DISTRIBUTIONS AND A DISCUSSION OF S4 AND THE RAMIFICATIONS

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March 2020

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1 DISTRIBUTIONS

1.1 INTRODUCTION

As we have already mentioned the new Act does away with the ***share capital maintenance*** rule and focusses on the ***solvency and liquidity test***. Over the years and certainly during the course of the old companies Act, distributions were related to the legal system in place. ***Creditors and minority shareholders required protection*** in the event that a distribution was made which was prejudicial to their interests. It was because of this that distributions had to be carefully regulated.

Under the old Act dividends could not be paid out of capital, a company could not acquire its own shares, a company could not generally provide capital for financial assistance for the acquisition of its own shares or shares in its holding company.

In 1999 this changed. With all the above items being allowed subject to the rules that were put in place. The liquidity and solvency test and a special resolution was required before a company could make a distribution.

It was really the total share capital of the company that shareholders put up for risk, and once this capital was lost and liabilities exceeded the assets then the company was insolvent. The only thing that a shareholder could lose was their share capital. There were no rights for creditors to obtain their losses from shareholders. If the strong regulations of corporate governance were not in place then creditors would sustain even bigger losses.

The share capital maintenance rule required a company to consistently maintain the level of funding contributed by its shareholders.

The problem with the share capital maintenance rule is that it certainly did not work in the case of many smaller companies because the funds of small companies were supplied by way of shareholder loan accounts. Shares were created with a nominal value of say R100 or R1,000 on the share capital account. The balance of the funding was provided by shareholders loans. When the shareholders who were directors saw that things were not going according to plan, they would pull out their loan funding to the detriment of creditors who had no say or control over the company. The shareholders loan was ranked the same as other creditor's funds. This situation was often subject to this abuse. In fact, when banks lend companies money, they may very well insist on a subordination of the shareholders loans, which will allow the banks to get out their money before the shareholders can withdraw their loans.

I cannot see that this is going to change with the new Companies Act as by doing away with the share capital maintenance regime and having the solvency and liquidity test the refund of a shareholder's loan is still not in fact a distribution, but a repayment of a loan. Of course, there could be other remedies that creditors might have in terms of the insolvency laws. So, the new Companies Act in doing away with share capital maintenance and introducing the solvency and liquidity test will help in certain instances prevent these situations preventing minority shareholders and creditors being prejudiced in certain circumstances, but certainly not in all cases.

Owing to the fact that the share capital maintenance regime has been dropped it is not necessary anymore to keep the CIPC informed of the movement of share capital the way we use to do in the past (remember the dreaded CM15 form) as they are no longer interested in keeping these records. This means that share issues and buybacks now do not have to be reported to the CIPC. This also means that it is exceedingly important for companies to make sure that the share capital records are perfect from an audit and inspection point of view and it is for this reason that we have to keep good records of share capital. As company secretarial practitioners you do not want the secretarial records to become the center of a dispute in a legal action.

The notion of share capital from a company law perspective basically ceases to exist but of course will continue to exist from an accounting point of view. The standards for share capital are based on common practice as the company's act says very little about the housekeeping and maintenance of shares.

The new Companies Act follows a similar approach to the 1999 company law changes. Section 48 deals specifically with the acquisition by a company of its shares and Section 46 deals with other distributions. The definition of distribution in Section 1 of the Act includes a transfer of the consideration for the acquisition by the company of its shares or shares in any company in its group.

The Act provides that all shares of a class must be treated equally, unless the MOI provides otherwise. It also provides that the MOI may entitle the shareholders to distributions calculated in specific ways and may provide for preferences as to distributions or liquidation rights in respect of different classes of shares.

One also needs to look at the liability of directors in s 77 which would make a director responsible for any loss incurred. Please see Section 77 (3) (e) (vi).

1.2 DEFINITION OF A DISTRIBUTION

In terms of the definition of distribution the following items would be included as part of a distribution;

- Money or property
- The occurrence of an obligation
- The forgiveness or waiver of any obligation.

Where there is a distribution which is part and parcel of a ***liquidation dividend*** this would not be included in the definition of a distribution.

The inclusions in a distribution would be;

- A payment of dividends
- Payment in lieu of capitalising of shares
- Buy back of shares
- Buy back of another company's shares in the group.
- Inter group share transfer. I.e. this is a share transaction between companies that belong to the same group.

It is interesting to note that there is ***no definition of dividend*** in the companies Act and we need to look at the meaning in terms of accounting principles.

If the MOI allows the board the company may pay out shareholders a cash payment as an alternative to a ***capitalization issue of shares***. In this case the payment will qualify as a distribution.

Companies in terms of the Act may issue redeemable shares and the redemption thereof requires compliance with the distribution and acquisition provisions of Sections 46 and 48. The ***redemption of preference shares*** falls outside the buyback provisions of the act, however the provisions in regard to solvency and liquidity must be applied.

1.3 AUTHORISATION OF A DISTRIBUTION

A distribution must be authorized by a company's directors. The actual distribution must be in terms of an existing obligation of the company or of a court order – See Section 46.

