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Understanding the new Companies Act

An overview of relevant aspects of the Companies Act, No.71 of 2008, and matters to consider regarding its implementation.

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In this issue:

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Introduction

The Companies Act, No. 71 of 2008 (the Act) significantly changes the landscape of company law in South Africa. The Act was signed by the President on 8 April 2009, but implementation was deferred to accommodate necessary amendments. The Companies Amendment Act, No. 3 of 2011, signed by the President on 20 April 2011 underwent a rigorous process of debate and deliberation by various stakeholders and industry role players during the legislative process. Draft Regulations to the Act were also issued during the latter part of 2010 by the Department of Trade and Industry and the final Companies Regulations 2011 (the Regulations) were published on 20 April 2011.

The effective date of the Act, incorporating the amendments and the Regulations, is 1 May 2011.

During the deliberations, certain sections in the Companies Amendment Act generated considerable attention in the media and discussion in public forums. An overview of these requirements is provided in this publication. PwC will also be publishing a number of other bulletins in the coming months to assist directors and the management of companies to get to grips with some of the challenges facing most companies during the transition period and thereafter.

Future publications will cover:

- New audit and accounting requirements
- Boards of directors and committees, corporate governance and the interplay with King III
- Directors' duties, responsibilities and liabilities
- Business rescue
- Fundamental transactions, valuations and shares
- The impact of the Act on state-owned entities

Arrangement of the Act

The Act is arranged into nine chapters and five schedules:

- Chapter 1: Interpretation, Purpose and Application
- Chapter 2 : Formation, Administration and Dissolution of Companies
- Chapter 3: Enhanced Accountability and Transparency
- Chapter 4: Public Offerings of Company Securities
- Chapter 5: Fundamental Transactions, Takeovers and Offers
- Chapter 6: Business Rescue and Compromise with Creditors
- Chapter 7: Remedies and Enforcement
- Chapter 8: Regulatory Agencies and Administration of the Act
- Chapter 9: Offences, Miscellaneous Matters and General Provisions
- Schedule 1: Provisions Concerning Non-Profit Companies
- Schedule 2: Conversion of Close Corporations to Companies
- Schedule 3: Amendment of Laws
- Schedule 4: Legislation to be Enforced by Commission
- Schedule 5: Transitional Arrangements

The Regulations should be read in conjunction with the Act, as these provide detail for the practical execution of certain provisions of the Act, including record keeping requirements, dispute resolution, the social and ethics committee, forms, recording of financial information required in accounting records and financial statements.

Conflict with other legislation

Section 5 of the Act determines that if conflict exists between the Act and any other national legislation, both acts apply concurrently to the extent that such an interpretation is possible. In situations of conflict between the Act and any of the following legislation, the latter takes preference:

- Auditing Profession Act, 2006;
- Labour Relations Act, 1995;
- Promotion of Access to Information Act, 2000;
- Promotion of Administrative Justice Act, 2000;
- Public Finance Management Act, 1999;
- Securities Services Act, 2004;
- Banks Act, 1990.

Should there be conflict between the Act and any listing requirements of a securities exchange, the Act prevails. Further consideration should also be given to the interaction between the Act and the legislation governing local government such as the Municipal Systems Act, 2000 and the Municipal Finance Management Act, 1999.

New categorisation of companies[1]

The Act distinguishes between two main categories of companies, namely profit and non-profit companies. This categorisation effectively does away with the concepts of 'widely held' and 'limited interest' companies introduced by the Corporate Laws Amendment Act, 2006.

The Act also introduces the 'state-owned' company, defined as a registered company listed as a public entity in Schedule 2 or 3 of the Public Finance Management Act, 1999 or a company owned by a municipality in terms of the Municipal Systems Act, 2000 and which is otherwise similar to a state-owned enterprise. Except to the extent of ministerial exemption, the provisions of the Act applicable to a public company also apply to a state-owned company.

Future publications will explain how the provisions of the Act apply to the different types of companies, including state-owned companies, with specific focus on the extended accountability requirements in Chapter 3 of the Act that, *inter alia*, require the establishment of an audit committee and the appointment of a company secretary and an auditor.

The diagram below shows the different types of companies that may be formed in terms of the Act.

