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The Companies Act
Financial assistance

Background

The Companies Act 71 of 2008 (the Act) came into effect on 1 May 2011. A significant change from the previous Act of 1973 arises in section 45 relating to financial assistance. During 2007, Mr. Trevor Manuel (the then Minister of Finance) raised concern regarding intra-group company loans without shareholder knowledge or approval, and section 45 seems to be a consequence of this.

It is important to note upfront that the transitional provisions of the Act clearly state the approval of financial assistance is subject to the Act even if the Memorandum of Incorporation (MOI) contains provisions to the contrary, and therefore the two year transition period does not apply to this section.

In this article, we explore the provisions of section 45 in detail and address key issues that have arisen to date, particularly with regards to the interpretation of section 45.

Who does section 45 apply to?

The heading of section 45 is somewhat misleading as it regulates financial assistance to an extensive group of persons and not only to directors. In terms of this section, unless the company's MOI provides otherwise, the board may authorise direct or indirect financial assistance to the following parties:

- a director and prescribed officer of the company or of a related or inter-related company;
- a related or inter-related company or corporation;
- a member of a related or inter-related corporation; or
- a person related to any of the above parties.

Section 2 of the Act explains related and inter-related companies, corporations and persons and also

addresses the definition of control. It essentially includes subsidiaries, entities exercising control or entities under joint control. Section 2 also clarifies related or inter-related individuals.
Due to the fact that the Act refers to a “director and prescribed officer of a related or inter-related company”, “a member of a related or inter-related corporation” as well as “a person related to any of the above parties”, section 45 extends to more than a traditional group of companies and incorporates an extremely wide pool of companies, close corporations, trusts and individuals.

Companies will need to identify all relationships and analyse whether the individual, company, close corporation or trust qualifies under the definition of a related or inter-related person. Companies should have already performed and documented this exercise, since section 45 came into effect immediately.

What constitutes financial assistance?

Section 45 does not define financial assistance; instead it refers to financial assistance including the lending of money, guaranteeing of a loan and securing of any debt or obligation. As a result, the items which are specifically referred to do not comprise an “all inclusive” list of financial assistance, but do provide an indication.

Due to the lack of definition provided in the Act, financial assistance extends to an extremely wide variety of transactions, and it may be important for a company to obtain a legal view to confirm any decision that has been made regarding whether or not a transaction qualifies under section 45. Companies should consider the following types of transactions, although this is not an exhaustive list:

- Long term loans;
- Intercompany accounts;
- Cash management or clearing accounts set up for a group;
- Transactions with related parties that are unreasonable or unfair, for example excessive credit terms;
- Subordination agreements;
- Providing a guarantee or surety for another party’s debt;
- Pledging an asset as security for another party’s debt;
- Settlement of a liability (including operating expenses and salaries) on behalf of another party and recovering this at a later date;
- Exchange of assets and the exchange does not take place simultaneously; or
- Company credit cards to directors who use the card for personal expenses, even if these are repaid.

The section does not apply to lending of money in the normal course of business where the primary business of the company is to lend money and it also excludes certain accountable advances.

What does the Act require?

Section 45 contains several requirements which have to be met when the board grants financial assistance, which comprise the following:

1. The financial assistance must comply with all of the conditions or restrictions contained in the MOI.
2. It must be pursuant to an employee share scheme or provided in line with a shareholders' special resolution adopted in the previous 2 years which approved the assistance specifically or generally for a category of potential recipients.
3. The board is required to apply a solvency and liquidity test and is required to ensure that the terms of the financial assistance are fair and reasonable (every board member voting on the resolution is required to comply with this condition).
4. The board is required to inform all shareholders and trade unions regarding the financial assistance and the terms thereof.

The transitional provisions of the Act are clear that section 45 applies from the effective date of the Act. Therefore any conditions in the MOI (or previous Articles of Association still in effect) allowing the board to provide financial assistance are void and the requirements of section 45 must be met.