46. Distributions must be authorised by board.—(1) A company must not make any proposed distribution unless—

(*a*) the distribution—

(i) is pursuant to an existing legal obligation of the company, or a court order; or

(ii) the board of the company, by resolution, has authorised the distribution;

(*b*) it ***reasonably appears*** that the company will satisfy the solvency and liquidity test immediately after completing the proposed distribution; and (*c*) the board of the company, by resolution, has acknowledged that it has applied the solvency and liquidity test, as set out in section 4, and reasonably concluded that the company will satisfy the solvency and liquidity test immediately after completing the proposed distribution.

(2) When the board of a company has adopted a resolution contemplated in subsection (1) (*c*), the relevant distribution must be fully carried out, subject only to subsection (3).

(3) If the distribution contemplated in a particular board resolution, court order or existing legal obligation has not been completed within 120 business days after the board made the acknowledgement required by subsection (1)(c), or after a fresh acknowledgement being made in terms of this subsection, as the case may be—

(a) the board must reconsider the solvency and liquidity test with respect to the 25 remaining distribution to be made pursuant to the original resolution, order or obligation; and

(b) despite any law, order or agreement to the contrary, the company must not proceed with or continue with any such distribution unless the board adopts a further resolution as contemplated in subsection (1)(c).

It appears that no shareholders' approval is required for distribution and according to Cassim in Contemporary Company Law it appears that the MOI cannot validly impose any prohibitions, conditions or requirements relating to the distribution. This means that any provisions in the MOI that prohibits certain distributions or acquisitions altogether or permit them only if certain conditions are met are not valid. According to Cassim this is borne out of reading section (15)(2)(a)(ii) of the Act and the definition of alterable provision in s 1 of the Act. If one examines s 46 it appears not to be an alterable provision, there is nothing in s 46 that may negate, restrict, limit, qualify, extend or otherwise alter in substance or in effect anything in a company's MOI. It is unlikely that the legislature had this intention so it should be amended. ***There however is an opposing view***.

The definition of distribution includes a distribution to "*one or more*" of the shareholders and s 47 governs the requirements of the value of the distribution and does not require the distribution to be at a uniform rate of all shares of the same class. However, it appears that class rights must be respected at all times and the directors do not have the power to discriminate amongst shareholders of the same class when it comes to the distribution of dividends.

2 SOLVENCY AND LIQUIDITY

2.1 INTRODUCTION

Whenever a company does a distribution it is actually critical for the company to comply with the solvency and liquidity laws as this is a high-risk area for the directors and the company. If the correct procedures are not carried out there are going to be numerous claims and the directors can in fact be sued. This could very well be an issue for the accounting firm that does the company secretarial work if the directors do not comply with the legislation. The company may not even know about the legislation and make a distribution without the proper procedures, which could make them personally liable if something goes wrong.

In the previous section we discussed distributions. Where a distribution is carried out the directors must perform a ***solvency and liquidity test*** and where the director's lack the knowledge of what is required the accounting firm must be in a position to guide them or undertake the work on their behalf.

2.2 THE SOLVENCY AND LIQUIDITY TEST

4. Solvency and liquidity test.—(1) For any purpose of this Act, a company satisfies the solvency and liquidity test at a particular time if, considering all reasonably foreseeable financial circumstances of company at that time—

(a) the assets of the company, as fairly valued, equal or exceed the liabilities of the company, as fairly valued; and

[Para. (*a*) substituted by s. 2 (*a*) of Act No. 3 of 2011.]

(b) it appears that the company will be able to pay its debts as they become due in the ordinary course of business for a period of—

(i) 12 months after the date on which the test is considered; or

(ii) in the case of a distribution contemplated in paragraph (*a*) of the definition of "distribution" in section 1, 12 months following that distribution.

(2) For the purposes contemplated in subsection (1)—

(a) any financial information to be considered concerning the company must be based on—

(i) accounting records that satisfy the requirements of section 28; and

(ii) financial statements that satisfy the requirements of section 29;

(b) subject to paragraph (*c*), the board or any other person applying the solvency and liquidity test to a company—

(i) must consider a fair valuation of the company's assets and liabilities, including any reasonably foreseeable contingent assets and liabilities, irrespective of whether or not arising as a result of the proposed distribution, or otherwise; and

(ii) may consider any other valuation of the company's assets and liabilities that is reasonable in the circumstances; and

(c) unless the Memorandum of Incorporation of the company provides otherwise, when applying the test in respect of a distribution contemplated in paragraph (*a*) of the definition of "distribution" in section 1, a person is not to include as a liability any amount that would be required, if the company were to be liquidated at the time of the distribution, to satisfy the preferential rights upon liquidation of shareholders whose preferential rights upon liquidation are superior to the preferential rights upon liquidation of those receiving the distribution.

[Para. (*c*) substituted by s. 2 (*b*) of Act No. 3 of 2011.]

