GETTING TO GRIPS WITH THE NEW COMPANIES ACT

The new Companies Act,[1] ("**the new Act**") ushers in a new era of company law and when it eventually comes into effect, it will, as can be expected, give rise to a fair amount of confusion about the implications for existing companies. To some degree, this confusion should be resolved when the draft Companies Amendment Bill, 2010 ("**the Bill**") is promulgated but many areas of uncertainty remain. Bearing this in mind, directors should be aware of certain major changes introduced in the new Act as they get to grips with its provisions.

The Memorandum of Incorporation ("the MOI")

Under the new Act, incorporating a new company requires a notice of incorporation to be filed with the Commission (previously the Registrar of Companies), accompanied by an MOI signed by the incorporators of that company.[2] An existing company's memorandum and articles of association will automatically form its MOI.[3]

During the transitional period

On the effective date, existing companies will be assumed to have amended their MOI (which will consist of the memorandum and articles of association in place at that stage) to comply with the new Act's name requirements (for example section 21 companies will automatically become non-profit companies).[4] Existing companies will be given a two year period after the new Act comes into force ("**transitional period**") to amend their MOI in order to bring it in line with the new Act's requirements.[5] During this transitional

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[1] Act 71 of 2008.

[2] Section 13 (1).

[3] Under the Companies Act 61 of 1973 ("**the current Act**"), the Memorandum of Association is the founding document of the company. The Articles of Association deal with the internal arrangements relating to control and administration and may also deal with other matters of considerable substance (the Articles must be registered together with the Memorandum in terms of section 59(1) of the current Act).

The definition of Memorandum of Incorporation in the new Act provides that it is the document that sets out specified matters (rights, duties and responsibilities of shareholders, directors and others within and in relation to the company and other matters contemplated in section 15, such as company rules) by which the company was incorporated under the new Act or by which a pre-existing company was structured and governed before the commencement of the new Act (or if later, the date that a close corporation was converted under the new Act). (Section 1 of the new Act.)

[4] Item 4(1) Schedule 5 read with section 11(3).

[5] Item 4(4) Schedule 5.

period the following will apply if any conflicts arise:[6]

- If there is a conflict between the provisions of a pre-existing company's MOI and the new Act, the MOI will prevail.[7] However, the new Act will prevail over the MOI in the event of a conflict between the new Act and any clause in a pre-existing company's MOI relating to:
    - directors duties, conduct and liability;
    - shareholders' rights to receive notice or have access to any information;
    - directors' and shareholders' meetings and adoption of resolutions;
    - fundamental transactions, take-overs and offers, except to the extent that it is exempted in terms of Chapter 5 of the new Act.[8]

The Bill in addition proposes the following arrangements for the transitional period:

- If there is a conflict between a binding provision adopted by a company[9] and a provision of the new Act, the binding provision will prevail.[10]

- If there is a conflict between a provision in a shareholders' agreement and a provision in the new Act or the company's MOI, the shareholders' agreement will prevail (except to the extent that the shareholders' agreement or the MOI provides otherwise).[11]

After the transitional period

After the two year transitional period granted by the new Act has expired, any

[6] Item 4(4) Schedule 5 read with section 115(3) of the Bill.

[7] Item 4 (a) Schedule 5.

[8] Item 7 (5) Schedule 5.

[9] Comparable to company rules as contemplated in item4 (3) Schedule 5 of the new Act.

[10] Section 115(3) (d) (ii) of the Bill.

[11] Section 115(3) (d) (iii) of the Bill.

provision of the MOI that conflicts with the provisions of the new Act will be void to the extent of that inconsistency.[12] The Bill however, proposes exceptions to this rule where the provisions of the MOI will not be rendered void for inconsistency, such as when public regulations or listing requirements require the MOI to contain provisions that are not in harmony with the unalterable provisions prescribed by the new Act.[13] In any case, the entire content of the MOI will not be rendered void until a court has declared it to be so, giving shareholders an opportunity to review and amend the MOI.

Alterable and Unalterable provisions

The new Act distinguishes between alterable and unalterable provisions. Companies will not be allowed to alter the substance or effect of unalterable provisions in their MOI or in the company rules.[14] On the other hand, an alterable provision is a provision that may be altered in the company's MOI. For example, a special resolution will require the support of seventy-five percent of the voting rights exercised under that resolution, but a company may lower the percentage required to approve a special resolution in its MOI, provided that the margin between the percentage required to approve a special resolution and an ordinary resolution is always ten percent.[15] It should be noted that the Bill proposes to amend the new Act such that the percentage for a special resolution may be not only be decreased but also increased in the MOI within the parameters set out in the new Act.[16]

Change of Name

In terms of the new Act, the name of a company is required to contain specific expressions. For example, a non-profit company should include the letters "NPC" in its name.[17] Private and public companies will still use the expressions "(Pty) Ltd" and

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[12] Section 15(1).).

