UNIVERSITY *of the* WESTERN CAPE

FACULTY OF LAW

Corporate Capacity, Special Purpose Vehicles, and Traditional Securitisation in South African Company Law

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A thesis submitted in fulfilment of the requirements for the degree of Doctor Legum (LLD) in the Faculty of Law at the University of the Western Cape

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December 2019

DECLARATION

I, Etienne Aubrey Olivier, declare that *Corporate Capacity, Special Purpose Vehicles and Traditional Securitisation in South African Company Law* is my own work, that it has not been submitted before for any degree or examination in any other university, and that all the sources I have used or quoted have been indicated and acknowledged as complete references.

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ACKNOWLEDGMENTS

‘No man is an island.’[1] The writing of this thesis would not have happened without the contribution of many. Unfortunately, I can only name a few. I ask the unnamed for their forgiveness.

First, I must express thanks to God. My continuing education in and love for the law is happening only because certain opportunities were made available to me. It would be remiss of me not to acknowledge how fortunate I have been.

My family plays an important role in my life. I express my heartfelt thanks to all of them.

I am grateful to my partner, Lonique Andrews. Thank you for acting as my sounding board, even when I bored you. Your influence on me is evident throughout this thesis, even if you refuse to acknowledge it.

Samantha Wood guided me in my tentative exploration into the world of financial reporting. I also received guidance from various individuals at the Companies and Intellectual Property Commission.

I received much-needed funding by way of a scholarship made available to me by the National Research Foundation and the Deutscher Akademischer Austauschdienst.

Finally, my supervisors, Brighton Mupangavanhu and Riekie Wandrag. I must say that your guidance, patience, encouragement, and insightful contribution to the writing of this thesis are greatly appreciated. I feel that I am a better student and person at the end of this journey which we have taken together.

Any mistakes herein are my own.

[1] Donne J ‘Devotions upon Emergent Occasions’ (1624).

DEDICATION

To my mother, Ria Olivier.

ABSTRACT

The ideals of shareholder and creditor protection are affected by legislation pertaining to the validity of a company's transactions. Until legislative reforms introduced in the twentieth century, a company's capacity and the ultra vires doctrine traditionally limited the company's ability to contract. Therefore, the legal framework regulating corporate capacity influences a company's interactions with outsiders. The goal of the law in this regard should be to facilitate commerce while providing adequate protection to all affected stakeholders. South Africa's Companies Act 71 of 2008 (the Act) contains several novel provisions regarding a company's capacity, the desirability of which is questionable.

Special purpose vehicles (SPVs) are used for various purposes in commerce, from asset holding in the financial services sector to concluding complex financial functions in corporate finance. For instance, traditional securitisation is a financial engineering technique that makes use of corporate SPVs. Traditional securitisation is a valuable risk management, earnings management, and corporate financing tool. Incorporators of securitisation SPVs often include capacity restrictions in the constitutions of such entities as a means of reducing the likelihood that the SPV will be subject to liquidation proceedings.This thesis analyses the capacity provisions in the Act to determine whether they provide a commercially desirable framework to facilitate the activities of SPVs used in traditional securitisation schemes.

The thesis argues that the capacity provisions in the Act in their current form are undesirable because they place third parties at too great a risk in exchange for inconsistent and unreliable shareholder protection. Executory ultra vires contracts concluded by limited capacity companies are at the same time valid and capable of being restrained by a single shareholder, director or prescribed officer of the company. It is argued that the Act's approach to corporate capacity is detrimental to commercial certainty and creditor protection, and that capacity restrictions under the current framework do not provide any more shareholder protection than ordinary authority limitations would. Consequently, it is argued that the capacity provisions in the Act do not make a positive contribution to the "insolvency-remoteness" of SPVs used in traditional securitisation schemes. It is recommended that the capacity provisions in the Act should be substantially amended, or deleted.

KEY WORDS

Companies Act 71 of 2008

Corporate capacity

Ultra vires doctrine

Restrictive conditions

Limited capacity companies

Special purpose vehicles

Insolvency-remoteness

Financial reporting

Off-balance sheet financing

Risk management

Corporate finance

Structured finance

Securitisation

Traditional securitisation

ABBREVIATIONS

ABS	Asset-backed security
ASIC	Australian Securities and Investments Commission
CDO	Collateralised debt obligation
CDS	Credit default swap
CIPC	Companies and Intellectual Property Commission
CLN	Credit-linked note
CMBS	Commercial mortgage-backed security
DTI	Department of Trade and Industry
EEC	European Economic Community
FRSC	Financial Reporting Standards Council
FWT	First World Trader
GAAP	Generally Accepted Accounting Principles
GCL	General Corporations Law (Delaware)
IFRS	International Financial Reporting Standards
JSE	Johannesburg Securities Exchange
LLC	Limited liability corporation
LLP	Limited liability partnership
MBCA	Model Business Corporation Act
MBS	Mortgage-backed security
MOI	Memorandum of Incorporation
NPC	Non-profit company
OTC	Over-the-counter

PIS	Public interest score
RMBCA	Revised Model Business Corporation Act
RMBS	Residential mortgage-backed security
SAHL	South African Home Loans
SAICA	South African Institute of Chartered Accountants
SA GAAP	South African Statements of Generally Accepted Accounting Practice
SMEs	Small to medium enterprises
SPV	Special purpose vehicle
SSS	Synthetic securitisation scheme
TSS	Traditional securitisation scheme
UBS	United Building Society
UK	United Kingdom
USA	United States of America

CONTENTS

CHAPTER ONE: INTRODUCTION TO THE STUDY

1.1 INTRODUCTION

The company law doctrine of ultra vires regulates the validity of transactions entered into beyond the legitimate powers of a company. In terms of the classical common law approach, as laid down by the House of Lords in *Ashbury Railway Carriage and Iron Co v Riche*,[1] ultra vires contracts purportedly made on behalf of a company were void ab initio and incapable of ratification by the company's shareholders.[2] The ultra vires doctrine has had an important effect on the evolution of corporate law and commercial practice during the nineteenth and twentieth centuries. The doctrine has gradually evolved in legal systems based on the English model of company law, to the point where the modern ultra vires doctrine is now almost unrecognisable from its original form.

During large parts of the nineteenth and twentieth centuries, a company's capacity was limited to concluding contracts aimed at achieving, or at least reasonably incidental to, the company's stated objects.[3] Companies were regarded to exist only for the purpose of acting in furtherance of their main object.[4] The capacity of statutory companies was determined by the provisions of the enabling statute.[5] The capacity of a company formed and registered pursuant to a general enabling Act was determined by the company's constitution,[6] particularly the objects clause in the memorandum of association.[7]

In addition to an object or objects, incorporators were entitled to stipulate the *powers* of a company, which would be those juristic acts that the company would be allowed

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[1] (1875) LR 7 HL 653 672.
[2] At 672 & 674.
[3] *Attorney General v Great Eastern Rly Co* (1880) 5 APP CAS 473 (HL); *Re Horsley & Weight Ltd* [1982] 3 All ER 1045 (CA) 1050-1. See Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' in Cassim FHI (ed.) et al *Contemporary Company Law* 2 ed (2012) 163-4.
[4] Smith A 'Ultra vires-A Problem of Sovereignty' (1946) 3 *Res Judicatae* 28 28.
[5] See, for example, *Eastern Counties Railway Co. v. Hawkes*, 5 H.L. Cas 331 (1855) 333.
[6] In English law, the articles of association, in conjunction with certain shareholder agreements and resolutions, constitute the "constitution" of the company. See ss 17 and 29 of the Companies Act 2006, and Davies P and Rickford J 'An Introduction to the New UK Companies Act' (2008) 5 *European Company and Financial LR* 48 55.
[7] Cillers HS et al *Cilliers and Benade Corporate Law* 3 ed (2000) 181. See also *Hompes v Beaumont Estate Co Ltd* 1903 TS 227 233.

to enter into in furtherance of its objects.[8] In English law, the distinction between a company's objects and its powers was regarded as fundamental to the ultra vires doctrine. Choong explains the position as follows:

> '[A]ny corporate transaction that falls within the scope of an object is necessarily *intra vires* whereas a corporate transaction that falls within the scope of a power is *intra vires* only if it is exercised for a purpose ancillary or reasonably incidental to the pursuit of the objects'.[9]

Therefore, the objects and powers as stated in the company's constitutive documents determined the extent of its capacity. Any contract which fell outside the limits of the company's capacity was void ab initio.[10] Furthermore, a contract that exceeded a company's capacity was not capable of being ratified by the company's shareholders.[11]

Since ultra vires contracts were void, no party to such an agreement would ever have been able to enforce it.[12] It was generally accepted that both the company and the third party could argue that the contract was ultra vires and so escape liability thereunder.[13] Furthermore, any performance rendered in terms of the failed agreement was to be returned.[14] This collection of rules became known as the ultra vires doctrine.[15]

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[8] Baxter C 'Ultra vires and Agency Untwined' (1970) 28 *Cambridge LJ* 280 281; Rajak H 'Judicial Control: Corporations and the Decline of Ultra vires' (1995) 26 *Cambrian LR* 9 24-6; Griffin S 'The Rise and Fall of the *Ultra vires* Rule in Corporate Law' (1998) 2(1) *Mountbatten Journal of Legal Studies* 5 11-16.

[9] Choong TC 'From *Ultra vires* to Agency: A Comment on the Recent Modifications to the *Ultra Vires* Doctrine' (1986) 28 *Malaya LR* 17 17.

[10] See *Abrahamse v Connock's Pension Fund* [1963] 1 All SA 159 (W) 163.

[11] *Ashbury Railway* 672; *Bell Houses Ltd v City Wall Properties Ltd* [1966] 2 All ER 674 681. See also *Quadrangle Investments v Witind Holdings* [1975] 2 All SA 179 (A) 184-5 and Locke N 'The legislative framework determining capacity and representation of a company in South African law and its implications for the structuring of special purpose companies' (2016) 133 *SALJ* 160 163.

[12] Furmston MP 'Who can plead that a contract is *ultra vires*?' (1961) 24 *Modern LR* 715 718. Section 6 of the South African Companies Act 46 of 1926 expressly stipulated that the invalidity of an ultra vires company contract prevented either of the parties from enforcing the agreement.

[13] Pennington RR *Company Law* 6 ed (1990) 95; Furmston MP (1961) 720; Hamilton RW *Corporations including partnerships and limited liability companies* 6 ed (1998) 214. See also *Re Jon Beauforte (London) Ltd*. [1953] 1 Ch. 131, a case which Anderson describes as '[t]he classic and infamous example of the "pitfall for third parties" that was the ultra vires rule.' See Anderson J 'The Evolution of the Ultra vires Rule in Irish Company Law (2003) 38 *Irish* Jurist 263 274-5.

[14] Cilliers HS et al (2000) 182.

[15] Davies PL & Worthington S *Gower's Principles of Modern Company Law* (2016) 10 ed 172-3.

The basis of the ultra vires doctrine has been argued to be the concession theory of corporate existence.[16] This conception of corporate personhood holds that corporations, being granted privileges and a charter by the sovereign or legislature, are restricted in terms of their capacity to the powers and privileges conferred.[17]

The ultra vires doctrine was adopted in South Africa.[18] Section 6 of the Companies Act 46 of 1926 required all companies to state their objects in the memorandum, and prohibited the enforcement of ultra vires transactions. Like in England, the objects clause was the cornerstone of a registered company's commercial activities, as it determined the company's capacity.[19] In addition, the courts accepted that the English understanding of the rule reflected the South African approach.[20] Companies were limited to concluding contracts related to, ancillary, or reasonably incidental to their objects.[21]

The invalidity of ultra vires contracts can be regarded as the external consequence of the ultra vires doctrine.[22] The internal consequence of the ultra vires doctrine was twofold: shareholders were entitled to prohibit a company from acting ultra vires by way of a court interdict,[23] and a company would have been entitled to hold its directors personally liable for any loss sustained by the company as a result of an ultra vires action.[24]

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[16] Schaeftler MA 'Clearing away the Debris of the Ultra vires Doctrine — A Comparative Examination of U.S., European, and Israeli Law' (1984) 16 *Law & Policy in International Business* 71 120; Schaeftler MA 'Ultra vires—Ultra Useless: The Myth of State Interest in Ultra vires Acts of Business Corporations' (1983) 9 *The Journal of Corporation Law* 81 87; Getz L 'Ultra vires and Some Related Problems' (1969) 3 *University of British Columbia LR* 30 32.

[17] Schaeftler MA (1984) 104; Ho VH 'Theories of Corporate Groups: Corporate Identity Reconceived' (2012) 42 *Seton Hall LR* 879 891-2; Greenfield K 'Ultra vires Lives! A Stakeholder Analysis of Corporate Illegality (With Notes on How Corporate Law Could Reinforce International Law Norms)' (2001) 87 *Virginia LR* 1279 1312.

[18] See, for example, *Hompes* 233 and *Abrahamse* 163. See also McLennan JS 'Contract and Agency Law and the 2008 Companies Bill' (2009) *Obiter* 144 144, and Schaeftler MA (1984) 74 note 7.

[19] De Wet JC & Van Wyk AH *De Wet en Yeats Kontraktereg en Handelsreg* 4 ed (1978) 547; *Hompes* 233; Cilliers HS et al *Cilliers and Benade Corporate Law* 3 ed (2000) 181.

[20] *Quadrangle Investments v Witind Holdings* [1975] 2 All SA 179 (A) 184-5.

[21] *Re Horsley & Weight Ltd* [1982] 3 ALL ER 1045 (CA) 1050-1.

[22] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' in Cassim FHI (ed.) et al *Contemporary Company Law* 2 ed (2012) 165.

[23] Naudé SJ 'Company contracts: the effect of section 36 of the new Act' (1974) 91 *SALJ* 315 316; McLennan JS (1979) 330.

[24] The basis of the director's liability in such an instance would be a breach of the director's fiduciary duty not to act beyond his authority. *Cullerne v London and Suburban General Permanent Building Society* (1890) 25 QBD 485. A company cannot authorise another to perform acts which are beyond the capacity of the company. Therefore, in every instance of ultra vires, the responsible director or agent

After *Ashbury Railway*, the effect of the ultra vires doctrine was gradually minimised by a judicial tendency to relax the doctrine by extending corporate capacity.[25] The "abuse" of the objects clause also contributed to the waning of the doctrine's impact.[26] First, the courts declared that the ambit of a company's capacity encompasses all objects reasonably related or ancillary to the main object.[27] The businessman's desire for versatility and ease of expansion, coupled with the fact that innocent third parties would be at risk of having their contracts with companies be void for lack of capacity, contributed to the need for creative solutions to the ultra vires problem.[28] Therefore, the ultra vires doctrine began to be evaded by the use of widely drafted objects clauses, often with each power designated as an independent object.[29] While courts disapproved of this 'pernicious practice which, instead of revealing a company's main object, served only to conceal it', such broad objects clauses were deemed valid.[30] The Court of Appeal in *Bell Houses* further limited the reach of the ultra vires doctrine by recognising the validity of "subjective objects" clauses.[31] At the time, many considered the decision in *Bell Houses* to have broken the back of the ultra vires doctrine,[32] as an objects clause couched in subjective terms would allow a company

would have been exceeding his authority. Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 165; McLennan JS (1979) 331; Naudé SJ (1974) 316; Obadina DA 'The New Face of *Ultra vires* and Related Agency Doctrines in the Commonwealth and USA' (1996) 8 *African Journal of International & Comparative Law* 309 313.

[25] Gower LCB et al (1979) 166; Field GW 'Ultra vires' (1879) *American LR* 632 640-5.

[26] Griffin S (1998) 9-11; Smith A (1946) 28; Anderson J (2001) 270-1; Getz L 'Ultra vires and Some Related Problems' (1969) 3 *University of British Columbia LR* 30 34.

[27] *Attorney General v Great Eastern Rly Co* (1880) 5 APP CAS 473 (HL); *Re Horsley & Weight Ltd* [1982] 3 All ER 1045 (CA) 1050-1. See Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 163-4.

[28] Choong TC (1986) 20.

[29] *Cotman v Brougham* [1918] AC 514 (HL) 522-3. See also Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 164 and Omar PJ 'Powers, purposes and objects: the protracted demise of the ultra vires doctrine' (2004) 16 *Bond LR* 93 102-3.

[30] *Cotman v Brougham* [1918] AC 514 (HL) 522-3, confirmed in *Re Horsley & Weight Ltd* [1982] 3 All ER 1045 (CA) 1050-1. See Leacock SJ 'The rise and fall of the ultra vires doctrine in United States, United Kingdom, and Commonwealth Caribbean corporate common law: a triumph of experience over logic' (2007) 5 *DePaul Business and Commercial LJ* 67 72. In South Africa, this practice was noted in *In re Standard Investment Co. of S.S., Ltd* 1921 TPD 203. See Beuthin RC 'The *Ultra vires* Doctrine – An Obituary Notice?' (1966) 83 *SALJ* 461 465.

[31] In casu, the objects clause of Bell Houses Ltd empowered the company '[t]o carry on any trade or business which can, in the opinion of the board of directors be advantageously carried on by the company in connextion with or as ancillary to any of the above businesses or the general business of the company'. *Bell Houses* 679 and 680-3.

[32] Kiggundu JS 'The never ending story of *ultra vires*' (1991) 24 *Comparative & International LJ* 1 20-1; Beuthin RC (1966) 461; Omar PJ (2004) 106.

to do anything that the directors decide to be advantageous to the company.[33] However, the potential for an ultra vires contract to be declared invalid remained a very real, if somewhat remote, risk for outsiders.[34] In many common law countries, legislation was passed in an attempt to dispel this uncertainty and protect third parties against the harsh consequences of the ultra vires doctrine.[35]

It would seem that the ultra vires doctrine was originally aimed at restricting speculation. The justification for the ultra vires doctrine put forth in *Ashbury* was that the rule protected the interests of a company's creditors and shareholders.[36] Gower comments that the ultra vires doctrine served as a guarantee to shareholders that 'an investor in a gold mining company did not find himself holding shares in a fried-fish shop'.[37] The rule ostensibly also safeguarded the interests of creditors to have the company's capital remain within the realms of the company's main business as reflected in the objects clause.[38]

Creditor protection is seldom mentioned in academic writings as a convincing motivation for the ultra vires doctrine. However, Greenfield reasons that because a company's ability to pay its debts depends on the activities to which it expends it capital, a strict ultra vires doctrine protected creditors.[39] Yet, as Schaeftler notes, neither English nor US law have ever recognised a creditor's right to prevent an ultra vires contract.[40] Schaeftler is highly doubtful of the proposition that a potential creditor of a modern company would consider the company's objects clause as a significant factor in deciding whether to provide credit, and points out that even if the creditor *did* place value on monitoring the company's stated business activities, the corporation

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[33] *Bell Houses* 686-7; Beuthin RC (1966) 461; Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 167; Leacock SJ (2007) 80; Getz L (1969) 53.
[34] The danger that the doctrine posed to outsiders is illustrated in cases like *Re Introductions Ltd v National Provincial Bank Ltd* [1968] 2 All ER 1221 and *Re Jon Beauforte (London) Ltd* [1953] Ch 131.
[35] In England, reform of the doctrine commenced with the European Communities Act 1972. In the USA, the Revised Model Business Corporations Act (RMBCA) addresses the ultra vires doctrine, but individual states had begun modifying the ultra vires doctrine from as early as 1915. See Chapter Two.
[36] Gower LCB et al *Gower's Principles of Modern Company Law* 4 ed (1979) 161; Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 164; Leacock SJ (2007) 77; Griffin S (1998) 7-8.
[37] Gower LCB et al (1979) 165. According to Getz, the ideal of shareholder protection was instrumental in the early development of the ultra vires doctrine. Getz L (1969) 50.
[38] *Ashbury Railway* 666; Cassim F 'The rise, fall and reform of the ultra vires doctrine' (1998) 10 *SAMLJ* 293 295; Kiggundu J (1991) 5-6.
[39] Greenfield K (2001) 1309.
[40] Schaeftler MA (1984) 163.

would still be able to amend its objects without notice to the creditor.[41] An additional reason for not allowing a creditor to enjoin ultra vires acts is the fear that the managerial role of the board may be usurped by outsiders.[42] Some criticised the ultra vires doctrine for its ability to prejudice creditors instead of protecting them. Gower comments that 'the individual creditor who had lent money to a company on an ultra vires borrowing was not likely to be consoled by the thought that he had suffered for the benefit of his fellow creditors.'[43] Indeed, the supposed creditor protection of the ultra vires doctrine was rather thin as a company's unsecured creditors were denied the right to apply for an interdict to prevent an ultra vires contract of a corporate debtor, and creditors could also not apply for the winding up for a company upon the failure of its substratum.[44] Blackman argues that even existing creditors were as likely to be prejudiced by the ultra vires doctrine as they were to be protected by it, as the rule was 'as likely to condemn a company to an unprofitable line of business as it was to prevent it from forsaking a profitable one'.[45]

Blackman makes a further important observation about some of the complications caused by the ultra vires doctrine:

> '[It] assumes that a person transacting with accompany can, simply by reading its memorandum, determine whether or not the company is acting in the furtherance of its authorised objects or business. Unfortunately, this assumption is without foundation; for most transactions are capable of furthering a great many different kinds of business, and many are capable of furthering every kind of business'.[46]

McGrath and Murphy suggest an alternative motivation for the application of the doctrine to incorporated companies:

> '[T]he real justification underlying the doctrine can be understood by considering the types of enterprise which were initially incorporated. The early companies were not the small, closely held businesses which make up the vast majority of incorporations today,

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[41] Schaeftler MA (1984) 164.
[42] Stevens RS 'A Proposal as to the Codification and Restatement of the Ultra Vires Doctrine' (1927) 36 *Yale LJ* 297 317; Schaeftler MA (1984) 165.
[43] Gower LCB et al (1979) 165.
[44] Griffin S (1998) 8.
[45] Blackman MS 'The capacity, powers and purposes of companies: the Commission and the new Companies Act' (1975) 8 *Comparative and International LJ of Southern Africa* 1 2.
[46] Blackman MS 'Directors' Duty to Exercise their Powers for an Authorised Business Purpose' (1990) 2 *SA Merc LJ* 1 1; McLennan JS (1979) 331.

> but much more similar to today's public companies. The management of the company was separate and quite distinct from those investing in the company as shareholders…where management and ownership are truly separate, there is a danger that the management of a company may misallocate the investor's money from its intended purpose to another, possibly riskier venture.'[47]

Talbot conducted an extensive analysis of the link between the emergence of limited liability, the change in the nature of share ownership, and the ultra vires doctrine.[48] He points out that the ultra vires doctrine was beneficial to balancing power within corporations, serving as a measure of protection to shareholders and creditors, regardless of the proportional size of investment or of the debt owed.[49] Talbot argues that the ultra vires doctrine served as a guarantee that the balance of power in a corporation could not shift too far in favour of the board and controlling shareholders.[50]

Another argument advanced for the emergence of the ultra vires doctrine was the idea that the public had an interest in seeing that the actions of a creature of statute (the company) remain within the limits of its powers.[51] This argument is partly based on the understanding of the public law doctrine of ultra vires in respect of public functionaries.[52]

Regardless of the true motivations for the ultra vires doctrine, the notion that a company's contractual capacity is limited to achieving its main object as set out in the company's memorandum has presented great difficulties in commerce.[53] The ultra

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[47] McGrath N & Murphy C 'The End of the Ultra vires Problem: Corporate Capacity before and after the proposed Companies Bill' (2008) 2(4) *Irish Business Law Quarterly* 16 17 (footnote omitted).
[48] Talbot LE 'Critical Corporate Governance and the Demise of the *Ultra vires* Doctrine' (2009) 38 *Common Law World Review* 170.
[49] Talbot LE (2009) 171 & 174.
[50] Talbot LE (2009) 175.
[51] In Woodrow Wilson's first address as Governor of the State of New Jersey, he stated that '[a] corporation exists, not of natural right, but only by license of the law, and the law, if we look at the matter in good conscience, is responsible for what it creates.' See *Ligget v Lee* (1933) 288 U.S. 517 559 note 37, Anderson J (2001) 266-7, and Greenfield K (2001) 1303-4. See also Pennington RR (1990) 91.
[52] Pennington RR (1990) 91.
[53] Davies and Worthington comment that the ultra vires doctrine 'had a major and adverse impact on the security of third parties' transactions with companies. Not even ratification was available in relation to ultra vires acts. So, it is not surprising that the doctrine was the object of reform; what is surprising is that reform took so long.' Davies & Worthington (2016) 173.

vires doctrine has also been the cause of a considerable amount of complexity in company law jurisprudence as a whole.[54]

The ultra vires doctrine was substantially modified by many common law jurisdictions during the twentieth century.[55] In South Africa, the reform of the ultra vires doctrine commenced with s 36 of the Companies Act 61 of 1973 (hereafter the 1973 Act). However, the position regarding corporate capacity has again been amended by the Companies Act 71 of 2008 (hereafter the Act).

1.2 BACKGROUND TO THE STUDY

It has been argued that it is prejudicial to the interests of a company for its powers to be restricted.[56] A popular view among academics is that restricting all companies to transacting in furtherance of a limited business purpose hinders growth, as it retards the commercial expansion of a business into new realms of profitability to suit changing circumstances.[57] These restrictions led to the avoidance and reform of the ultra vires doctrine in the twentieth century.[58]

The mischief inherent in the traditional ultra vires doctrine was the fact that it could invalidate an otherwise valid contract, thereby prejudicing outsiders.[59] The practice of obscuring a company's capacity by way of lengthy objects clauses only contributed to the uncertainty and risk that outsiders were faced with.[60]

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[54] On the ultra vires doctrine, McLennan writes: '[T]his topic has perhaps received more judicial and academic attention than any of the numerous other controversial topics in the field of company law'. McLennan JS (1979) 329. Cassim agrees that the ultra vires doctrine has had a profound impact on corporate law thinking. Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 163.
[55] See Schaeftler MA (1984) 74-5 notes 7 and 8 for a broad but brief analysis of reform to the ultra vires doctrine in common law countries.
[56] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 168.
[57] McLennan JS 'The ultra vires doctrine and the turquand rule in company law: a suggested solution' (1979) 96 *SALJ* 329 332.
[58] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 166; Cassim FHI 'The Rise, Fall and Reform of the Ultra vires Doctrine' (1998) 10 *SA Merc LJ* 293 295-7; McLennan JS (1979) 331-3; Naudé SJ (1974) 316.
[59] In *Re Jon Beauforte (London) Ltd* [1953] 1 All ER 634, a company formed with the objects of tailoring and dressmaking embarked on the business of manufacturing veneered panels. *Re Jon Beauforte (London) Ltd* 635. A subsequent contract for the supply of coke was declared ultra vires because it was an intra vires power exercised for an unauthorised purpose, Roxburgh J reasoning that the third party had received constructive notice of the company's capacity. *Re Jon Beauforte (London) Ltd* 635-6.
[60] *Cotman* 522-3.

In the aftermath of *Bell Houses*, many common law countries attempted to nullify the ultra vires doctrine with remedial legislation.[61] Arguably, the rejection of the ultra vires doctrine in common law jurisdictions is indicative of a tendency to allow corporations freedom in respect of their affairs.[62] The 1973 Act addressed the ultra vires doctrine in South African company law. By bestowing extremely wide powers on companies, the provisions of the 1973 Act greatly reduced the impact of the ultra vires doctrine.[63] Section 36 of that Act, in particular, by declaring that ultra vires acts of companies are not void if entered into by the directors, dealt a serious blow to the commercial relevance of the ultra vires doctrine.

The relaxed approach to corporate capacity continues to apply under the new Act, albeit with some important modifications. The Act further distances South African company law from the traditional ultra vires doctrine by expressly stating that, as a general rule, a company has similar contractual capacity to a natural person.[64] Capacity shall no longer be dependent on objects clauses, as their inclusion in a company's Memorandum of Incorporation (MOI) is not mandatory. However, capacity restrictions will still be allowed.[65]

At this point, it may serve to distinguish between three different scenarios: (i) a proposed ultra vires contract that has not yet been entered into, (ii) an executed ultra vires contract (i.e. a contract in terms of which all performances have been made), and (iii) an executory ultra vires contract (i.e. a contract that has been concluded, but certain important performances are outstanding).[66] As will be seen later, a discussion

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[61] McLennan JS (1979) 324.

[62] Taylor CR 'The Inadequacy of Fiduciary Duty Doctrine: Why Corporate Managers Have Little to Fear and What Might Be Done about it' (2006) 85 *Oregon LR* 993 1010-1. At 999 and 1011 note 86, the author remarks that the ultra vires doctrine severely curtailed corporate behaviour in the nineteenth century.

[63] In addition, the relevant sections of the 1973 Act served to effectively render irrelevant the practice of inserting unreasonably wide objects clauses in the MOAs of companies. See Naudé SJ (1974) 320.

[64] Section 19(1)(*b*) of the Act. In so doing, the Act adopts a suggestion made by the Cohen Committee in 1945. See also See Locke N 'The Legislative Framework Determining Capacity and Representation of a Company in South African Law and its Implications for the Structuring of Special Purpose Companies' (2016) 133 *South African LJ* 160 164.

[65] See 3.4.1 below.

[66] See para 4.56 of the International Accounting Standards Board (IASB) *Conceptual Framework for Financial Reporting* (2018), where an "executory contract" is defined as 'a contract, or a portion of a contract, that is equally unperformed—neither party has fulfilled any of its obligations, or both parties have partially fulfilled their obligations to an equal extent.' A further distinction can be made between executory contracts and "purely executory" contracts, i.e. contracts where no performances had yet been made. See Wermuth EA and Gilmore WC *Modern American Law* (1921) 153.

about the evolution of the ultra vires doctrine requires an understanding of these three stages of contractual completeness.

1.2.1 The evolution of the ultra vires doctrine in South African company law

South Africa's initial legislative solution to the ultra vires problem was cautious, but arguably extremely effective.[67] The 1973 Act retained the requirement of objects clauses, but widened the scope of a company's object to include practically any business activity with vague terms such as 'main business',[68] 'ancillary objects',[69] and 'plenary powers'.[70] The legislation was so broad that in the absence of an express exclusion, directors were free to bind companies to practically any conceivable commercial activity.[71] By bestowing extremely wide powers on companies, the provisions of the 1973 Act greatly reduced the risk that a transaction could be considered to be ultra vires a company. The relevant sections of the 1973 Act seemed to effectively render irrelevant the practice of inserting extremely wide objects clauses in the memorandums of companies.[72] In addition, the 1973 Act even made it possible for a company's main business to *change* in order to suit the accompanying ancillary objects.[73] This created a situation where the capacity of a company was a murky and imprecise concept. However, s 36 of the 1973 Act nullified the ultra vires doctrine and provided a great deal of certainty and protection to outsiders. Despite the fact that the exact scope of a company's capacity could still be open to interpretation, s 36 of the 1973 Act brought about a very important change to the issue of corporate capacity: the section abolished the general rule that ultra vires contracts are void. Section 36 of the 1973 Act stated:

> 'No act of a company shall be void by reason only of the fact that the company was without capacity or power so to act or because the directors had no authority to perform

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[67] Academics were generally in agreement that the ultra vires doctrine was largely neutralised by the 1973 Act. This was clearly the intention of the "Van Wyk De Vries Commission", upon whose recommendations the 1973 Act was drafted. See Commission of Enquiry into the Companies Act, Main Report, RP45/1970 (hereinafter "Van Wyk De Vries Commission") 27.16; McLennan JS (1979) 334; Cilliers HS et al (2000) 182.

[68] Section 33(3) of the 1973 Act.

[69] Sections 33(1) and (2) of the 1973 Act.

[70] Section 34 of the 1973 Act. See McLennan JS (1979) 359.

[71] McLennan JS (1979) 334; Mongalo T *Corporate Law and Corporate Governance: A Global Picture of Business Undertakings in South Africa* (2003) 238.

[72] Naudé SJ (1974) 320.

[73] By virtue of ss 33(2) and (3) of the 1973 Act. See Cilliers HS et al (2000) 184, McLennan JS (1979) 338, and Naudé SJ (1974) 326.

> that act on behalf of the company by reason only of the said fact and, except as between the company and its members or directors, or as between its members and its directors, neither the company nor any other person may in any legal proceedings assert or rely upon any such lack of capacity or power or authority.'

Under the 1973 Act, ultra vires contracts were no longer void, but the internal remedies coupled to the ultra vires doctrine were retained: a company's shareholders remained entitled to apply for an interdict restraining the company from concluding ultra vires contracts, and the company retained its right to recover from the directors any loss sustained as a result of such action. However, s 36 appeared to have brought about an important change to the common law position, by depriving shareholders of the right to restrain a company from performing in terms of an executory ultra vires contract; the right of restraint in terms of the 1973 Act seemed to be limited to enabling the shareholders to prohibit the *conclusion* of an ultra vires contract. Academics were in agreement that the wording of s 36 did not envision a shareholder's right to restrain a company from *performing* in terms of an ultra vires contract.[74] The rationale for this interpretation is reasonable: since s 36 clearly regarded an ultra vires contract as being valid, a company's shareholders would have had no basis to prevent the company from performing in terms of such an agreement.

