

## Can legal costs constitute financial assistance?

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It is not uncommon for a target company to bear the legal costs incurred by its shareholders in respect of a sale of its shares. On face value, this practice appears benign. However, an analysis reveals that this may fall within the scope of section 44 of the Companies Act 71 of 2008 (the Act).

Clearly if a company simply pays the legal costs of its shareholders this would constitute financial assistance, but in practice the analysis is rarely this simple. Consider the following scenario. Three shareholders (Shareholders) collectively own 100% of the entire issued share capital in a company (Target Co). The Shareholders enter into a sale and purchase of shares agreement (SPA) in terms of which they agree to sell all of their shares in Target Co to another company (Purchaser) for a purchase price of ZAR10 million based on a guaranteed net asset value. In terms of the SPA, the purchase price is subject to an adjustment that will be determined as at the closing date of the transaction.

In the course of negotiating and finalising the SPA, Target Co bore the legal costs incurred by the Shareholders, which amounted to ZAR1 million (as the Shareholders did not have the funds to do so, as is often the case). After closing, the purchase price payable by the Purchaser to the Shareholders in respect of the sale shares was ZAR9 million, being ZAR10 million net of the legal costs of ZAR1 million. The purchase price was effectively reduced by ZAR1 million and similarly Target Co was impoverished by ZAR1 million.

This poses the question of whether or not Target Co provided financial assistance to the Shareholders in terms of section 44 of the Act.

Section 44 of the Act has three key elements and makes reference to a company:

- giving financial assistance by way of a loan, guarantee, the provision of security or otherwise;
- to any person;
- for the purpose of, or in connection with the purchase of any securities of the company.

It seems that Target Co provided financial assistance to the Shareholders and the

Purchaser on the following basis:

### **In respect of the Shareholders**

- *the giving of financial assistance by way of a loan, guarantee, the provision of security or otherwise* (the payment by Target Co of the legal costs);
- *to any person* (the Shareholders); and
- *for the purpose of, or in connection with the purchase of any securities of the company* (the rationale for incurring the legal costs was to effect a sale and purchase of Target Co's shares).

### **In respect of the Purchaser**

- *the giving of financial assistance by way of a loan, guarantee, the provision of security or otherwise* (the reduction of the purchase price from ZAR10 million to ZAR9 million as a consequence of Target Co bearing the legal costs incurred by the Shareholders);
- *to any person* (the Purchaser); and
- *for the purpose of, or in connection with the purchase of any securities of the company* (the payment of the purchase price was in respect of the purchase of Target Co shares).

Assume that the Shareholders did not have the requisite cash reserves to pay the legal costs, in the absence of Target Co agreeing to bear these, the transaction would not be possible.

Similarly, assume that the Purchaser was only able to raise finance for an amount of ZAR9 million. If Target Co did not bear the legal costs incurred by the Shareholders and adjust the purchase price accordingly, the purchase price would have remained at ZAR10 million and no transaction would have occurred.

The importance of complying with section 44 of the Act is well-known. If a board of directors decides to advance financial assistance in a manner or on terms inconsistent with the requirements of the company's memorandum of incorporation (MOI) or the Act, such decision will be void to the extent of such inconsistency and incapable of ratification *ex post facto*, however this of itself does not have the effect of voiding the underlying transaction. In addition, Target Co may have a claim against whichever party was enriched as a result of the provision of unauthorised financial assistance.

Also, if a director was involved in making a decision that is declared void in terms of section 44 of the Act and failed to vote against it, then such director may be liable for any loss sustained by the company as a result thereof in terms of section 77 of the Act.

There is, however, respite for companies that have failed to procure the requisite shareholder approval in terms of section 44 of the Act. The Supreme Court of Appeal in *Moraitis Investments (Pty) Ltd v Montic Dairy (Pty) Ltd*, has recently resurrected the common law principle of *unanimous consent*.

The principle of unanimous consent creates a "safe harbour" if a company has complied with all of the requirements of section 44 of the Act save for the requirement of formal shareholder approval. If all shareholders have full knowledge of the impugned matter and all shareholders have consented to same, whether in writing or by conduct, a company may bypass the formal shareholder approval and processes whether contained in the Act or a company's MOI.

On the facts set out above, it can be argued that if a transaction involves the disposal of all shares in a company, and all of the shareholders are a party to the agreement, it can be inferred that all shareholders have consented to the transaction *vis-a-vis* the giving of financial assistance, and accordingly circumvent the requirements of shareholder approval as set out in section 44 of the Act. It is, however, best practice to always ensure that all necessary resolutions have been passed prior to the provision of financial assistance.

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