BBOS or ESOP, which were at odds with the law.

The practice note expressly recognises DCEs (which includes trusts) as valid vehicles for furthering B-BBEE. It acknowledges that these arrangements differ from the traditional model of share ownership.

B-BBEE practice note issued by the DTIC brings clarity on the rules for discretionary collective enterprises...*continued*

Whether distributions are made or not has no bearing on whether economic interest points may be claimed in terms of the B-BBEE Codes.

Black participants and the portion of their entitlement to benefits and the presentation of financial reports

It is noted in the guidelines that each participant must know in advance the portion of their entitlement to receive economic interest, and that during B-BBEE measurement, proof of payment must be produced. It is also noted, in the context of BBOs, that beneficiaries cannot be selected each year to receive benefits in the form of dividends from the measured entity, for payment of their education, training or social upliftment projects, and that these are matters that should be catered for under skills development, corporate social investments or socio-economic development.

In terms of the practice note, the Minister confirms that schemes that provide for a discretion to the trustees to, from time to time, select individuals from a defined class of beneficiaries that would benefit out of distributions of the scheme, and that allow the fiduciaries to determine the proportion of entitlement that a particular beneficiary will receive once the beneficiary is selected out of such defined class, are acceptable for B-BBEE recognition. For instance, if the scheme expressly provides for a fixed percentage of distributions to vest in the "defined class of natural person", it satisfies the rule of identifying the proportion of entitlement of participants by means of a "written record of fixed percentages of claim", provided that the scheme does not give the fiduciaries the discretion to distribute less than that fixed percentage to beneficiaries who are members of the defined class of natural person. The practice note states further that where a scheme provides for a formula to determine the proportion of a claim of a 'defined class of persons' or the

entitlement of individuals selected out of that defined class and the fiduciaries are not awarded a discretion to deviate from the formula, the scheme also complies with the rule that the fiduciaries "may have no discretion" on the terms.

According to the practice note, once the fiduciaries exercise their discretion, each beneficiary selected to partake in a particular distribution acquires a vested right to such portion of distribution that has been allocated to them at that point in time. The practice note recognises that with this type of mechanism, if an individual was selected at one point in time to partake in a distribution of the scheme, it does not necessarily entitle them to partake in future distributions.

In addition, the practice note provides that distributions may be in cash or in kind, and that distributions in kind do not in any way detract from the economic interest points claimable by or through DCEs. DCEs that are single-purpose educational, developmental and community upliftment types of BBOs or trusts are recognisable for black ownership.

Furthermore, according to the practice note, whether distributions are made or not has no bearing on whether economic interest points may be claimed in terms of the B-BBEE Codes. Measured entities may not be penalised for not having made distributions in any particular year.

The practice note also states that the requirement under the B-BBEE Codes that a DCE's financial reports be presented to participants at an annual general meeting implies that participants must be invited to the annual general meeting of the DCE but does not mean that all will attend or that attendance of all participants is a requisite for the DCE to comply.

B-BBEE practice note issued by the DTIC brings clarity on the rules for discretionary collective enterprises...continued

The practice note, however, states that the B-BBEE Codes places no restrictions on the nature of participants (other than the fact that only black participants attract recognition on the ownership scorecard) and in this regard, minors for example, are not restricted from being participants or beneficiaries in any way, whether as part of a defined class of natural persons or individually.

Family trusts

In the guidelines, the B-BBEE Commission states that there is a need at all times to make a distinction between a trust for purposes of estate planning or avoiding payment of estate duty, and a trust that is established for purposes of B-BBEE.

The guidelines also state that these trusts should not be used as an investment facilitation or have an element of passiveness and there should be active participation from black participants, irrespective of whether the shares are directly or indirectly held. The practice note does not specifically deal with this, but there is a general acknowledgement on the acceptability of all trusts and of the passive nature of the role of beneficiaries in trusts, which also applies to family trusts.

Children as beneficiaries or participants

Notably, in the guidelines, the B-BBEE Commission recognises that black children satisfy the definition of black people as per the B-BBEE Act but expresses the view that this does not mean that true empowerment will be achieved in instances where children are cited as beneficiaries. It states that children are mere financial beneficiaries and not indirect shareholders through the trust, because they are not able to exercise voting rights in a manner that is consistent with real ownership, and can only enjoy a financial benefit. The B-BBEE Commission suggests therefore that including children as beneficiaries will be regarded as a circumvention of the B-BBEE Act as they have no capacity to exercise rights flowing from such ownership.