[1] See Sections 1 and 8 of the Companies Act, 2008

Categories of companies

Profit company
A company incorporated for the purpose of financial gain for its shareholders

State-owned company

An enterprise registered in terms of the Act as a company and either:

(a) listed as a public entity in Schedule 2 or 3 of the Public Finance Management Act, 1999; or

(b) is owned by a municipality, as contemplated in the Local Government Municipal Systems Act, 2000 and is otherwise similar to an enterprise referred to in par (a).

Public company

A profit company that is not a state-owned company, a private company or a personal liability company.

Personal liability company

A profit company that meets the criteria for a private company, whose Memorandum of Incorporation states that the company is a personal liability company.

Private company

A profit company:

(a) that is not a public, personal liability, or state-owned company; and

(b) its Memorandum of Incorporation

(i) prohibits it from offering any of its securities to the public and

(ii) restricts the transferability of its securities.

Non-profit company

(a) A company incorporated for a public benefit or other object as required by item 1(1) of Schedule 1; and

(b) The income and property of which are not distributable to its incorporators, members, directors, officers or persons related to any of them except to the extent permitted by item 1(3) of Schedule 1.

Implications for close corporations[2]

As of 1 May 2011, no further registrations of close corporations is possible, but existing close corporations may convert to companies by filing, amongst other required documents, a notice of conversion. Conversion is, however, not compulsory and close corporations will continue to exist until deregistration or dissolution in terms of the Close Corporations Act, 1984. Close corporations will be treated as private companies and are subject to the same audit requirements as private companies.

[2] See Amendment of Laws in Schedule 3 and Transitional Provisions in Schedule 5

Matters for discussion with the auditor

Accounting records and financial statements[3]

The Act requires companies to keep accurate and complete accounting records in one of the official languages of the Republic and in the prescribed format necessary to enable the company to satisfy its obligations in terms of the Act or any other law with respect to the preparation of financial statements.

If a company provides any financial statements to any person for any reason, these statements must satisfy the financial reporting standards as to form and content if any such standards are prescribed and amongst other requirements, must present fairly the state of affairs and business of the company. The statements must also prominently indicate whether they have or have not been audited or independently reviewed in compliance with any applicable requirements of the Act.

Audits and independent reviews[4]

The Act requires that an auditor be appointed for both public and state-owned companies and that all such companies be audited annually.

Private companies, personal liability companies and non-profit companies are subject to audit where provided for:

- in the memorandum of incorporation; or
- by way of a shareholders resolution; or
- in terms of a board decision; or
- by the Regulations to the Act.

The minister may prescribe by way of regulation the categories of any profit or non-profit company to be audited.

The Regulations introduced a public interest score whereby a private, personal liability or non-profit company that achieves a score of 350 or more is subject to audit and those below 350 are subject to an independent review, subject to the requirements and the exemptions contained in Section 30.

[3] See Sections 27, 28 and 29 read with the Regulations
[4] See Section 30 and Chapter 3 read with the Regulations

The public interest score is calculated according to the average number of employees in the company, the value of third-party liabilities, the turnover of the company and the number of persons who directly or indirectly have a beneficial interest in any of the company's issued securities. The next publication in this series will focus on the specific requirements relating to audit and review.

Auditor rotation[5]

The provisions regarding auditor rotation apply from the effective date of the Act .The same individual may not serve as the auditor or designated auditor of a company for more than five consecutive financial years. The rotation requirement in section 90 should be considered against the background of other regulatory requirements contained in the independence requirements for auditors such as the Independent Regulatory Board for Auditors' Code of Professional Conduct and the requirements of the *King Code of Governance for South Africa 2009* (King III).

Board committees

The board is responsible for the strategic direction, governance and effective control of the company. In discharging its responsibilities the board may make an assessment that certain functions are better performed by committees rather than by the board itself. King III recommends the establishment of certain committees by the board such as the :

- Risk committee
- Remuneration committee
- Sustainability committee
- Nomination committee.

Section 72 of the Act comprehensively deals with board committees and makes provision for the appointment by the board of any number of committees of directors, except to the extent that the memorandum of incorporation of a company provides otherwise.

Companies should consider the requirements in the Act relating to board and audit committees against the background of the requirements of King III.

[5] See Section 92 and The King Code of Governance for South Africa 2009

The audit committee[6]

The importance of the audit committee from a corporate governance perspective is emphasised in King III. An independent audit committee plays a key role in identifying and managing financial risks.