The modified ultra vires doctrine created by the 1973 Act attempted to strike a balance between the perceived need for shareholders to have certainty regarding the business into which they are investing their money, and the interest of outsiders to have certainty in *their* dealings with companies. However, by codifying the internal consequences of ultra vires contracts, the 1973 Act deprived outsiders of absolute certainty regarding the validity of company contracts. Arguably, this uncertainty was counterproductive to commercial activity. It can hardly be denied that limitations on a company's capacity always have the potential to prejudice outsiders.[75]

It may be beneficial to reflect on the questions arising from the previous framework, as s 20(1) of the Act reads almost identically to s 36 of the 1973 Act. There is authority for the view that when a subsequent enactment is an exact replica of an earlier one,

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[74] Cilliers HS et al (2000) 186-7; Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 165, 167-8, & 170; Naudé SJ (1974) 325. However, the wording of ss 20(1)(*b*) and 20(5) of the new Act could conceivably allow for such a restraining application. See 3.5.5 below.
[75] Omar PJ (2004) 101.

the intention of the Legislature was to have the later provision be interpreted by the courts in the same way that the earlier provision was.[76] Unfortunately, there was no opportunity for the courts to interpret and apply the capacity provisions contained in 1973 Act.[77] Therefore, that particular interpretative guideline may be of little assistance. Yet, at the very least, there was a significant body of academic writing on s 36, and the issues identified therein should be considered.

The language of s 36 of the 1973 Act gave rise to some debate among academics. Several problems and ambiguities were encountered as the rather clumsily-worded section was analysed and interpreted. Since there has been no judicial decision interpreting and applying s 36, the uncertainties remained unresolved. Some of the unclear issues regarding s 36 included:

- the meaning of 'directors';[78]
- whether s 36 could be circumvented by a clause in the Articles of Association limiting the directors' authority to concluding intra vires contracts;[79] and
- the meaning of 'except as between the company and its members or directors'.[80]

Leacock is critical of the English law approaches to reforming the ultra vires doctrine, arguing that the changes 'tended to become mired in almost inextricable complexity'.[81] Arguably, the 1973 Act was guilty of this sin, as there was considerable uncertainty and debate among South African academics regarding the interpretation of s 36.[82]

Whatever its alleged defects, the 1973 Act certainly removed most of the lingering potential for capacity restrictions to prejudice outsiders.[83] Despite the uncertainty

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[76] See De Ville JR *Constitutional and Statutory Interpretation* (2000) 233, and the cases cited at notes 55 & 56.
[77] McLennan JS (1979) 335.
[78] Naudé SJ (1974) 324 & 332-3; Oosthuizen MJ 'Aanpassing van die verteenwoordigingsreg in maatskappyverband' (1979) *Journal of South African Law* 1 2-3; Cilliers HS et al (2000) 186; McLennan JS (1979) 336; Obadina DA (1996) 329. Similar concerns were raised regarding the wording of s 9(1) of the European Communities Act 1972. See Schaeftler MA (1984) 121-2.
[79] McLennan JS (1979) 337 & 358; Naudé SJ (1974) 334.
[80] Naudé questioned whether s 36 created a distinction between company contracts concluded with insiders and those concluded with outsiders. See Naudé SJ (1974) 324 and McLennan JS (1979) 336.
[81] Leacock SJ (2007) 75. The author regards the American approach as being simple and efficient.
[82] Leacock SJ (2007) 75.
[83] McLennan JS (1979) 335.

regarding the interpretation of s 36, no notable litigation arose on the subject.[84] Therefore, the legislature may have been forgiven for thinking that the legislation had achieved its aim, and for resisting the impulse to fix what was, by all appearances, working. As it transpired, Parliament completely altered the approach to corporate capacity with the new Act.

1.2.2 The new approach to corporate capacity in South African law

In keeping with the modern approach, the Act proclaims that, as a general rule, the powers of companies are unlimited.[85] The Act merely provides the option for limited capacity by allowing a company to have "restrictive conditions" to its powers stipulated in the company's MOI.[86]

The Act has amended the legal position regarding corporate contractual capacity in several important respects. The traditional ultra vires doctrine would deem contracts beyond the capacity of a company as being completely void and incapable of ratification.[87] The provisions of the 1973 Act extended the capacity of companies and at the same time declared ultra vires acts concluded by directors to be valid.[88] Under the new Act, an ultra vires contract concluded by a company shall at the same time be valid[89] and capable of ratification.[90] In addition, the company may be interdicted from entering into such an agreement at all.[91] It is not certain whether the relevant section in the Act may be invoked to restrain the performance of a contract that had already been concluded.[92]

The Act has apparently opted for a "best of both worlds" approach to corporate capacity, in terms of which a reformulated ultra vires doctrine will be available for those persons wishing to incorporate and invest in a company over which seemingly greater control can be imposed. Directors are under a duty to act within a company's

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[84] McLennan JS 'Time for the Final Abolition of the Ultra vires and Constructive Notice Doctrines in Company Law' (1997) 9 *SA Merc LJ* 334-5; Mongalo T (2003) 238.
[85] Section 19(1)(*b*) of the Act.
[86] Section 15(2)(*b*) of the Act.
[87] *Ashbury Railway* 672.
[88] There was some contention regarding the interpretation of s 36, notably regarding the word 'directors'. See Naudé SJ (1974) 324, Cilliers HS et al (2000) 186 and McLennan JS (1979) 336.
[89] Section 20(1)(*a*) of the Act.
[90] Section 20(2) of the Act.
[91] Section 20(5) of the Act.
[92] The reach of the right to restrain ultra vires contracts will be discussed in Chapter Three.

capacity.[93] Directors breach a fiduciary duty and incur liability for causing a company to act ultra vires.[94] Therefore, the capacity provisions may serve as a means of keeping the actions of directors in check. The ability to control the actions of directors could encourage the formation of such restricted capacity companies and facilitate investment in such entities. In 2004, the Department of Trade and Industry released a policy paper entitled *South African Company Law for the 21st Century; Guidelines for Corporate Law Reform* (hereinafter DTI Policy Document).[95] The document indicates that the ability to restrict the actions of a board of directors was indeed one of the motivations for retaining the internal consequences of the ultra vires doctrine.[96]

It is debateable whether the Act creates a sound, logically consistent and fair regulatory framework within which the activities of limited capacity companies function. Since the Act is relatively new,[97] it is appropriate to consider whether the capacity provisions adequately facilitate the processes involved with these commercial entities while providing sound levels of protection for all parties concerned, in a manner that promotes the welfare of the South African economy 'as a partner within the global economy.'[98]

1.2.3 Securitisation

The technique of asset-backed securitisation was first used in the USA during the 1970s.[99]

Securitisation refers to the transformation, through a series of contracts, of an income producing asset into a security issued by a special purpose vehicle (SPV) and purchased by institutional investors.[100] Simply put, securitisation transforms claims

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[93] Blackman MS (1990) 8.
[94] McLennan JS (1979) 331. Academics were in agreement that s 36 of the 1973 Act did not terminate this duty. Blackman MS (1990) 9. See also Naudé SJ 'Company contracts: the effect of section 36 of the new Act' (1974) 91 *SALJ* 315 328.
[95] GN 1183 of 2004 (hereinafter DTI Policy document), available at www.gov.za/sites/www.gov.za/files/26493_gen1183a.pdf, accessed on 9 April 2018.
[96] DTI Policy document 4.2.
[97] The Act came into effect on 1 May 2011.
[98] As envisioned by s 7(*e*) of the Act.
[99] Saayman & Styger (2003) 744-6; Petersen C 'Predatory Structured Finance' (2007) 28 *Cardozo LR* 2191-2206; Committee on Bankruptcy and Corporate Reorganisation of The Association of the Bar of the City of New York 'Structured Financing Techniques' (1995) 50 *The Business Lawyer* 537-40.
[100] Scott S 'An Introduction to the Securitisation of Claims Incorporating a Collective Security Arrangement' (2006) 18 *SAMLJ* 397 398.

(illiquid assets) into cash flow (liquid assets). It is this transformation that has caused securitisation to be described as "alchemy".[101] An institution may wish to do this for a variety of reasons, as securitisation has several advantages.[102]

The practice of securitisation may be viewed with some suspicion after the collapse of the subprime mortgage-backed securities (MBS) market in the USA which triggered the global economic crisis of 2007/2008.[103] However, the worth that this innovative means of financing can bring to an economy is undeniable.[104]

1.3 PROBLEM STATEMENT

Corporate capacity rules influence a company's interaction with outsiders (creditors) and its relationship with insiders (the board of directors and the shareholders). The commercial desirability of the capacity provisions is influenced by the extent to which the shareholders of limited capacity companies may rely on the Act to have ultra vires company contracts declared void or unenforceable. It is also important for persons dealing with such companies to have certainty regarding the validity of their transactions. The thesis will investigate whether the Act maintains the seemingly adequate level of outsider protection that had existed under the 1973 Act.

Despite the reform of the ultra vires doctrine, the desire for companies with restricted powers has not vanished from the commercial landscape. Capacity restrictions are often imposed on SPVs. An SPV is a legal entity established to complete a specific

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[101] Schwarcz SL 'The Alchemy of Asset Securitization' (1994) 1 *Stanford Journal of Law, Business & Finance* 133 134.

[102] Itzikowitz & Malan 'Asset Securitisation in South Africa' (1996) 8 *SAMLJ* 175 185-6; Locke N *Aspects of traditional securitisation in South African law*, (unpublished LLD thesis, UNISA, 2008) 30-36.

[103] Legg M & Harris J 'How the American dream became a global nightmare: an analysis of the causes of the global financial crisis' (2009) 32 *University of New South Wales LJ* 350 350-60; Hackney J 'The Enlightenment and the Financial Crisis of 2008: An Intellectual History of Corporate Finance Theory' (2009) 54 *St Louis University LJ* 1257 1268-9 & 1272; Born B 'Financial Reform and the Causes of the Financial Crisis' (2011) 1 *American University Business LR Symposium* 1 1-4; Schwarcz SL 'Securitization and Post-Crisis Financial Regulation' (2015) 101 *Cornell LR Online* 115 117; Eggert K 'The Great Collapse: How Securitization Caused the Subprime Meltdown' (2009) 41 *Connecticut LR* 1257; Arner D 'The Global Credit Crisis of 2008: Causes and Consequences' (2009) 49 *The International Lawyer* 91 92. A popular argument is that excessive risk-taking and risk management failures by the world's largest financial institutions caused the global financial crisis. See Miller RT 'Oversight Liability for Risk-Management Failures at Financial Firms' (2010) 84 *Southern California Law Review* 47 50-1.

[104] Schwarcz SL (1994) 133. See also 'Overview of Securitisation as a Funding Tool', available at https://www.sahomeloans.com/content/uploads/2016/11/Securitisation-A-Funding-Tool.pdf, accessed on 13 January 2017.

and limited commercial goal.[105] SPVs may be formed to fulfil a range of commercial and financial objectives, including the financial engineering technique of asset securitisation.[106] SPVs should ideally be structured to be "insolvency-remote". An entity is regarded as insolvency-remote when steps have been taken to reduce the risk of the SPV undergoing or being affected by liquidation proceedings.[107] One technique used to achieve insolvency-remoteness is the insertion of limited capacity clauses in the MOI of the SPV— herein lies the link between SPVs and the capacity provisions in the Act. Those incorporating an SPV may wish or be obliged to insert restrictive capacity clauses in the MOI of the entity.

In certain situations, a limited capacity company may have to register as an RF company in terms of the Act. Clarity is needed regarding precisely which limitations would qualify as provisions that should bring the RF requirement into play, and in respect of the effect of compliance with the RF provisions on the activities of RF companies. The Act has left certain key phrases undefined.[108] This creates room for speculation and uncertainty regarding the evolving ultra vires doctrine.

Certain commercial activities that make use of SPVs may benefit from absolute and effective restrictive conditions to the SPV's capacity, so as to promote or safeguard the goals of the enterprise. For example, an arrangement where there is no intention of allowing the SPV to acquire more debt by way of issuing securities, or raising funds from the market through equity issuances, could benefit from absolute certainty regarding the company's limited capacity. Since the capacity provisions do not create an absolute prohibition on ultra vires contracts, the Act may have to be amended to better facilitate the potential commercial utility of creating a true limited capacity company. It may be beneficial for a particular transaction or series of transactions for a company to be completely and effectively restrained from acting ultra vires.

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[105] Locke N (2016) 161.
[106] Schwarcz SL *Structured Finance: A Guide to the Principles of Asset Securitization* 3 ed (c2002-) §1.1.
[107] Baudistel JK 'Bankruptcy-remote Special Purpose Entities: An Opportunity for Investors to Maximize the Value of Their Returns While Undergoing More Careful and Realistic Risk Analysis' (2013) 86 *Southern California LR* 1309 1314-5; Pearce JA and Lipin IA 'Special Purpose Vehicles in Bankruptcy Litigation' (2011) 40 *Hofstra LR* 177 179; Muñoz DR 'Bankruptcy-remote transactions and bankruptcy law—a comparative approach (part 1): changing the focus on vehicle shielding' (2015) *Capital Markets Journal* 10(2) 239-274, available at SSRN https://ssrn.com/abstract=2733613 (accessed on 17 August 2018); *In Re Doctors Hospital of Hyde Park Inc.* 2013 WL 5524696 (Bankr ND Ill 2013).
[108] For example, the Act fails to define "restrictive conditions".

However, the Act does not seem to allow for this, as the very notions of restricted capacity and the ultra vires defence are suspect in light of the approach adopted by s 19(1)(*b*) and s 20(1)(*a*).

An SPV is used as an intermediary vehicle in traditional securitisation schemes.[109] It is common practice for the constitution of an incorporated securitisation SPV to include a clause restricting the powers of the company to administering the securitisation scheme only and fulfilling the duties attached thereto.[110] This type of provision is intended to protect the SPV from being affected by insolvency proceedings.[111] It is important to maintain a clear understanding of the interaction between the capacity provisions and the structured financing technique of traditional securitisation.

1.4 RESEARCH QUESTION AND SUB-QUESTIONS

The overall aim of the thesis is to provide a meaningful and comprehensive answer to the following research question:

"Does the Companies Act 71 of 2008 provide a commercially desirable legal framework to regulate corporate capacity and facilitate the activities of incorporated SPVs used in traditional securitisation schemes?"

To respond to the research question, the thesis will address the following sub-questions:

1. How did the company law doctrine of ultra vires emerge and evolve in South African law prior to the coming into effect of the Act?
2. How does the Act regulate the activities of limited capacity companies and what is the legal status of ultra vires contracts entered into on behalf of such entities?
3. How can incorporated SPVs be structured and used in South Africa?
4. Do the capacity provisions in the Act enhance the insolvency-remoteness of an SPV used in traditional securitisation schemes?

[109] South African law distinguishes between "traditional" and "synthetic" securitisation. Itzikowitz & Malan (1996) 180; Scott S (2006) 397; Locke N (2008) 15; Wessels F 'Synthetic securitisation in South African law', (unpublished LLD thesis, University of Pretoria, 2016).
[110] Locke N (2008) 43.
[111] Locke N (2016) 162.

5. What are the strengths and weaknesses of the South African approach to corporate capacity when measured against comparable laws in the USA and UK?
6. Can the Act be amended so as to improve South African law in this regard?

1.5 SIGNIFICANCE OF THE STUDY AND LITERATURE REVIEW

The exercise of corporate power will always be an important issue in law and in commerce. It is a worthwhile study to analyse the evolved ultra vires doctrine and the legal effectiveness of capacity restrictions, as it contributes to academic and practical knowledge pertaining to corporate law and the business of SPVs. Furthermore, the fact that the RF provisions are (at first glance) ideally suited to, and therefore perhaps targeted at, the needs of SPVs, further enhances the importance of research in this area of law.

While the ultra vires doctrine has been the topic of many an article and doctoral thesis in South Africa, the modern version of the doctrine has yet to comprehensively be analysed in the context of limited capacity companies used in traditional securitisation schemes. The scarcity of South African legal writing on the activities of SPVs involved in structured finance transactions serves to motivate why this topic is worthy of research.

The capacity provisions in the Act have been criticised for their lack of clarity and for the uncertainty brought to an area of law that for decades had seemed to be settled.[112] It is important to eliminate any uncertainty pertaining to the capacity provisions, as these sections will have a critical (albeit often unstated) impact on the activities of companies in South Africa.[113] These considerations indicate that the thesis will advance knowledge in the field of corporate and commercial law.

This thesis will greatly benefit from an analysis of the available literature on the topic, as it will serve to indicate what the current thinking on the new capacity provisions is.

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[112] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 179. See also McLennan JS 'Time for the Final Abolition of the Ultra vires and Constructive Notice Doctrines in Company Law' (1997) 9 *SA Merc LJ* 333 334-5.

[113] Delport comments that '[c]apacity and representation of a company are some of the most important principles of company law as this is the interface with the outside world, and certainty for the third party and the company should be a given.' Delport P 'Companies Act 71 of 2008 and the "Turquand" Rule' (2011) 4 *THRHR* 132 132.

A short summation of the views of academic leaders in South African company law will provide a platform from which this author will set forth his own understanding of the relevant law.

1.5.1 Corporate capacity in terms of the Companies Act 71 of 2008

There has been some valuable research done regarding the capacity provisions in the Act by leaders in the field of South African corporate law. However, due to the voluminous nature of the Act and the variety of topics which form part of the body of corporate law, most references to the capacity provisions have formed part of broader analyses. Respectfully, it is submitted that to my knowledge, no author has yet provided a thorough and definitive summation of corporate capacity under the Act. In addition, there are areas of uncertainty among academics and practitioners regarding certain aspects of the capacity provisions in the Act. These areas of uncertainty include:

(1) The type of clauses necessary to bring the RF provisions into full effect;
(2) The interpretation of the term "restrictive condition" and its interaction with s 20(1) of the Act;
(3) The interpretation of ss 20(2) and (5) (i.e the interaction between the shareholders' right to ratify an ultra vires contract and the right of shareholders, directors and prescribed officers to restrain it);
(4) The scope of s 20(5), in particular how far the right to restrain ultra vires acts extends; and
(5) The applicability and impact of the new statutory doctrine of constructive notice created by s 19(5)(*a*) of the Act.

Cassim notes that contemporary company law systems generally reject the outmoded idea of restricting a company's business activities, and that the Act has followed this trend.[114] However, the author comments that the ultra vires doctrine remains an important issue in respect of disputes between a company, its shareholders and its directors.[115] Cassim observes that the effect of s 19(1)(*b*) of the Act is to entitle a company to pursue any lawful activity which it is capable of pursuing, the exception

[114] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 168.
[115] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 165.

being juristic acts which an artificial person is incapable of performing, like marriage.[116] He points out that s 19(1)(*b*) is similar to provisions in the company legislation of other common law jurisdictions such as Australia.[117] Section 124(1) of the Australian Corporations Act of 2001 provides that companies have "the legal powers and capacity of an individual".

Stein and Everingham remark that the consequence of s 19(1)(*b*) of the Act is that it has become virtually impossible for a company to act ultra vires, unless the company's capacity has been specifically restricted by its MOI.[118] The authors argue that s 19(1)(*b*) abolishes the ultra vires doctrine because it is no longer necessary for a profit company to state its intended business, and therefore third parties may assume that a company has the capacity to transact, unless it is an RF company, in which case the doctrine of constructive notice would apply.[119]

Cassim highlights the absence of a requirement in the Act for a company to have an objects clause in its MOI.[120] He welcomes this change for removing the complexity regarding the terms "main objects", "ancillary objects" and "plenary powers" as provided for by the 1973 Act.[121] Since objects clauses have now become optional, the entire arrangement regarding corporate capacity has done an about-turn. In this regard, Cassim seems to approve of the capacity provisions in the Act, as they free a company from the obligation to state its intended business activities in its constitution.[122]

Van der Linde notes that s 20 of the Act deals with a range of scenarios, only one of which is the effect of restrictions to a company's capacity, and that the various subsections are capable of finding application in one or more of those situations.[123] Since unrelated issues are regulated in the same section (and often the same

[116] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 168
[117] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 168.
[118] Stein C & Everingham GK *The new Companies Act unlocked* (2011) 72.
[119] Stein C & Everingham GK (2011) 81-2.
[120] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 169.
[121] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 169.
[122] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 169.
[123] Van der Linde K 'The Validity of Company Actions under Section 20 of the Companies Act 71 of 2008' (2015) 4 *Journal of South African Law* 833 835.

subsection), she expresses the concern that confusion could arise in respect of corporate capacity.[124]

McLennan wrote about the capacity provisions before the Companies Bill became an Act. His views are relevant as the final version of the Act in respect of capacity was nearly identical to the language of the Bill, save for the replacement of "special conditions" with "restrictive conditions" in s 15(2)(*b*).[125] At the time, the author remarked that the South African approach to the company law doctrines of ultra vires and constructive notice remained unclear and unsatisfactory.[126] While McLennan noted that there had been no reported cases on the topic since ss 33, 34 and 36 of the 1973 Act had effectively nullified the ultra vires doctrine,[127] he was critical of the Bill for containing 'a number of puzzling provisions' in respect of capacity.[128] On s 13(3), for example, the author questions the purpose of the relevant clause being prominent if one has not read the MOI.[129]

Van der Linde highlights the importance of assessing what the purposes of a company are and the way in which these purposes should be determined.[130] Cassim interprets the phrase "purpose, powers and activities of a company" in s 20(1)(*a*)(i) as referring to the objects of a company as understood at common law and under the 1973 Act.[131] Van der Linde questions whether a company's capacity will necessarily be limited by clauses in its MOI that relate to its purposes and activities.[132] In this regard, she argues that a company's capacity should only be regarded as limited if the MOI *clearly* alters the default position of unrestricted capacity.[133]

Delport suggests that the "RF" requirement in a company's name is applicable only to those companies that insert in their MOIs "restrictive conditions applicable to the

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[124] Van der Linde K (2015) 834.
[125] McLennan JS 'Contract and Agency Law and the Companies Bill 2008' (2009) 30(1) *Obiter* 144 150-2. However, Locke suggests that since the phrase was specifically amended to read "restrictive conditions", it should have a different meaning to "special conditions". See Locke N (2016) 187. An alternative view is that the new phrase was just a refinement or clarification of the discarded one.
[126] McLennan JS (2009) 145.
[127] McLennan JS (2009) 145-6.
[128] McLennan JS (2009) 150.
[129] McLennan JS (2009) 150.
[130] Van der Linde K (2015) 835.
[131] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 172.
[132] Van der Linde K (2015) 835.
[133] Van der Linde K (2015) 836.

company" in terms of s 15(2)(*b*) of the Act.[134] The author argues that Practice Note 4 of 2012[135] indicates that the relevant phrase in s 15(2)(*b*) should refer to the capacity and powers of a company only,[136] but argues that the term could also refer to 'conditions that alter any alterable provision or that increase the burden of an unalterable provision.'[137] However, Delport expresses doubt as to whether limitations placed on the authority of the board of directors can qualify as restrictive conditions.[138]

McLennan is of the opinion that s 19(1)(*b*) sets out the link between capacity and special conditions.[139] He notes that s 19(1)(*b*)(ii) could suggest that a special condition is a provision that restricts the capacity of a company in some way,[140] and that s 19(5)(*a*) seemingly rendered the doctrine of constructive notice applicable to such provisions. Consequently, the author raises the possibility that "incorporators could set up a regime that resurrects *ultra vires* in all its pristine frightfulness."[141]

Van der Linde disagrees with McLennan's interpretation of the interaction between s 15(2)(*b*) and s 19(5), namely that any capacity limitation amounts to a "restrictive condition" to which the statutory doctrine of constructive notice would apply.[142] She argues that s 19(5) makes no mention of s 19(1)(*b*)(ii), and therefore submits that capacity limitations are *not* equivalent to restrictive conditions.[143] Instead, the author expresses the view that a capacity limitation in terms of s 19(1)(*b*)(ii) 'simply has the effect of altering the alterable provision set out in the introductory part of section 19(1)(*b*)'.[144] According to van der Linde, a restrictive condition is only present when a capacity restriction is coupled with a requirement for its amendment in addition to the normal amendment requirements stipulated by s 16.[145]

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[134] Delport P *Henochsberg on the Companies Act 71 of 2008* (2018) 74.
[135] Practice Note 4 of 2012 in terms of s 188(2)(*b*) of the Companies Act, 2008, available at http://www.cipc.co.za/files/9613/9565/1718/PracticeNote4of2012.pdf, accessed on 6 April 2018.
[136] Delport P (2018) 74.
[137] Delport P (2018) 74. The author bases this interpretation of the Act on a reading of Practice Note 4 of 2012, despite his criticism of the document for its failure to consider the effect of s 20(1) of the Act.
[138] Delport P (2018) 74.
[139] McLennan JS (2009) 150.
[140] McLennan JS (2009) 151.
[141] McLennan JS (2009) 151.
[142] Van der Linde K (2015) 837.
[143] Van der Linde K (2015) 837.
[144] Van der Linde K (2015) 837. The author differentiates between provisions that alter an alterable provision in terms of s 15(2)(*a*)(ii) and restrictive conditions in terms of s 15(2)(*b*).
[145] Van der Linde K (2015) 837.

Delport shares the view that a failure to couple a restrictive condition with a provision prohibiting the amendment of that or any other provision in the MOI of the company results in the need to label the company "RF" falling away.[146] Locke agrees that a limitation on a company's capacity would only constitute a 'restrictive condition' in terms of s 15(2)(*b*) of the Act if the clause was coupled with a prohibition of or additional requirement in respect of the amendment of the clause imposing the limitation to the company's capacity.[147]

Cassim notes the similarity between s 20(1) of the Act and provisions in Australian and English company law.[148] Section 125 of Australia's Corporations Act 2001 stipulates that objects or capacity restrictions are not to affect the validity of an act of the company or an exercise of its power which exceeds or is contrary to the stated restrictions or objects. Sections 31 and 39 of the UK Companies Act 2006 are phrased in similar terms.[149]

McLennan also commented on the impact of s 20(1) of the Bill. He argues that both the ultra vires doctrine and the doctrine of constructive notice are effectively nullified by s 20(1). In other words, the author takes the view that the effect of s 20(1) is to largely negate ss 13(3), 15(2)(*b*), 19(1)(*b*)(ii) and 19(5), at least in respect of outsiders contracting with the limited capacity company.[150]

On the question of who may rely on non-compliance with a special condition, McLennan is willing to accept that directors and other officers should be prevented from relying on a capacity limitation to protect themselves, as these persons are under a fiduciary duty to ensure that the company complies with its MOI.[151] However, shareholders have no such duty towards a company, and neither are they privy to the internal operation of a company. Therefore, McLennan feels that in this respect, inequitable results could be caused by s 20(1).[152]

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[146] Delport P (2018) 72-4.
[147] Locke N (2016) 167. Cf Cassim R 'Formation of Companies and the Company Constitution' in Cassim FHI (ed.) *Contemporary Company Law* 2 ed (2012) 131.
[148] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 169.
[149] See 2.4.1 below.
[150] McLennan JS (2009) 152.
[151] McLennan JS (2009) 152.
[152] McLennan JS (2009) 152.

Delport, commenting on the effect of s 20(1), takes the following view:

> 'If there is a lack of authority on any other basis (*even a restriction in authority based on the capacity*), s 20(1)(*a*) does not apply and the company is not bound by the contract, even if the third party is *bona fide*'.[153]

Cassim reads s 20(1)(*b*) of the Act as implicitly making provision for the traditional common law rules in respect of ultra vires action, namely the company's right to hold its directors personally liable for breaching a fiduciary duty in causing the company to exceed its capacity, and the right of a shareholder to restrain the company from acting ultra vires.[154] According to Cassim, '[t]he *ultra vires* doctrine is preserved internally as a form of shareholder protection and protection for the company', as directors that cause a company to act contrary to restrictions to the company's capacity may incur liability to the company for breaching a fiduciary duty, and ultra vires agreements will be capable of being restrained by the shareholders 'in certain circumstances'.[155] Therefore, Cassim considers the ultra vires doctrine to have been abolished externally, but preserved as an internal mechanism to control the actions of the board.[156] This is so because any restrictions to a company's capacity under the Act effectively amount to restrictions on the authority of directors to conclude contracts beyond those limitations, and any breach thereof could lead to liability under s 77(3)(*a*) of the Act.[157] Therefore, Cassim comments that 'the question of capacity has in this way become a question of authority'.[158]

Van der Linde remarks that the wording of s 20(1) regarding the prohibition on raising capacity restrictions in litigation is narrower than the wording of its predecessor. Whereas s 36 of the 1973 Act prohibited the company's lack of capacity being raised for "whatever" reason, s 20(1) merely prevents the issue being raised to assert that an ultra vires action is void.[159] While pointing out that, strictly speaking, such prohibition serves no purpose in light of the clear statement that such action is *not* void,[160] the

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[153] Delport P (2018) 97. Italics added.
[154] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 172.
[155] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 170. Precisely what those circumstances are depend on the wording of s 20(5) of the Act.
[156] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 170-1.
[157] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 172.
[158] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 171.
[159] Van der Linde K (2015) 836.
[160] Van der Linde K (2015) 836

author questions whether outsiders, or even the company itself, would be entitled to rely on a capacity limitation to make *other* assertions, for example where a company would enforce a claim for damages against a director that knowingly caused the company to act ultra vires.[161]

Van der Linde argues that if a company acts ultra vires, aggrieved insiders that have suffered loss thereby would in all probability rely on the restrictions in the MOI to assert a claim against the directors based either on breach of contract or on breach of the directors' fiduciary duties.[162]

Section 20(2) of the Act allows for the ratification of ultra vires contracts. Locke remarks that '[t]he possibility of ratification shows that, in terms of the new company-law regime, a company always has the possibility of full capacity, even when its capacity is limited in the MOI'.[163] Delport argues that the ratification of a contract beyond the capacity of the company 'has the effect of amending the Memorandum of Incorporation'.[164]

Stein and Everingham suggest that the right to ratify must be read with the remedy in s 20(5) of the Act.[165] Cassim argues that after ratification the internal consequences of ultra vires agreements, namely the liability of the directors and the right of restraint, should fall away.[166] Van der Linde takes the view that the ratification of ultra vires contracts in terms of s 20(2) of the Act will *only* have an impact in respect of the internal remedies[167] (the company's right to sue the directors for breaching a fiduciary duty and the insiders' right to restrain the company from acting ultra vires), although she laments the fact that the Act fails to clearly explain the effect of ratification of the company's action on the relevant director's liability for his conduct.[168]

Cassim argues that the wording of s 20(2) suggests that a special resolution ratifying an ultra vires contract simultaneously absolves the directors of liability for breaching the fiduciary duty, while noting that the comparable provision in English law has been

[161] Van der Linde K (2015) 837
[162] Van der Linde K (2015) 837.
[163] Locke N (2016) 164.
[164] Delport P (2018) 95.
[165] Stein C & Everingham GK *The new Companies Act unlocked* (2011) 83-4.
[166] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 173.
[167] Van der Linde K (2015) 838
[168] Van der Linde K (2015) 838.

amended to now only require an ordinary resolution to ratify the breach of a director's duty.[169] Van der Linde agrees with Cassim's suggestion that ratification of an ultra vires contract should automatically ratify the unauthorised conduct of the directors,[170] but cautions that this approach would only be reasonable if, in the circumstances, the directors were unaware of the capacity restriction and their lack of authority.[171]

Delport notes that the contractual nature of the MOI at common law allowed a member of a company to restrain ultra vires conduct by the company, and that this right has now become codified by s 20(5).[172] According to Locke, the only remaining benefit that a limitation of capacity can confer is found in s 20(5) of the Act, which contains the right of the shareholders or directors of a limited capacity company to restrain the company from acting ultra vires.[173] Delport argues that if the right to restrain an ultra vires contract is not exercised, the transaction will remain valid as a result of s 20(1) of the Act.[174]

Van der Linde suggests that the right to restrain in terms of s 20(5) should be excluded in the event that an ultra vires contract has been ratified in terms of s 20(2), in the same way that the shareholders' right to claim damages in accordance with s 20(6)(*b*) is excluded in the event of ratification of the ultra vires action.[175] However, Van der Linde notes that the application of s 20(6) is limited to situations where a person causes the company to act ultra vires and will not apply to conduct by the directors that is unauthorised due to a different restriction in the company's MOI.[176]

Cassim observes that the right to restrain an ultra vires contract in terms of s 20(5) does not distinguish between executed and executory contracts, noting that the present position is contrary to the accepted interpretation of s 36 of the 1973 Act.[177] In other words, whereas it was relatively clear that under s 36 of the 1973 Act the right to restrain could not successfully be invoked to prevent the performance of an ultra

[169] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 173-4 and ss 239(1) and (2) of the United Kingdom Companies Act 2006.
[170] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 172-3.
[171] Van der Linde K (2015) 839.
[172] Delport P (2018) 97.
[173] Locke N (2016) 164-5.
[174] Delport P (2018) 97.
[175] Van der Linde K (2015) 838.
[176] Van der Linde K (2015) 840.
[177] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 175.

vires contract, the wording of the present Act may suggest the contrary.[178] By speculating that a third party's right to damages in the event of ultra vires action will depend on when an ultra vires contract is restrained in terms of s 20(5), Van der Linde also seems to accept the possibility that the performance of an ultra vires contract may be restrained subsequent to its conclusion.[179] Locke sums up the uncertainty in respect of s 20(5) as follows:

> 'The section does not…restrict the time at which the shareholders or directors of a company may apply for such an order. It therefore appears as if an order may be sought even after conclusion of a contract, but before its full execution'.[180]

Cassim argues that shareholder protection is diminished where the right to restrain is limited to preventing the conclusion of ultra vires contracts.[181] Claasen argues that allowing the insiders of a limited capacity company to restrain the company from acting ultra vires at all will always have the potential to cause prejudice to third parties.[182] Cassim views s 20(5) as an attempt 'to draw a proper balance between the interests of the company and the rights of the third party'[183] in relation to ultra vires contracts, but regards it as unfortunate that the effect of s 20(5) is that a company's capacity ends up being restricted in the same manner as an ultra vires contract and thus, remnants of the ultra vires doctrine will continue to exist in South African company law.[184]

Delport remarks that the Act does not clearly specify whether a company's creditors could use s 20(5) to prevent the directors from acting contrary to s 76(2)(*a*), which prohibits directors from using inside information to gain an advantage or to knowingly cause harm to a company.[185]

Cassim argues that the right of a bona fide third party to claim damages in terms of s 20(5) does not entitle him to pursue a claim for specific performance in terms of the

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[178] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 175.
[179] Van der Linde K (2015) 838.
[180] Locke N (2016) 165.
[181] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 176.
[182] Claasen M 'Third party protection under the current application of the ultra vires doctrine' (2014), available at http://the writecandidate.co.za/third-party-protection/, accessed on 11 June 2018.
[183] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 177.
[184] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 177.
[185] Delport P (2018) 97.

contract in the face of a restraining action.[186] The author interprets the section as prohibiting a mala fide third party, or one with actual knowledge of the relevant limitation and an appreciation of the company's failure to observe such restriction, from claiming damages in the event that the contract is restrained.[187] According to Cassim, the effect of paragraphs (*a*) and (*b*) of s 20(5) is that *both* good faith and a lack of knowledge regarding the company's limited capacity must be present in order for the outsider to retain his right to damages.[188] Cassim argues that the mala fide third party in such an instance will be unable to enforce the contract or claim damages from the company. The author is critical of this approach because it departs from the settled position under both the 1973 Act and the common law.[189] Cassim makes reference to the judgment of Slade LJ in *Rolled Steel Products (Holdings) Ltd v British Steel Corporation*[190] wherein it was emphasised that, as a general rule, the outsider's knowledge of the company's lack of capacity is irrelevant to the determination of whether the contract is ultra vires.[191]

Cassim is of the view that once an ultra vires contract has been ratified in terms of s 20(2), the company's shareholders lose their right in terms of s 20(6) to claim damages from the directors for causing the company to act ultra vires.[192] The author notes that the wording of s 20(6)(*b*) of the Act allows for a company's shareholders to ratify even a fraudulent or grossly negligent causing of a company to act contrary to restrictions to the company's capacity.[193] Delport makes a similar observation.[194] In addition, Delport submits that s 20(6) 'elevates the proprietary right of a shareholder to a financial right and the absence of any indication that there must be a causal link…is significant and will also clearly lead to a multiplicity of actions'.[195]

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[186] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 176-8.
[187] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 176.
[188] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 178.
[189] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 176.
[190] [1985] 3 All ER 52.
[191] At 85. See Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 176, where the author comments on this issue that '[k]nowledge should be relevant to the issue of authority, and not capacity.'
[192] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 174. Locke interprets the interaction between ss 20(2) and 20(6) in the same way. See Locke N (2016) 166.
[193] Cassim F 'Corporate Capacity, Agency and the Turquand Rule' (2012) 174.
[194] Delport P (2018) 96.
[195] Delport P (2018) 96.