The practice note, however, states that the B-BBEE Codes places no restrictions on the nature of participants (other than the fact that only black participants attract recognition on the ownership scorecard) and in this regard, minors for example, are not restricted from being participants or beneficiaries in any way, whether as part of a defined class of natural persons or individually.

Structures that circumvent the B-BBEE Act could amount to fronting

The guidelines refer to certain structures which, if presented as black ownership structures, could be seen as a circumvention of the B-BBEE Act. This includes evergreen structures where shares never vest; structures that provide for the ceding of voting rights of participants to the measured entity or its appointed representatives; and structures that limit involvement or active participation of beneficiaries in the measured entity through the trustees or relevant fiduciaries. It also notes that trusts established for aspects such as community projects or skills development or employee wellness benefits, no matter how beneficial they may be, cannot be recognised for ownership purposes as they do not result in ownership and true empowerment for black people.

B-BBEE practice note issued by the DTIC brings clarity on the rules for discretionary collective enterprises...continued

The explanations set out in the practice note should aid in providing more clarity in respect of several issues that have otherwise been the subject of much uncertainty within the B-BBEE space.

In terms of the practice note, evergreen ESOP structures that provides perpetual benefit to workers of a company may also satisfy the ownership provisions of the B-BBEE Codes. It also notes that participants seldom have the right to vote at general meetings and their rights are represented by fiduciaries who make decisions for and on their behalf. For this reason, the voting rights of such participants, although exercised by the fiduciaries, will be attributed to the race and gender of the participants and not that of the fiduciaries. According to the practice note, single-purpose educational, developmental and community upliftment types of BBOSs or trusts are recognisable for black ownership.

Board participation in relation to ESOPs

In the guidelines, the B-BBEE Commission states that represented by the trustees, the beneficiaries must be able to take part in decisions taken by other shareholders in meetings through active board participation and exercisable voting rights.

In addition, the guidelines state that an ESOP is a form of ownership and should not be confused with daily operations of an entity and its labour relations issues where dismissed, retrenched, deceased and incapacitated employees end up forfeiting their share/units as employment contracts and terms are not attached to their shareholding and should not be implemented as such.

While not dealt with specifically in the practice note, the memorandum to the practice note states that broader policy questions have arisen on ways to further strengthen broad-based empowerment vehicles like ESOPs, including through measures to encourage participation of worker nominees on company boards and establishing evergreen structures.

The explanations set out in the practice note should aid in providing more clarity in respect of several issues that have otherwise been the subject of much uncertainty within the B-BBEE space.

Verushca Pillay and Batool Hayath

2020 CONSISTENT LEADERS IN M&A LEGAL DEALMAKERS

2020

1st by M&A Deal Flow.
1st by BEE Deal Flow.
1st by BEE Deal Value.
2nd by General Corporate Finance Deal Flow.
2nd by General Corporate Finance Deal Value.
3rd by M&A Deal Value.
Catalyst Private Equity Deal of the Year.

2019

M&A Legal DealMakers of the Decade by Deal Flow: 2010-2019.
1st by BEE M&A Deal Flow.
1st by General Corporate Finance Deal Flow.
2nd by M&A Deal Value.
2nd by M&A Deal Flow.

2018

1st by M&A Deal Flow.
1st by M&A Deal Value.
2nd by General Corporate Finance Deal Flow.
1st by BEE M&A Deal Value.
2nd by BEE M&A Deal Flow.
Lead legal advisers on the Private Equity Deal of the Year.

DealMakers

2017

2nd by M&A Deal Value.
1st by General Corporate Finance Deal Flow for the 6th time in 7 years.
1st by General Corporate Finance Deal Value.
2nd by M&A Deal Flow and Deal Value (Africa, excluding South Africa).
2nd by BEE Deal Flow and Deal Value.

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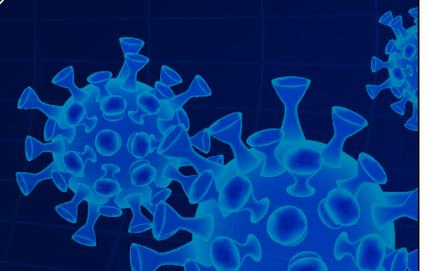
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BBBEE STATUS: LEVEL ONE CONTRIBUTOR

Our BBBEE verification is one of several components of our transformation strategy and we continue to seek ways of improving it in a meaningful manner.

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