Section 94 of the Act regulates the different aspects of audit committees and applies concurrently with section 64 of the Banks Act, dealing with audit committees of banks, as prescribed. It is required that at each annual general meeting, a public company, state-owned company or other company that is required by its memorandum of incorporation to have an audit committee, must elect an audit committee, with the exception of a subsidiary of which the holding company has an audit committee, that will perform the prescribed audit committee functions on behalf of the subsidiary.

The Act, *inter alia,* prescribes the membership, composition and duties of the audit committee as well as the appointment of the auditor. The Regulations require that at least one third of the members of a company's audit committee at any particular time, must have academic qualifications, or experience, in economics, law, corporate governance, finance, accounting, commerce, industry, public affairs or human resource management.

Section 94 also requires all members of the audit committee to be directors of the company and stipulates that they should not be involved in the day-to-day management of the company's business. In addition members should not represent a material customer or supplier or be a full-time employee of the company.

The social and ethics committee

The Regulations determine that all state-owned companies, listed public companies and other companies with a public interest score of more than 500 must appoint a social and ethics committee, unless exempted by the Tribunal.

A social and ethics committee of a company is entitled to require from any director or prescribed officer of the company any information or explanation necessary for the performance of the committee's functions. It may further amongst other requirements, request from any employee of the company any information or explanation necessary for the performance of the committee's functions and attend any general shareholders meeting.

[6] See Section 94, King III read with the Regulations

Solvency and liquidity[7]

A company satisfies the solvency and liquidity test at a particular time if, considering all reasonably foreseeable financial circumstances of the company at that time, the assets of the company, as fairly valued, equal or exceed the liabilities of the company as fairly valued; and 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 12 months after the date on which the test is considered; or in the case of a distribution as defined, 12 months following that distribution.

Any financial information to be considered concerning the company must be based on accounting records and financial statements as prescribed. In applying the solvency and liquidity test, a fair valuation of the company's assets and liabilities must be considered, including any reasonably foreseeable contingent assets and liabilities. Any other fair valuation of the company's assets and liabilities that is reasonable in the circumstances may also be considered.

Directors and prescribed officers[8]

By definition in the Act, a director includes an alternate director and also a prescribed officer. A prescribed officer is a person who exercises general executive control over and management of the whole or a significant portion of the business and activities of the company or who regularly participates to a material degree in the exercise of general executive control and management of the whole or a significant portion of the business and activities of the company, irrespective of any title given by the company to an office held by that person, or function performed by that person for the company.

A person who is ineligible to be appointed as director may not be appointed or elected as such or consent to the appointment or act as a director. It is also possible for a person to become ineligible while serving as a director.

The memorandum of incorporation of a company may also impose additional grounds of ineligibility or disqualification of directors and minimum qualifications to be met by directors. A person is, *inter alia*, ineligible to be a director of a company if the person is a juristic person, an unemancipated minor or does not satisfy any qualification set out in the company's memorandum of incorporation. Grounds for disqualification include removal from an office of trust, misconduct involving dishonesty or prohibition in terms of public regulation.

[7] See Sections 1, 4, 28 and 29

[8] See Section 66, 75, 76, and 77 read with Regulation 38

Requirements for directors[9]

A director may not use the position of director to gain a personal advantage or an advantage for another person other than the company. A director may also not knowingly cause harm to the company.

A director must exercise the powers and perform the functions of a director in good faith and for a proper purpose, in the best interests of the company and with the degree of care, skill and diligence that may reasonably be expected of a person carrying out the same functions in relation to the company as those carried out by that director and having the general knowledge, skill and experience of that director.

Loans to directors and inter-company loans[10]

Section 45 replaces the old section 226 and includes the lending of money, providing guarantees or other security. Subject to certain provisions, Section 45 provides that the board of directors of a company may authorise the provision by the company of direct or indirect financial assistance–

- to a director or prescribed officer of the company or of a related or inter-related company, or
- to a related or inter-related company or corporation, or
- to a member of a related or inter-related corporation, or
- to a person related to any such company, corporation, director, prescribed officer or member.

Contrary to section 226 of the Companies Act of 1973, a technical interpretation of section 45 results in the inclusion of all inter-company loans within the scope of this section.