Not much has been written on the topic of the new statutory doctrine of constructive notice. Most academics accept that the effect of s 19(4) is to abolish the common law doctrine of constructive notice,[196] but the scope of the new statutory doctrine of constructive notice in respect of limited capacity RF companies has not yet been fully examined.[197]

Locke views the traditional ultra vires doctrine as unjustifiable in a modern commercial law setting, but argues that in the context of SPVs, it remains important to minimise the possibility of directors acting outside of the special purpose of the company:

> 'It is integral for the proper functioning of such a company that its capacity be effectively limited to its main business object and that its board be incapable of receiving authority to conduct transactions outside the main objects of the company'.[198]

McLennan speculates that the drafters of the capacity provisions in the Act were attempting to achieve a type of restricted ultra vires doctrine, with its application being reserved for insiders. McLennan sees little sense in such a framework, commenting that '[e]ither the company has the capacity to do something or it does not. How can some activity be *intra vires vis-à-vis* outsiders but *ultra vires vis-à-vis* insiders?'[199] McLennan accepts that there may often be a need or desire to restrict the activities of the board of directors of a company, but rejects the notion of making use of the capacity provisions to achieve this.[200] McLennan argues that if a company wishes to limit the powers of the directors, it can easily achieve this by way of contractual provisions to that effect.[201] Indeed, McLennan would go as far as arguing that the capacity provisions are largely unnecessary.[202] The author argues that the Act should adopt the approach of the Close Corporations Act 69 of 1984, in terms of which both

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[196] See, for example, Jooste R 'Observations on the impact of the 2008 Companies Act on the Doctrine of Constructive Notice and the *Turquand* rule' (2013) 130 *SALJ* 464 486, Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 179, and Delport P (2018) 89.

[197] However, some preliminary questions have been posed in this regard. See Jooste R (2013) 468-9, and Olivier E 'Section 19(5)(*a*) of the Companies Act 71 of 2008: enter a positive doctrine of constructive notice?' (2017) 28(3) *Stellenbosch LR* 614 614-23.

[198] See Locke N (2016) 161.

[199] McLennan JS (2009) 151.

[200] McLennan JS (2009) 151.

[201] McLennan JS (2009) 151. The author acknowledges, however, that a director's liability for breach of such a contract would have no effect on the rights of bona fide creditors of the company.

[202] McLennan JS (2009) 153.

the ultra vires doctrine and the doctrine of constructive notice are abolished in their entirety.[203]

Cassim expresses concern regarding the lack of clarity surrounding s 20 of the Act, and criticises the Legislature for failing to provide an ideal solution to the problems inherent in restricted corporate capacity.[204]

1.5.2 Special purpose vehicles in South African law

There is no universal statutory provision in South African law that defines the term 'special purpose vehicle'.[205] The research on SPVs by South African authors is sparse, and the existing contributions on these entities focus largely on their role in the context of securitisation schemes.[206] Therefore, for general guidance on the legal entity that has come to be termed "SPV" or "SPE" (Special Purpose Entity), it is necessary to refer to the writings of foreign academics.

Muñoz explains that "SPV" is a term of art used in financial circles to refer to a legal entity used to fulfil specific commercial goals.[207] These entities came to the forefront of academic discussion in the wake of the Enron accounting scandal.[208] Researchers have noted the emergence and popularity of these shell-like entities that are used as conduits to facilitate, enable or to protect a single enterprise of another organisation.[209]

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[203] McLennan JS (2009) 153. See ss 2(4) and 17 of the Close Corporations Act 69 of 1984.
[204] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 179.
[205] However, Para 1 of the Schedule to the Banks Act 94 of 1990: Designation of an activity not falling within the meaning of "The Business of a Bank" (Securitisation scheme) *GG* 30628 of 1 January 2008 (hereinafter "Securitisation Notice") defines a "special-purpose institution" as 'a company or trust, insolvency remote, incorporated, created or used solely for the purpose of the implementation and operation of a traditional or synthetic securitisation scheme'.
[206] See, for example, Locke N (2016) 160-88, Locke N 'The Role of Rating Agencies in the Course of a Securitisation Scheme' (2008) *De Jure* 545-560, Scott S (2006) 397-412, Itzikowitz & Malan (1996) 175-189, and Locke N 'Die oordrag van saaklike sekerheidsregte aan die Spesiale doelwitmaatskappy tydens tradisionele sekuritisasie' (2010) *Journal of South African Law* 450 450-67.
[207] Muñoz DR 'Bankruptcy-remote transactions and bankruptcy law—a comparative approach (part 1): changing the focus on vehicle shielding' (2015) *Capital Markets Journal* 10(2) 239-274, available at SSRN https://ssrn.com/abstract=2733613 (accessed on 17 August 2018) at 4. According to Lubbe, Moddack & Watson, "special purpose entity (SPE)" (which can be taken to be synonymous to SPV), 'is set up for a specific purpose, often to borrow money, as the liability is limited to that entity'. Lubbe I, Moddack G, and Watson A *Financial Accounting: GAAP Principles* 3 ed (2011) 555-6.
[208] See, for example, Schwarcz SL et al *Securitization, Structured Finance, and Capital Markets* (2004) 96, Schwarcz SL 'Enron and the Use and Abuse of Special Purpose Entities in Corporate Strucutres' (2001) 70 *University of Cincinnati LR* 1309 1309-10, and Carpenter H 'Special Purpose Entities: A Description of the Now Loathed Corporate Financing Tool' (2002) 72 *Mississippi LJ* 1065-1098.
[209] Kim, Song & Wang describe the SPV as follows: 'An SPV is a legally distinct entity with a limited life created by a sponsor company to carry out limited activities or transactions specified in the contracts'. See Kim J, Song BY, and Wang Z 'The Use of Special Purpose Vehicles and Bank Loan Contracting' (2014) 7, available at

Pearce and Lipin remark that an SPV usually has no business premises and few or no employees,[210] and that its activities are usually limited to the furtherance of the project for which it was established.[211] Baudistel explains that SPVs are often formed and managed (separately) by a holding company in a parent-subsidiary relationship; this enables the holding company to exercise control over the activities of the SPV.[212] It has been argued that an effective subsidiary SPV should have 'an asset, liability and legal status that ensures independence and makes the SPVs obligations secure even if the parent company were to become insolvent'.[213]

An SPV can take a variety of legal forms. Pearce and Lipin note that in the USA, the SPV usually takes the form of a limited liability corporation (LLC), a trust, or a limited liability partnership (LLP), while in Europe, LLCs and limited purpose corporations are used.[214] It has been noted that in South Africa, the SPV used in securitisation schemes usually takes the form of a company.[215]

1.5.3 Traditional securitisation SPVs

Scott writes that an important ingredient to a successful securitisation scheme is 'the financial and legal effectiveness of the chosen structure.'[216] The legal effectiveness of the chosen structure depends on the suitability of the legal framework within which it

https://www.uts.edu.au/sites/default/files/Bus_Acc_aut14Apr04_JBKim_BSong_ZWang.pdf , accessed on 28 September 2018.

[210] Pearce JA & Lipin IA 'Special Purpose Vehicles in Bankruptcy Litigation' (2011) 40 *Hofstra LR* 177 179; Gorton GB & Souleles NS 'Special Purpose Vehicles and Securitization' in Carey & Stulz (eds.) *The Risks of Financial Institutions* (2007) 549 550, available at http://www.nber.org/chapters/c9619, accessed on 11 April 2018.

[211] Indeed, commentators have noted that all companies with restricted powers are commonly called SPVs, as they are incorporated to perform a specific function. See Stein & Everingham (2011) 72.

[212] Baudistel JK (2013) 1314.

[213] See 'Special purpose vehicles SPV for building development', available at https://www.designingbuildings.co.uk/wiki/Special_purpose_vehicles_SPV_for_building_development, accessed on 18 August 2018.

[214] Pearce & Lipin (2011) 194; Bridson JL 'S&P Global Ratings: Europe Asset Isolation and Special-Purpose Entity Criteria—Structured Finance' (2013) 4, available at https://www.standardandpoors.com/ja_JP/delegate/getPDF?articleId=1832489&type=COMMENTS&subType=CRITERIA, accessed on 31 August 2018.

[215] Boshoff A & Krisch K 'Structured finance and securitisation in South Africa: overview', available at https://uk.practicallaw.thomsonreuters.com/4-521-4150?transitionType=Default&contextData=(sc.Default)&firstPage=true&comp=pluk&bhcp=1, accessed on 29 August 2018.

[216] Scott S (2006) 405.

is to operate.[217] Saayman & Styger agree that securitisation flourishes where regulations are favourable.[218]

With respect, it is submitted that the effect of restrictive conditions to the powers of SPVs used in securitisation financing arrangements, and the resulting legal implications, have not fully been addressed in academic literature in South Africa. This is unfortunate, as SPVs generally and securitisation SPVs in particular play an important role in commerce. Institutional investors, including banks, insurance companies and collective investment schemes, invest in the financial instruments created by way of securitisation schemes. Consequently, the retirement savings of South Africans may be impacted to some degree by the operation of securitisation schemes.[219] Therefore, further research into this area of law, building on the strides already made, is critically important.

There has been some valuable research done regarding SPVs in the context of securitisation in South Africa, most notably by Locke. Locke's research made a major contribution to research in the complex field of structured finance in South African corporate law.[220] However, Locke's contributions have necessarily been limited by the sheer complexity and depth of legal issues related to traditional securitisation schemes. The author has only provided one (very valuable) analysis of the capacity provisions in the Act in the context of securitisation SPVs.[221]

Locke analysed whether and to what extent the capacity and representation sections in the Act 'cater for the structuring of special purpose companies'.[222] The author highlights the importance of effective restrictions to the main object of an SPV and to the authority of its board.[223] Indeed, she argues that the MOI of a securitisation SPV should not only include restrictive conditions limiting the company's capacity, but also express capacity-linked limitations to the board's authority.[224] Locke also warns that a

[217] Scott S (2006) 405.
[218] Saayman & Styger (2003) 753.
[219] Locke notes that the effects of the sub-prime RMBS market collapse in the USA were felt especially by older citizens, in that the value of their retirement savings decreased. See Locke N (2016) 162.
[220] In particular, the author's doctoral thesis Locke N (2008), Locke N (2008) 'The role of ratings agencies in the course of a securitisation scheme' (2008) 41 *De Jure* 545, and Locke N (2016).
[221] Locke N (2016) 160.
[222] Locke N (2016) 161.
[223] Locke N (2016) 161.
[224] Locke N (2016) 163.

securitisation SPV that acts ultra vires will lose the protection of the Securitisation Notice and will be regarded as a bank in terms of the Banks Act.[225]

Locke argues that SPVs should be structured as RF companies, with their MOIs containing either absolute prohibitions or additional requirements to amend the capacity restrictions.[226] The author suggests that approval by the trustee for debenture-holders would be a suitable additional amendment requirement for the capacity limitation of a securitisation SPV.[227] Locke argues further that third parties' constructive notice of the relevant clauses will prevent them from arguing that they acted in good faith in a claim for damages in the event that a shareholder of a limited capacity company restrains the company from performing in terms of an ultra vires contract.[228]

An SPV involved in a securitisation scheme is responsible for the collection of income from claims and the payment of distributions to investors. For this reason, Scott writes that the SPV is the most important entity in the entire securitisation scheme, and that its legal nature should garner as high a rating as possible.[229] Therefore, she advises that the SPV should be managed in a way to avoid complications or disputes.[230] Locke argues that securitisation SPVs are better suited to operate, generally, if they are incorporated as companies, as a company is better able to create the insolvency-remoteness required by the securitisation scheme.[231]

Locke wrote approvingly of the Companies Bill provisions regarding capacity (which have remained substantially the same with the enactment of the Act), making the point that they were flexible enough to allow for the inclusion of provisions in an MOI that limit the capacity of an SPV.[232] However, besides the legislative framework, Locke identifies another important consideration that may urge shareholders and directors to uphold the restrictions to the capacity of the securitisation SPV:

[225] 94 of 1990. See Locke N (2016) 182.
[226] Locke N (2016) 182.
[227] Locke N (2016) 182.
[228] Locke N (2016) 182.
[229] Scott S (2006) 408.
[230] Scott S (2006) 408.
[231] Locke N (2008) 37.
[232] Locke N (2008) 303.

> 'Market forces will also urge shareholders and directors of an SPV to uphold the limitations on the powers and capacity of an SPV. Rating of the securities issued by the SPV will continue throughout the existence of the scheme. A contravention of the terms of the memorandum of incorporation will reflect negatively on the insolvency insulation of the SPV and may lead to a downgrade in the rating.[233]

Locke notes that both the transferred assets and the structure of the scheme as a whole receive ratings by ratings agencies.[234] Credit ratings agencies will consider the risk attached to the assets as well as structural risk in the process of assigning ratings necessary for the operation of the scheme.[235] Locke notes that the SPV's insolvency-remoteness is a factor that is considered when ratings are assigned to securitised instruments, in addition to any other factors that may place the investors at risk.[236]

1.6 METHODOLOGY

The candidate will conduct literary research in order to write a doctoral thesis. This thesis will not be an empirical study. Instead, the thesis will make use of a desktop methodology. Relevant primary sources such as legislation and case law will be studied. The views on this topic of South African and foreign authors will be consulted and evaluated as secondary sources.

To provide a comparative perspective, the present South African approach to corporate capacity will be contrasted against the relevant laws of the USA and UK. The law of the selected foreign jurisdictions, and commentary thereon by foreign authors, will be studied for the purpose of legal comparison, with a view to strengthening the basis from which later recommendations will be made.

The UK was chosen as a comparator because South African company law is largely based on the principles originally established in English law.[237] Therefore, the shared history will provide a good basis from which to analyse divergent trends. The USA was

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[233] Locke N (2008) 303.
[234] See Locke N (2008) 'Rating Agencies' 550-1.
[235] See Locke N (2008) 'Rating Agencies' 550-1. The "Big Three" ratings agencies are Fitch Ratings, Moody's Investors Service, and Standard & Poor's. See Finney D 'A Brief History of Credit Rating Agencies' available at http://www.investopedia.com/articles/bonds/09/history-credit-rating-agencies.asp, accessed on 12 January 2016.
[236] See Locke N (2008) 'Rating Agencies' 550-1.
[237] Cilliers HS et al (2000) 21 and 23; Williams RC (2012) para 3; Levenberg PN 'Directors' Liability and Shareholder Remedies in South African Companies – Evaluating Foreign Investor Risk' (2017) 26 *Tulane Journal of International and Comparative Law* 1 12; Mongalo T (2003) 1-3.

chosen as a comparator as, just like South Africa, it is a common law country based on the English system of company law. A compelling factor in favour of the chosen comparators is the common language of English.

Throughout the thesis-writing process, the candidate will engage with supervisors to gain wider perspectives, as well as liaise with practitioners to gain a practical viewpoint on the theoretical issues being discussed in the thesis.

1.7 CONCLUSION

This chapter has introduced the thesis. The topic was introduced, explained, and contextualised. The problem was identified, from which research sub-questions were posed. Chapter One emphasised the significance of this particular research by way of a literature review on what can be considered the three pillars of the thesis: corporate capacity in terms of the new Act, special purpose vehicles, and traditional securitisation schemes. Finally, the chapter explained the methodology to be employed for the purpose of the writing of the thesis.

In Chapter Two, the thesis will begin the response to the research question by analysing the emergence and evolution of the ultra vires doctrine in the USA and UK.

CHAPTER TWO: THE EVOLUTION OF THE ULTRA VIRES DOCTRINE IN THE UK AND THE USA

2.1 INTRODUCTION

The common law ultra vires doctrine declared that contracts beyond a company's capacity as encapsulated in its objects clause are void ab initio. The central research question posed by this thesis is whether the capacity provisions in the Companies Act 71 of 2008 (the Act) give effect to the ideal of insolvency-remoteness in respect of special purpose vehicles (SPVs) used in traditional securitisation schemes. Chapter Two will address sub-question 6 that pertains to the strengths and weaknesses of the South African approach to corporate capacity from a comparative perspective.[1] This chapter will contribute to answering whether the domestic approach is commercially desirable. Furthermore, Chapter Two will respond to sub-question 1, by briefly tracing the emergence of the English doctrine that would come to be applied in South Africa.[2]

This chapter will discuss the evolution of the ultra vires doctrine in the United Kingdom (UK) and United States of America (USA). South African company law draws many of its fundamental rules from the principles originally established in English law.[3] The ultra vires doctrine originated in England, but the USA has been the frontrunners in making legislative amendments to the ultra vires doctrine.[4] Therefore, much can be gained from analysing the evolved ultra vires doctrine in the UK and the USA. The present UK approach appears to be a complete abolition of the ultra vires doctrine. In contrast, the American solution still retains certain aspects of the traditional ultra vires doctrine.

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[1] See 1.4 above.
[2] See 1.4 above.
[3] Cilliers HS *Cilliers and Benade Corporate Law* 3 ed (2000) 21 & 23; Williams RC 'Companies' in *The Law of South Africa* vol 4(1) Second Reissue (2012) para 3; Levenberg PN 'Directors' Liability and Shareholder Remedies in South African Companies – Evaluating Foreign Investor Risk' (2017) 26 *Tulane Journal of International and Comparative Law* 1 12; Mongalo T *Corporate Law and Corporate Governance – A Global Picture of Business Undertakings in South Africa* (2003) 1-3.
[4] Schaeftler MA 'Clearing Away the Debris of the Ultra Vires Doctrine – A Comparative Examination of U.S., European, and Israeli Law' (1984) 16 *Law & Policy in International Business* 71 172.

This chapter will reflect on several important developments in English company law during the nineteenth century, trace the history of the ultra vires doctrine from its inception in nineteenth century England to the current legislative approaches in both the UK and the USA, discuss the motivations for the existence and evolution of the doctrine, and evaluate the features, strengths and weaknesses of the respective positions.

It has been argued that '[a] comparative analysis of foreign law can illuminate the merits and pitfalls of a particular local law.'[5] This chapter will achieve such illumination in respect of the capacity provisions in the Act. It is also worth noting that one of the company law reform objectives was to promote the global competitiveness of South African company law by '[m]aking company law compatible and harmonious with best practice jurisdictions internationally'.[6] The Act also allows courts to consider foreign law when interpreting the Act.[7] This indicates that the comparison to be done in this chapter will be of value.

2.2 THE EMERGENCE OF THE ULTRA VIRES DOCTRINE IN THE UK

The business world briefly and quite disastrously flirted with the corporate form in the events that led to the passing of what became known as the Bubble Act of 1720.[8] The unincorporated joint stock company was popular during the seventeenth and eighteenth centuries.[9] These commercial associations were comparable to partnerships in that the members were personally liable in the event of the company's failure.[10] The Bubble Act put an end to the speculation and unregulated

[5] Schaeftler MA (1984) 71.
[6] See p 3 of the Explanatory Memorandum to the Companies Bill 2007, available at http://www.companylaw.uct.ac.za/usr/companylaw/downloads/legislation/Companies_Bill_2007.pdf (accessed on 29 March 2019), and Mupangavanhu BM *Directors' Standards of Care, Skill, Diligence and the Business Judgment Rule in view of South Africa's Companies Act 71 of 2008: Future Implications for Corporate Governance* (Unpublished PhD thesis, UCT, 2016) 61.
[7] Section 5(2) of the Act.
[8] Du Bois AB 'M.S. Amos, The English Business Company after the Bubble Act: 1720-1800' (1939) 52 *Harvard LR* 542 542; Williams RC (2012) 4.
[9] Browning BG 'Much ado about Nothing: The Doctrine of *Ultra Vires* and its Place in Commercial History – Particularly in Manitoba' (1977) 8 *Manitoba LJ* 359 361.
[10] Browning BG (1977) 361.

"incorporations" that were prevalent during this time, by prohibiting unauthorised company formation and the issue of transferable shares.[11]

The common law seemingly regarded charter companies (profit companies incorporated by Royal Charter) as having the same legal capacity as natural persons of full capacity.[12] Relying on *British South Africa Co. v De Beers Consolidated Mines Ltd*,[13] Carpenter notes that the ultra vires contracts of charter companies were valid.[14] However, in *Sutton's Hospital case*,[15] certain aspects of what would become the ultra vires doctrine were arguably already evident. In casu, it was held that if a charter company exceeded its objects, proceedings could be initiated to restrain the company or have its charter revoked.[16]

The traditional company law ultra vires doctrine was developed in England during the nineteenth century, and was first applied to statutory companies.[17] Statutory companies are specialised entities established by way of a special Act of Parliament; the enabling statute was regarded as restricting the contractual capacity of the company to the furtherance of its primary objective/s stipulated in the statute, and any purported agreement that fell outside the scope of the company's capacity would be ultra vires and void.[18] The ultra vires doctrine arguably emerged on the basis that statutory companies were creatures of statute, and as a consequence, the courts were entitled to restrict their powers in accordance with ordinary principles of statutory interpretation.[19]

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[11] Arsht SS 'A History of Delaware Corporation Law' (1976) 1(1) *Delaware Journal of Corporate Law* 1 2.
[12] Rajak H (1995) 12-14.
[13] [1910] 1 Ch 354 375.
[14] Carpenter CE 'Should the Doctrine of Ultra Vires be Discarded?' (1923) 33 *Yale LJ* 49 49-50.
[15] (1612) 10 Co. Rep. 1.
[16] Anderson J 'The Evolution of the Ultra Vires Rule in Irish Company Law (2003) 38 *Irish Jurist* 263 264.
[17] For example, in *Shrewsbury & co. Railway v London & Northwest Railway Co.* [1853] 22 L.J. Che. 682, and *East Anglian v. The Eastern Counties Railway Company* (11 Com. Ben. Rep. 775). See Griffin S 'The Rise and Fall of the *Ultra Vires* Rule in Corporate Law' (1998) 2(1) *Mountbatten Journal of Legal Studies* 5 5, and Beuthin RC and Luiz SM *Beuthin's Basic Company Law* 2 ed (1992) 79.
[18] Griffin S (1998) 5; McGrath N & Murphy C 'The End of the Ultra Vires Problem: Corporate Capacity before and after the proposed Companies Bill' (2008) 2(4) *Irish Business Law Quarterly* 16 16, Pennington RR *Company Law* 6 ed (1990) 91.
[19] Rajak H (1995) 15-16; Getz L 'Ultra Vires and Some Related Problems' (1967) 3 *University of British Columbia LR* 30 43; Pennington RR (1990) 91; Griffin S (1998) 5-6.

In one of the early cases, *Eastern Counties Railway Co. v. Hawkes*,[20] an Act of Parliament had established a company for the purpose of constructing a railway line between London and Norwich. The company purchased immovable property to facilitate the completion of a new branch railway not authorised by the statute.[21] At some point during the railway line's construction, the company informed the seller that it had decided to abandon the branch railway and advised that the seller should keep the property and accept reasonable compensation.[22] The seller demanded his contract and approached the courts for relief. The court a quo granted an order of specific performance.[23] On appeal, the appellants placed reliance on the fact that the branch line had not been authorised by the relevant Act, arguing that the contract of sale should therefore be void.[24] However, the Lord Chancellor concluded that on the facts of the particular case, the transaction was *not* ultra vires.[25]

Only from 1844, with the enactment of the Joint Stock Companies Act 1844,[26] did the concept of companies established by incorporation in terms of a general enabling statute take root.[27] At the time, many commercial associations continued to function principally as partnerships.[28] Another notable piece of legislation enacted during this time was the Limited Liability Act 1855, which provided protection to the members of registered joint stock companies.[29] Arguably, the curtailment of contractual capacity was primarily a consequence of the recognition of limited liability.[30]

The Joint Stock Companies Act 1856[31] required every company to include an objects clause in its memorandum that would determine the company's capacity.[32] Before the

[20] 5 H.L. Cas 331 (1855).
[21] *Eastern Counties* 332.
[22] *Eastern Counties* 333.
[23] *Eastern Counties* 334.
[24] *Eastern Counties* 334-5.
[25] *Eastern Counties* 347-350.
[26] (7 & 8 Vict. c.110).
[27] Cilliers HS et al (2000) 21; Rajak H (1995) 13.
[28] See Pyemont L *Company Law of the Cape and other South African Colonies* (1906) 1, where the author compares the commercial partnerships of the nineteenth century to the Roman law Gildae Mercatores. See also Cohen C 'The Distribution of Powers in a Company as a Matter of Law' (1973) 90 *SALJ* 262 262.
[29] Griffin S (1998) 6; Ferran E *Company Law and Corporate Finance* (1999) 17; Rajak H (1995) 13-4.
[30] Griffin S (1998) 6.
[31] (19 & 20 Vict. c.47).
[32] Cilliers HS et al (2000) 181; Diemont MA & Boehmke MA *Pyemont's Company Law of South Africa* 6 ed (1953) 37-8.

enactment of this Act, the capacity of joint stock companies was unlimited.[33] The Companies Act 1862 was the first Act to allow for the creation and registration of a company with limited liability whose capacity was determined by an objects clause in the memorandum of association.[34] The Companies Act 1862 further regulated corporate capacity by limiting the circumstances under which a company's memorandum could be amended.[35]

Despite the developments introduced by the Companies Act 1862, the precise nature and scope of a company's objects clause was still open to debate.[36] It was uncertain whether a company could pursue objects that were neither expressly permitted nor prohibited by its enabling Act.[37] It was also not clear whether the ultra vires doctrine should apply to registered companies in the same way that it was applied to statutory companies.[38] The House of Lords clarified the position in *Ashbury Railway Carriage and Iron Co v Riche*.[39]

In *Ashbury Railway*, the memorandum of a company registered in terms of the Joint Stock Companies Act 1862 empowered it to manufacture and sell railway carriages.[40] The company purchased a concession for the construction of a railway in Belgium.[41] The House of Lords opted for a wide approach to the ultra vires doctrine, holding that a registered company could only do those acts that were expressly or by necessary implication permitted by its constitution.[42] The transaction was held to be ultra vires and void.[43] The House of Lords held that such a contract could never be ratified, even with the unanimous consent of all of the company's shareholders.[44]

The House of Lords in *Ashbury Railway* reasoned that the ultra vires doctrine protected a company's present and future shareholders, potential creditors of the

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[33] Griffin S (1998) 6.
[34] Smith A 'Ultra Vires-A Problem of Sovereignty' (1946) 3 *Res Judicatae* 28 31.
[35] Omar PJ 'Powers, purposes and objects: the protracted demise of the ultra vires doctrine' (2004) 16 *Bond LR* 93 99.
[36] Griffin S (1998) 7; Rajak H (1995) 16; Smith A (1946) 33.
[37] Rajak H (1995) 16.
[38] Pennington RR (1990) 92-3.
[39] (1875) LR 7 HL 653. See Pennington RR (1990) 92-3.
[40] *Ashbury Railway* 666.
[41] *Ashbury Railway* 666-7.
[42] Rajak H (1995) 21.
[43] *Ashbury Railway* 667 & 672.
[44] *Ashbury Railway* 672 & 674. See also Boulter M 'Corporations and The Doctrine of *Ultra Vires*' (1935) 1 *Res Judicatae* 163.

company, and the general public.[45] Shareholder and creditor protection were and still are important concepts in corporate law.[46] However, it was not clear that the ultra vires doctrine ever truly gave effect to these ideals. Criticism of the doctrine flowed freely.[47] Thus, reform.

2.3 LEGISLATIVE REFORM OF THE ULTRA VIRES DOCTRINE

The ultra vires doctrine has been the subject of legislative reform in numerous common law jurisdictions.[48] Several different types of legislative solutions were introduced to reform the ultra vires doctrine. Some jurisdictions share similarities, but there does not seem to be a uniform approach.