The special resolution approved by the shareholders must be passed before the financial assistance is provided and ratification after the fact is not possible. However, the Act does allow the shareholders to provide general authority for the provision of financial assistance to a particular group of recipients and therefore it is possible for the special resolution to cover all types of financial assistance. Nevertheless it is advisable for the board, at the least, to include maximum limits of financial assistance that may be given pursuant to the particular special resolution.

It is important to note that the Act allows for the approval of resolutions via circularisation to all of the shareholders (referred to as a round robin) and therefore it is not necessary to wait for an annual general meeting. Furthermore, it is no longer required for special resolutions to be registered with the Companies Commission.

The board is required to perform the solvency and liquidity test before the financial assistance is approved and the transaction takes place. Although a special resolution is not required each time a transaction takes place, the solvency and liquidity test and resulting board approval must be applied and obtained each time a transaction takes place. Section 4 of the Act addresses the application of the solvency and liquidity test, which is used on several occasions in terms of the Act, and is discussed in more detail later in the article.

The board is also required to determine that the terms of the financial assistance are fair and reasonable to the company. The financial well-being of the company should be the most important factor in this consideration and the following questions may also be relevant:

1. Are the terms of the financial assistance fair and reasonable when factoring in the risk profile of

the related or inter-related person together with the interest rate, repayment terms, security and other conditions?

2. Is the company able to provide the financial assistance and will it hinder or prevent the company from exploring other more profitable opportunities?
3. Is the financial assistance being provided on the instruction of a majority shareholder and will it result in an adverse effect on the profits of the company (for instance earning a lower interest rate than could be obtained elsewhere)?

It is important to note that the board is required to give consideration to the company, and not to the group as a whole. As a result, the board may be faced with conflict in that the financial assistance may be to the detriment of the company on its own but will benefit the group as a whole. In such circumstances, it would be important for the company providing the financial assistance to be adequately compensated in order that the benefit obtained by the group is passed on to the company.

Unless every shareholder is also a director of the company, the Act requires the board to provide written notice to all shareholders and trade unions whenever it resolves to provide financial assistance. This written notice must be provided:

- within 10 business days after the board adopts the resolution, if the total value of all loans, debts, obligations or assistance contemplated in that resolution, together with any previous such resolution during the financial year, exceeds 0.1% of the company's net worth at the time of the resolution; or
- within 30 business days after the end of the financial year, in any other case.

Net worth is not defined or clarified further in the Act and is therefore subject to interpretation. It could be interpreted as the difference between total assets and total liabilities.

Furthermore, it is not clear whether "together with any previous such resolution during the financial year" refers to financial assistance provided during the year to all related and inter-related persons as defined under the Act or whether it refers to financial assistance provided only to the person to whom the current board resolution relates. If it were interpreted that it applies to the cumulative financial assistance provided to all related and inter-related persons, this will result in notices being issued continuously and companies would have an enormous administrative task on their hands. It is unlikely that the Act intended this i.e. each time goods are sold on credit to a related or inter-related person a notice is sent to the shareholders and unions. In order that the purpose and intention of the Act is not lost, the latter interpretation, i.e. that it applies to financial assistance provided only to the person to whom the current board resolution relates, may be more relevant.

How is the solvency and liquidity test applied?

Section 4 of the Act explains the application of the solvency and liquidity test. The solvency and liquidity test is based on accounting records or financial statements that satisfy requirements of the Act, as set out in section 28 and 29 and regulation 25 and 27, which also prescribe the financial reporting standards.

The purpose of the solvency test is to determine whether the assets, fairly valued, exceed the liabilities, fairly valued, on the date that the test is performed. The liquidity test is designed to indicate whether the company will be able to settle the debts for the foreseeable 12 months, as and when they become due in the ordinary course of business. The liquidity test entails performing a detailed cash flow forecast that covers a minimum of 12 months, and analyses the expected cash inflows and outflows of the company, thereby indicating whether the company will have sufficient cash resources to be able to settle the debts as they fall due.