[13] Section 5(d) and section 11(a) of the Bill.

[14] S1 "Unalterable provision"

[15] Section 65(9) and (10)..

[16] Section 41(c) of the Bill.

[17] Section 11 (3) (c) (v).

"Ltd" respectively.[18] Existing companies that fall within the definition of non-profit, personal liability and state-owned companies will be assumed to have amended their MOI and their name so as to include the required expressions.[19] However, for other companies, such as companies limited by guarantee electing to become profit companies, it will be necessary to alter the company name to meet the new Act's requirements.[20]

Company Rules

If allowed by its MOI, the board can make rules concerning the governance of a company with regard to matters that are not addressed in the new Act or the company's MOI. The general meeting would have to ratify the rules by an ordinary resolution in order for them to become permanently binding.[21] The rules provide a greater degree of flexibility for companies as it may be easier to create or amend a rule than to amend the MOI (an amendment to the MOI usually requires a special resolution to be passed[22]). When amending or adding a rule, the company is required to file a copy of the amended rules with the Commission.[23]

If an existing company has any binding provisions that fulfil the same purpose as the rules under the new Act, these provisions will continue to be effective as rules during the transitional period. These rules will remain binding after the transitional period, provided that they are consistent with the new Act.[24]

Shareholders' Agreements

Unlike the current practice where a shareholders' agreement signed by all the shareholders will prevail over the Articles of Association, in terms of the new Act, if there is any inconsistency between the provisions of the shareholders' agreement

[18] Section 11(3) (c).

[19] Item 4(1) (a) to (c) schedule 5.

[20] Item 4(1) (d) Schedule 5. Another example is a company required to include the expression (RF) in its name because its MOI prescribes additional restrictive or procedural requirements for the amendment of the MOI. Section11 (3) read with section 15 (2) (b) and (c) and section 16 of the new Act and section 11 of the Bill.

[21] Section 15(4) (c).

[22] Section 65(11) read with clause 41 of the Bill.

[23] Section 15(3).

[24] Item 4(3) Schedule 5.

and the MOI, the shareholders' agreement will be void to the extent of that inconsistency.[25]

The new Act will give shareholders a two year transitional period to bring shareholders' agreements in line with the provisions of the new Act.[26] Thereafter, provisions in the shareholders' agreement will be void to the extent that they are inconsistent with the new Act. For example, a typical shareholders' agreement may contain a clause to the effect that the company shall not perform certain acts, such as issuing shares, without the prior written approval of the shareholders or without a special resolution being passed. Under the new Act, the board of directors' authorisation is sufficient for an ordinary issue of shares, meaning that any provisions to the contrary in a shareholders' agreement may be void.[27] Similarly, under the new Act if a company gives notice that it is intending to sell the majority of its assets, minority shareholders have the right to force a buyback of their shares at fair value.[28] Therefore, if there are any provisions to the contrary in a shareholders' agreement, those provisions will be void.

Share Capital

Currently, if companies have par value shares, it means that the fixed value and amount of issued shares is indicated in the memorandum of association. In the case of companies with no par value shares, the memorandum of association only indicates the amount of issued shares as these shares do not have a fixed value. A major change introduced by the new Act, is that a share will no longer have a fixed or nominal value ('par value shares'), but will be fixed in number only ('no par value shares').[29]

Although ultimately the transition to no par value shares will have to be made, in the interim, par value shares already issued by companies will continue to carry the par value assigned to them. This state of affairs will continue until such time as the Minister makes regulations providing for the conversion of par value shares into no

[25] Section 15(7).

[26] As clarified in section 115 (3) (c) of the Bill.

[27] Section 38(1).

[28] Section 164(5).

[29] Section 35(2).

par value shares. The new Act further specifies that any regulations made by the Minister must preserve the rights of holders of par value shares or provide for the company to compensate holders of par value shares for the loss of their rights.[30] Until such time as the Minister publishes the abovementioned regulations, it is unclear how this potentially problematic transition is to occur and it is therefore recommended that directors pay special attention to any developments in this regard.

Essential Special Resolutions

The new Act requires a special resolution to be passed in circumstances where a special resolution is not currently required. For example, remuneration for directors' services may only be paid in accordance with a special resolution approved by the shareholders within the past two years,[31] which is not a requirement under the current Act.[32] The Bill confirms that a special resolution is required before payment of directors' remuneration.[33]

The current Act does not require shareholders to approve remuneration for directors' services, let alone require that such approval be obtained two years in advance. Even though it is common for standard articles of association,[34] to require that directors' remuneration be determined by the company in a general meeting from time to time, this only requires the passing of an ordinary resolution. This is a far less onerous requirement than that contained in the new Act. However, it can be argued that the new Act's requirement relates only to remuneration for services as a director (non-executive directors) and not to remuneration for services as an employee (executive directors).