There does not seem to be any legal system that has abolished the company law ultra vires doctrine in its entirety.[49] Instead, legislatures choose to minimise or remove the harsh external impact of the doctrine, while maintaining certain of its internal rules to varying degrees.[50] The most common legislative approach to reforming the ultra vires doctrine has been to abolish the external consequence of ultra vires contracts.[51] In other words, the statute would declare that ultra vires contracts are *not* void, or that no one may assert that an ultra vires contract is void on the basis of lack of capacity.[52] The American Bar Association's Model Business Corporation Act (MBCA) has been hailed as the frontrunner in this regard.[53] Another technique used to minimise the scope of the ultra vires doctrine is the practice of conferring a host of powers on companies in an extensive statutory list,[54] as seen in the USA[55] and Australia.[56] Such

[45] *Ashbury Railway* 666.
[46] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' in Cassim FHI (ed.) *Contemporary Company Law* 2 ed (2012) 164.
[47] Stevens RS 'A Proposal as to the Codification and Restatement of the Ultra Vires Doctrine' (1927) 36 *Yale LJ* 297 317; Getz L (1969) 56; Gower LCB et al (1979) 165; Schaeftler MA (1984) 165; Griffin S (1998) 8; Blackman MS (1975) 2.
[48] Obadina DA 'The New Face of *Ultra Vires* and Related Agency Doctrines in the Commonwealth and USA' (1996) 8 *African Journal of International & Comparative Law* 309 333.
[49] Obadina DA (1996) 315.
[50] Obadina DA (1996) 315.
[51] Obadina DA (1996) 317.
[52] Obadina DA (1996) 325-26.
[53] Obadina DA (1996) 317-19.
[54] Obadina DA (1996) 315-16, the author referring to the Bermuda Companies Act 1981 as an example.
[55] By virtue of, for example, § 3.01 of the Revised Model Business Corporation Act (RMBCA) and § 122 of the State of Delaware's General Corporations Law (GCL).
[56] By virtue of s 124(1) of the Corporations Act 2001.

techniques are used to reduce the need for interpretation of a company's implied powers.[57]

Some jurisdictions remove the objects clause requirement, often in conjunction with the conferring of "full capacity" or "the capacity of a natural person" on companies. For example, s 16(1) of New Zealand's Companies Act 105 of 1993 provides that 'a company has, both within and outside New Zealand, — (a) full capacity to carry on or undertake any business or activity, do any act, or enter into any transaction; and (b) for the purposes of paragraph (a), full rights, powers, and privileges'. Section 124(1) of the Corporations Act 2001 states that companies have the legal capacity and powers of both an individual and a body corporate. The Australian Act goes as far as making the entire constitution optional. Section 125(1) of the Corporations Act 2001 states that 'if a company has a constitution, it may contain an express restriction on, or a prohibition of, the exercise of any of its powers', and s 125(2) states that '[i]f a company has a constitution, it may set out the company's objects.'[58] In terms of this solution, legislatures confer unlimited capacity on companies, while retaining the option for a company to restrict its own powers and subject itself to a modified version of the ultra vires doctrine.[59]

The motivations for reform and the nature of the legislative amendments are influenced by several factors, as seen by the different solutions to the ultra vires problem in common law countries. Corporation statutes that retain the internal consequences of the ultra vires doctrine are indicative of a desire to protect shareholders, as these are the parties that benefit from the traditional internal remedies.[60] However, it is clear that third party interests have also been on the minds of legislators, particularly during the second half of the twentieth century.[61] Whereas the House of Lords in *Ashbury Railway* reasoned that creditors had a legitimate interest in seeing that a company observes its stated objects and powers, the

[57] Obadina DA (1996) 315.
[58] See Ferran E 'Company Law Reform in the UK' (2001) 5 *Singapore Journal of International & Comparative Law* 516 528 note 51.
[59] Obadina DA (1996) 329.
[60] Obadina argues that the differences in legislative treatments of corporate capacity reflect divergent views on the usefulness of the ultra vires doctrine as a measure of shareholder protection. Obadina DA (1996) 333.
[61] Milman D '1967-1987: A Transformation in Company Law?' (1988) 17 *Anglo-American LR* 108 117-121.

academic consensus in the twentieth century tended to recognise instead that existing creditors are not assisted by the ultra vires doctrine, and that prospective creditors may in fact be prejudiced by it.[62] Milman points to the reigning in of the ultra vires doctrine as proof of the creditor protection trend, concluding that this change 'left an outsider contracting with a limited company in a much more secure position'.[63] Obadina argues that the ideal of third party protection is seen in statutes that limit the ultra vires defence to executory transactions, i.e. contracts in terms of which full performances have not been made.[64] He argues further that jettisoning the ultra vires doctrine prioritises commercial expediency 'by enabling companies to respond flexibly and pragmatically to market opportunities'.[65] It is apparent that remedial legislation pertaining to corporate powers have tried to maintain a suitable balance between the potentially conflicting interests of shareholder control and outsider protection, while ensuring that corporations are not unreasonably restricted in their activities.

It is worth remembering that the capacity approach of any jurisdiction must consider the variety of circumstances and types of companies that may exist, from the large publicly-held company with thousands of shareholders, to the one-man company, to the wholly-owned subsidiary of a parent. The chosen approach must be general and flexible enough to cater for multiple eventualities.

2.4 THE EVOLUTION OF THE ULTRA VIRES DOCTRINE IN THE UK

Several important decisions stand out in the English experience with the ultra vires doctrine. *Colman v. The Eastern Counties Railway Company*[66] is regarded as the first case where the ultra vires doctrine was applied.[67] In casu, Lord Langdale recognised the right of a shareholder to restrain a statutory company and its directors from entering into transactions not expressly permitted by its Act.[68] The rule that ultra vires contracts are void was applied in *The East Anglican Railway Company v. The Eastern*

[62] Griffin S (1998) 8; Blackman MS 'The capacity, powers and purposes of companies: the Commission and the new Companies Act' (1975) 8 *Comparative and International LJ of Southern Africa* 1 2.
[63] Milman D (1988) 121.
[64] Obadina DA (1996) 333.
[65] Obadina DA (1996) 333.
[66] (1846) 10 Beav. 1.
[67] Rajak H (1995) 9 note 2; Browning BG (1977) 363; Getz L (1969) 30.
[68] *Colman* 16-7; Rajak H (1995) 16-7. See also *Solomon v Laing* (12 Beav. 339).

Counties Railway Company.[69] In this case, the ultra vires doctrine was applied to free a company from its obligation towards a third party.[70]

The ultra vires doctrine was reigned in significantly by the House of Lords not long after its decision in *Ashbury Railway*, through its extension of the reach of a company's capacity in *Attorney General v Great Eastern Rly Co*.[71] In the latter case, the House of Lords imposed a requirement of reasonable interpretation regarding objects clauses and corporate capacity, declaring that:

> '[W]hatever may fairly be regarded as incidental to, or consequential upon, these things, which the legislature has authorised, ought not (unless expressly prohibited) to be held, by judicial construction, to be ultra vires'.[72]

In *Cotman v Brougham*,[73] an oil company underwrote shares in a rubber company. The company's memorandum stipulated that the stated objects were all individual main objects of the company; one of these objects was subscribing for shares in other companies. The court held that the "independent objects" clauses were valid and declared the underwriting agreement to be intra vires the company.[74]

The lawmakers did make one contribution during this time. Section 5 of the Companies Act 1948 eased the regulatory burden by allowing companies to amend their objects clauses by way of a shareholders' special resolution.[75] However, the flexibility provided by this change was not enough to completely dispel the threat of the ultra vires doctrine.[76] It would take time to amend a company's objects clause, once it decides to do so, and in that time, the company may miss out on a profitable contract.

In *Bell Houses Ltd v City Wall Properties Ltd*[77] the Court of Appeal upheld a transaction as intra vires on the basis of a "subjective objects" clause in the relevant company's

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[69] 11 Com. Ben. 803 809.
[70] Rajak H (1995) 19.
[71] (1880) 5 APP CAS 473 (HL). This approach was confirmed in *Re Horsley & Weight Ltd* [1982] 3 All ER 1045 (CA) 1050-1.
[72] *Attorney General* 478. See also Rajak H (1995) 23.
[73] [1918] AC 514 (HL).
[74] *Cotman* 522-3. See also Boulter M 'Corporations and the Doctrine of *Ultra Vires*' (1935) 1 *Res Judicatae* 162 162-3. The term "intra vires" in this context means within the company's powers.
[75] Griffin S (1998) 17.
[76] Griffin S (1998) 17.
[77] [1966] 2 All ER 674.

memorandum.[78] Danckwerts LJ held that the effect of a subjective objects clause is 'to make the bona fide opinion of the directors sufficient to decide whether an activity of the plaintiff company is intra vires', holding that the contract at issue was intra vires on that basis.[79] This decision was widely regarded as the final nail in the doctrine's coffin.[80]

In 1972, the British Parliament enacted the European Communities Act 1972 (EC Act) to affirm the UK's entry into the European Economic Community (EEC).[81] Section 9 of the EC Act was aimed at complying with EEC law on the ultra vires doctrine as set out in the First Directive on Company Law (the First Directive).[82] Article 9 of the First Directive itself was a compromise between different approaches to the ultra vires doctrine.[83] Article 9(1) of the First Directive addressed the issue of contracts beyond a company's objects: the provision stipulated that ultra vires acts by companies are binding, effectively abolishing the ultra vires doctrine in respect of outsiders.[84]

The EC Act did not completely abolish the ultra vires doctrine, as its wording did not expressly remove the ultra vires defence in transactions between a company and bona fide third parties.[85] Section 9(1) of the EC Act read: 'In favour of a person dealing with a company in good faith, any transaction decided on by the directors shall be deemed to be one which it is within the capacity of the company to enter into…'. Therefore, incongruously, the EC Act prevented a company from avoiding liability on an ultra vires contract decided on by the directors, but allowed third parties to rely on a company's objects clause to escape liability on an ultra vires contract.[86] Such a framework is inconsistent with the traditional view that the ultra vires doctrine served the interests of companies and their shareholders at the expense of third parties.[87] The wording of s 9(1) of the EC Act was also criticised because where a third party had actual

[78] *Bell Houses* 679.
[79] *Bell Houses* 686.
[80] Beuthin RC 'The *Ultra Vires* Doctrine – An Obituary Notice?' (1966) 83 *SALJ* 461 461; Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 167; Kiggundu JS 'The never ending story of *ultra vires*' (1991) 24 *Comparative & International LJ* 1 20-1; Omar PJ (2004) 106.
[81] Pretorius JT (ed.) et al *Hahlo's South African Company Law Through the Cases* 6 ed (1999) 65.
[82] Directive 68/151, OJ, L 65/8.
[83] Schaeftler MA (1984) 117.
[84] Anderson J (2003) 276; Pretorius JT et al (1999) 65; Cassim FHI 'The Rise, Fall and Reform of the Ultra Vires Doctrine' (1998) 10 *SA Merc LJ* 293 297.
[85] Schaeftler MA (1984) 121-2.
[86] Schaeftler MA (1984) 122.
[87] Schaeftler MA (1984) 122.

knowledge that he was contracting ultra vires a company, or the contract was not concluded by 'the directors', the ultra vires doctrine still operated.[88] The provision left room for third parties to be prejudiced by ultra vires transactions concluded by non-director representatives.[89]

Section 9 of the EC Act was adopted without change by s 35 of the Companies Act 1985.[90] Section 35 of the Companies Act 1985 was replaced by s 108(1) of the Companies Act 1989, to read as follows:

> '(1) The validity of an act done by a company shall not be called into question on the ground of lack of capacity by reason of anything in the company's memorandum.'
>
> (2) A member of a company may bring proceedings to restrain the doing of an act which but for subsection (1) would be beyond the company's capacity, but no such proceedings shall lie in respect of an act to be done in fulfilment of a legal obligation arising from a previous act of the company.'

The Companies Act 1989 did not declare that companies have unlimited capacity, and it did not remove the requirement for a company's memorandum to contain an objects clause.[91] This Act removed the external effect of the ultra vires doctrine but codified its traditional common law internal remedies. The shareholders' right to restrain ultra vires action remained intact and was given statutory recognition.[92] Furthermore, the directors remained under a fiduciary duty to act within the confines of their powers and of the company's capacity.[93] The amended s 35(3) expressly provided that '[i]t remains the duty of the directors to observe any limitations on their powers flowing from the company's memorandum'.[94]

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[88] Schaeftler MA (1984) 122-3.
[89] Similar concerns were raised regarding the comparable parts of s 36 of the South African Companies Act 61 of 1973. See Naudé SJ (1974) 324 & 332-3, Cilliers HS et al (2000) 186, McLennan JS (1979) 336, and Obadina DA (1996) 329.
[90] Section 35(1) of the Companies Act 1985 was a verbatim reproduction of s 9(1) of the EC Act.
[91] Griffin S (1998) 23; Pennington RR (1990) 97.
[92] Section 35(1) of the Companies Act 1985, substituted by s 108(1) of the Companies Act 1989. See Pennington RR (1990) 97.
[93] Pennington RR (1990) 96-8; Cassim FHI (1998) 301.
[94] Section 35(3) of the Companies Act, substituted by s 108(1) of the Companies Act 1989.

There remained doubt regarding precisely when a member could take action to restrain ultra vires contracts under the Companies Act 1989.[95] Some felt that the shareholders' right to restrain could only prevent the conclusion of ultra vires contracts, but could not affect such transactions once concluded by the company.[96] It is submitted that this was the correct interpretation. The wording of the amended s 35(2) was clear: the shareholders' right of restraint was restricted to contemplated ultra vires action. Executory contracts could not be assailed on the basis of the ultra vires doctrine.

The Companies Act 1989 also allowed for ratification of ultra vires contracts by way of a shareholders' special resolution, through s 35(3). This provision was quite curious, as a special resolution that ratified an ultra vires contract would do nothing regarding the binding nature of the contract in question.[97] Pennington argued that such a special resolution would have merely laid the foundation for a subsequent special resolution that absolved the directors of liability for breaching the fiduciary duty not to exceed their authority.[98] It is noteworthy that American legislation contains no comparable section. These considerations are pertinent to the understanding of South Africa's Act, because s 20(2) thereof seems to be modelled on s 35(3) of the amended Companies Act 1985.[99] However, the South African Act has no comparable provision regarding a *second* special resolution absolving the directors of liability for causing the company to act ultra vires.[100]

The capacity provisions in the Companies Act 1989 applied until the coming into effect of the Companies Act 2006.

2.4.1 The modern English approach

In what some may regard as a radical move, the Companies Act 2006 removes the objects clause from the memorandum and places it in the articles of association.[101]

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[95] Cassim FHI (1998) 298-9.
[96] Pennington RR (1990) 97; Obadina DA (1996) 332.
[97] Pennington RR (1990) 98.
[98] Pennington RR (1990) 98.
[99] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 174.
[100] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 174.
[101] Davies P & Rickford J 'An Introduction to the New UK Companies Act' (2008) 5 *European Company and Financial LR* 48 58.

The approach to the objects clause is relaxed: unless a company's articles specifically restrict the company's objects, the company's objects will be unlimited.[102] Section 39(1) of the Companies Act 2006 provides that '[t]he validity of an act done by a company shall not be called into question on the ground of lack of capacity by reason of anything in the company's constitution.' Therefore, even if a company *does* restrict its objects in its constitution, those limitations will have no effect on the validity of the company's contracts.[103]

Davies and Worthington suggest that many existing companies shall continue to have objects clauses, and that newly incorporated companies may choose to impose capacity restrictions in their constitutions.[104] However, the authors maintain that an objects clause under the Companies Act 2006 will merely limit the authority of the company's board and its agents, like any other authority restriction.[105] According to Davies and Worthington, 'it is precisely because the rules on authority hold the balance between the interests of the company and of third parties in what is now regarded as the appropriate way that it was possible for s.39 to be cast in such blunt terms.'[106]

Sections 35(2) and (3) of the amended Companies Act 1985 have been abandoned completely. The Companies Act 2006 makes no mention of proceedings to restrain the breach of the objects clause or of ratification of ultra vires transactions.[107]

If a company's articles contain an objects clause, the directors will be bound to observe the restrictions to the company's capacity as authority restrictions. Section 171 of the Companies Act 2006 places a positive duty on a company's directors to 'act in accordance with the company's constitution' and 'only exercise powers for the purposes for which they are conferred'. Section 40(1) completes the picture by stating:

[102] Section 31(1) of the Companies Act 2006.
[103] Davies & Rickford (2008) 58. Footnotes omitted. The authors regard this approach as consistent with Article 2(b) of the Second Company Law Directive (Directive 2012/30/EU) that requires *disclosure* but not *limitation* of objects.
[104] Davies & Worthington (2016) 174.
[105] Davies & Worthington (2016) 174.
[106] Davies & Worthington (2016) 174.
[107] Davies & Rickford (2008) 58.

> ‘In favour of a person dealing with a company in good faith, the power of the directors to bind the company, or authorise other to do so, is deemed to be free of any limitation under the company’s constitution.’

The result of these provisions is that a bona fide third party dealing with a company may be assured that a contract with the company cannot be assailed on capacity grounds by the company’s reliance on its objects clause. More would be required for a company to prove that a director lacked the authority to contract. Effectively, a company’s capacity is meaningless for good faith third parties. All that is relevant is the authority of a company’s agents. This may be influenced by an authority restriction couched in the language of an objects clause, as corporate principals are free to restrict the authority of their agents, but third parties would be able to rely on ostensible authority in the same way that they would be able to do against natural principals.[108]

The Companies Act 2006 leaves no room for true capacity restrictions at all, regarding objects clauses as mere authority restrictions to which no shareholder right of restraint or doctrine of constructive notice apply. The current English approach does nothing for shareholder control, one of the original (and arguably most convincing) arguments in favour of maintaining at least the internal operation of the ultra vires doctrine. The UK approach provides a great deal of third party protection and will therefore foster commercial certainty; this must be regarded as a positive. As an internal matter, restraint of corporate officers is left to the law of agency, contractual provisions, and fiduciary responsibilities. The UK Parliament has clearly taken the position that the interests of third parties outweigh the interest of shareholder control as exercised through the ultra vires doctrine, and that the rules on contract and authority adequately address the balance of decision-making power within a company.

The approach of the Companies Act 2006 to the ultra vires doctrine is admirably clear and leaves no room for any of the ambiguities that had plagued its predecessors. I can see no weakness in the present UK position, and it by no means implements a revolutionary idea: as long ago as 1945, the Cohen Committee recommended the

[108] In this regard, see *Freeman & Lockyer v Buckhurst Park Properties (Mangal) Ltd* [1964] 2 QB 480 (CA) 638-40 and *Rama Corporation* 556 & 558-71

complete abolition of the ultra vires doctrine in English company law.[109] After a history of legislative complexity and piecemeal reform of the ultra vires doctrine in England, the Companies Act 2006 provides an incredibly short and definitive response to the issue of corporate capacity: a company's lack of capacity as determined by its objects clause cannot affect the validity of any contract that a company concludes with a third party.[110] Therefore, in the UK, where the ultra vires doctrine was created nearly two centuries ago, it has finally been assigned to the scrapheap of commercial and legal progress.

2.5 THE EVOLUTION OF THE ULTRA VIRES DOCTRINE IN THE USA

In accordance with the federal system of government in the USA, different legislation governs the company law of corporations incorporated in the different states. A company may be incorporated in any state or in the District of Columbia, regardless of the registered office or where the company conducts its business.[111]

During the latter part of the nineteenth century, corporations in the USA could be formed for limited purposes only.[112] At the time, the majority of companies were those that did business related to major enterprises such as banking, insurance, transportation, and mining.[113] American commentators have noted that '[m]ost of the early corporations were more or less public in their nature, and it was, therefore, highly important to keep them within their chartered powers.'[114] It was argued that the doctrine was capable of protecting the state's interest in limiting the power and size of companies, and was largely premised on society's lack of trust in the corporate form and large accumulations of economic influence.[115] Some viewed the ultra vires

[109] Report of the Committee on Company Law Amendment, CMD (1945) paras 11-2. See Kiggundu JS (1991) 13 and Wedderburn KW 'What is the Point of Ultra Vires?' (1966) 29(2) *The Modern LR* 191 194.
[110] Davies & Worthington (2016) 173.
[111] USA Corporate Services Inc. 'Choosing a State of Incorporation', available at https://www.usa-corporate.com/start-us-company-non-resident/where-to-incorporate/states/, accessed on 22 June 2018.
[112] See *Liggett Co. v. Lee* 288 U.S. 517 (1933) 554. See also Kulwicki DA 'Amalgamated Sugar: The Auspicious Return of the Ultra Vires Doctrine (1988) 49 *Ohio State LJ* 841 848.
[113] Anderson J (2003) 266; *Liggett* 554.
[114] Wermuth EA & Gilmore WC *Modern American Law* (1921) 147. See also Elliot CB & Abbott HS (1911) 257.
[115] See Greenfield K 'Ultra Vires Lives! A Stakeholder Analysis of Corporate Illegality (With Notes on How Corporate Law Could Reinforce International Law Norms' (2001) 87 *Virginia LR* 1279 1302-3, and the remarks of Brandeis J in *Ligget* at 554-5.

doctrine in the USA as being aimed at the protection of shareholders, creditors, *and* the interests of the state.[116]

At first, the ultra vires doctrine was understood and applied in a similar way to other common law jurisdictions: the capacity of corporations was limited to acts that fell within their purposes[117] or powers as provided for by the relevant statute, charter, or incorporations certificates.[118] The federal courts, led by the US Supreme Court, established and maintained the general proposition that ultra vires contracts were void for lack of capacity.[119] Several arguments were initially advanced in support of the strict application of the ultra vires doctrine, including illegality, constructive notice, and public policy.[120] However, like in other parts of the world, the ultra vires doctrine was criticised in the USA for its potential to result in prejudicial and unfair consequences.[121] Colson argued that the Supreme Court's treatment of the ultra vires doctrine failed to properly consider the important interest of certainty in commercial dealings.[122] Some commentators regarded the doctrine as commercially undesirable,[123] and others called for its complete abolition.[124]

The internal consequences of ultra vires acts exceeded those recognised in the UK. It was accepted that a director that causes a company to act ultra vires and suffer loss may be sued for damages by the corporation or by a shareholder.[125] This is in line with

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[116] Schaeftler MA (1984) 71; Kulwicki DA (1988) 846-7; Greenfield K (2001) 1304.
[117] Throughout US literature on the ultra vires doctrine, mention is made of a company's "purpose" as opposed to its "object". Nothing seems to turn on the difference in terminology.
[118] Schaeftler MA (1984) 72.
[119] *Central Transportation Co. v Pullman's Palace Car Co.* 139 US 24 (1890) 59 27-8. See Ham WD 'Ultra Vires Contracts Under Modern Corporate Legislation' (1958) 46 *Kentucky LJ* 215 219, Carpenter CE (1923) 52, and Schaeftler MA (1984) 71 note 3. Colson identifies *Head & Armory v Providence Insurance Co.* 6 US (2 Cranch) 127, 160 (1804) as an even earlier application of the ultra vires doctrine. See Colson CL 'The Doctrine of Ultra Vires in United States Supreme Court Decisions' (1936) 42(3) *West Virginia Law Quarterly* 179 185-6.
[120] Ham WD (1958) 219-24; Carpenter CE (1923) 59-67; Stevens RS 'A Proposal as to the Codification and Restatement of the Ultra Vires Doctrine' (1927) 36 *Yale LJ* 297 328. See also Wermuth & Gilmore (1921) 154-5, and the comments of Gray J in *Pullman* at 55.
[121] Schaeftler MA (1983) 82; Schaeftler MA (1984) 73; Carpenter CE (1923) 68-9.
[122] Colson CL (1936) 302.
[123] Colson CL (1936) 334; Campbell W 'The Model Business Corporation Act' (1956) 11 *The Business Lawyer* 98 102.
[124] See, for example, Warren EH (1910) 504. The author, even as long ago as 1910, labelled the ultra vires doctrine as 'the revival of an antiquated conception of corporate action'.
[125] See Greenfield K (2001) 1307, referring to *Roth v. Robertson* 64 Misc. 343 (N.Y. Misc. 1909) and its affirmation of the rule that imposed liability on a company's officers for entering into ultra vires contracts that subsequently cause loss to the company. *Roth* 345. In *Roth*, bribery payments were made by a corporation's director; action was brought by a shareholder of the company against the responsible

the English approach. In the USA, it was also accepted that a shareholder could enjoin the conclusion of ultra vires transactions.[126] However, it was also within a state's power to sue to prevent a company from acting in excess of its purposes and powers.[127] This is a remarkable feature of the ultra vires doctrine in the USA. A further notable aspect of the ultra vires doctrine in the USA is the recognition of a rather drastic remedy for the state against a company for committing ultra vires acts: the state attorney general could bring proceedings for the forfeiture of the company's charter.[128]

At the state level, the strict ultra vires doctrine was relaxed on similar grounds to those explained by the House of Lords in *Attorney General* (1880).[129] Judgements handed down by state courts during the nineteenth and twentieth centuries modified and refined the application of the ultra vires doctrine in an attempt to mitigate its prejudicial consequences.[130] Unforunately, by the early twentieth century, judicial treatment of the doctrine was in a state of inconsistency and confusion.[131] A similar understanding about corporate capacity and the general operation of the ultra vires doctrine was evident across state lines,[132] but state variations of the central doctrine emerged.[133] According to the US Supreme Court, ultra vires contracts were absolutely void, unenforceable, and could not be ratified by the company's shareholders.[134] Some states confirmed this understanding of the ultra vires doctrine,[135] but the strict ultra

director for repayment of the corporation's funds expended on the bribes. The director argued in his defence that the payments were thought to be in the best interests of the company. *Roth* 344. The transaction was held to be ultra vires, and the shareholders' derivative claim against the director was upheld. *Roth* 345-7.

[126] Greenfield K (2001) 1306-7; Carpenter CE (1923) 65; Stevens RS (1927) 307.

[127] Stevens RS (1927) 307. See also Greenfield K (2001) 1307-8, where the author cites Dodge v. Woolsey, 59 U.S. (18 How.) 331, 341 (1855) as an early explanation of the basis of the shareholders' right to restrain ultra vires acts of a corporation.

[128] Stevens RS (1927) 307.

[129] Anderson J (2003) 272.

[130] Ham WD (1958) 225; Schaeftler MA (1984) 79. According to Wermuth and Gilmore, courts were quite willing to allow enforcement on an ultra vires contract if it would do justice between the parties. Wermuth & Gilmore (1921) 147.

[131] Warren EH 'Executed Ultra Vires Transactions (1910) 23 *Harvard LR* 495 498-504; Colson CL (1936) 216-7.

[132] Stevens RS (1927) 301-8.

[133] Ham WD (1958) 231-45.

[134] This was confirmed in Runcie v. Corn Exch. Bank Trust Co., 6 N.Y.S.2d 616, 622 (Snp. Ct. 1938).

[135] Schaeftler MA (1984) 72 note 3; Carpenter CE (1923) 50-51; Ham WD (1958) 219.

vires doctrine was applied consistently by federal courts only; many state courts at an early stage abandoned the rule that all ultra vires contracts are void.[136]

The enforceability of an ultra vires contract under American common law depended on whether the contract was executory or executed.[137] It was almost universally the case that the courts treated a purely executory contract (one in terms of which no performances had been made yet) as unenforceable.[138] However, several state courts would allow for the enforcement of an executory ultra vires contract at the instance of the party that had performed.[139] Therefore, under American common law, the approach to ultra vires contracts varied, and all that was certain was that not all ultra vires transactions were regarded as void ab initio and unenforceable, as was the position in the UK.[140] However, US courts did apply two rules consistently: the one prohibiting the rescission of fully executed ultra vires contracts on the basis of lack of capacity,[141] and the one prohibiting the enforcement of wholly executory ultra vires contracts on the basis of lack of capacity.[142] Courts would not allow a party to sue for performance in the event of breach of an ultra vires contract,[143] but fully executed ultra vires contracts were completely safe from attack.[144] Clearly, the ultra vires doctrine in the USA evolved into an inconsistent and complicated set of rules. Such uncertainty

[136] Elliot & Abbott (1911) 257; Wermuth & Gilmore (1921) 145. See also Ham WD (1958) 216, Coleman WD 'The Mississippi Court and the Doctrine of Ultra Vires' (1938) 10 *Mississippi LJ* 293 293-304, Schaeftler MA (1984) 79, Carpenter CE (1923) 49 and 52-5, and Stevens RS (1927) 297, 300-301 and 314-5. Colson argues that the inconsistency was particularly evident in decisions handed down by the US Supreme Court. See Colson CL (1936) 179 and Colson CL 'The Doctrine of *Ultra Vires* in United States Supreme Court Decisions' (1936) 42(4) *West Virginia Law Quarterly* 297 332.
[137] Schaeftler MA (1984) 73 note 3.
[138] See Ham WD (1958) 226 and the authorities cited at note 51.
[139] See Ham WD (1958) 225 and the authorities cited at note 48.
[140] Obadina points out that while American courts have limited the application of the ultra vires doctrine to executory contracts, English courts always regarded all ultra vires contracts as completely void ab initio. Obadina DA (1996) 312.
[141] Stevens RS (1927) 305.
[142] See Colson CL (1936) 315-6, where the author notes that this was one rule that both the Supreme Court and the state courts applied consistently. In fact, the author could only identify one state case, *Harris v Independence Gas Co.* 76 Kans. 750, 92 Pac. 1123 (1907), where it was held that a wholly executory ultra vires contract was enforceable.
[143] Wermuth & Gilmore (1921) 153. The authors make reference to the US Supreme Court case of *Case v. Kelly*, 133 U.S. 21 (1890), a case which, according to the authors, displays the courts' general unwillingness to 'lend their aid in order to enable parties to effectuate an ultra vires contract'. Wermuth & Gilmore (1921) 154.
[144] Wermuth & Gilmore (1921) 155; Elliot & Abbott (1911) 259. See also Ham WD (1958) 225 and the authorities cited there at notes 45 and 46.

is undesirable. The fact that a contract could be valid in terms of state law but void in terms of federal law could not have been beneficial to commercial dealings.

American legislators substantially amended the ultra vires at a relatively early stage in the USA.[145] At the turn of the twentieth century, state legislatures, motivated by the desire to attract incorporation business,[146] started to liberalise their incorporation statutes and address the ultra vires problem by way of remedial legislation. While the US state courts had gradually limited the circumstances where the ultra vires doctrine could be raised and used as a defence to avoid liability on a contract, remedial legislation was deemed necessary because the state courts had never developed a truly adequate or consistent solution to the ultra vires issue.[147] State legislatures began to carefully limit the circumstances under which the defense of ultra vires could be raised.[148] In 1915, the state of Vermont became the first to legislate the ultra vires doctrine.[149] In 1927, the state of Ohio followed suit with a statute that adopted the unlimited capacity and no constructive notice approach.[150] By 1933, eleven states had enacted statutes that either entirely repealed or severely curtailed the ultra vires doctrine.[151] Some states would allow a company to list any number of objects and powers, while others required no objects clauses at all and/or enabled a company's purposes clause to simply state that the company's business was "to engage in any lawful business".[152] Schaeftler points to the removal of restrictions on the number and types of corporate purposes, and the granting of the right to amend a company's purpose, as important contributors to the decline of the ultra vires doctrine.[153]

[145] Browning BG (1977) 370.
[146] Schaeftler MA (1984) 106.
[147] Ham WD (1958) 227-9. For an overview of the American statutes that addressed the ultra vires doctrine between 1915 and 1958, see Ham WD (1958) 231.
[148] Schaeftler MA (1984) 73.
[149] Ham WD (1958) 230; Schaeftler MA (1984) 79 note 13.
[150] Ham WD (1958) 231.
[151] Colson CL (1936) 333. In 1984, it was noted that the corporation statutes of all but one state addressed the ultra vires doctrine. Schaeftler MA (1984) 73 note 5.
[152] Anderson J (2003) 272. One commentator noted that by the 1980s, 'a majority of U.S. corporations have purpose clauses which either encompass every conceivable lawful business activity by means of boiler-plate language, or simply state that the corporation may engage in any lawful activity'. Schaeftler MA (1984) 88. By the end of the decade, every state corporation statute in the USA included an "any lawful purpose" provision. See Kulwicki DA (1988) 848.
[153] Schaeftler MA (1984) 106-7.

In 1946, The Committee on Corporate Laws of the Section of Corporation, Banking and Business Law of the American Bar Association published the MBCA for use by state legislatures in drafting revised corporation statutes.[154] The MBCA was the culmination of a project which had commenced in 1943.[155] The MBCA, and state corporation legislation that adopted it, went a long way towards banishing the remnants of the ultra vires doctrine.[156] At the same time, the British Parliament had still made no moves to modify the ultra vires doctrine, showing that the USA was "ahead of the game" in this respect.[157]

The MBCA limited the right to rely on ultra vires to three types of proceedings: those by a shareholder against a company, those by a company or a shareholder (derivatively)[158] against the company's directors and other officers, and those by the state attorney general against the company.[159] Section 7 of the MBCA declared ultra vires contracts to be valid, recognised the shareholder's right to restrain,[160] the company's right to raise ultra vires in proceedings against its directors, and the right of the state attorney general to enjoin a company from acting ultra vires or to dissolve the corporation for acting ultra vires.[161]

It has been noted that after the publication of the MBCA, states' approach to the ultra vires doctrine started to exhibit 'remarkable uniformity'.[162] The vast majority of states made use of s 7 of the MBCA as solutions to the ultra vires problem.[163]

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[154] Campbell W (1956) 98; Ham WD (1958) 239-40.
[155] See Campbell W (1956) 98. The author explains that the MBCA was modelled on the Illinois Business Corporation Act of 1933. Campbell W (1956) 100. See also Holmes WH 'The Revised Model Business Corporation Act and Corporate Law Reform in Mississippi: Part One' (1986) 56 *Mississippi LJ* 165 165-6.
[156] Campbell W (1956) 102-103; Kulwicki DA (1988) 848.
[157] Obadina DA (1996) 317-9.
[158] One commentator argues that in the USA the shareholders' right to restrain ultra vires contracts can only be personal and not derivative. Greenfield K (2001) 1355.
[159] Kulwicki DA (1988) 847. See note 69 therein, where the author quotes the ultra vires solution in the RMBCA, comments that '[e]very state except Hawaii has adopted an *ultra vires* provision', and proceeds to cite the ultra vires provisions of each state. It should be noted that the state of Hawaii *does* now have an ultra vires provision; it has adopted the RMBCA solution, by way of HI Rev Stat § 414-41 to 44.
[160] Schaeftler MA (1984) 78.
[161] Schaeftler MA (1984) 90.
[162] Schaeftler MA (1984) 81.
[163] 'In forty-three states and the District of Columbia, the statutory provision regarding the ultra vires doctrine is an adaptation from the MBCA' Schaeftler MA (1984) 73 note 5.