The solvency test is at a point in time, in fact after the distribution is made, and the liquidity test must be completed for a period of 12 months following the distribution which is a prediction of the company's cash flows over the ensuing 12-month period. The 12-month period in Section 4(1)(b) is also new. It gives Directors more certainty when applying the solvency and the liquidity test. It is also designed to protect creditors and make sure that the company survives after the distribution. The Directors must make a prediction of the company's cash flow for the period of twelve months into the future. This predication can be based on trading conditions in previous years. As we know this is quite a complicated exercise and should be conducted properly with all the necessary accountant's skill. Accfin has a software program called ***Cash Flow Forecaster*** which will help with this exercise. https://www.accfinsoftware.com/cash-flow-forecaster.html

Section 4 (1) requires an arithmetical calculation. Section 4 (2) contains some vital rules as to the method of making this calculation. All financial information concerning the company must be considered and must be based on the ***Accounting Records and Financial Statements***. In making this determination the Board must consider a fair valuation of the company's assets and liabilities including any reasonable foreseeable contingent assets and liabilities irrespective of whether or not arising as a result of the proposed distribution or otherwise and may consider any other valuation of the company's assets and liabilities that is reasonable in the circumstances. This gives the Board some degree of flexibility into determining the value of assets or liabilities.

This in fact ***creates a severe difficulty*** in that none of the financial records are forward looking but are based on the historical records of the company. In order to do this properly it's just not good enough to look at the historical books. The directors must look at the future budgets and cash flows and funding plans that reflect the future forecasts of the business. The directors must view very carefully their capital expenditure budgets required. If this is not done then how can the liquidity test be carried out properly?

At this stage there are no standards to govern how these tests should be done, therefor the board would need to apply a high degree of skill in carrying out these tests and in the situation of private companies the directors will be leaning on their accounting firm's skill if they even realise what the risks are. Surely this is an opportunity for the accounting firm but could also be a huge risk.

In order to safeguard the creditors of the company before the company can make any distribution as defined, the board of directors must apply the ***solvency and the liquidity test*** and ***acknowledge by way of Directors Resolution*** that it has ***reasonably concluded*** that the company will satisfy the solvency and liquidity test immediately after the distribution is made. These two aspects of the solvency and liquidity tests and the acknowledgement must be met whether a distribution is pursuant to a ***board resolution*** or an ***existing obligation*** or ***a court order***.

The solvency and liquidity test are very important and there are seven instances where the directors have to ensure that the solvency and liquidity tests are carried out: -

- S44 – financial assistance and
- S45 – loan to directors, prescribed officers or related and inter-related companies.
- S47 - capitalisation shares with a cash alternative
- S48 – buyback of shares
- S113 – amalgamation and mergers
- foreign transfers to register a company in South Africa
- distributions mostly dividends

In terms of the solvency test the **assets must be fairly valued** and the assets must be valued at a **specific point in time just** after the distribution has taken place. This means that the assets can be revalued over and above what the balance sheet says. Properties held can be looked at, at their current market value and intangible assets undervalued on the balance sheet can be brought in at their fair value.

Failure by Director to comply with these tests could render the director personally liable under s 77 (2) for any loss sustained by the company and could render that director liable to be placed under probation.

The board must ***acknowledge*** that it has applied the solvency and liquidity test and must have reasonably concluded that the company will satisfy it. They acknowledge this by passing a director's resolution to this effect.

The liquidity test is met *"**if it reasonably appears that the company will satisfy the solvency and liquidity test, and the board has acknowledged that it had applied the solvency and liquidity test"***

2.3 120 DAY RULE

There is a time limit for the solvency and distribution test to take place.

S 46

(3) If the distribution contemplated in a particular board resolution, court order or existing legal obligation has not been completed within 120 business days after the board made the acknowledgement required by subsection (1) (*c*), or after a fresh acknowledgement being made in terms of this subsection, as the case may be—

> (*a*) the board must reconsider the solvency and liquidity test with respect to the remaining distribution to be made pursuant to the original resolution, order or obligation; and
>
> (*b*) despite any law, order or agreement to the contrary, the company must not proceed with or continue with any such distribution unless the board adopts a further resolution as contemplated in subsection (1) (*c*).

In the event that the full distribution does not take place within 120 days the board of directors have to carry out a solvency and liquidity test again as well as acknowledge that they can proceed and complete a distribution. In other words, if 120 days has expired and the distribution has not been completed in full then the test has to be completed again before the distribution can be continued.

Once the acknowledgement has taken place periodic testing must take place if the company intends proceeding with the distribution.

2.4 THE INCURRENCE OF A DEBT

If the distribution takes the form of a debt or other obligation the requirements of this section apply when the board takes the decision to take on the debt. The time when the solvency and the liquidity test is satisfied is generally immediately after completing the proposed distribution. However, there is an exception and this is in regard to the incurrence of a debt in which case the timing must be when the board resolves to incur the debt. The company must satisfy the test when the board resolution is done unless the board resolution provides otherwise.

S 46 (4) says;-

(4) If a distribution takes the form of the incurrence of a debt or other obligation by the company, as contemplated in paragraph (*b*) of the definition of "distribution" set out in section 1, the requirements of this section—

> (*a*) apply at the time that the board resolves that the company may incur that debt or

obligation; and

(*b*) do not apply to any subsequent action of the company in satisfaction of that debt or obligation, except to the extent that the resolution, or the terms and conditions of the debt or obligation, provide otherwise.