It is significant that the Act, *inter alia*, determines that the board of directors may not authorise any financial assistance, unless a special resolution to this effect has been adopted by the shareholders within the preceding two years. The special resolution must approve the specific financial assistance in respect of the specific recipient.

[9] See Section 76

[10] See Section 45

The resolution may also generally approve financial assistance for a category of recipients, where the specific recipient must fall within that category. The board of directors must furthermore be satisfied that the company will satisfy the solvency and liquidity test after providing the financial assistance. Notice of the adopted resolution must be provided to all shareholders and any trade union representing its employees.

Amendment of memorandums of incorporation and shareholder agreements[11]

Incorporating a new company requires the filing of a notice of incorporation and memorandum of incorporation with the Commission. An existing company's memorandum and articles of association will automatically form its memorandum of incorporation.

Existing companies are afforded a two-year period after the Act becomes effective to align their memorandums with the new requirements and file it without charge. Shareholders' agreements that are inconsistent with the memorandum of incorporation will no longer prevail over the memorandum of incorporation and will be void to the extent of the inconsistency.

Provisions in the shareholders' agreement will also be void to the extent that they are inconsistent with the Act. However, a two-year transition period allows for shareholders' agreements to be brought in line with the provisions of the Act.

On the effective date of 1 May 2011, the Companies Act, 1973, Section 21 and Section 53(b) companies' memorandums of incorporation were deemed to be amended to comply with the Act.

[11] See the Transitional Provisions in Schedule 5 of the Act

Business rescue[12]

The new business rescue provisions replace the current judicial management provisions of the Companies Act, 1973. Following the implementation of these new requirements, the enforcement of liquidation action against or by a company is precluded until business rescue of the company has been explored.

"Business rescue" is defined in the Act as a process to facilitate the rehabilitation of a company that is financially distressed by providing for the temporary supervision of the company and of the management of its affairs, business and property. It includes by definition a temporary moratorium on the rights of claimants against the company or in respect of property in its possession; and, *inter alia*, the development and implementation, if approved, of a plan to rescue the company by restructuring its affairs, business, property, debt and other liabilities, and equity as prescribed.

If a company is in financial distress, but appears to have potential future viability, assuming its current problems were to be resolved, Chapter 6 presents an avenue for companies facing such circumstances. Should this be the preferred route for the company's survival, the board is able to invoke the provisions by passing a resolution, registered at the Commission, to voluntarily begin the proceedings. Alternatively, Chapter 6 proceedings can also be commenced by any affected party, including shareholders, creditors, registered trade unions or employees, by way of court order.

Once in business rescue, a temporary moratorium on the rights of claimants is triggered and the proceedings are overseen by an appointed business rescue practitioner (BRP), an officer of the court, who has wide-ranging powers, including the ability to suspend current commercial contracts and to suspend management's control, if necessary. The BRP is also responsible for the development of a rescue plan, if there is considered to be any reasonable prospect of the company being rescued.

The Act provides substantial protection for employees during this phase, requiring the BRP to preserve employment and only terminate employment relationships in the ordinary course of business. The plan must optimise the probability of the company's rescue and continued existence, provide for the positions of affected parties (who participate in the approval of this plan) and articulate the need for finance (called post commencement finance which enjoys the highest level of security) for the continued operations and rescue of the business. The proposed rescue plan must be considered and approved by creditors and, if applicable, by shareholders and employees, to become effective and must fundamentally show an improved outcome for creditors over and above that which would be achieved by liquidation.

[12] See Chapter 6

Fundamental transactions[13]

The Act deals comprehensively with fundamental transactions. Broadly speaking, fundamental transactions encompass the manner and methodologies by which mergers, acquisitions and takeovers are to be effected and regulated. The impact of the Act on the implementation of fundamental transactions will be significant and while a number of the Act's provisions have improved the overall regulation of fundamental transactions, it will inevitably create uncertainty in the minds of affected parties.

In addition to takeovers, the Act makes provision for the following fundamental transactions:

- Disposals of all or the greater part of a company's assets or undertaking;
- Mergers and amalgamations; and
- Schemes of arrangement.

The Takeover Regulation Panel

The Takeover Regulation Panel governs fundamental transactions of public companies, state-owned companies and certain private companies. The Panel replaces the old Securities Regulation Panel. The Panel is, *inter alia*, responsible for regulating any affected transaction as defined and in accordance with the Takeover Regulations, to ensure the integrity of the marketplace and fairness to the holders of the securities of regulated companies. Before the implementation of a fundamental transaction, the company must be issued with a compliance certificate by the Panel.