2.5.1 The modern American solution

In 1984, the Committee on Corporate Laws of the American Bar Association completed a comprehensive review and revision of the MBCA.[164] The 1984 Revision came to be called the Revised Model Business Corporation Act (RMBCA).[165]

According to § 3.01(a) of the RMBCA,[166] the purpose of a corporation is the engaging of any lawful business, 'unless a more limited purpose is set forth in the articles of incorporation'.[167] Therefore, the RMBCA allows for a company's articles of incorporation to deviate from the broad general purpose of doing lawful business by restricting the company to a limited purpose.[168] The RMBCA states that, as a general rule, every company has 'the same powers as an individual to do all things necessary or convenient to carry out its business and affairs'. Section 3.02 enumerates and describes with great thoroughness all the powers that a company may enjoy.[169]

The RMBCA declares that as a general rule, the validity of company contracts may not be challenged on the basis that the company lacks the power.[170] The Official Comment to § 3.04(*a*) emphasises that there is no potential for reliance on the ultra vires doctrine 'as a sword or as a shield': neither the company nor the third party may avoid liability on a contract on the grounds that the contract was ultra vires the company.[171] However, the RMBCA allows for a challenge to a company's power to act

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[164] Goldstein E 'Revision of the Model Business Corporation Act' (1985) 63 *Texas LR* 1471 1471.
[165] Booth RA 'A Chronology of the Evolution of the MBCA' (2000) 56 *The Business Lawyer* 63 66.
[166] 2016 Revision (9 December 2017).
[167] According to the Official Comment to § 3.01 of the RMBCA, '[t]he choice of an "any lawful business" clause has become nearly universal in states that permit the clause', but '[m]any corporations may also find it desirable to supplement a general purpose clause with an additional statement of business purposes. This may be necessary for licensing or for qualification or registration purposes in some states.'
[168] This view is confirmed by § 3.02. under the heading 'General Powers', particularly the words '[u]nless its articles of incorporation provide otherwise'.
[169] For example, § 3.02(4) is particularly broad and may encompass, on its own, almost every conceivable commercial transaction. It reads: 'to purchase, receive, lease, or otherwise acquire, and own, hold, improve, and otherwise deal with, real or personal property, or any legal or equitable interest in property, wherever located.' Section 3.02(5) allows a company 'to sell, convey, mortgage, pledge, lease, exchange, and otherwise dispose of all or any part of its property'.
[170] Section 3.04(a) of the RMBCA. The Official Comment to § 3.01 explains that '[e]ven if the articles of incorporation limit lines of business in which the corporation may engage, the limited scope of the ultra vires concept in litigation between the corporation and outsiders means that a third person entering into a transaction that violated the restrictions in the purpose clause *may* be able to enforce the transaction in accordance with its terms *if the third person was unaware of the narrow purpose clause when entering into the transaction*.' Emphasis added.
[171] Official Comment to § 3.04 of the RMBCA. It was observed that under s 7 of the MBCA of 1960, both companies and third parties were prevented from relying on the ultra vires doctrine to ward off a claim

in three scenarios: (i) a shareholder may bring proceedings to enjoin a company from acting ultra vires,[172] (ii) a company may challenge its own lack of capacity in proceedings against its directors and other officers,[173] and (iii) the state attorney general may bring proceedings for the dissolution of a company on the basis that 'the corporation has continued to exceed or abuse the authority conferred upon it by law'.[174]

The Official Comment to § 3.04 states that the allowed internal remedies do not apply to illegal contracts,[175] presumably in a bid to dispel any lingering beliefs that the ultra vires doctrine should be used in the context of contracts prohibited or not authorised by statute or the common law.[176]

The RMBCA clearly spells out a court's powers during a proceeding brought by a shareholder to enjoin a corporation from acting ultra vires: the court may prohibit or set aside the act, provided that it is equitable to do so and that 'all affected persons are parties to the proceeding'.[177] The words 'set aside' in § 3.04(c) imply that a court has the power to rescind at least an executory contract, and possibly a fully executed ultra vires transaction. In addition, the court may award damages for loss suffered by the company or any other party as a result of the restraint of the ultra vires act.[178]

The Official Comment to § 3.04 of the RMBCA provides some elaboration on the effect of capacity restrictions on third parties: outsiders are not required to make inquiries regarding a potential limited purpose or powers clause in a company's articles of incorporation ('A person who is unaware of these limitations when dealing with the corporation is not bound by them').[179] Therefore, it is made clear that the doctrine of

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under a contract, *and* from attempting to recover property in terms of an ultra vires contract. Obadina DA (1996) 317.

[172] Section 3.04(b)(1) of the RMBCA.

[173] Section 3.04(b)(2) of the RMBCA.

[174] Section 3.04(b)(3) read with § 14.30(1)(ii) of the RMBCA.

[175] Official Comment to § 3.04 of the RMBCA.

[176] See Kulwicki DA (1988) 842, 845 & 848-9, and Greenfield K (2001) 1284 & 1314-9. In *Roth*, the court deemed the relevant contract illegal (at 345), but applied to it the rules of recovery in terms of ultra vires contracts. *Roth* 346. See also Mack FA 'The Law on Ultra Vires Acts and Contracts of Private Corporations' (1930) 14(4) *Marquette LR* 212 212.

[177] Section 3.04(c) of the RMBCA.

[178] Section 3.04(c) of the RMBCA. However, damages for loss of anticipated profits cannot be claimed.

[179] Official Comment to § 3.04 of the RMBCA.

constructive notice does not apply to purposes clauses in a company's articles of incorporation.

State courts were previously willing to treat ultra vires contracts differently on the basis of whether they were wholly executory, partially executory, or fully executed, but it is made clear that under the RMBCA's approach 'except to the extent described in section 3.04(b)… the same rules apply to all contracts no matter at what stage of performance'.[180]

The RMBCA's approach to the allowed ultra vires proceedings contemplated by § 3.04(b) must be read subject to § 3.04(c).[181] The Official Comment explains that the "affected persons" whose interests may be protected include third parties that transact with the company.[182] It is confirmed that ultra vires contracts may be restrained only if all "affected persons" are parties to the litigation.[183] The Official Comment explains further:

> 'The requirement that the action be "equitable" generally means that only third persons dealing with a corporation while specifically aware that the corporation's action was ultra vires will be enjoined.[184]

Therefore, in states that adopt the RMBCA's approach as explained by the Official Comments therein, the knowledge of the third party is a determinant to the availability of restraining rights and the enforceability of an ultra vires contract.

The RMBCA allows a state attorney general to challenge the validity of a corporate action in a suit for dissolution of a company for acting ultra vires.[185] In this regard, the Official Comment contains the following cryptic statement:

[180] Official Comment to § 3.04 of the RMBCA.
[181] Official Comment to § 3.04 of the RMBCA.
[182] Official Comment to § 3.04 of the RMBCA.
[183] Official Comment to § 3.04 of the RMBCA.
[184] Official Comment to § 3.04 of the RMBCA.
[185] Section 3.04(c) read with § 14.30(a)(1)(ii) of the RMBCA. In the Official Comment to the latter section, it is stated that the state is thereby provided a mechanism to 'ensure compliance with the fundamentals of corporate existence and prevent abuse'.

> 'The provision does not answer the question whether a corporation may be dissolved or enjoined by the attorney general for committing an ultra vires act; it simply preserves the power of the state to assert that certain corporate action was ultra vires.'[186]

The sections in the RMBCA and Delaware's General Corporation Law (GCL) that govern corporate powers and the ultra vires doctrine are very similar. The GCL also stipulates a wide range of powers that corporations may use to promote their stated purposes.[187] The GCL proclaims that ultra vires acts are valid, but that a company's lack of capacity may be asserted in the same three scenarios envisioned by the RMBCA.[188] The GCL imposes the same limitations on the shareholder right to restrain a company from acting ultra vires.[189]

In the USA, the capacity issue has come to be governed largely by ordinary principles of agency law,[190] but with some important statutory modifications that retain aspects of the ultra vires doctrine. As a general rule, a company's capacity to act may not be challenged (in effect, ultra vires contracts are valid) *except* in the following three instances: a company may raise its lack of capacity in legal proceedings against a director, officer, or agent of the company, a company's shareholder may raise capacity to assert that an ultra vires contract is void, and the state attorney general has the power to rely on a company's lack of capacity to apply for the dissolution of the entity. The end result is that a corporation's ultra vires acts are only provisionally valid and enforceable.

Both the RMBCA and the GCL give thorough guidance regarding the scope of the shareholders' right to restrain an ultra vires contract. The clear explanation of the shareholder remedy and of the courts' powers in that regard is an admirable aspect of the evolved American approach. The words 'set aside and enjoin the performance' in § 124 of the GCL and 'enjoin or set aside the act' in § 3.04(c) of the MBCA suggest that it is possible for a shareholder of a limited capacity company to take proceedings to prevent the company from performing in terms of an executory ultra vires contract, provided that it is 'equitable' in the circumstances. Whether to grant such an order in

[186] Official Comment to § 3.04 of the RMBCA.
[187] Sections 121 & 122 of the GCL.
[188] Section 124 of the GCL.
[189] Section 124 of the GCL.
[190] Schaeftler MA (1984) 172.

a given case is left to the discretion of the courts. If a company's shareholder files for an injunction to prevent the company acting ultra vires, a court has the power and discretion to enjoin the transaction before its conclusion, to enjoin performance of executory ultra vires contracts, and, seemingly, to even set aside fully executed ultra vires contracts, provided that such order is equitable in the opinion of the court, and all affected parties are parties to the proceedings.

2.5.2 Criticism of the RMBCA solution

Schaeftler has conducted the most thorough evaluation of the RMBCA provisions on capacity. There are several aspects of the USA's ultra vires approach that the author finds objectionable. He argues that the shareholders' right to enjoin ultra vires executory contracts causes uncertainty in respect of a company's transactions and unduly places third parties at risk.[191] Indeed, the RMBCA approach forces outsiders to read the company's purposes clause for absolute certainty that a particular contract will be enforceable.[192] Schaeftler is of the opinion that '[t]he risk should fall on the shareholders rather than the third party'[193] and that shareholders' recourse in the event of an executory ultra vires contract having been concluded should be limited to a claim for damages against the company's executives.[194] This argument has some merit: it may be unreasonable to expect outsiders to have greater knowledge than a company's shareholders, and to put them at risk in the name of shareholder protection. However, it must be borne in mind that the ideal level of shareholder protection is also dependent on the ability of shareholders to exercise existing remedies to control a corporation. This, in turn, is highly dependant on the type of company and ownership structure one is dealing with. It is important to consider, for instance, the difference in ownership structure and shareholder power in a one-man company versus those in a large publically-traded corporation with thousands of shareholders, when considering the appropriateness of shareholder remedies.

Schaeftler argues out of a perspective of expedience, suggesting that abolishing the shareholders' right to enjoin executory ultra vires contracts 'would enhance economic efficiency by redistributing transaction costs, and may eliminate any external costs

[191] Schaeftler MA (1984) 91.
[192] Schaeftler MA (1984) 93.
[193] Schaeftler MA (1984) 91.
[194] Schaeftler MA (1984) 92.

which may exist under the present ultra vires injunction rule'.[195] Schaeftler bases this argument, in part, on the nature of shareholding in large public companies. He writes:

> '[S]hareholders' nonreliance on the purpose clause in making their initial investment decision, as well as their primary concern with a satisfactory rate of return, suggests that shareholders in publicly-held corporations should not possess the right to enjoin an executory ultra vires contract.'[196]

Schaeftler makes a good point in this regard. However, the position may be different in the case of smaller, closely-held companies, where ownership and management rest in the hands of the same person or persons. In such a case, it may be more justifiable for a shareholder to have the right to enjoin executory ultra vires contracts.

Schaeftler acknowledges that the risk of third parties actually being prejudiced by a shareholder's enjoining of an ultra vires contract is relatively small.[197] He argues that the slim chance that a non-controlling shareholder will be able to detect an ultra vires contract while it is still executory,[198] combined with the fact that investors in limited capacity companies may bring derivative actions against officers that cause the company to act ultra vires,[199] and the cost and inconvenience of litigation, would likely dissuade a shareholder from applying for an injunction based on the ultra vires doctrine.[200] It can be added that the availability of the "any lawful purpose" clause means that very few companies would ever be in danger of concluding ultra vires contracts, contributing to the certainty of third parties. All these arguments are borne out by the paucity of cases where the right to restrain ultra vires contracts was enforced by a shareholder.[201] Schaeftler is correct: the chance of third parties being prejudiced by a shareholder's restraining application is minimal. However, the risk remains.

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[195] Schaeftler MA (1984) 95.
[196] Schaeftler MA (1984) 92-3 (footnotes removed).
[197] Schaeftler MA (1984) 98.
[198] Schaeftler MA (1984) 99. It will be remembered that in American law it was settled at an early stage that the ultra vires doctrine could not be used to undo a completely executed contract. Schaeftler MA (1984) 99.
[199] Schaeftler MA (1984) 100.
[200] Schaeftler MA (1984) 99. At note 57 Schaeftler suggests that shareholders in publicly held corporations are far more likely to punish wrongdoing by way of selling their shares than through litigation.
[201] Schaeftler MA (1984) 100 and the cases cited there at note 59.

Providing the state with a right to restrain ultra vires acts is a highly peculiar feature of the RMBCA. The granting of a state right to apply for the dissolution of a company is a particular drastic remedy. Most legal systems do not have a similar rule forming part of their revised ultra vires doctrine.[202] Neither the UK Companies Act 2006 nor the South African Act contain a similar provision, and neither did their respective predecessors. Schaeftler warns that the existence of the state right to dissolve or restrain a company for ultra vires acts is not completely harmless, in light of the (admittedly remote) possibility that a state uses this right as a threat against corporations to enforce compliance with other regulations.[203]

Schaeftler conducted invaluable research into the prevalence of ultra vires proceedings being initiated by states. He found that states in the USA are mostly not inclined to make use of the ultra vires provisions and to involve themselves in the lawful activities of companies, and neither do state attorneys general receive many complaints regarding ultra vires contracts by corporations.[204] In fact, Schaeftler was unable to find a reported case where a court has granted a state's prayer for dissolution of or injunction against a corporation for ultra vires acts.[205]

If a remedy has fallen into disuse, or if it was never truly in use, its validity naturally becomes questionable. Greenfield argues that it may not be in the state's interest to use this remedy too often at all, but '[t]he fact that it exists should cause corporations to take seriously the importance of staying within their legal capacity'.[206] According to Colson, the policy of limiting a company to acts within its powers stands on weak ground if the state rarely, if at all, takes steps to restrain or sanction ultra vires transactions.[207]

Schaeftler argues that the availability of an "any lawful business" clause shows that states have long ago abandoned their supposed interest in regulating lawful corporate activity.[208] Schaeftler is of the view that the states' right to challenge ultra vires

[202] Schaeftler MA (1984) 90.
[203] Schaeftler MA (1984) 112.
[204] See Schaeftler MA (1984) 109-10 and Schaeftler MA (1983) 91-2.
[205] Schaeftler MA (1983) 86.
[206] Greenfield K (2001) 1360.
[207] Colson CL (1936) 301.
[208] Schaeftler MA (1984) 108; Schaeftler MA (1983) 90.

contracts is 'inconsistent with modern corporate realities'.[209] He argues that this remedy was based on the old-fashioned notion that the state, having a duty to protect the public welfare, had an interest in discouraging and preventing companies from entering into ultra vires transactions.[210] Perhaps this state remedy was inherited from cases like *Sutton's Hospital case*,[211] where it was held that if a charter company exceeded its objects, proceedings could be initiated to restrain the company or have its charter revoked.[212]

Greenfield sees great value in the retention of shareholder and state standing to enjoin ultra vires acts.[213] However, he was arguing from the perspective that the ultra vires doctrine applies to illegal contracts.[214] This view is rejected in the Official Comments to the RMBCA.[215]

Schaeftler argues that the state's enforcement of this right against a company would cause undue prejudice to the company and its shareholders for the negligence of legal advisors, incorporators, or the board of directors.[216] According to Schaeftler, the retention of state power to challenge ultra vires acts is out of place, 'for the state has no corresponding authority to object to mere unauthorized corporate acts'.[217] The author recommends that state standing to dissolve or restrain a corporation on the basis of the ultra vires doctrine should be repealed in the USA.[218]

The evolved ultra vires doctrine in the USA attempts to balance shareholder control with third party protection. Allowing shareholders to restrain ultra vires contracts where corporations have limited purposes presumably provides greater certainty and protection for shareholders, but it regrettably leaves third parties in an insecure position. The risk to third parties (and indeed to corporations with limited purpose clauses) is exacerbated by the state's right to intervene in ultra vires corporate action.

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[209] Schaeftler MA (1984) 101. At 112, the author makes the point that provisions that confer such a right on a state is indicative of conservatism and 'fail to reflect society's acceptance of the corporation as a legitimate vehicle for promoting lawful economic objectives'.
[210] Schaeftler MA (1984) 101; Schaeftler MA (1983) 85.
[211] (1612) 10 Co. Rep. 1.
[212] See Anderson J (2003) 264.
[213] Greenfield K (2001) 1323-30.
[214] Greenfield K (2001) 1414-22.
[215] Official Comment to § 3.04 of the RMBCA.
[216] Schaeftler MA (1984) 108.
[217] Schaeftler MA (1984) 112; Schaeftler MA (1983) 93.
[218] Schaeftler MA (1984) 78 and 112.

Even though there is no prevalence of states exercising this right, it does represent a risk. This risk and uncertainty must be regarded as a weakness in the American approach. Bona fide third parties contracting with authorised representatives of a corporation should be able to expect that the resulting contract will, all other formalities aside, be within the corporation's legal power to conclude and perform; the state right to intervene in a private agreement places the third party at risk. The American approach to the ultra vires doctrine promotes flexibility and shareholder protection, but by making provision for the shareholders' right to restrain ultra vires conduct and the states' right to sue for the dissolution of a corporation for exceeding its limited capacity, it unjustifiably places both third parties and companies at risk.

It is submitted that the internal remedies that would allow for executory ultra vires transactions to be restrained go too far in protecting a corporation's shareholders at the expense of the legitimate expectation of its would-be creditors. No convincing argument has been suggested to refute the arguments made in this regard by Schaeftler. In support of the learned author, it is submitted that the RMBCA should be amended so as to remove the right to restrain ultra vires contracts. The intricacies of corporate decision-making should be controlled by contract and authority, not by rules clinging to an outmoded doctrine that was never truly embraced in the USA in the first place.

2.6 CONCLUSION

Chapter Two described and analysed the evolution of the capacity laws in the UK and the USA, so as to provide a point of reference and comparison for the subsequent analysis of the South African position. This was done to respond to the research sub-questions of how the ultra vires doctrine originated in company law, and whether the South African Act measures favourably against comparable laws in two key foreign law jurisdictions.

There were similar motivations for the existence and reform of the ultra vires doctrine across the Atlantic, but the scope of the current doctrine varies in the UK and USA. The traditional ultra vires doctrine was ostensibly designed to protect the interests of both shareholders and creditors of companies, at a time when the management of large companies was largely separate from ownership. Balancing the competing

interests of shareholders of limited purpose company with those of a third party dealing with the company remains an important consideration when reforming the ultra vires doctrine. During the twentieth century, the ultra vires doctrine was modified in various ways, including judicial expansion of the objects clause with the implied powers notion, and legislative amendment of the consequences of ultra vires acts. Generally, these modifications tended to be aimed at third party protection.

In both the USA and the UK, objects clauses are now optional but permitted. In both legal systems, the default position is that a corporation has the power to pursue any lawful business, and that ultra vires contracts between a company and a third party are valid. The biggest difference between American and English company law regarding the ultra vires doctrine lies in the consequences of acts beyond a company's objects/purposes clause. In England, the concept of ultra vires corporate action now stands on shaky ground. There can be no such thing as an ultra vires contract, only one that is beyond the authority of a company's representatives. Since the Companies Act 2006 does not contemplate a right to restrain ultra vires contracts, these transactions will not be voidable on capacity grounds. In the UK, shareholder control through capacity restrictions is rejected in favour of certainty and creditor protection. In the USA, ultra vires contracts are provisionally valid, but may be prohibited before conclusion or set aside once concluded upon application by the relevant company's shareholders or by the state. In addition, the state has the power to apply for the dissolution of a company on the basis of ultra vires acts. In the USA, shareholders of limited purpose companies have a means to restrain ultra vires conduct, but third parties are at risk as an executory contract with a corporation could be set aside on the basis of a corporation's lack of capacity. In the USA, shareholders and limited purpose companies are also placed at risk by the remote but real possibility that a state attorney general applies for an order dissolving the company on the basis of its conclusion of ultra vires acts.

It is submitted that the RMBCA should be amended so as to provide greater certainty and third party protection. The UK's Companies Act 2006 should be considered as a model solution to the ultra vires problem in company law.

The RMBCA approach differs from the South African Act in two important respects: (i) a third party's knowledge of the ultra vires nature of a contract can determine whether the right of restraint may be enforced; and (ii) the state has the power to intervene when a corporation acts ultra vires. The South African Act contains no such provisions. However, the American approach is more similar to South African law than the English approach is. Neither the RMBCA nor The UK Companies Act 2006 allows for a company's shareholders to ratify ultra vires contracts, as the South African Act does, but the Companies Act 2006 contains no right of restraint in respect of ultra vires contracts, while the RMBCA and South African Act do. A further difference is that neither the RMBCA nor the Companies Act 2006 allow for a director to restrain an ultra vires contract, while the South African Act does.[219]

Chapter Three will analyse the South African approach to corporate capacity.

[219] See 3.5.4 below.

CHAPTER THREE: CORPORATE CAPACITY IN TERMS OF THE COMPANIES ACT 71 OF 2008

3.1 INTRODUCTION

This thesis questions whether the capacity provisions in the Companies Act 71 of 2008 (the Act) provide a commercially desirable legal framework for the purposes of incorporated special purpose vehicles (SPVs) used in traditional securitisation schemes. Traditional securitisation schemes commonly involve the creation and use of a limited capacity SPV. Therefore, an investigation into the Act's regulation of limited capacity companies will be of value.

Limited capacity companies are used for various purposes in commerce, from nominee companies in the asset management environment to special purpose vehicles used in traditional securitisation schemes. In addition, it may be that the MOIs of many older companies still contain objects clauses. Therefore, it is important to understand the effect of capacity restrictions under the new Act.

This chapter will interpret and analyse the capacity provisions in the Act with a view to investigating the validity of ultra vires contracts concluded by limited capacity companies. This chapter will respond to research sub-question 2.[1] The discussion herein will lay a foundation from which to further explore the effect of the capacity provisions on limited capacity SPVs in a commercial setting.

3.2 INTERPRETATION OF THE ACT

The literal approach, in terms of which words are given their ordinary, grammatical meaning, has traditionally been the starting point to statutory interpretation in South African law.[2] The exception to the literalist approach was explained by Innes J in *R v Venter*:[3]

> 'When to give the plain words of the statute their ordinary meaning would lead to an absurdity so glaring that it could never have been contemplated by the legislature, or where it would lead to a result contrary to the intention of the legislature, as shown by

[1] See 1.4 above.
[2] *Randburg Town Council v Kerksay Investments (Pty) Ltd* [1997] ZASCA 68.
[3] 1907 TS 910.

> the context and such other considerations as a Court is justified to take into account, the court may depart from the ordinary effect of the words to the extent necessary to remove the absurdity and to give effect to the true intention of the legislature'.[4]

However, the new Constitution has a decisive impact on Acts of Parliament[5] and is designed to influence statutory interpretation.[6] According to s 39(2) of the Constitution:

> 'When interpreting any legislation, and when developing the common law or customary law, every court, tribunal or forum must promote the spirit, purport and objects of the Bill of Rights.'

The Constitution mandates the use of a purposive and contextual approach to statutory interpretation.[7] The importance and extent of legislative context was illustrated by the dissenting judgment in *Jaga v Dönges NO & Another; Bhana v Dönges NO &* Another,[8] where Schreiner JA stated:

> 'Certainly no less important than the oft repeated statement that the words and expressions used in a statute must be interpreted in the light of their context. But it may be useful to stress two points in relation to the application of this principle. The first is that 'the context', as here used, is not limited to the language of the rest of the statute regarded as throwing light of a dictionary kind on the part to be interpreted. Often of more importance is the matter of the statute, its apparent scope and purpose, and within limits, its background.[9]

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[4] *R v Venter* 914-5. See De Ville JR *Constitutional and Statutory Interpretation* (2000) 94-7; Du Plessis L *Re-interpretation of Statutes* (2002) 93-4.

[5] No more so than the supremacy clause, which declares that legislation that is found to be inconsistent with the Constitution is invalid. See s 2 of the Constitution. Du Plessis comments that '[c]onstitutional supremacy as both "a constitutional fact" and a value has dealt the dominance of the literalist-cum-intentionalist theory of interpretation – in the areas of statutory and constitutional interpretation at least – a decided blow.' See Du Plessis L (2015) 1337 (footnotes omitted).

[6] Du Plessis L (2002) 133. The author explains that statutes are subject to the Constitution, on the one hand, and must be read in light of the Constitution, particularly in terms of s 39(2), on the other.

[7] *Bertie Van Zyl (Pty) Ltd and Another v Minister of Safety and Security and Others* [2009] ZACC 11 para 21; see also *Bato Star Fishing (Pty) Ltd v Minister of Environmental Affairs and Tourism and Others* [2004] ZACC 15 para 91, where Ngcobo J stated: 'The technique of paying attention to context in statutory construction is now required by the Constitution, in particular, s 39(2). As pointed out above, that provision introduces a mandatory requirement to construe every piece of legislation in a manner that promotes the 'spirit, purport and objects of the Bill of Rights'.'

[8] 1950 (4) SA 653 (A), a case cited with approval in both *Bato Star* at para 89 and *Bertie Van Zyl* at para 21.

[9] *Jaga* 662G-H.

In *Natal Joint Municipal Pension Fund v Endumeni Municipality*,[10] the new locus classicus on statutory interpretation in South African law, the SCA firmly rejected the "intention of the Legislature" approach.[11] Instead,

> '[C]onsideration must be given to the language used in the light of the ordinary rules of grammar and syntax; the context in which the provision appears; the apparent purpose to which it is directed and the material known to those responsible for its production…from the outset one considers the context and the language together, with neither predominating the other.[12]

The purpose of a statute can be seen as creating a context that explains the intended scope and impact of the legislation.[13] Du Plessis notes that purposiveness seems to gradually be replacing clear language as the key to constitutional interpretation in South African law, which could affect the approach of the courts to the interpretation of ordinary legislation.[14] The author cautions against the uncritical acceptance of purposive interpretation as *the* method to extract meaning from statutory texts,[15] pointing out that 'the processes involved in constitutional (and statutory) interpretation are too complex to be captured in but one essential or predominant buzzword'. To paraphrase Du Plessis, the purpose of a provision is incapable of being determined *before* its interpretation; instead, the purpose of the legislation must be established *through* its interpretation.[16]

Mupangavanhu makes the important observation that the "golden rule" of statutory interpretation as explained by Innes J in *R v Venter*[17] cannot be employed without regard *first* to the legislative purpose, context and awareness of the constitutional values – summarised as 'context'.[18] Mupangavanhu describes the scope of 'context' broadly, including within its ambit 'the history of the legislation; the common law prior

[10] 2012 (4) SA 593 (SCA) para 20.
[11] *Endumeni* para 20.
[12] *Endumeni* paras 18-19.
[13] See De Ville JR (2000) 244.
[14] Du Plessis L (2002) 115.
[15] Du Plessis L (2002) 116.
[16] Du Plessis L (2002) 116.
[17] For explanation of the golden rule, see generally De Ville JR *Constitutional and Statutory Interpretation* (2000) 94-97; Du Plessis L (2002) 93-94.
[18] Mupangavanhu BM (2019) 9-10.

to the enactment of the Act; law reform or policy objectives; defects in the law not provided for by the common law and new remedies provided for in the Act'.[19]

As an overarching interpretative guideline in South Africa's constitutional dispensation, the interpreter 'must endeavor to interpret the statute in a manner that renders the statute constitutionally compliant', while ensuring that the resulting interpretation is one that remains a reasonable one in light of the grammatical meaning of the text.[20] In *National Coalition for Gay and Lesbian Equality and Others v Minister of Home Affairs and Others*,[21] the Constitutional Court (CC) added that the purposive approach to interpretation envisioned by s 39(2) must be limited by the following consideration:

> 'There is, it is true, a principle of constitutional interpretation that where it is reasonably possible to construe a statute in such a way that it does not give rise to constitutional inconsistency, such a construction should be preferred to another construction which, although also reasonable, would give rise to such inconsistency. Such a construction is not a reasonable one, however, when it can be reached only by distorting the meaning of the expression being considered.'[22]

This was confirmed in *Investigating Directorate: Serious Economic Offences and Others v Hyundai Motor Distributors (Pty) Ltd and Others: In re Hyundai Motor Distributors (Pty) Ltd and Others*,[23] where, per Langa DP, the CC stated that 'judicial officers must prefer interpretations of legislation that fall within constitutional bounds over those that do not, provided that such an interpretation can be reasonably ascribed to the section'.[24] In *Democratic Alliance v African National Congress and Another*[25] the CC reiterated that the interpretation of statutes in the constitutional dispensation is still restricted by the criteria of reasonableness; it is not permissible to unreasonably strain the language of an Act to make its provisions comply with the spirit, purport, and

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[19] Mupangavanhu BM (2019) 10.
[20] *Provincial Minister for Local Government, Environmental Affairs and Development Planning, Western Cape v Municipal Council of the Oudtshoorn Municipality and Others* [2015] ZACC 24 para 12; see also *Cool Ideas 1186 CC v Hubbard and Another* [2014] ZACC 16 para 28, and *Bertie Van Zyl* para 21, where the CC stated that '[t]he purpose of a statute plays an important role in establishing a context that clarifies the scope and intended effect of a law', while at para 22 adding the proviso that '[a] contextual or purposive reading of a statute must of course remain faithful to the actual wording of the Act'. See also *Smyth v Investec Bank Limited* [2017] ZASCA paras 28-9.
[21] [1999] ZACC 17.
[22] Footnotes omitted. Per Ackermann J at para 23.
[23] [2000] ZACC 12.
[24] At para 23.
[25] [2015] ZACC 1.

objects of the Bill of Rights.[26] Therefore, it is clear that South African courts are generally amenable to interpretation based on the purposive method,[27] but subject to the criterion of "reasonable literalism".[28]

The history of a statute is an important aspect of its purpose. Referring to Von Savigny, Du Plessis explains that historical interpretation 'requires entry into and identification with the historical situation from which a law emerged'.[29] The author reflects on the fact that the mischief rule, which itself is an expression of purposive interpretation,[30] requires an awareness of the history of a legislative text.[31] According to this view, the history of the South African Companies Acts regarding corporate capacity, including the mischief eradicated by the previous Act, would remain relevant considerations when giving meaning to the provisions in the current Act.[32]

Parliament often includes a section in an Act that sets out its purposes.[33] Such sections should be approached with caution, as even where a statute does have an "objects" clause, the stated purposes still require interpretation.[34] De Ville warns that the following difficulties may be encountered when giving meaning to an objects clause in an Act:

> '[T]he different purposes as specified may lead to conflicting results in certain cases; the question may arise whether the statute has any purposes apart from the ones explicitly set out; the question may arise how to establish the purposes(s) of a specific provision in light of the general aims as specified'.[35]

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[26] Para 41.
[27] For example, the case of *Stopforth v Minister of Justice and Others, Veenendaal v Minister of Justice and Others* [1999] ZASCA 72.
[28] See *Road Traffic Management Corporation v Waymark Infotech (Pty) Ltd* [2018] ZACC 12 para 32.
[29] Du Plessis L (2002) 259.
[30] Du Plessis L (2002) 96, 115-7, & 259.
[31] Du Plessis L (2002) 259.
[32] As Du Plessis notes, 'references to the predecessors and successors of a provision to be construed and surrounding circumstances more or less coinciding with the adoption of the provision have all been held to be allowable historical indicia of the meanings that may be attributed to a provision' (footnotes omitted). See Du Plessis L (2002) 259-60 and 262. See also De Ville JR (2000) 233-4.
[33] De Ville JR (2000) 244-5.
[34] De Ville JR (2000) 245.
[35] De Ville JR (2000) 245-6.