Audit Requirements

The new Act only requires public companies, state-owned companies and certain other categories of companies to audit their annual financial statements.[35] Under the

[30] Item 6(3) Schedule 5.

[31] Section 66 (9).

[32] Act 61 of 1973.

[33] Section 41 (d)(f) of the Bill.

[34] Item 55 of Table B and Item 54 of Table A of Schedule 1.

[35] Draft Regulation 29(1).

new Act, certain companies, such as private companies, non-profit companies and personal liability companies are no longer required to have their annual financial statements audited, unless the company's MOI provides otherwise.[36] In terms of the Draft Regulations issued by the Minister in 2009 ("**the Regulations**"), these companies must, in certain circumstances, have their annual financial statements independently compiled and reported; alternately, any such company may have its financial statements reviewed by an independent accounting professional. The Close Corporation Act[37] does not require a close corporation to have its financial statements audited and this state of affairs will continue under the new Act.[38] Those close corporations that choose to convert to a company in terms of the new Act will only be obliged to conduct an audit if they fall into any of the abovementioned categories of companies.

It goes without saying that an independent review allows a company to save on audit fees and places a lesser administrative burden on a company.[39] It remains to be seen whether, in light of the provisions of the new Act, financial institutions will still require audited financial statements to be submitted before a loan is granted and whether circumstances will still exist where a company will be required to present its audit history

Trading under insolvent circumstances

Under the current Act, a director that carries on business recklessly will be personally liable for the debts of the company.[40] The new Act, however, goes one step further and prohibits a company from trading under insolvent circumstances,[41] even if this would not in the circumstances be considered reckless. Insolvent circumstances are circumstances where the assets of a company or the consolidated assets of a holding company, as fairly valued, equal or exceed the liabilities of the company or the

[36] Section 34(2).

[37] Act 69 of 1984.

[38] The Close Corporations Act will remain in effect after the new Act comes into force, subject to certain amendments made by the new Act to the Close Corporations Act.

[39] EM Odendaal and H de Jager "Audit vs Independent Review" *South African Journal of Accountability and Auditing Research* 2010 (4) 33 at 35.

[40] Section 424(1) of the current Act.

[41] Section 22(1)(b).

consolidated liabilities of the holding company, as fairly valued.[42] Directors who continue to trade in insolvent circumstances will be guilty of an offence and liable for significant penalties, including a sentence of up to ten years.[43]

This is problematic as this provision does not allow for actions taken by a company to address its insolvency, such as obtaining a subordination agreement. Furthermore, it could create a problem for small companies where trading while factually insolvent is not unusual.[44] As this provision stands at present, this means that a company with temporary cash flow problems resulting in its liabilities temporarily exceeding or even being equal to its assets will be unable to trade.[45] The Bill contains no amendments to deal with this problem of commercial insolvency. In the future, the courts may interpret this provision to avoid such consequences but directors should, until then, be wary of the implications of trading when the company is factually insolvent.

Business Rescue

The new Act provides for business rescue as an alternative to liquidation and a replacement for the process of judicial management. Business rescue is aimed at rehabilitating companies that are financially distressed. During business rescue the company and the management of its affairs and assets are placed under the temporary supervision of a business rescue practitioner, a temporary moratorium is placed on creditors' claims against the company and its property, and a business rescue plan is developed and implemented to rescue the company by restructuring its affairs.[46]

Provisions causing concern

Although it seems to serve a valuable purpose, the business rescue process as set out in the new Act has been subjected to a great deal of criticism. A major concern is that this process can be invoked too lightly. In order to implement the business rescue process all that is required is for the board to

[42] Section 4 (1) (a) incorporating the proposed amendments by section 3(a) of the Bill.

[43] Section 22 (1) read with section 214(1) (c) (i) and section 216(a).

[44] Wainer *SALJ* 812.

[45] Section 4(1) (a).

[46] Section 128 (1) (b).

pass a resolution, without giving prior notice to employees, shareholders or creditors, if the board has reasonable grounds for believing that the necessary criteria have been met.[47] Objectively such criteria might not be met. It is therefore suggested that the board obtains sufficient input from both within the company and from external advisers, if necessary, to make a well informed decision.

Business rescue places a moratorium on all legal proceedings against the company, unless conducted with the business rescue practitioner's consent, leave of the court or in other circumstances.[48] This means that creditors (for example lessors and financial institutions holding suretyships and guarantees) will have difficulty enforcing their claims during the business rescue process.