Appraisal rights

One of the most innovative features of the Act is the fact that it grants appraisal rights to dissenting shareholders whenever a company adopts a resolution approving a fundamental transaction. Accordingly, shareholders who unsuccessfully oppose any fundamental transaction will thereafter be able to compel the company to repurchase all of their shares at a fair value, unless a court orders otherwise.

13 See Chapter 5

Transitional provisions[14]

To facilitate the transition from the old to the new Companies Act in respect of pre-existing companies, transitional provisions pertaining to, *inter alia,* the following matters are prescribed:

- Pre-existing companies will continue to exist as if they were incorporated under the new Act and retain their current names and registration numbers, subject to item 4 in Schedules.
- Pending matters before the Registrar under the old Act must be concluded in terms of the old Act.
- Amendments to align the memorandum of incorporation with the new Act may be filed with the registrar within two years from the general effective date of the new Act.
- Shareholders' agreements entered into before the general effective date will be valid for a period of two years following the general effective date of the new Act.
- Directors, prescribed officers, company secretaries or auditors of a pre-existing company continue to hold that office as from the effective date, subject to the company's memorandum of incorporation, and the Act. If the person holding such a position is ineligible, he or she is regarded as having resigned from every such office in any company as from the effective date.
- As from the effective date, a pre-existing company is deemed to have a number of vacancies on the board equal to the difference between the minimum number of directors required by or in terms of the Act and the actual number of directors of that pre-existing company immediately before the effective date, if that number is less than the minimum required.
- Approval of any distribution, financial assistance, insider share issues or options, is subject to the new Act, even if it had been approved by a company's shareholders before the effective date and despite any terms to the contrary contained in the company's memorandum of incorporation.
- If, immediately before 1 May 2011, a pre-existing company has passed its financial year end but has not completed the requirements in terms of the previous Act for publishing, audit and approval of its annual financial statements for that financial year, the provisions of the old Act continue to apply with respect to the publishing, audit and approval of those statements. The provisions of the new Act will apply to each subsequent financial year end and annual financial statements of that company.

14 See Schedule 5

How PwC can help you

PwC has significant experience in assisting clients with the changing terrain of regulatory compliance. We take a structured approach to enable clients to achieve and sustain compliance in an efficient and cost-effective manner.

Our solutions help companies to assess the impact of the new Companies Act and other legislation on their business as well as designing and implementing the changes required to ensure ongoing compliance.

Our understanding of the specific requirements of the Act, together with our blend of regulatory compliance, auditing, tax, risk management, information technology, process consulting and industry-specific expertise allows us to provide an end-to-end compliance solution.

Issues requiring prompt attention with which we can assist you, include:

- Memorandums of incorporation;
- Shareholders' agreements;
- Training for affected persons in the company such as directors;
- Determining who the prescribed officers are;
- Audit and/or review requirements and the calculation of the public interest score;
- Performing a gap analysis on the requirements of audit and board committees to ensure compliance with the requirements of the Act;
- Ensuring that directors, company secretaries and auditors comply with the eligibility requirements and are not disqualified;
- Assessing whether the company is required to establish a social and ethics committee and the appropriate agenda and terms of reference for this committee;
- Performing a regulatory compliance risk assessment;
- Compiling a Companies Act risk management and monitoring plan;
- Determining the impact of Regulations on the use of the correct forms and company documentation; and
- Evaluating potential tax implications on fundamental transactions and business rescue proposals.

This list is not exhaustive and has been provided to assist you to identify critical issues that should be dealt with promptly to minimise the risk of potential non-compliance with the Act.

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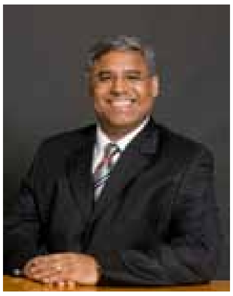

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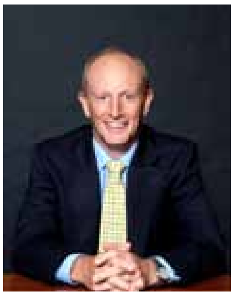

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