Turning to the Act, s 5(1) stipulates that the statute must be interpreted and applied in a manner that gives effect to the purposes contained in s 7.[36] Furthermore, when courts or regulatory agencies are confronted with a provision in the Act that is reasonably capable of having more than one meaning, they are obligated to 'prefer the meaning that best promotes the spirit and purpose of this Act, and will best improve the realisation and enjoyment of rights'.[37] According to Mupangavanhu, a reading of the interpretative guidelines in the Act, together with s 39(2) of the Constitution, 'leaves no doubt that the Act is intentionally aligned to the section 39(2) objectives.'[38]

There does not seem to be a hierarchy in the language of the 'Purposes' section in the Act. Therefore, it would seem that guidance regarding a particular section's purpose and meaning must be sought from all those purposes in s 7 that are applicable to the relevant section and to the given situation. It is submitted that the purposes most relevant to this thesis include:

- Flexibility and simplicity in respect of company formation and maintenance;[39]
- Transparency;[40]
- Optimum conditions for spreading economic risk;[41]
- Balancing the rights and obligations of shareholders and directors;[42] and
- Predictable and efficient company regulation.[43]

Section 5(2) provides further guidance by permitting a court, when interpreting or applying the Act, to consider foreign company law '[t]o the extent appropriate'.[44]

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[36] Cassim is critical about the purposes section read with the interpretation sections in the Act: 'How exactly would a court or regulatory agency give effect to the 14 wide-ranging purposes of the Act as set out in s 7? How is a court (or regulatory agency) to decide which particular purpose should have priority? A closer examination of these purposes shows that they are prefatory in nature and ought to have remained so.' See Cassim FHI 'Introduction to the New Companies Act' in Cassim FHI (ed.) et al *Contemporary Company Law* 2 ed (2012) 4.
[37] Section 158(*b*) of the Act.
[38] Mupangavanhu BM 'Impact of the Constitution's Normative Framework on the Interpretation of Provisions of the Companies Act 71 of 2008' (2019) 22 *PELJ* 9.
[39] Section 7(*b*)(ii).
[40] Section 7(*b*)(iii).
[41] Section 7(*g*).
[42] Section 7(*i*).
[43] Section 7(*l*).
[44] Section 5(2) prompted the comparative analysis done in Chapter Two. It may be that that discussion is of assistance in the interpretation of the capacity provisions in the Act.

Therefore, the Act allows for South African company law to be influenced by international best practices.[45]

3.3 THE MEMORANDUM OF INCORPORATION

In South African law, a company's Memorandum of Incorporation (MOI) is its central governing document.[46] The MOI has replaced the Memorandum of Association and the Articles of Association that were required under the Companies Act 61 of 1973 (the 1973 Act). The MOI is intended to be the one instrument in which the rights, duties and responsibilities of shareholders, directors and all other relevant persons are set out.[47] Section 15(1) entrenches the supremacy of the Act over internal governance rules by declaring void any provision in an MOI that is inconsistent with the Act, while s 15(2) sets out a range of potential matters that may be regulated, altered, or prohibited by the MOI.[48]

The legal nature of the MOI is explained by s 15(6) of the Act, which confirms the position that prevailed under the 1973 Act, namely that the terms of a company's constitution are contractually binding.[49] However, whereas previously the common law regarded a company's constitution as a contract between a company and its shareholders only, the Act now explicitly includes directors and prescribed officers as parties to the contract.[50] A breach of the terms of the MOI by any of these parties amounts to a breach of contract.

The Act prescribes that, upon registration of a company, a copy of the company's MOI be submitted to the CIPC.[51] In contrast, Australian law permits the registration of a

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[45] Mupangavanhu BM 'The Lawfulness of a Memorandum of Incorporation Clause that Permits a Company Board to Refuse Transfer of Shares Without Reasons: Analysis of *Visser Sitrus (Pty) Ltd v Geode Hoop Sitrus (Pty) Ltd*' (2017) 31(2) *Speculum Juris* 191 197-8.

[46] Section 1 of the Act; Cassim FHI 'Introduction to the New Companies Act' (2012) 9; Cassim MF 'Formation of Companies and the Company Constitution' in Cassim FHI (ed.) et al *Contemporary Company Law* 2 ed (2012) 122-3

[47] Section 1 of the Act.

[48] Cassim FHI 'Introduction to the New Companies Act' (2012) 1; Levenberg PN 'Directors' Liability and Shareholder Remedies in South African Companies – Evaluating Foreign Investor Risk' (2017) 26 *Tulane Journal of International and Comparative Law* 1 15; Katz MM 'Governance under the Companies Act 71 of 2008: Flexibility is the keyword' (2010) *Acta Juridica* 248 251-2.

[49] Cassim MF 'Formation of Companies and the Company Constitution' (2012) 142; Morojane TCR 'The Binding Effect of the Constitutive Documents of the 1973 and 2008 Companies Acts of South Africa' (2010) 13(1) 190 *Potchefstroom Electronic LJ* 171 171-190.

[50] Cassim MF 'Formation of Companies and the Company Constitution' (2012) 147.

[51] In terms of ss 13(1)(*a*) and (*b*) of the Act.

company without submission of a constitution to the Australian Securities and Investments Commission (the ASIC).[52] In fact, Australian companies are generally not *required* to have a constitution at all, except in two situations: if the company is a 'No Liability' public company, or if it is a 'special purpose company' that seeks to be charged a reduced annual review fee.[53] Even if the company falls into one of those two categories, the company is just obligated to *have* a constitution, but it is still not required to lodge it with the ASIC.[54]

While it is true that a company's MOI may be classified as a type of contract, a company's constitution has traditionally been regarded as more than a private agreement between parties.[55] A key difference is the fact that the corporate contract is made available for inspection by the public at the offices of the company registration body. In English company law, it has always been required that registered companies publicise their constitution by way of registering it with the registrar of companies.[56] European Union (EU) law also requires member states to adopt measures that enforce the disclosure of a company's constitution.[57]

In South Africa, the Companies and Intellectual Property Commission (CIPC) facilitates the perusal of a company's MOI on its online portal: members of the public are permitted to request access to the MOI of any registered company.[58] Therefore, in the sense of being accessible to the public, a company's MOI in South African law remains a public document.

Making a company's constitution accessible to the public enables outsiders to rely on the registered constitution in assessing the company's internal regulatory framework.[59] When a company files its MOI with the CIPC, it projects and makes known the

[52] Sections 117-119 of the Australian Corporations Act 2001.
[53] ASIC 'Constitution and Replaceable Rules' at https://asic.gov.au/for-business/registering-a-company/steps-to-register-a-company/constitution-and-replaceable-rules/, accessed on 9 June 2019.
[54] ASIC 'Constitution and Replaceable Rules' at https://asic.gov.au/for-business/registering-a-company/steps-to-register-a-company/constitution-and-replaceable-rules/, accessed on 9 June 2019.
[55] Davies & Worthington (2016) 62.
[56] Davies & Worthington (2016) 62. See ss 9-13 of the UK Companies Act 2006.
[57] In terms of art 2(1)(*a*) of First Council Directive 68/151/EEC [1968] O.J. 41.
[58] CIPC 'Request for Corporate Info or Perusal of Files', available at http://www.cipc.co.za/index.php/find-enterprise-ip-informatr/moo2/public-disclosure/?surveySuccess=1&qsid=1479452022#1479452022, accessed on 13 July 2018.
[59] Davies & Worthington (2016) 62.

governance system of the company. The registration of the MOI ensures predictability and certainty for all stakeholders.

3.4 CAPACITY LIMITATIONS IN A COMPANY'S MOI

3.4.1 The objects clause and corporate capacity

In terms of s 19(1)(*b*)(ii) of the Act, a company has 'all of the legal powers and capacity of an individual', except to the extent that the company's MOI provides otherwise. The Act bestows upon all companies practically the same capacity as natural persons, allowing them to conclude any type of contract in connection with any lawful business.[60] However, s 19(1)(*b*)(ii) acknowledges that a company may deviate from the broad capacity conferred by the Act. In other words, the Act permits a company's MOI to stipulate which acts the company is *not* entitled to pursue.[61]

The Act does not have an equivalent of s 52(1)(*b*) of the 1973 Act, which required companies to state their main business in an objects clause in the memorandum of association. There is no longer any need for a profit company to set out its intended business activities in an objects clause, as these companies, by default, are free to pursue any commercial activity. A profit company is under no obligation to state its intended business activities in its MOI.[62] The Act now only requires non-profit companies to have an objects clause in their MOIs.[63]

The Act should be applauded for simplifying the requirements of a company's constitution by not requiring profit companies to have an objects clause; it eliminates much of the unnecessary complexity surrounding capacity that existed under the 1973 Act.[64] It is true that the Short Standard Form MOI for private companies (CoR 15.1B) contains a clause titled 'Powers of the Company', but what follows is a simple statement to the effect that the company's powers are not subject to any limitation as contemplated by s 19(1)(*b*)(ii) of the Act.

[60] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 169.
[61] Locke N (2016) 164.
[62] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 169.
[63] Item 1(1) of Schedule 1 to the Act.
[64] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 169.

3.4.2 Restrictive conditions

The interpretation of "restrictive conditions" has the potential to have an important impact on the commercial activities of all companies governed by the Act. The Act fails to define the term.

It has been argued that "restrictive conditions" are capacity restrictions, i.e. provisions that under the Companies Act 61 of 1973 would have been referred to as objects clauses.[65] The CIPC suggests that 'restrictive conditions' should be read against the backdrop of the objects clause, the ultra vires doctrine and the constructive notice doctrine.[66] Therefore, the CIPC implies that 'restrictive conditions' are no more than capacity restrictions.

The Act does not recognise ancillary objects and plenary powers as the 1973 Act did.[67] Arguably, these concepts were deemed superfluous in light of the general abolition of the objects clause.[68]

Delport questions whether a clause in an MOI that restricts the authority of the directors would amount to a restrictive condition, and seems to conclude that it would not.[69] I cannot disagree. Such an interpretation would run counter to the history of the Companies Act provisions regarding the ultra vires doctrine. Historically, the provisions in the South Africa Companies Acts that regulated corporate capacity have left the law of agency unchanged.[70] The provision that substantially modified the ultra vires doctrine, s 36 of the 1973 Act, governed the situation where the directors' lack of authority was brought about *solely* by the company's lack of capacity; its purpose was to regulate the powers and capacity of *companies*, and not of their directors.[71] The entire ethos of s 36 of the 1973 Act, and of its successor, is centered around the powers and capacity of companies, and not of their agents.[72] Therefore, "restrictive condition" should not refer to a provision in an MOI that merely limits the authority of

[65] Delport P (2018) 74; McLennan JS (2009) 151. Cf Van der Linde K (2015) 837.
[66] Item 3.1 of the Practice Note.
[67] Sections 33 and 34 of the 1973 Act, respectively.
[68] The Act does not require companies to have an objects clause in their MOI. Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 169.
[69] Delport P (2018) 74.
[70] Olivier E (2017) 620.
[71] Naudé SJ (1974); Olivier E (2017) 620.
[72] Naudé SJ (1974) 330-1; Main Report at 27.07.

a company's agents, but rather to a provision that restricts the capacity of a company.[73]

The Act provides no express guidance with regards to the format, structure, or content of a restrictive condition. Therefore, the content of restrictive conditions is largely left to the drafter of the MOI.

I have graciously been granted the opportunity to view a restrictive condition by Purple Group Limited, a financial services provider whose shares are listed on the Johannesburg Stock Exchange (JSE).[74] An example of a restrictive condition can be found in the MOI of one of Purple Group's subsidiaries, First World Trader Nominees (RF) Pty (Ltd) (FWT). FWT is a nominee company that holds assets (predominantly securities) on behalf of beneficial owners. Nominee companies are used by banks, insurance companies, stock brokers and collective investment scheme managers to isolate the risk of clients' assets being affected by the insolvency of the parent, broker, or management company. The MOI of FWT declares that the sole business of the company is to act as a nominee company, holding assets on behalf of other persons, and dealing with such assets in accordance with the instructions of the beneficial owners.[75] The MOI proceeds to prohibit (sometimes conditionally, and sometimes unconditionally) the company from completing a range of transactions.[76] Therefore, the MOI of FWT sets out and limits the company's objects and powers as understood at common law under the banner of 'restrictive conditions'.[77] It would hardly be surprising if restrictive conditions continue to be drafted in the style of objects and powers. However, it has become unnecessary for a company's MOI to be drafted in the old way of voluminous clauses with numerous independent objects coupled with a host of powers. A "subjective objects" clause would also not make sense under the new Act.[78] Such techniques were aimed at avoiding the ultra vires doctrine. If

[73] Delport P (2018) 73. Cf Locke N (2016) 185-7.
[74] I obtained this document after requesting same from helpme@easyequities.co.za.
[75] Clause 2.2(3) of the MOI of FWT.
[76] Clause 2.2(4) of the MOI of FWT.
[77] Incidentally, the company's MOI also includes additional requirements for the amendment of the restrictive conditions. The document states that such an amendment cannot be made without the prior written approval of the Registrar of Financial Services Providers, particularly if the proposed amendment would conflict with the requirements set out in Board Notice 63 in Government Gazette 29911, and/or any regulations published under the Financial Advisory Intermediary Services Act, 2002, and/or any other requirements stipulated by the Registrar.
[78] *Bell Houses Ltd v City Wall Properties Ltd* [1966] 2 All ER 674 679 & 686. See also 2.4 above.

incorporators wish to create a company with unlimited powers under the new Act, they need do nothing at all beyond registering the company with a standard form MOI.

It is hoped that the courts will interpret restrictive conditions applicable to limited capacity companies in accordance with the liberal English law approach to objects clauses shown in cases like *Attorney General v Great Eastern Rly Co*.[79] According to Cilliers et al, s 33 of the 1973 Act captured the spirit of this approach.[80] Despite the fact that the Act contains no comparable clause to s 33 of the 1973 Act, or perhaps because of it, it is submitted that the common law approach should be followed. English law has built up considerable jurisprudence on the reach of the ultra vires doctrine; the approach has been to regard objects and contracts reasonably incidental or ancillary to a company's main object, as well as powers designated as independent objects, as being intra vires the company.[81] This approach protects third parties by reducing the risk that a contract is ultra vires. Predictable regulation is an important purpose of the Act.[82] This would be achieved if the courts abide by the English law approach to a company's objects and powers when interpreting restrictive conditions in the MOIs of limited capacity companies. Such an approach would reduce the risk of third parties being involved in capacity disputes with companies.

In conclusion, it is submitted that restrictive conditions should be interpreted to mean a clause in an MOI that restricts the company's capacity by limiting either the business or trade of a company, or the types of contracts that the company may enter into. This would accord with the common law understanding that a company's capacity consisted of its objects and its powers.[83] This interpretation provides greater flexibility to investors as it presents several options for the types of restrictions which may be imposed on a company. It may be desirable to limit a company to a particular line of business, but not the types of contracts it may conclude, vice versa, or both. Therefore,

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[79] (1880) 5 APP CAS 473 (HL). See also *Foster v London, Chatham and Dover Railway Co* 1895 1 QB 711, and Kiggundu J 'The never ending story of *ultra vires*' (1991) 24 *CILSA* 1 7-9.
[80] Cilliers HS et al *Corporate Law* 3 ed (2000) 183-4.
[81] *Cotman v Brougham* [1918] AC 514 (HL) 522-3. See also *Rolled Steel* 80, and *Re Horsley & Weight Ltd* [1982] 3 All ER 1045 1050-1.
[82] Section 7(*l*) of the Act.
[83] See Baxter C 'Ultra vires and Agency Untwined' (1970) 28 *Cambridge LJ* 280 281, Rajak H 'Judicial Control: Corporations and the Decline of Ultra vires' (1995) 26 *Cambrian LR* 9 24-6, and Griffin S 'The Rise and Fall of the *Ultra vires* Rule in Corporate Law' (1998) 2(1) *Mountbatten Journal of Legal Studies* 5 11-16.

whether investors wish to, for example, forbid a company from standing surety, or whether they want to restrict a company to the manufacture of railway carriages, the supposed protection offered by the capacity provisions in the Act would be available to them.

3.4.3 "RF" companies

Section 11(3)(*b*) of the Act imposes a duty to include the expression "RF" at the end of a company's name 'if the company's Memorandum of Incorporation includes any provision contemplated in section 15(2)(b) or (c) restricting or prohibiting the amendment of any particular provision of the Memorandum'. Section 15(2)(*b*) contemplates two types of provisions: restrictive conditions, and requirements for the amendment of restrictive conditions in addition to the default MOI amendment requirements set out in s 16 of the Act. Section 15(2)(*c*) of the Act contemplates a clause in an MOI that prohibits the amendment of any other clauses in the MOI. Therefore, the RF requirement arises where a company's MOI includes either a restrictive condition coupled with an additional amendment requirement, or a clause prohibiting the amendment of any other provision in the MOI.[84] Furthermore, if a company's MOI includes any one of the clauses contemplated by s 11(3)(*b*), the company's Notice of Incorporation must contain 'a prominent statement drawing attention to such provision, and its location in the Memorandum of Incorporation'.[85]

According to the CIPC, the letters "RF" are the abbreviation for "Ring Fenced."[86] The argument has been made that the purpose of the RF requirement is to alert outsiders to the relevant restrictive provisions so that they may take appropriate precautions.[87]

Adoption of the RF provisions is an option for limited capacity companies. If a company has a restrictive condition in its MOI without an additional amendment requirement, it does not need to call itself an RF company, and the statutory doctrine of constructive notice will not apply.[88] However, the statutory doctrine of constructive notice will apply to dealings between outsiders and limited capacity RF companies. A limited capacity

[84] Van der Linde K (2015) 837; Locke N (2016) 167; Delport P (2018) 74. Cf Cassim MF 'Formation of Companies and the Company Constitution' (2012) 131.
[85] Section 13(3) of the Act.
[86] Item 2 of the Practice Note.
[87] Cassim MF 'Formation of Companies and the Company Constitution' (2012) 114.
[88] Section 19(5)(*a*). See 3.5.8 herein.

company's decision to adopt the RF provisions may be influenced by whether the company wishes to have s 19(5)(*a*) be applicable to its dealings with outsiders.[89]

3.5 THE VALIDITY OF ULTRA VIRES ACTIONS

The default position is that companies have similar powers to natural persons.[90] However, a restrictive condition in a company's MOI may limit its capacity.[91] If a corporation imposes limitations on its contractual capacity as contemplated by s 19(1)(*b*)(ii) of the Act, several other provisions in the Act come into play.

3.5.1 Ultra vires actions are not void (externally)

According to s 20(1) of the Act:

> 'If a company's Memorandum of Incorporation limits, restricts or qualifies the purposes, powers or activities of that company, as contemplated in section 19(1)(*b*)(ii)—
>
> *(a)* no action of the company is void by reason only that—
>
> (i) the action was prohibited by that limitation, restriction or qualification; or
>
> (ii) as a consequence of that limitation, restriction or qualification, the directors had no authority to authorise the action by the company; and
>
> *(b)* in any legal proceeding, other than proceedings between—
>
> (i) the company and its shareholders, directors and prescribed officers; or
>
> (ii) the shareholders and directors or prescribed officers of the company,
>
> no person may rely on such limitation, restriction or qualification to assert that an action contemplated in paragraph (*a*) is void.'

If a company's MOI includes a capacity restriction, 'no action of the company is void by reason only that' the action exceeded or violated the restrictive condition, or, because of the company's lack of capacity, 'the directors had no authority to authorise

[89] See 3.5.8 herein.
[90] Section 19(1)(*b*) of the Act.
[91] Van der Linde argues that a company's capacity should only be regarded as limited if the MOI *clearly* alters the default position of unrestricted capacity. Van der Linde K (2015) 836.

the action by the company'.[92] It seems clear that s 20(1) cannot apply to a contract that is unauthorised for a reason not arising directly from the company's capacity.[93]

A preliminary requirement for the applicability of s 20(1) is a clause in a company's MOI that 'limits, restricts or qualifies the purposes, powers or activities of that company', as contemplated in section 19(1)(*b*)(ii)'. It is submitted that the word 'purposes' in s 20(1) should be interpreted to mean the 'objects' of a company as understood at common law. Such an interpretation would be consistent with the ordinary meaning of the words.[94] The word 'purposes' should refer to the company's line of business or trade, as a company's "objects" did in the past. It is submitted that the 'powers' of a company should refer to the types of contracts that the company may validly perform in order to achieve its purpose/s. This interpretation would be consistent with the understanding in English law of the distinction between the "objects" and the "powers" of a company.[95] The 'activities' of a company could legitimately mean either 'purpose' or 'powers', or it could be a more general concept denoting both. It is submitted that 'activities' does not refer to non-contractual acts, as 20(1) deals with limitations, however they may be phrased, on the contractual capacity of a company.[96] Furthermore, the CIPC has made it clear that the purpose of a non-profit company (NPC) to work towards a public or social benefit is not included in the meaning of 'purpose' as envisioned by s 20(1). It is submitted that s 19(1)(*b*)(ii) refers to capacity restrictions. Therefore, the references in s 20(1) to a limitation to the company's purposes, powers or activities should be understood to refer to a restrictive condition in terms of s 15(2)(*b*) of the Act.

The word 'action' in s 20(1) is not defined anywhere in the Act. Considering the context of s 20(1) and the capacity provisions as a whole, it seems reasonable to conclude

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[92] Section 20(1)(*a*) of the Act.
[93] Delport P et al *Henochsberg on the Companies Act 71 of 2008* (2018) 97.
[94] According to www.dictionary.com, the word 'purpose' is synonymous with the word 'object'. http://www.dictionary.com/browse/purpose?s=t (accessed on 29 May 2018).
[95] Omar PJ 'Power, purposes and objects: the protracted demise of the ultra vires doctrine' (2004) 16 *Bond LR* 93 104-5. However, academics have noted that this distinction had become blurred and rather meaningless in South African law. Cassim FHI 'The Rise, Fall, and Reform of the Ultra Vires Doctrine' (1998) 10 *SA Merc LJ* 293 310; Blackman MS 'The capacity, powers and purposes of companies: the Commission and the new Companies Act' (1975) 8 *Comparative and International LJ of Southern Africa* 1 10.
[96] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 172. F See Item 7 of the Practice Note.

that an 'action' is an activity of a company, the validity of which may come into question because of limitations to the contractual capacity of the company contained in the MOI. Logically, only contracts may be beyond the contractual capacity of a company. Therefore, it is submitted that the word 'action' in s 20(1) refers to contracts.[97]

Ultra vires contracts concluded on behalf of limited capacity companies are not automatically void.[98] By taking this position, s 20(1)(*a*) of the Act is similar to legislation in the United Kingdom (UK) and United States of America (USA).[99]

3.5.2 Internal relations

Section 20(1)(*b*) of the Act prohibits reliance on a restrictive condition to assert that an action of a company is void, except in two instances: (i) in legal proceedings between the company and its shareholders, directors and prescribed officers, and (ii) in legal proceedings between the shareholders and directors or prescribed officers of the company.[100] Therefore, if an outsider concludes an ultra vires contract with a limited capacity company, neither party may raise non-compliance with a restrictive condition to allege that the contract is void, in any legal proceeding. However, among themselves, the company, its shareholders, directors and prescribed officers, *may* rely on a restrictive condition to argue in legal proceedings that an ultra vires contract is void.[101]

It seems that s 20(1)(*b*) refers to the two internal remedies that had existed under the previous legislation. The consensus regarding the similarly-worded s 36 of the 1973 Act was that what was being referred to was (a) the right of the shareholders to apply

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[97] Cassim suggests that the word 'action' is wide enough to include non-commercial activity such as a donation. Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 172.

[98] Locke N 'The Legislative Framework Determining Capacity and Representation of a Company in South African Law and its Implications for the Structuring of Special Purpose Companies' (2016) 133 *South African LJ* 160 164; McLennan JS 'Contract and Agency Law and the 2008 Companies Bill' (2009) *Obiter* 144 152.

[99] See 2.4.1 & 2.5.1 above.

[100] The meaning of the term "prescribed officer" is defined in Regulation 38 of the Companies Regulations, 2011. See Idensohn K 'The Meaning of 'Prescribed Officers' under the Companies Act 71 of 2008' (2012) 129 *South African LJ* 717, Botha MM 'Are Senior Managerial Employees Prescribed Officers in terms of the Companies Act 71 of 2008 and are they treated the same as Executive Directors?' (2012) *Journal of South African Law* 786, and Cassim R 'Governance and the Board of Directors' in Cassim FHI (ed.) et al *Contemporary Company Law* 2 ed (2012) 414-5.

[101] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 170-2. Stein and Everingham approve of this 'exception to the abolishment of the *ultra vires* doctrine' because it would usually be reasonable to expect a company's insiders to be aware of restrictions to the company's capacity. Stein C & Everingham GK *The new Companies Act unlocked* (2011) 82.

for an interdict to restrain the company from acting ultra vires, and (b) the company's right to hold the responsible directors liable for breaching their duty not to exceed their authority.[102] However, what was never fully settled was whether s 36 also created a distinction between company contracts with outsiders and company contracts with directors and shareholders, the company's lack of capacity affecting the latter, but not the former.[103]

Naudé argues that placing the directors on par with shareholders in this way may lead to inequitable results. He writes:

> '[I]t creates a situation where the validity of important contracts between companies may depend upon the insignificant shareholding of the one in the other for investment purposes. It is even conceivable that an abuse may take place: the holding of shares for the devious purpose of escaping from a contract at a later stage if the need to do so should arise'.[104]

McLennan holds a similar fear in respect of the new Act. He writes:

> 'A person, in all good faith, enters into a contract with a company only to discover later that he or she cannot enforce the contract merely because he or she happens to hold a tiny fraction of the company's equity. This is not a good idea.'[105]

Investors in new companies guide themselves by the prospectus, reputation of the incorporators, and assets under management of the new company, to name but a few relevant factors. Investors in existing companies may hold shares in a large number of companies, and likely guide themselves more by a share's performance, dividend yield, price to earnings ratio, and other technical and fundamental indicators, than by examining MOIs.[106] Therefore, it may indeed be undesirable to burden current and prospective shareholders of limited capacity companies with this risk.

The Act does not *expressly* create the distinction between ultra vires contracts with outsiders and ultra vires contracts with insiders. In addition, the Act does not state that s 20(1)(*b*) (the entitlement of the identified parties to rely on a restrictive condition to

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[102] Naudé SJ (1974) 315; McLennan JS (1979) 335; Cilliers HS et al (2000) 187; De Wet JC & Van Wyk AH *De Wet en Yeats Kontraktereg en Handelsreg* 4 ed (1978) 550-1.
[103] Naudé SJ (1974) 324.
[104] Naudé SJ (1974) 329.
[105] McLennan (2009) 152.
[106] Schaeftler MA (1984) 92; Getz L (1969) 56.

assert that an ultra vires contract is void) will trump the unambiguous statement in s 20(1)(*a*) that such actions are *not* void. In terms of the ordinary meaning of the text, ultra vires contracts between limited capacity companies and its directors, shareholders or prescribed officers would be subject to s 20(1)(*a*) in the same way as ultra vires contracts with outsiders would be. This interpretation would ensure greater third party protection, particularly in the case of limited capacity companies dealing with shareholders.

Section 20(1)(*b*) recognises a right to rely on a restrictive condition to argue that an ultra vires contract between a company and its insiders is void. However, it is submitted that this right cannot overrule the point of departure that such actions are not void.[107] At best, s 20(1)(*b*) is a poorly-worded recognition of the claims and remedies that could arise if a company acts ultra vires. If a director of a limited capacity company causes the company to act ultra vires, the company may rely on its own lack of capacity to sue the director for breaching a fiduciary duty.[108] Any restrictions to a company's capacity under the Act effectively amount to restrictions on the authority of directors to conclude contracts beyond those limitations, and any breach thereof could lead to liability for the responsible director under s 77(3)(*a*) of the Act.[109] In addition, s 20(1)(*b*) seems to recognise the possibility of the insiders of a limited capacity company raising the company's lack of capacity to restrain the company or the directors from acting ultra vires.[110]

3.5.3 Potential difficulties

3.5.3.1 Avoidance

An important issue was raised regarding the scope of s 36 of the 1973 Act. [111] The question, rephrased in the context of the new Act, is as follows: can s 20(1) of the Act

[107] Van der Linde K (2015) 836. Van der Linde correctly points out that the wording of s 20(1)(*b*) is narrower than the wording of its predecessor, as s 36 of the 1973 Act prohibited the company's lack of capacity being raised for "whatever" reason.

[108] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 165; Cilliers HS et al *Corporate Law* 3 ed (2000) 182; McLennan JS 'The Ultra Vires Doctrine and the Turquand Rule in Company Law—A Suggested Solution' (1979) 96 *South African LJ* 329 331; Schaeftler MA 'Clearing away the Debris of the Ultra Vires Doctrine — A Comparative Examination of U.S., European, and Israeli Law' (1984) 16 *Law & Policy in International Business* 71 86; Van der Linde K (2015) 837.

[109] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 171-172. See also 3.5.9 herein.

[110] See 3.5.5 herein.

[111] Naudé SJ 'Company Contracts: The Effect of Section 36 of the New Act' (1974) 91 *South African LJ* 315 334; McLennan JS (1979) 336.

be circumvented by way of a clause in the MOI of a limited capacity company that restricts the authority of the company's directors to the conclusion of intra vires contracts?[112]

If an ultra vires contract is concluded by the board of directors of a limited capacity company with such a clause in its MOI, it is not immediately clear whether s 20(1) could apply. Arguably, s 20(1) would be negated as the directors' lack of authority would have arisen not only from the company's lack of capacity, but also from a violation of an express limitation on their authority (that happens to be connected to the company's capacity). This potential loophole can have significant consequences, as if s 20(1) cannot find application, the unauthorised agreement would be void due to the lack of authority.[113]

The Act does not prohibit a company from restricting the authority of its directors to concluding intra vires contracts. Any principal can surely restrict and make the existence of his agent's authority subject to any lawful conditions. Therefore, it is submitted that the language of the Act *does* make it possible for a company's lack of capacity to (indirectly) be enforced on outsiders by way of a capacity-linked authority restriction.[114]

If such clauses could indeed negate s 20(1), third parties dealing with limited capacity companies may be placed at risk. The risk is exacerbated by the fact that the Act does not require the public's attention to be drawn to such limitations of authority.

3.5.3.2 Good Faith

Section 36 of the 1973 Act did not require the third party to have acted in good faith.[115] It seems that that position has been maintained, as nothing in the wording of s 20(1) prevents a third party dealing with a limited capacity company from enforcing an ultra vires contract, despite having known full well, at the time of its conclusion, that the contract was ultra vires the company.

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[112] For example: "The directors and other representatives of the company shall have no authority to bind the company to acts which conflict with restrictive conditions applicable to the company's purpose, powers or activities."

[113] Dendy M 'Agency and Representation' in *The Law of South Africa* vol 1 3 ed (2014) 137; Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 187.

[114] See also Locke N (2016) 185.

[115] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 167.

For a brief time in English law, the courts treated the knowledge of the third party and the purpose of the directors' exercise of authority as contributors to the question of a company's capacity.[116] This line of reasoning was rejected in *Rolled Steel Products (Holdings) Limited v British Steel Corporation*.[117] The English common law approach to ultra vires contracts evolved to the point where the third party's knowledge was of no consequence to the issue of a company's capacity to conclude a contract.[118]

It is submitted that it would not be unreasonable to follow the literal meaning of the Act in this regard, as it reflects the evolved English common law approach: the good or bad faith of the third party that has concluded an ultra vires contract with a limited capacity company should have no effect on the operation of s 20(1). The third party's good faith should only become relevant in the context of any claim for damages that the third party may have in the event of a successful restraining application in terms of s 20(5).[119]

3.5.3.3 Who must conclude the ultra vires contract?

It is not unusual for a company's board of directors to delegate authority to the managing director, senior employees, and other agents, to enter into contracts on the company's behalf.[120] However, it seems that s 20(1) of the Act will only find application where 'the directors' concluded the ultra vires action on behalf of the company. It could be argued that the protection of s 20(1) becomes available only if it was a director, and not any other authorised representative, that had concluded the ultra vires contract.[121]

Arguably, s 20(1) requires the ultra vires action to be entered into exclusively by 'the directors' in order to protect shareholders and enable greater control over the activities of a limited capacity company. If so, the word "directors" could prove to be problematic.