While the solvency and liquidity test is based on accounting records or financial statements that comply with the Act, certain adjustments may be required as follows:

- The fair value of assets and liabilities must be determined. Many balances in the financial statements are prepared on a fair value basis in accordance with the relevant financial reporting standards but it is not a requirement of the Act that fair value is determined in accordance with these standards. In addition these fair values are often not reflective of the amount that could be obtained for the asset in its current condition or the amount required immediately to settle the liability. Therefore, it may be important to adjust the carrying values of the assets and liabilities to account for this. Furthermore, the fair value for assets and liabilities not carried at fair value would need to be determined.

- The Act requires reasonably foreseeable contingent assets and liabilities to be factored into the calculation. This would include items such as liabilities to the South African Revenue Services that would arise as a result of the transaction. It is important to note that the inclusion of these items would not only affect the solvency test, but should also be factored in to the cash flows when performing the liquidity test. In addition, contingent assets and liabilities are traditionally not accounted for under the financial reporting standards and generally are disclosures in the financial statements.

What happens to financial assistance in existence at 1 May 2011?

Where financial assistance was approved and extended before 1 May 2011 the company does not need to comply with the provisions of section 45. The transactions would have been appropriately approved by the shareholders in terms of the 1973 Act and therefore approval under the new Act is not required. However, where the approval was obtained prior to 1 May 2011, but the assistance is only extended after 1 May 2011, the company should adhere to the requirements of the new Act. Furthermore, where there are substantial changes to the terms and conditions of any financial assistance that existed at 1 May 2011, it will need to be approved in accordance with the requirements of the new Act.

It is important to consider the effect of the transitional provisions on subordination agreements which were in existence at 1 May 2011. Where there are substantial changes to the underlying loan that has been subordinated that affect the subordination agreement, the requirements of the new Act may need to be applied to the subordination agreement. For instance, the subordination agreement may need to be approved in accordance with the new Act where the agreement subordinates the entire loan regardless of the amount and there are further amounts extended on the underlying loan, since the subordination is increased by the additional amount advanced. Conversely, where the subordination agreement subordinates a fixed amount, it will probably not require approval under the new Act when there are further amounts extended on the underlying loan since the subordination agreement is unaffected by the additional amounts advanced.

What happens if the requirements of the Act are not met or adhered to?

Non-compliance with the provisions of the Act would mean that the transaction is void and the company would have no legal claim against the other party for the recovery of the funds. Furthermore, the directors who voted in favour of the decision are personally liable for any damage, cost or loss suffered by the company as a result of the non-compliance with this section of the Act.

It is not possible in law to ratify a resolution that is void. Consequently, any subsequent general meeting cannot cure the defect by passing a special resolution in an attempt to ratify the making of the loan. A company should consult their legal counsel as to whether another solution exists to rectify the situation. A possible solution could be to request the recipient of the financial assistance to repay all of the amounts received and subsequently reissue the financial assistance while adhering to the requirements of the Act. As a result the first loan would be extinguished and replaced with a second compliant loan. However, the facts and circumstances of the transactions will vary and it is important that a legal opinion is obtained in any situation where the Act has not been complied with.

The company’s auditor would also need to consider whether a reportable irregularity exists in terms of the Auditing Professions Act, 2005, and whether there is an effect on the audit report on the annual financial statements. If the company does not require an audit and instead is subject to an independent review, the independent reviewer may have an obligation to report a reportable irregularity to the Commission in terms of regulation 29 of the Act.

Conclusion

Section 45 will force companies to think twice about providing financial assistance and requires the board to inform the shareholders thereof, which is not necessarily negative, however it is likely to be an administrative burden for most. Furthermore, there may be circumstances where the company is only factually insolvent and is able to provide the financial assistance, but will be precluded from doing so under the Act, hindering the development and growth of the companies to whom they provide the support. Specifically, this may be a problem in instances where the group company is requested to provide guarantees or sureties to external financiers. It may also result in companies being forced to source external funding at more expensive rates. We question whether the Act has achieved its purpose to promote the development of the South African economy by encouraging entrepreneurship and enterprise efficiency.

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