The new Act allows the business rescue practitioner to suspend or cancel parts of or whole agreements to which the company is a party.[49] This essentially allows the business rescue practitioner to 'cherry-pick' the agreements and the provisions of these agreements to which the company will continue to be bound.[50] The other party to an agreement that has been suspended or cancelled will only have recourse to a claim for damages,[51] which restricts the contractual remedies that would have otherwise been available in terms of the common law. This provision may necessitate companies entering into contracts in such a way that their dealings are structured so as to minimise their risk.

In light of the commercial impracticalities in the abovementioned provision, the Bill attempts to afford other parties to agreements with a company subject to business rescue proceedings, greater protection. The proposed amendments provide that the business rescue practitioner's power to cancel agreements in whole, part or conditionally subject to an urgent court

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[47] Section 129(1).

[48] Section 133.

[49] Section 136(2)

[50] D Ndaba "Business Rescue Provisions of New Act could have major consequences" 2 April 2010 *Engineering News* Accessed at http://www.engineeringnews.co.za/article/business-rescue-proceedings.

[51] Section 136(3).

application where it will have to be shown that the cancellation is on terms that are just and reasonable in the circumstances.[52] The proposed amendments make it clear that the business rescue practitioner will only be able to suspend the company's obligations for the duration of the business rescue proceedings.[53] The Bill also lists certain contracts, such as employment contracts, which the business rescue practitioner will not be able to suspend, and confirms the protection afforded to parties to contracts relating to security granted by the company in relation to a disposal of property.[54]

Effect on Directors

Directors will continue to exercise directors' functions subject to the business rescue practitioner's authority.[55] Directors will have a duty to the company to exercise a management function in accordance with the business practitioner's instructions, insofar as far as it is reasonable to do so.[56] Directors will still be bound by the provisions regulating disclosure of directors' personal financial interests.[57] Save for certain key fiduciary duties, the new Act relieves directors from other fiduciary duties such as the duty of care and skill during business rescue proceedings, and places such duties on the business rescue practitioner instead.[58]

Access to company information

Even though the new Act aims to provide for increased transparency of companies and company information, the Regulations place a more onerous burden on individuals or companies seeking access to company information. The Regulations state that any right to information as set out in the new Act must be exercised in

[52] Section 82(a) of the Bill.

[53] Section 82(a) of the Bill.

[54] Section 82(b) of the Bill read with section 134 of the Act.

[55] Section 137(2) (a).

[56] Section 137(2) (b).

[57] Section137(2)(c).

[58] Section 137(2) (d) and section 140(3) (b).

accordance with the Promotion of Access to Information Act ("**PAIA**").[59] The consequence of this is that in order to exercise its rights, an individual or company must follow the procedure set out in PAIA by delivering a request for access to information form and any further documentation required in terms of PAIA, to the company from which information is required.[60] It is hoped that this regulation will be amended before the Regulations are promulgated.

Solvency and Liquidity Test

Under the new Act, a company must pass the solvency and liquidity test in certain circumstances, for example, when the board wishes to approve a distribution of profits.[61] The Regulations stipulate that where this test refers to "aggregate assets" and "aggregate liabilities", the assets of each subsidiary should exceed that subsidiary's liabilities.[62] The Bill, however, proposes to delete the reference to "aggregate" assets and liabilities and instead proposes that when applying this test to a holding company of a group of companies, the consolidated assets of the company, fairly valued, must equal or exceed the consolidated liabilities of the company, fairly valued.[63] This seems to indicate that the legislature has chosen to remove the onerous test for companies that are part of a group structure proposed in the Regulations.

CONCLUSION

Although the Bill appears to clarify certain ambiguities in the new Act, many aspects remain uncertain, impractical and potentially problematic. Nevertheless, the Department of Trade and Industry remains adamant that the new Act, subject to amendment by the Bill, will become effective in October 2010. In due course, any ambiguities in the legislation will no doubt be solved either through further amendment by the legislature or interpretation by the courts, but it should be remembered that insofar as the new Act does not extend to a certain situation, then the principles of the common law will still apply.

[59] Act 2 of 2000.

[60] Regulation 26.

[61] Section 46(1) (b).

[62] Regulation 33.

[63] Section 3(a) of the Bill.

This article has attempted to provide directors with a snapshot of some key issues to be mindful of when the new Act comes into force. However, it would be prudent for directors to check with the company's legal advisors before taking board decisions in respect of any of the above matters.

Directors would be well advised to review their memorandum and articles of association in anticipation of the commencement of the new Act and to file any required amendments to the MOI with the Commission during the transitional period. It would also be useful for directors to consider the alterable provisions in the new Act and where they wish to amend these provisions, to do so in the MOI. Furthermore, directors should commence a review of the company's shareholders' agreement in order to ensure that it complies with the new Act and the company's MOI. Hopefully, by taking such steps and bearing in mind the issues highlighted above, directors can ease their companies though the transition into compliance with the new Act.