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[116] Baxter C 'Ultra Vires and Agency Untwined' (1970) 28 *Cambridge LJ* 280 280-95.
[117] [1985] 3 All ER 52 85.
[118] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 176; Rajak H 'Judicial Control: Corporations and the Decline of Ultra Vires' (1995) 26 *Cambrian LR* 9 26.
[119] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 176-8. See also 3.5.9 herein.
[120] McLennan SJ (1979) 336; Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 187; Oosthuizen MJ (1979) 2-3; Naudé SJ (1974) 332.
[121] The similarly-worded s 9(1) of the European Communities Act 1972 was criticised for its exclusion of transactions entered into by a single director or other agent with authority. Schaeftler MA (1984) 122-3. The author argues that the inconsistency is especially acute in larger companies where the board itself seldom concludes contracts on the company's behalf. See Naudé SJ (1974) 332, McLennan JS (1979) 336, Cilliers HS et al (2000) 186 and Delport P et al *Henochsberg on the Companies Act 61 of 1973* 5 ed (2011) 65 for discussion of this aspect of s 36 of the 1973 Act.

Does it mean that the ultra vires contract must have been consented to by at least two directors in order for s 20(1) to operate, or would it suffice in one director had represented the board?

According to s 6(b) of the Interpretation Act,[122] words in the plural number include the singular, unless a contrary intention is evident. There does not seem to be any indication in the Act that s 20(1) will only find application if more than one director concluded the action. If the section should be interpreted so as to make its operation dependant upon the action having been concluded by the 'directors', then it is submitted that it would not be unreasonable to follow the principle in s 6(b) of the Interpretation Act. Greater outsider protection would be achieved thereby.

Where s 20(1) of the Act differs markedly from its predecessor, is in the phrase 'the directors had no authority to *authorise* the action by the company'. Section 36 of the 1973 Act referred to the directors having had no authority to *perform* the action. Arguably, the wording of s 20(1)(*a*)(ii) removes the apparent lacuna that had existed under the 1973 Act. The phrase 'authority to authorise the action' could refer to the directors' power to authorise others to conclude the action. Instead of demanding that a director personally concluded the ultra vires contract, which is what the wording of s 36 arguably did, s 20(1) of the Act could be interpreted so as to merely require the directors to have had no authority to *authorise* another person to conclude the contract. Such an interpretation would bring ultra vires contracts concluded by non-director representatives of limited capacity companies into the ambit of s 20(1) and completely close the potential avenue of abuse highlighted by some.[123]

It has rightly been argued that an interpretation that would require a director personally to have concluded the ultra vires contract would frustrate much of the intended impact of the legislation, as it would allow the full force of the traditional ultra vires doctrine to affect transactions between outsiders and non-director representatives of companies with restricted capacity.[124] Furthermore, an interpretation that would restrict s 20(1) to ultra vires actions concluded by directors is capable of being exploited by companies, to the detriment of third parties, as it allows for a company to avoid liability on an ultra

[122] 33 of 1957.
[123] Naudé SJ (1974) 333; McLennan JS (1979) 336.
[124] Naudé SJ (1974) 333; McLennan JS (1979) 336.

vires contract. A limited capacity company could simply empower non-director representatives to contract on its behalf and retain the right to unilaterally and legitimately repudiate unprofitable contracts.[125] Such a result would be at odds with the Act's purpose of regulating companies in a way that adequately spreads economic risk.[126] The risk to third parties that would result from such an interpretation is too great.

For the reasons set out above, it is submitted that an ultra vires contract concluded by any person authorised to act on behalf of a limited capacity company should fall within the ambit of s 20(1) of the Act.

3.5.4 Ratification

According to s 20(2) of the Act, if a company's MOI restricts its capacity, an action concluded by the company or its directors that is inconsistent with such restriction may be ratified by way of a shareholders' special resolution, provided that such action is not prohibited by the Act.[127] Traditionally, ultra vires contracts were incapable of ratification, even with the unanimous approval of all the company's members.[128] Therefore, a new internal consequence of ultra vires contracts has been introduced.

Section 20(2) may cause confusion, as s 20(1) of the Act declares that ultra vires contracts are not void. One might question the purpose of making provision for the ratification of valid contracts. No similar provision existed in respect of ultra vires contracts under the 1973 Act.[129]

In the context of the comparable (and now repealed) sections of the UK Companies Act 1985, Cassim suggests that ratification of an ultra vires contract was required before the company would be able to sue on the agreement.[130] However, it is submitted that the failure to ratify a *valid* agreement should have no effect on any of the parties' rights to enforce the contract through legal proceedings.

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[125] Naudé SJ (1974) 332-3.
[126] Section 7(*g*) of the Act.
[127] Sections 20(2) and (3) of the Act.
[128] *Ashbury Railway Carriage and Iron Co v Riche* (1875) LR 7 HL 653 672.
[129] Williams RC 'Companies' in *The Law of South Africa* vol 4(1) Second Reissue (2012) para 122 note 7.
[130] Cassim FHI (1998) 301.

Once an ultra vires contract has been ratified, it is doubtful whether the remaining internal consequences could still apply. Cassim argues that after ratification of such an agreement, both the fiduciary liability of the directors and the right of restraint fall away.[131] According to Van der Linde, ratification of ultra vires contracts in terms of s 20(2) of the Act will *only* have an impact in respect of the internal remedies.[132]

If an ultra vires contract is ratified by the company's shareholders, it is possible that the responsible directors would incur no personal liability. It has been argued that in such an instance, the special resolution ratifying the ultra vires contract also serves to ratify the directors' breach of duties.[133]

The Act fails to clearly explain the effect of ratification of the company's action on the relevant director's liability for his conduct.[134] Cassim notes that s 35(3) of the United Kingdom Companies Act 1985 (as amended), upon which s 20(2) of the Act is apparently modelled, expressly stated that a special resolution ratifying an ultra vires contract would not affect the liability incurred by the directors.[135] Since s 20(2) has no comparable clause, and the remedy in s 20(6)(*b*) falls away when the shareholders have ratified the relevant action, it is understandable that some would argue that the Legislature intended for the ultra vires contract and the director's breach of duty to be ratified in a single special resolution.[136] Van der Linde agrees with Cassim's view that ratification of an ultra vires contract should automatically ratify the unauthorised conduct of the directors,[137] but adds the caveat that this approach would only be reasonable if, in the circumstances, the directors had been unaware of the capacity restriction and their lack of authority.[138]

The suggestion that ratification of an ultra vires contract simultaneously and retroactively authorises the responsible directors, and thereby ratifies the breach of

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[131] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 173.
[132] Van der Linde K (2015) 838.
[133] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 173-4; Locke N (2016) 166.
[134] Van der Linde K (2015) 838.
[135] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 174.
[136] English law now allows for the directors' breach of fiduciary duty to be ratified by an ordinary resolution, by virtue of s 239(2) of the UK Companies Act 2006. Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 174.
[137] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 172-3.
[138] Van der Linde K (2015) 839.

the fiduciary duty, is not a particularly persuasive one. While such an explanation would be convenient and minimise procedural hurdles, it conflicts with the basic limitation of ratification at common law, namely that it is generally not capable of affecting personal rights acquired by third parties in the interim period between an unauthorised act and its subsequent ratification.[139] If a director concludes an unauthorised contract on a company's behalf, the company is entitled to hold that director personally liable for any loss sustained by the company as a result of the unauthorised contract, on the basis of a breach of the director's fiduciary duty.[140] It is accepted in South African law that while ratification, by a fiction of law, creates a contractual relationship between a principal and a third party as if the purported agent had been properly authorised, it certainly does not prevent the principal from suing the unauthorised agent for breach of contract.[141] In *Mine Workers' Union v Broderick*,[142] the Appellate Division stated:

> 'A principal may for a variety of reasons choose to ratify an unauthorised contract entered into by his agent but this does not mean that he has abandoned, as against the agent, any rights that he has against the latter for his breach of the terms of his agency'.[143]

In the context of ratification, the relationship between the principal and the third party is separate from the one between the principal and the agent. While an action based on the breach of a fiduciary duty towards a company is a distinct one from an ordinary breach of contract claim, it is submitted that the same principle regarding ratification should apply. A special resolution that ratifies an ultra vires contract, on its own, should not retroactively authorise the directors to conclude the contract. In the absence of a second, separate special resolution ratifying the responsible director's conduct, the director should remain liable to the company for breaching his fiduciary duty in terms of the common law. The mere fact that the shareholders choose to ratify an agreement

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[139] *Jagersfontein Garage & Transport Co. v Secretary, State Advances Recoveries Office* 1939 OPD 37 46.
[140] See 3.5.2 herein.
[141] For the simple reason that '[t]he principal may ratify and approve of what his agent has done or he may ratify and disapprove'. Kerr AJ *The Law of Agency* 4 ed (2006) 81.
[142] 1948 4 SA 959 AD.
[143] *Broderick* 979.

should not automatically mean that they forgive the responsible director and absolve him of all liability.

Once an ultra vires contract has been ratified in terms of 20(2), the company's insiders should lose the right to restrain the contract in terms of s 20(5).[144] The 'action' will then be unquestionably valid.[145] If the shareholders of a limited capacity company adopt a special resolution ratifying an ultra vires contract, the agreement should become unassailable on capacity grounds. In order to maintain a consistent and predictable legislative framework, a subsequent restraining application under such circumstances should not be possible. This interpretation will ensure greater third party protection. A person dealing with a limited capacity company may request that the shareholders ratify the agreement to prevent any capacity issues being raised at a later stage. It would frustrate the transaction if, after the contract had been ratified, a single shareholder could approach a court to restrain the transaction.

3.5.5 Restraint

For fear of conferring too much power on directors, the Commission of Enquiry into the Companies Act (commonly referred to as the "Van Wyk de Vries Commission") recommended that internally, the ultra vires doctrine should still operate to protect a company's shareholders in the event that a director caused the company, or shows his intention to cause the company, to act ultra vires.[146] Section 36 of the 1973 Act affirmed the existence of the remedy. The DTI Policy Document also recommended the inclusion of a shareholder right to restrain in the capacity framework.[147]

Section 20(5) is perhaps the most important provision in the capacity framework created by the Act; the interpretation of this section will determine the extent of the restriction available over the activities of limited capacity companies. It reads:

> 'One or more shareholders, directors or prescribed officers of a company may apply to the High Court for an appropriate order to restrain the company or the

[144] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 177.
[145] At least in respect of the company's capacity.
[146] Commission of Enquiry into the Companies Act, Main Report, RP45/1970 (hereinafter "Van Wyk de Vries Commission") 27.16.
[147] *South African Company Law for the 21st Century; Guidelines for Corporate Law Reform* at GN 1183 of 2004 4.2, available at www.gov.za/sites/www.gov.za/files/26493_gen1183a.pdf, accessed on 25 May 2018.

directors from doing anything inconsistent with any limitation, restriction or qualification contemplated in subsection (2), but any such proceedings are without prejudice to any rights to damages of a third party who—

(a) obtained those rights in good faith; and

(b) did not have actual knowledge of the limit, restriction, or qualification.'

Section 20(2) refers to capacity restrictions. Section 20(5) allows for a violation of the relevant limitation to be restrained by way of a court order, on application by a director, shareholder, or prescribed officer of the company.[148]

The traditional right of a member to restrain a company's ultra vires conduct was demonstrated in, for example, *Colman v Eastern Counties Rly Co*.[149] At common law, each individual shareholder was capable of exercising this right.[150] Section 20(5) departs from the common law position by including directors and prescribed officers of limited capacity companies as beneficiaries of the right. Arguably, s 20(5) extends the right to restrain to directors and prescribed officers so as to better balance the rights and obligations of shareholders and directors of limited capacity companies.[151] Through the right of restraint, the conduct of the board can be controlled by the shareholders (even a minority shareholder), and even a single board member may overrule the board's decision to act ultra vires.

Section 20(5) of the Act allows the identified insiders of a limited capacity company to enforce compliance with the restrictive conditions contained in the company's MOI.[152] Section 20(5) makes provision for a minority stakeholder to prevent the "misuse" of the company's capital for purposes not related to, or in violation of, the restrictive conditions stated in the company's MOI.

It is noteworthy that s 20(5) does not allow any debenture holders of the company to apply for a prohibitory interdict, as s 25(4)(*b*) of Ghana's Companies Act[153] and s

[148] A trade union representing employees of a company may take apply to restrain the company from acting contrary to the Act, by virtue of s 20(4). However, trade unions may not institute proceedings to compel a company to comply with restrictive conditions in terms of s 20(5).
[149] (1846) 10 Beav 1. See Pennington RR *Company Law* 6 ed (1990) 94.
[150] Anderson J 'The Evolution of the Ultra Vires Rule in Irish Company Law (2003) 38 *Irish* Jurist 263 268; Field GW 'Ultra Vires' (1879) 13 *American LR* 632 658-9.
[151] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 177.
[152] Locke N (2016) 164.
[153] 179 of 1963.

39(4)(*b*) of Nigeria's Companies and Allied Matters Act 1990 do.[154] Such a provision may provide creditor protection, but it is not present in the South African Act. Neither the Companies Act 2006 nor the RMBCA confer on a company's creditors the right to restrain ultra vires contracts.

It should be possible for the identified insiders to restrain proposed ultra vires action on the basis of s 20(5). However, once an ultra vires contract has been concluded and all performances made, the contract should be irreversible. The words 'restrain the company or the directors from doing anything' are forward-looking— s 20(5) does not contemplate an order for the return of performances made in terms of an executed contract. Furthermore, it would be unreasonable and commercially undesirable to allow a director, prescribed officer or shareholder of a limited capacity company to institute proceedings to restrain a contract that had already been concluded, and in terms of which full performances had already been made. In such a framework, there can be no certainty for outsiders dealing with limited capacity companies. Therefore, it is submitted that fully executed ultra vires agreements should be safe.

Section 20(5) appears to permit a restraining application to prevent even the performance of executory ultra vires contracts.[155] The words 'doing anything inconsistent with any limitation, restriction or qualification' are certainly wide enough to refer to the performance of executory ultra vires contracts.[156] Interestingly, the DTI recommended that a company's lack of capacity should *not* be allowed to prevent the fulfillment of existing obligations.[157] Does the absence of such wording in section 20(5) leave open the possibility for the section to be invoked to prevent the performance of executory ultra vires contracts? The language of the Act would suggest so. The result would be a situation where all that can safely be said regarding an executory ultra vires contract concluded with a limited capacity company is that the agreement is only provisionally valid and enforceable.

The academic consensus regarding s 36 was that shareholders could only restrain the company from *concluding* an ultra vires contract, but could not restrain the

[154] Obadina DA 'The New Face of *Ultra Vires* and Related Agency Doctrines in the Commonwealth and USA' (1996) 8 *African Journal of International & Comparative Law* 309 321.
[155] Locke N (2016) 164-5; Fouché M *Legal Principles of Contract and Commercial Law* 8 ed (2015) 384.
[156] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 175-6.
[157] DTI Policy Document 4.2.

performance of an ultra vires contract after it had already been concluded.[158] If the literal meaning of s 20(5) were to be followed, the approach to corporate capacity would return to the pre-1973 Act position: outsiders would be at risk of having their contracts with limited capacity companies become unenforceable based on the ultra vires doctrine, and a plaintiff in the same situation as the one in the *Ashbury Railway* case would be at risk of suffering the same fate. In such a framework, the enforceability of an executory ultra vires agreement with a limited capacity company would depend on whether the company's insiders wish for the company to abide by it. This is hardly an ideal position for the outsider to be in.

If s 20(5) would allow for the restraint of existing obligations, the only way for a party to an executory ultra vires contract with a limited capacity company to completely secure his contract with the company would be to request that the company's shareholders ratify the agreement in terms of s 20(2). Such a position could result in commercial uncertainty and potential prejudice to the creditors of such companies, and potentially offset the balance between the competing interests of third party creditor and unhappy insider. What would prevent a limited capacity company from narrowly restricting its capacity, then doing business with the intention of using s 20(5) to escape liability under a contract that had become unprofitable or undesirable?

Arguably, an interpretation of s 20(5) that would create such a far-reaching right of restraint is out of place in light of the general rule that such actions are valid. However, if all ultra vires contracts are irrevocably valid, why would the Legislature make provision for ratification of ultra vires contracts in terms of s 20(2)? The existence of the shareholders' right to ratify ultra vires contracts would suggest that certain ultra vires agreements, probably only executory ones, are indeed capable of being declared void. If not, s 20(2) would make little sense.

The task of establishing an appropriate balance between the insiders' right to restrain and the outsider's right to enforce an ultra vires contract was never going to be an easy one.[159] Arguably, shareholder protection is diminished where the right to restrain

[158] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 167-8.
[159] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 177.

is limited to preventing the conclusion of ultra vires contracts.[160] Certainly, an interpretation of section 20(5) that would allow for the restraint of uncompleted ultra vires contracts may prejudice outsiders. However, if the Legislature had wanted to limit the right to restrain, it could have easily done so with appropriate language. The fact that it did not is telling. Evidently, the wording of section 20(5) reflects a policy choice made by Parliament. It is submitted that the wording of section 20(5) *does* allow for the restraint of executory ultra vires contracts. This approach may be capable of criticism, but the literal interpretation of the section does not result in unreasonable absurdity, and arguably gives effect to several key purposes contemplated in s 7 of the Act. On this interpretation, the Act's ultra vires restraint provision would be similar to the approach in America's RMBCA.[161]

3.5.6 The interaction between ratification and restraint

If an insider of a limited capacity company has successfully relied on s 20(5) to obtain a prohibitory interdict preventing the conclusion or performance of an ultra vires contract, the company's shareholders should not be able to ratify it. Van der Linde argues that the right to restrain in terms of s 20(5) should be excluded in the event that an ultra vires contract has been ratified in terms of s 20(2), in the same way that the shareholders' right to claim damages in accordance with s 20(6)(*b*) is excluded in the event of ratification of the ultra vires action.[162] This approach seems reasonable and consistent with established South African law. At common law, ratification was never regarded as 'a legal miracle which renders non-existent everything which transpired between the inception of the inchoate juristic act and its validation'.[163] Ratification can generally not affect rights acquired and duties imposed in the period between the moment of conclusion of an unauthorised agreement and the moment of its ratification.[164] Therefore, it should not be possible for the shareholders of a limited capacity company to ratify an ultra vires contract in the face of a prohibitory interdict. Once the restraining application has been granted, the shareholders should not be able to validly ratify the agreement unless and until the court order is overturned. This

[160] Griffin S (1998) 25. See also Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 176.
[161] See 2.5.1 above.
[162] Van der Linde K (2015) 838 & 840.
[163] *Jagersfontein* 46.
[164] *Jagersfontein* 41.

interpretation would ensure certainty and continuity, as it would be consistent with the common law principles of ratification.

It would seem that s 20(2) may also be invoked to thwart an insider that declares his intention to invoke s 20(5) of the Act. If ratification in terms of s 20(2) truly trumps a subsequent restraining application in terms of s 20(5), as argued above,[165] then the option to ratify ultra vires contracts could serve as a means for the shareholders of a limited capacity company to preemptively prevent a restraining application being instituted by another insider of the company. On this interpretation, s 20(2) grants to shareholders, in particular, a measure of control over the business of a limited capacity company, that the management of the company does not enjoy. Only shareholders may ratify ultra vires contracts, not directors or prescribed officers. A single director, prescribed officer or shareholder may take steps to *prevent* the company from acting ultra vires, but only a special resolution by the company's shareholders may irrevocably bind the company to ultra vires conduct.

It should be borne in mind that a court, if approached in terms of s 20(5) of the Act, would be under no obligation to grant the application. Furthermore, there does not seem to be a reason why the remaining insiders of the company, or even the third party, could not oppose the restraining application. Opposing the application may in certain circumstances be a more effective means of ensuring that an ultra vires contract remains binding than attempting to secure ratification by way of a special resolution.[166]

3.5.7 Failure of the substratum as a ground for the winding up of a company

At common law, the failure of a company's substratum is a ground for the winding up of the company. When a company's primary object becomes impossible to pursue, courts are empowered to consider this as a "just and equitable ground" for the company's liquidation.[167]

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[165] At 3.5.4.

[166] Locke suggests that a third party may be able to rely on estoppel to rebut a restraining application on the grounds that the applicant had failed to act within a reasonable time and/or created a representation of 'acquiescence'. Locke N (2016) 165.

[167] *Bell Houses* 682-4; Browning BG 'Much ado about Nothing: The Doctrine of *Ultra Vires* and its Place in Commercial History – Particularly in Manitoba' (1977) 8 *Manitoba LJ* 359 368. See also *Re Crown Bank* (1890) 44 Ch D 634 641-5; Cassim FHI 'The Rise, Fall and Reform of the Ultra Vires Doctrine' (1998) 10 *SA Merc LJ* 293 301; Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' 165-

The danger of a company being liquidated for a failure of its substratum was easily avoided by the drafting techniques exemplified in cases such as *Cotman* and *Bell Houses*.[168]

The liquidation of solvent companies is regulated by the Act, while the liquidation of insolvent companies is dealt with by the 1973 Act.[169] Both Acts make provision for winding-up on any just and equitable ground.[170] Yeats argues that the words 'just and equitable' in the Act should be interpreted in the same way that they were treated under the 1973 Act, and that the developed case law on this point should still be applicable.[171] It is submitted that this is the correct view as there is no express indication that the Act has amended the common law in this regard. Therefore, failure of substratum should still be considered a just and equitable ground for the winding-up of a company whose primary object becomes impossible to pursue.

In order to qualify as a failure of the company's substratum, it needs to be impossible for the company's main object to be pursued in the future. Therefore, the just and equitable ground of failure of substratum should, it is submitted, only be available where a restrictive condition in a company's MOI amounts to a "main object" as understood at common law, and such object or limited purpose becomes impossible.[172]

A company could easily avoid this risk by having its MOI specify more than one purpose, or none at all.

3.5.8 The statutory doctrine of constructive notice

The doctrine of constructive notice played a significant role in corporate relations in the early days of the registered business company. This doctrine was introduced as an acknowledgment of the important role of representative power amid the continued growth of commercial partnerships and the introduction of the registered joint stock

6; Pretorius JT (ed.) et al *Hahlo's South African Company Law Through the Cases* 6 ed (1999) 61; Yeats J 'Winding-Up' in Cassim FHI (ed.) *Contemporary Company Law* 2 ed (2012) 917.

[168] Browning BG (1977) 368. See 2.4 above.

[169] Items 9(1) and 9(2) of Schedule 5 to the Act.

[170] By virtue of s 344(*h*) of the 1973 Act and ss 81(1)(*c*)(ii) and 81(*d*)(iii) of the Act. See Yeats J 'Winding-Up' (2012) 916-7.

[171] Yeats J 'Winding-Up' (2012) 916-7.

[172] Failure of substratum as a just and equitable ground for liquidation could also, in theory, be applicable where the public benefit object of a non-profit company becomes impossible.

company in England during the nineteenth century.[173] *Ernest v Nicholls*[174] is often cited by South African academics as the locus classicus in this regard.[175]

It has been said that the doctrine of constructive notice *deemed outsiders to have knowledge of the contents of a company's public documents*, but this may have been a misleading way to formulate the rule, as such a statement could imply that an outsider contracting with a company could rely on the company's public documents without having read them at the relevant time. This phraseology may have crept into commercial and judicial usage, but it is not readily apparent from the decision in *Ernest*; it appears that Lord Wensleydale regarded it as *advisable* for outsiders to read the company's public documents, as those documents could lawfully restrict the authority of the company's representatives, but did not contemplate that the knowledge of third parties should be a deemed fact as such, nor that there was a duty on third parties to read a company's public documents,[176] nor that third parties could rely on a particular clause without actually having read it.[177] The constructive notice doctrine is perhaps better explained by saying that persons dealing with a company could not assert, in legal proceedings relating to the validity of a contract, that they were ignorant of the contents of the company's public documents.[178]

The doctrine of disclosure, which ran like a golden thread throughout domestic company law prior to the present Act, required companies to file their public documents with the Registrar of Companies, where they would be available for inspection by the public.[179] These public documents included the articles and memorandum of the company, as well as any special resolutions passed by the

[173] Olivier E (2017) 614.
[174] 1857 6 HL Cas 401.
[175] Cilliers HS (2000) 181; Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 179.
[176] McLennan JS (1979) 351. Cf the language used by Jervis CJ in *Royal British Bank v Turquand* (1856) 6 E&B 327 332.
[177] McLennan JS (1979) 342; McLennan JS 'Demise of the Constructive-notice Doctrine in England' (1986) 103 *SALJ* 558 558.
[178] *Rama Corporation Ltd v Proved Tin & General Investments Ltd* 1952 1 All ER 554 556; Du Plessis JJ (1991) 300.
[179] Delport P (2011) 133; Cilliers HS et al (2000) 190; Olivier E (2017) 614.

company. Effectively, the constructive notice doctrine prevented third parties from alleging that they were unaware of the contents of a company's public documents.[180]

It has been said that the common law doctrine of constructive notice supported the ultra vires doctrine, as an outsider concluding an ultra vires contract with a company would have been prevented from alleging that he had had no knowledge of the company's lack of capacity.[181] In the USA, it was often stated that an outsider was obligated to take notice of limitations found in a company's charter and that failure to observe such limitations would prevent him from enforcing an ultra vires contract against the company.[182] However, Stevens argues that the early constructive notice decisions in the USA failed to fully adopt the logical consequences of the doctrine, in particular regarding the difference between the effect of an outsider's constructive notice on the enforceability of an ultra vires contract and the effect on the liability of the company's agents on the basis of an implied warranty of authority.[183] A case on point is *Sanford v McArthur*,[184] where an agent was absolved of liability because the third party was taken to have known the extent of the agent's authority.[185] However, in *Seeberger v McCormick*,[186] a company's agent was held liable on an implied warranty of authority, despite the same third party previously being denied the right to enforce the contract against the company on the basis of constructive notice of the company's lack of capacity.[187] The inconsistency was summed up by Stevens as follows: '[T]he courts which at one time assert that one who deals with a corporation is bound to know the charter limitations upon its authority, do at other times render decisions in utter disregard of that principle'.[188]

The link between constructive notice and the ultra vires doctrine has been rejected in English law.[189] The academic consensus on this point has evolved until it is now

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[180] McLennan JS (1979) 342; *Mine Workers' Union v JJ Prinsloo, Mine Workers' Union v JP Prinsloo, Mine Workers' Union v Greyling* 1948 3 SA 831 (A) 848; Olivier E (2017) 614.
[181] Cilliers HS et al (2000) 181; Obadina DA (1996) 312.
[182] Stevens RS 'A Proposal as to the Codification and Restatement of the Ultra Vires Doctrine' (1927) 36 *Yale LJ* 297 321-2 and the cases cited at note 90. See also Carpenter CE 'Should the Doctrine of Ultra Vires be Discarded?' (1923) 33 *Yale LJ* 49 61.
[183] Stevens RS (1927) 322.
[184] 57 Ky 411 (1857).
[185] Stevens RS (1927) 322 note 9.
[186] 178 Ill 404 (1899).
[187] *McCormick v Market Bank* 61 Ill App 33 (1895); Stevens RS (1927) 322.
[188] Stevens RS (1927) 322.
[189] Getz L (1969) 47; Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 176.

generally accepted that a contract is ultra vires if it exceeds the company's capacity, regardless of the knowledge of any person.[190] At common law, an ultra vires transaction was regarded as void because the company was legally incapable of entering into it, so a third party should not have been able to negate the doctrine and enforce an ultra vires contract, on the basis of his ignorance of the company's lack of capacity. Therefore, it is submitted that the common law doctrine of constructive notice did not truly support the ultra vires doctrine.

Section 19(4) of the Act represents an important change. Most South African academics accept that the effect of s 19(4) is to abolish the common law doctrine of constructive notice.[191] By abolishing the doctrine of constructive notice, the Act has deprived the concept of a company's "public documents" of much of its legal effect. This approach is to be applauded both for its simplicity and for the protection it affords to persons transacting with companies. By virtue of s 19(4), companies that do not take the steps envisioned by s 19(5)(*a*) are unable to rely in litigation on an outsider's constructive notice of the contents of the company's MOI.

Section 19(5)(*a*) of the Act introduces a modified version of the constructive notice doctrine and directs its operation at certain provisions in the MOIs of RF companies. The provisions in the MOI of an RF company contemplated by ss 15(2)(*b*) and (*c*) are:

- restrictive conditions applicable to the company;
- impositions of a requirement to amend a restrictive condition in addition to the MOI amendment requirements envisioned by s 16 of the Act; and
- provisions prohibiting the amendment of any clause or clauses in the MOI.

It is not clear whether Parliament intended to maintain the scope of the common law doctrine in respect of the public provisions in the MOIs of RF companies, or whether

[190] *Rolled Steel Products (Holdings) Limited v British Steel Corporation* [1985] 3 All ER 52 85. Commentators welcomed the decision in *Rolled Steel* for overturning a string of unfortunately reasoned decisions on the ultra vires doctrine. Getz L (1969) 47; Baxter C 'Ultra Vires and Agency Untwined' (1970) 28 *Cambridge LJ* 280 280-95.

[191] Jooste R 'Observations on the impact of the 2008 Companies Act on the Doctrine of Constructive Notice and the *Turquand* rule' (2013) 130 *SALJ* 464 468; Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 179; Delport P et al (2018) 89.

the intention was to create an entirely new approach to outsider knowledge of a company's internal regulatory documents.[192]

It is submitted that the statutory doctrine of constructive notice should operate as follows: if an RF company complies with the formal requirements stipulated by s 19(5)(*a*) and includes in its MOI any of the "public provisions" contemplated in ss 15(2)(*b*) and (*c*), a person contracting with that company may not, in legal proceedings between that person and the company, allege that he had been or was unaware of the contents of the relevant clauses. The statutory doctrine of constructive notice should remain a negative doctrine denying third parties the right to claim ignorance in respect of the clause that they are deemed to have had notice and knowledge of.[193] Furthermore, the only person capable of invoking the doctrine should be a company for the purpose of protecting itself from undue or unwanted liability; s 19(5)(*a*) should not enable the agent of an RF company to escape personal liability to third parties for his unauthorised actions.[194]

When a third party enters into an ultra vires contract with an RF company, s 20(1) will render the contract provisionally valid. Section 19(5)(*a*) does not overrule the general rule; it merely says that a person dealing with the company is deemed to have knowledge of the restrictive condition which the company exceeded. It is submitted that this rule will not assist an RF company in escaping an ultra vires contract, for the same reason that the common law doctrine of constructive notice did not support the ultra vires doctrine, and because the capacity provisions in the Act do not contemplate it. Therefore, the purpose and benefit of this capacity-linked statutory doctrine of constructive notice are unclear.

3.5.9 The liability of the agent for causing a company to act ultra vires

It can be questioned whether a director that causes a company to act ultra vires will have breached a fiduciary duty. Arguably, the fiduciary duty will not have been breached as the board is authorised to conclude ultra vires contracts. It was argued that the effect of s 36 of the 1973 Act was to break the traditional link between capacity

[192] Jooste R (2013) 469; Olivier E (2017) 614-5.
[193] Olivier E (2017) 619-23.
[194] Olivier E (2017) 623.

and authority.[195] One may question whether the effect of s 20(1) is that a company's board of directors is implicitly authorised to act ultra vires the company. The implications of such an interpretation could be of great importance: inter alia, it would mean that directors could cause a company to act ultra vires without fear of personal liability. This would frustrate the internal control mechanism envisioned by s 20(1)(*b*), as the threat of litigation and personal liability for causing the company to contract beyond its restrictive conditions would be removed.

It may be true that externally, the directors' lack of authority to act ultra vires will not affect the validity of ultra vires contracts. This is only so, however, because the legislation deems the resulting contract to be valid, and not because the directors are *authorised* to act ultra vires. The Act does not confer unqualified authority on the board of directors. According to s 66(1), a company's board is authorised to 'perform any of the functions of the company, except to the extent that this Act or the company's Memorandum of Incorporation provides otherwise'. However incongruous it may sound, s 20(1) implies that an ultra vires action between a limited capacity company and an outsider is an action of the company. Therefore, it may be said that a director that causes a company to act ultra vires will not be acting in violation of the capacity provisions. However, the powers of directors remain subject to the company's MOI. A restrictive condition that limits the capacity of a company simultaneously restricts the authority of the company's representatives to the conclusion of intra vires acts. There does not seem to be a convincing reason to depart from that settled principle. It is submitted that internally, the authority of the board of a limited capacity company is still limited to the conclusion of intra vires acts, and any deviation from that capacity amounts to a breach of both the terms of the MOI and of the board's authority, regardless of the validity of the contract. Breach of authority brings the directors' statutory liability to the company for loss caused by breach of fiduciary duties and duty of care, skill and diligence, into play.[196]

In terms of s 218(2) of the Act, '[a]ny person who contravenes any provision in this Act is liable to any other person for any loss or damage suffered by that person as a result

[195] Naudé SJ (1974) 335; Olson JF 'South Africa moves to a global model of corporate governance but with important national variations' in Mongalo T (ed.) *Modern Company Law for a Competitive South African Economy* (2010) 239.
[196] See section 77(2) and 76(3) of the Act.

of the contravention'. It is debatable whether entering into an ultra vires contract amounts to a contravention of the Act. Delport suggests that the 'contravention' contemplated by s 218(2) includes any offence in terms of the Act, as well as a failure to comply with a provision in the Act that does not amount to an offence.[197] Whether s 218(2) applies is important, as the risk of a statutory claim for damages may be an additional incentive for the board of a limited capacity company to refrain from causing the company to act ultra vires.[198]

Nowhere in the Act is a company expressly prohibited from entering into an ultra vires contract. Indeed, one could argue that the presence of s 20(1) is an implicit acknowledgment that limited capacity companies *may* act ultra vires. Therefore, it is doubtful whether such conduct on the part of the board can result in liability in terms of s 218(2). On the same line of reasoning, s 20(6)(*a*) may also not be applicable, as the responsible agent would arguably not have caused the company to do anything inconsistent with the Act.[199]

Section 20(6)(*b*) confers on the shareholders of a limited capacity company a statutory right to claim damages against 'any person who intentionally, fraudulently, or due to gross negligence causes the company to do anything inconsistent with a limitation, restriction or qualification, contemplated in this section, unless that action has been ratified by the shareholders in terms of subsection (2).' The statutory right to claim damages falls away when an ultra vires contract has been ratified in terms of s 20(2). This section does not expressly abolish the common law right of shareholders to sue the responsible directors for loss caused by an ultra vires contract. Therefore, the common law right may be available to a minority shareholder despite the company's ratification of the agreement.[200]

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[197] Delport P et al (2018) 640.

[198] See *De Bruyn* v *Steinhoff International Holdings N.V. and Others* [2020] ZAGPJHC 145 (26 June 2020) paras 182-219*, Hlumisa Investment Holdings (RF) Limited and Another v Kirkinisa and Others* 2019 (4) SA 569 (GP) paras 26-51*, Rabinowitz v Van Graan and Others* 2013 (5) SA 315 (GSJ) 17-22, and *Sanlam Capital Markets (Pty) Ltd v Mettle Manco (Pty) Ltd and Others* [2014] 3 All SA 454 (GJ) para 42 for judicial consideration of section 218(2) of the Act.

[199] Section 20(6)(*a*) confers on all shareholders of all companies the right to claim damages against 'any person who intentionally, fraudulently, or due to gross negligence' causes the company to violate the Act.

[200] The interpretation of s 20(6) of the Act was considered by Unterhalter J in *De Bruyn* paras 220-37.

Section 218(3) provides that the statutory right to damages for a contravention of the Act will not affect the existence of any other remedy that a person may have. Therefore, the traditional common law remedies that the third party may have against the purported agent are not excluded.

Section 20(5) of the Act acknowledges that the third party may have a common law claim for damages against the agent by providing that restraint of an ultra vires contract will not affect the third party's right to damages; the only provisos are that the third party 'obtained those rights in good faith', and did not have actual knowledge of the relevant limitation. Therefore, it would seem that a mala fide third party, *or* one who had had actual knowledge of the company's limited capacity,[201] will be non-suited in a claim for damages against the company or against the responsible director or agent.[202] The effect of paragraphs (*a*) and (*b*) is that *both* good faith and a lack of knowledge regarding the company's limited capacity must be present in order for the outsider to retain his right to damages.[203] Cassim seems to interpret the last part of s 20(5) as conferring a statutory right to claim damages in the event of restraint of an ultra vires contract.[204] It is submitted that the language of s 20(5) does not go that far. Section 20(5) merely acknowledges the possibility of a common law claim for damages, and stipulates that an order of restraint will not affect such a claim on behalf of a bona fide third party.

3.5.10 Summation of key capacity provisions

At this point, it may be helpful to summarise the interpretation of certain key capacity provisions in the Act. The below understanding will be accepted as being correct when discussing the effect of the Act on the requirements and activities of SPVs.

Under the Act, the role of the evolved ultra vires doctrine will remain minimal in practice. A company's capacity only becomes an issue when its MOI contains restrictive conditions. In such a case, s 20(1)(*a*) provides that ultra vires contracts are not void. The shareholders of a limited capacity company may pass a special

[201] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 177-9.
[202] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 176.
[203] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 178.
[204] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' (2012) 176.

resolution to ratify ultra vires contracts.[205] Ratification would prevent a subsequent restraining application.

Companies that include restrictive conditions in their MOIs may choose to couple restrictive conditions to additional amendment requirements. In such a case, the limited capacity company must comply with the formal requirements necessary to become an RF company.[206] A restrictive condition in an MOI must be coupled with an additional amendment requirement in order for the 'RF' requirement and the statutory doctrine of constructive notice to find application.[207]

Prior to its conclusion, a proposed ultra vires contract may be restrained by way of a prohibitory interdict in terms of s 20(5). Executory ultra vires contracts concluded by the agents of a limited capacity company are only provisionally valid and enforceable because one or more directors, shareholders or prescribed officers may approach a High Court for an order restraining the company or the directors from performing in terms of an ultra vires contract. However, an executed ultra vires contract cannot be affected by s 20(5).

In the absence of restraint, ultra vires contracts are valid.[208]

3.6 CONCLUSION

This chapter contributes to answering the central research question of whether South African company law creates a commercially desirable capacity framework to facilitate the activities of SPVs used in traditional securitisation schemes by giving meaning to certain important provisions pertaining to limited capacity companies in South Africa.

Under the Act, the role of the evolved ultra vires doctrine will remain minimal in practice. A company's capacity can only become an issue when its MOI contains restrictive conditions. Ideally, a restrictive condition should clearly draw attention to the fact that the company's powers and capacity are limited, in conjunction with a clear and simple statement of the company's main business purpose/s and, if necessary, explaining in greater detail the extent of the company's powers. It is hoped that South

[205] Section 20(2) of the Act.
[206] In particular, those stipulated by ss 11(3) and 13(3) of the Act.
[207] See 3.4.3 herein.
[208] Section 20(1) of the Act.

African courts will interpret restrictive conditions in a company's MOI in terms of the established common law approach as inherited from English law: restrictive conditions should be interpreted broadly and generously, and courts should be able to infer implied powers reasonably necessary for the fulfilment of the company's purposes. This approach will reduce the risk of third parties being involved in protracted capacity disputes with limited capacity companies.

It is important to note that the common law ground of failure of the substratum as a just and equitable ground for a company's liquidation has not been abolished, and is capable of finding application to limited capacity companies in terms of the new Act. However, the risk of a company being wound up on this basis can be reduced or even avoided by the insertion in the company's MOI of either more than one purpose, or none at all.

All registered South African companies must submit an MOI to the CIPC. The MOI of any registered company is accessible by members of the public, by way of requesting same from the CIPC and paying the required fee. Companies that include restrictive conditions in their MOIs may choose to couple restrictive conditions to additional amendment requirements. In such a case, the limited capacity company must comply with the formal requirements necessary to become an RF company. A restrictive condition in an MOI must be coupled with an additional amendment requirement in order for the 'RF' requirement and the statutory doctrine of constructive notice to find application.

Section 20(1)(*a*) of the Act provides that ultra vires contracts of limited capacity companies are not void; it was submitted that the application of this rule should not depend on the title of the company's representative or on the good faith of the third party. The shareholders of a limited capacity company may pass a special resolution to ratify ultra vires contracts.[209] Ratification should prevent a subsequent restraining application. The purpose of the optional RF provisions and the capacity-linked statutory doctrine of constructive notice is not clear: s 19(5)(*a*) does not provide any

[209] Section 20(2) of the Act.

obvious benefit to limited capacity RF companies with regards to avoiding liability on an ultra vires contract.

The authority of the board of directors of a limited capacity company is restricted to acts within the company's capacity, despite the validity of ultra vires contracts. The shareholders of limited capacity companies should retain their right to sue the responsible directors or other officers for damages, despite ratification of an ultra vires contract in terms of s 20(2) of the Act. This interpretation would retain an important remedy that shareholders have to control the actions of directors.

The right to restrain ultra vires conduct in the Act has been drafted so widely that third parties cannot be completely secure when dealing with limited capacity companies. Executory ultra vires contracts concluded by the agents of a limited capacity company are only provisionally valid and enforceable because one or more directors, shareholders or prescribed officers may approach a High Court for an order restraining the company or the directors from performing in terms of an ultra vires contract. Once such an order has been obtained, it should not be possible for the company's shareholders to pass a special resolution ratifying the contract.

As long as a company's insiders have a right to restrain the performance of ultra vires contracts, third parties will be placed at risk.[210] As a means of nullifying this risk and protecting third parties, the UK Companies Act 2006 has completely abandoned the right to restrain. In English law, objects clauses are treated as authority restrictions, with the law of agency regulating the validity of company contracts.[211] It is submitted that the UK capacity provisions are admirable.

The extent of the control provided by restrictive conditions is questionable because of the general rule regarding the validity of ultra vires contracts and the vague wording of s 20(5). Furthermore, the capacity provisions create uncertainty and risk for a company's existing and future creditors. For these reasons, it is submitted that Parliament should consider amending the capacity provisions in the Act; the UK's

[210] Schaeftler (1984) *Law & Policy in International Business* 160-1.
[211] Davies PL & Worthington S (eds.) *Gower & Davies: Modern Company Law* 10 ed (2016) 174. See also 2.4.1 herein.

Companies Act 2006 should be considered as a model solution to the ultra vires doctrine.

Chapter Three provided an answer to the question of the validity of ultra vires contracts entered into by a limited capacity company: executory ultra vires contracts will be valid unless restrained or set aside in terms of s 20(5). In Chapter Four, the thesis will discuss the practical uses of incorporated SPVs in South Africa.

CHAPTER FOUR: SPECIAL PURPOSE VEHICLES IN SOUTH AFRICAN COMPANY LAW

4.1 INTRODUCTION

The central research question posed by this thesis is whether the capacity provisions in the Companies Act 71 of 2008 (the Act) facilitate the operation of special purpose vehicles (SPVs) used in traditional securitisation schemes. Chapter Three analysed the legal framework governing limited capacity companies in South Africa. It was necessary to lay a foundation that encompasses an interpretation of the capacity provisions in the Act in order to be able to discuss the effect of the Act on the activities of special purpose vehicles (SPVs) in the South African context.

Chapter Four will respond to research sub-question 3 by analysing the various practical uses to which SPVs may be put and the regulation of these entities in South African company law.[1] The discussion will commence with an evaluation of the use of the corporate form as a business vehicle. Thereafter, the chapter will proceed to analyse the concept of SPVs and the important characteristic of "insolvency-remoteness", discuss the various commercial activities that generally make use of SPVs, and describe the various types of corporations that may be used as SPVs.

4.2 BUSINESS ENTITIES

A business entity is an association that is used to conduct commercial transactions. More precisely, '[a] business entity is an organisation that uses economic resources for the primary goal of maximising profit.'[2]

South African law recognises four forms of profit-oriented business entities: the sole trader, the partnership, the business trust, and the registered corporation.[3] The last of these can be split into two groups: companies regulated by the Act, and close corporations.[4]

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[1] See 1.4 above.
[2] Kolitz DL *A Concepts-Based Introduction to Financial Accounting* 5 ed (2015) 4-5.
[3] Cilliers HS et al *Cilliers and Benade Corporate Law* 3 ed (2000) 4.
[4] The Close Corporations Act 69 of 1984 introduced to the South African business landscape a smaller, flexible and less complex form of company to cater for the needs of small to medium enterprises

Several factors may play a role in the determination of the ideal business entity for a planned enterprise. These factors include, but are not limited to,

(i) whether legislation or other directives prescribe a particular form for the intended business;[5]

(ii) whether the incorporators wish to create an entity to enjoy the benefits of its separate legal personality;

(iii) the intended number of participants in the business;

(iv) whether the investors desire active participation in the management of the business;

(v) whether the business aims to obtain financing through sources other than loans and donations;

(vi) the costs and formalities involved with starting and running the entity; and

(vii) the tax liability of the entity.

4.3 THE COMPANY AS A BUSINESS ENTITY

It is not easy to create a definition for a company, because of the variety of ways in which the ownership and management of a corporate entity can be structured.[6] Cilliers et al suggest that a general description of a company as an association of persons with a common object is adequate.[7] A more specific explanation is that a company is a juristic person formed by persons via contract to further certain interests, the legal

(SMEs). See Mongalo T *Corporate Law and Corporate Governance – A Global Picture of Business Undertakings in South Africa* (2003) 21.

[5] For example, the Johannesburg Stock Exchange (JSE) Equities Rules require all authorised members (institutions that trade in securities on the JSE), and all Central Securities Depository Participants (CSDPs), to establish and maintain a nominee *company* for the purpose of providing trading or custody services to their respective clients. JSE Equities Rules paras 3.50.3 and 3.70.3.

[6] Cilliers HS et al (2000) 5.

[7] Cilliers HS et al (2000) 5. For discussion on the theory of the corporation, see O'Kelley CRT 'The Entrepreneur and the Theory of the Modern Corporation' (2006) 31 *Journal of Corporate Law* 753, Mantziaris C 'The Dual View Theory of the Corporation and the Aboriginal Corporation (1999) 27 *Federal LR* 283, Phillips MJ 'Reappraising the Real Entity Theory of the Corporation' (1994) 21 *Florida State University LR* 1061, and Mupangavanhu BM *Directors' Standards of Care, Skill, Diligence, and the Business Judgment Rule in view of South Africa's Companies Act 71 of 2008: Future Implications for Corporate Governance* (unpublished LLD thesis, University of Cape Town, 2016) 36-44.

nature, powers, registration, ownership, and management of which, are regulated by statute, common law, and by the contractual terms within the company's constitution.[8]

The definition of a "company" in the Act refers to a 'juristic person incorporated' in terms of an enabling statute.[9] It is evident that juristic personality is key to the concept of a company.[10] Juristic or legal personality refers to an entity's ability to bear rights and duties. Generally, only legal subjects may have legal rights and duties.[11] The most obvious example of a legal subject is a natural person, who from birth is capable of acquiring rights. In addition, the law bestows legal personality on certain entities in certain circumstances, i.e. legal/juristic persons.[12] The most common example of an entity that acquires legal personality is a company.[13]

In common law jurisdictions that follow the English law approach, a company is regarded as a distinct legal entity, separate from its members; the assets and liabilities of a company are those of the company, and not of its directors and shareholders. This is a fundamental concept of South African company law.[14] In *Salomon*, Lord Halsbury held that in the absence of proof of a fraudulent motive, or of the fact that a company was being used as an instrument,

> 'it seems to me impossible to dispute that once the company is legally incorporated it must be treated like any other independent person with its rights and liabilities appropriate to itself, and that the motives of those who took part in the promotion of the company are absolutely irrelevant in discussing what those rights and liabilities are.'[15]

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[8] Section 15(6) of the Act provides that the terms of a company's MOI and its rules are binding between and among a company and its shareholders, directors, and other officers, 'in the exercise of their respective functions within the company'.
[9] Section 1 of the Act.
[10] *Salomon v Salomon* [1897] AC 22 (HL). See Mupangavanhu BM (2016) 46.
[11] Cassim R 'The Legal Concept of a Company' in Cassim FHI (ed.) et al *Contemporary Company Law* e 2d (2012) 31; Williams RC 'Companies' in *The Law of South Africa* vol 4(1) Second Reissue (2012) para 63; Davies PL and Worthington S *Gower's Principles of Modern Company Law* 10 ed (2016) 29.
[12] Cilliers HS et al (2000) 6.
[13] Cilliers HS et al (2000) 6.
[14] Cassim R 'The Legal Concept of a Company' (2012) 36 & 39; Williams RC (2012) para 62.
[15] *Salomon* 30. See also *Dadoo v Krugersdorp Muncipal Council* 1920 AD 530 550-1 and *Airport Cold Storage (Pty) Ltd v Ebrahim* 2008 (2) SA 303 (C) para 17.

The principle of separate legal personality is now codified in s 19(1)(*a*) of the Act.[16] Several consequences flow from the principle of separate legal personality, including limited liability of the insiders in respect of the debts of the company,[17] and perpetual existence of the entity.[18] Commentators have identified separate legal personality, limited liability, and perpetual existence, attributes that the partnership and the sole trader do not enjoy, as advantages of using a company as a business vehicle.[19]

4.4 GROUPS OF COMPANIES

A company can either be used directly as a business entity (i.e. the main or all of the business of the association is conducted by and through the company) or it can be used as an intermediary vehicle to fulfil some or all of the functions of another entity or to bear the risk of a special project. A company can make use of the company group structure to designate assets and activities to a separate entity while maintaining a measure of control over the activities of the separate entity.

The term 'group of companies' refers to two or more companies within a single corporate cluster.[20] The Act defines a "group of companies" as 'a holding company and all its subsidiaries'.[21] A "holding company" is defined as a juristic person that controls a subsidiary in a way contemplated in ss 2(2)(*a*) or 3(1)(*a*).[22] A group of companies is characterised by the control that one company (the holding company) exercises over the other companies (the subsidiaries). Under the Act, the holding company-subsidiary relationship exists when Company A, in its own name or through a nominee, controls either the majority of the voting rights associated with Company B's issued securities, or has the right to control the appointment of the majority of voting rights on Company B's board of directors.[23]

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[16] Section 19(1)(*a*) provides that a company 'is a juristic person'. Juristic personality is also emphasised in the definition of "company" in s 1 of the Act.
[17] Section 19(2) of the Act. The exceptions contemplated by s 19(2) relate to personal liability companies, and situations where the 'corporate veil' is pierced. Delport P *Henochsberg on the Companies Act 71 of 2008* (2018) 86-87; Cassim R 'The Legal Concept of a Company' (2012) 35.
[18] Sections 19(1)(*a*) and 83(1) of the Act. See also Davies & Worthington (2016) 29-42.
[19] Cilliers HS et al (2000) 4; Davies & Worthington (2016) 32.
[20] Botha DH 'Recognition of the Group Concept in Company Law' (1982) 15 *De Jure* 107 107.
[21] Section 1 of the Act.
[22] Section 1 of the Act.
[23] Section 3 of the Act.

Each company within a group has a separate business and management, but all work towards the goal of benefitting the entire group's interests.[24] An advantage of the control and interconnectedness within a group is that it allows for the group to be managed as a single unit, so that companies within the same group can be used to benefit the holding company and other companies within the group.[25] Despite this unifying group identity, the directors of each separate company within a group owe their fiduciary duties to that particular company/ies only, and not to the group as a separate entity.[26] In this regard, the remarks made by Stevens are worth noting:

> 'The nature of a group of companies is such that some of the directors will often serve simultaneously on the boards of several companies within the group…cooperation between the various companies is inevitable in respect of planning, production, information technology and the like'.[27]

While Stevens was discussing company groups in the context of German law, nothing in the South African Act prevents such "incestuous" board appointments, or coordinated operations between companies within the same group.[28]

Delport identifies a potential lacuna in the definition of "subsidiary": '[t]he right to remove the directors with majority voting rights on the board is not included and such a right would not, it is submitted, put s 3 into operation.'[29] If his view is correct, it would mean that Company A could own exactly 50% of the voting rights in Company B's securities, control the appointment of exactly 50% of the voting rights on Company B's board of directors, *and* have the right to remove the entire board of directors of Company B, without Company B being a subsidiary of Company A.[30] Company A would have a very large measure of control over Company B, but the holding company-subsidiary relationship would not be established.[31]

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[24] Botha DH (1982) 107-8; Jooste R 'Groups of Companies and Related Persons' in Cassim FHI (ed.) in *Contemporary Company Law* 2 ed (2012) 194.
[25] Botha DH (1982) 108.
[26] Botha DH 'Holding and Subsidiary Companies: Fiduciary Duties of Directors' (1983) 16 *De Jure* 234 240; Jooste R 'Groups of Companies and Related Persons' (2012) 205-8.
[27] Stevens R 'Liability within company groups' (2016) 4 TSAR (*Journal of South African Law*) 709 712.
[28] Stevens R (2016) 712.
[29] Delport P et al (2018) 32(8).
[30] Delport P et al (2018) 32(8); Jooste R 'Groups of Companies and Related Persons' (2012) 203.
[31] It has been argued that that such conduct may be subject to challenge in terms of the anti-avoidance provisions in s 6 of the Act. Delport P et al (2018) 32(8); Jooste R 'Groups of Companies and Related Persons' (2012) 203.

The courts have been willing to recognise the 'economic unit' that is a group of companies.[32] However, South African law respects and defends the separate legal personality of each company within the group.[33]

There could be a variety of motivations for conducting operations through a group of companies, including the desire to maintain separate entities to conduct separate business activities. Stevens makes a compelling argument:

> 'The most important reason, however, is probably to reduce the risk to which the holding company is exposed. Risk in this context means the possible legal risk which necessitates the creation of a vertical structure of a holding company and a subsidiary company. The point of departure is that every company within a group structure is a separate juristic person and as such it has its own rights and liabilities. This in turn means that one company in a group structure is not liable for the liabilities of another company within the group structure. In the light of the fact that each of the various entities within a company group structure retains its individual juristic personality, it automatically reduces the commercial risk of the other companies within the group.'[34]

In addition to establishing subsidiaries to manage different aspects of the group's commercial activities, a company may isolate risk by using a subsidiary as a financing vehicle. For example, a subsidiary SPV can be used in an asset securitisation scheme to separate the risk attached to a particular pool of financial assets from the risk attached to the originator.[35] By allocating risk in this way, a company can potentially obtain funding from the capital markets at a lower cost.[36] The cost of obtaining finance through a subsidiary SPV may be lower than the cost of obtaining finance through the

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[32] *Langeberg Koöperasie Bpk v Inverdoorn Farming & Trading Co Ltd* [1965] 2 All SA 463 (A) 469; *S v de Jager* 1965 (2) All SA 495 (A) 498-502.

[33] Botha DH (1982) 109& 111; Jooste R 'Groups of Companies and Related Persons' (2012) 196; Locke N 'The Approach of the Supreme Court of Appeal to the Enterprise Reality in Company Groups' (2012) 23 *Stellenbosch LR* 476 476; Stevens RA *The External Relations of Company Groups in South African Law: A Critical Comparative Analysis* (unpublished LLD thesis, Stellenbosch University, 2011) 709. See Davies & Worthington (2016) 231 for a discussion of the position in the United Kingdom. The exception is when the remedy of piercing the corporate veil is imposed on companies within a group. See *Ex Parte Gore and Others NNO* 2013 (3) SA 382 (WCC) paras 2-15.

[34] Stevens RA (2016) 709; Baudistel JK 'Bankruptcy-remote Special Purpose Entities: An Opportunity for Investors to Maximize the Value of Their Returns While Undergoing More Careful and Realistic Risk Analysis' (2013) 86 *Southern California LR* 1309 1311.

[35] Schwarcz SL *Structured Finance: A Guide to the Principles of Asset Securitization* 3 ed (2002) 2.

[36] Rothman writes that [i]solating the assets makes the financing more attractive to a lender by lessening potential risk'. Rothman SJ 'Lessons from General Growth Properties: The Future of the Special Purpose Entity' (2012) 17 *Fordham Journal of Corporate & Financial Law* 227 230.

holding company itself if 'the risks associated with the pool of receivables are lower than the risks associated with the operating company'.[37]

The goal of risk isolation is also seen in the creation and use of real estate holding and mortgaging subsidiary SPVs, a la General Growth Properties, Inc (General Growth). General Growth used subsidiary SPVs to develop or acquire shopping centres, with the goal of isolating each SPV and its assets from its respective parent.[38]

Subsidiaries can also aid in the development and support of specialisation within a group.[39] Plank draws inspiration for this view from General Motors Acceptance Corporation, a subsidiary of General Motors Corporation, whose purpose was to specialise in financing motor vehicle dealerships to be buyers of vehicles manufactured by the firm.[40] This structure allowed credit providers and investors to lend to and invest in the subsidiary without having to bear the risks associated with the manufacturing of motor vehicles.[41]

The principle of separate legal personality in the group context is capable of being abused.[42] The interwoven nature of the companies within a group has the potential to allow for the shrouding of economic and legal realities and the abuse of the control implicit in the holding company-subsidiary relationship.[43] This risk has lead regulators to intervene in certain areas.[44] For example, a group of companies is required to prepare consolidated financial statements wherein the financial statements of the subsidiaries and holding company are combined to project one document that

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[37] Plank TE 'The Security of Securitization and the Future of Society' (2004) 25(5) *Cardozo LR* 1655 1678.
[38] Parkins LM, Foreman ME, & Hoffmann TR 'In re General Growth Properties, Inc.: Motions to Dismiss SPE Cases Denied' (2009) 5 *Pratt's Journal of Bankruptcy Law* 483 485; Nasr A 'Special-Purpose Entity Lending Structures: What Developments Have Been Made since the Landmark Bankruptcy Case in Re General Growth Properties, Inc.' (2017) 25 *American Bankruptcy Institute LR* 177 178; Rothman SJ (2012) 245-7.
[39] Plank TE (2004) 1680.
[40] Plank TE (2004) 1680.
[41] Plank TE (2004) 1680-1.
[42] Plank TE (2004) 1682. See, for example, *Ex Parte Gore and Others NNO* 2013 (3) SA 382 (WCC) para 8.
[43] Bhana D 'The Company Law Implications of Conferring a Power on a Subsidiary to Acquire the Shares of its Holding Company' (2006) 17 *Stellenbosch LR* 232 233; Jooste R 'Groups of Companies and Related Persons' (2012) 194.
[44] Davies & Worthington (2016) 231.

represents the financial status of the group.[45] This requirement is intended to compel the supply of relevant and important information regarding the net assets of the group as a whole.[46] The Act also regulates the provision of financial assistance by a holding company to one of its subsidiaries.[47]

The integrity of separate legal personality in company groups is not inviolable, as there are grounds to ignore the independence of individual companies within a group in a particular set of circumstances. In South African law, a court may impute the liability of one company within a group to another company within the same group, or indeed to the individual members of that company or of any other company within the group, on the basis of the common law remedy of "piercing the corporate veil" or in terms of s 20(9) of the Act.[48] A strict legal and practical separation between corporate entities should be observed in order to avoid inter-group veil-piercing proceedings.

4.5 SPECIAL PURPOSE VEHICLES

There is no universal statutory provision in South African law that defines the term "SPV". "SPV" is a term of art used in financial circles to refer to legal entities with limited powers that are used to fulfil specific commercial goals.[49] These entities came to the forefront of academic discussion in the wake of the accounting scandal that lead to the bankruptcy of energy and derivatives trading giant Enron in 2001.[50]

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[45] Paragraph 2(a) of International Financial Reporting Standard (IFRS) 10; Davies & Worthington (2016) 231.

[46] Lubbe I, Moddack G, and Watson A *Financial Accounting: GAAP Principles* 3 ed (2011) 550-1.

[47] The requirements of s 45(3) of the Act must be complied with before a company may provide financial assistance to a subsidiary. Section 45(2) read with s 2(1)(*c*)(ii) of the Act. However, s 11 of the Companies Amendment Bill 2018, (presently open for public comment) proposes to exclude financial assistance by a holding company to its subsidiary from the ambit of s 45(2).

[48] See *Hülse-Reutter v Gödde* (2001) (4) SA 1336 (SCA) para 20 and *Cape Pacific Ltd v Lubner Controlling Investments (Pty) Ltd and Others* 1995 (4) SA 790 (A) for a summation of the common law position. For discussion on the new statutory piercing remedy, see Cassim R 'Piercing the Veil under Section 20(9) of the Companies Act 71 of 2008: A New Direction' (2014) 26 *SA Merc LJ* 307 307; and *Ex Parte Gore* paras 30-36.

[49] Muñoz DR 'Bankruptcy-remote transactions and bankruptcy law—a comparative approach (part 1): changing the focus on vehicle shielding' (2015) *Capital Markets Journal* 10(2) 239-274, available at SSRN https://ssrn.com/abstract=2733613 (accessed on 17 August 2018) 4; Lubbe, Moddack & Watson (2011) 555-6; Basu JR 'Accounting for and Disclosure of Special Purpose Entities by Financial Holding Companies: Lessons from PNC Financial Services' (2003) 7 *North Carolina Banking Institute* 177 177. See also Powers WC, Troubh RS, and Winokur HS 'Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp.' (2002) (hereinafter "Powers Report") 37-8.

[50] See, for example, Schwarcz SL et al *Securitization, Structured Finance, and Capital Markets* (2004) 96, Schwarcz SL 'Enron and the Use and Abuse of Special Purpose Entities in Corporate Structures' (2001) 70 *University of Cincinnati LR* 1309, and Carpenter H 'Special Purpose Entities: A Description

In a very broad sense, it can be argued that all companies are SPVs, as their incorporators surely have some purpose in mind when registering the corporation. However, the term SPV has emerged in practice to refer specifically to shell-like entities that are used as conduits to facilitate, enable or protect a single enterprise of another organisation.[51] An SPV usually has few or no employees or business premises,[52] and its activities are limited to the furtherance of the project for which it was established.[53]

SPVs are often formed by a holding company in a parent-subsidiary relationship.[54] This enables the holding company to exercise control over the activities of the SPV. An SPV can take a variety of legal forms. Pearce and Lipin note that in the United States of America (USA), the SPV usually takes the form of a limited liability corporation (LLC), a trust, or a limited liability partnership, while in Europe, LLCs and limited purpose corporations are used.[55] In South Africa, an SPV could theoretically be a partnership, corporation or trust. The various advantages and disadvantages of the respective business entities, in conjunction with the requirements of the objective of the SPV, will determine which business form is most appropriate in the circumstances. It is submitted that a corporation is the most suitable type of business entity for SPV purposes, as risk isolation is more easily achievable in an environment where assets can be transferred to a completely separate entity. For instance, in securitisation schemes, the SPV usually takes the form of a company.[56]

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of the Now Loathed Corporate Financing Tool' (2002) 72 *Mississippi LJ* 1065. See also Da Silveira AD 'The Enron Scandal a Decade Later: Lessons Learned' (2013), available at https://ssrn.com/abstract=2310114, accessed on 12 October 2019, at 28-31.

[51] Kim J, Song BY, and Wang Z 'The Use of Special Purpose Vehicles and Bank Loan Contracting' (2014) 7, available at https://www.uts.edu.au/sites/default/files/Bus_Acc_aut14Apr04_JBKim_BSong_ZWang.pdf , accessed on 28 September 2018.

[52] Pearce JA & Lipin IA 'Special Purpose Vehicles in Bankruptcy Litigation' (2011) 40 *Hofstra LR* 177 179; Gorton GB & Souleles NS 'Special Purpose Vehicles and Securitization' in Carey & Stulz (eds.) *The Risks of Financial Institutions* (2007) 549 550, available at http://www.nber.org/chapters/c9619, accessed on 11 April 2018.

[53] Stein C & Everingham GK *The new Companies Act unlocked* (2011) 72.

[54] Baudistel JK (2013) 1314.

[55] Pearce & Lipin (2011) 194; Bridson JL 'S&P Global Ratings: Europe Asset Isolation and Special-Purpose Entity Criteria—Structured Finance' (2013) 4, available at https://www.standardandpoors.com/ja_JP/delegate/getPDF?articleId=1832489&type=COMMENTS&subType=CRITERIA, accessed on 31 August 2018.

[56] Boshoff A and Krisch K 'Structured finance and securitisation in South Africa: overview', available at https://uk.practicallaw.thomsonreuters.com/4-521-

As a general observation, it can be noted that there must be some benefit for the parties to transactions involving SPVs.[57] The very existence and use of SPVs suggests that some advantage is derived therefrom. It has been argued that:

> 'SPVs have a number of key utilitarian features and benefits that allow investors access to investment opportunities which would otherwise not exist. These include facilitating and supporting securitisation, financing, risk sharing and raising capital to name a few. In the absence of SPVs, these objectives would not be possible without putting the entire corporation at risk. It also provides significant benefits to the parent firm by allowing ease of asset transfer, reducing 'red tape', providing tax benefits and legal protection.'[58]

A firm that wishes to engage in special or high risk projects could create an SPV to fund and manage the project.[59] Muñoz notes that SPVs can be used by real estate investment firms to hold, bond, and manage separate immovable properties through separate SPVs, as a risk isolation mechanism.[60] The case of General Growth is instructive: in its insolvency application, the company included more than 160 of its subsidiary real estate-holding SPVs.[61] General Growth had used individual subsidiary SPVs to develop or acquire shopping centres, with the goal of isolating each SPV and its assets from its respective parent.[62]

Researches have commented that SPVs 'are now pervasive in corporate finance'.[63] For instance, SPVs are used as financial intermediaries in securitisation schemes.[64]

4150?transitionType=Default&contextData=(sc.Default)&firstPage=true&comp=pluk&bhcp=1, accessed on 29 August 2018.

[57] Baudistel JK (2013) 1311.

[58] Gosrani N & Gray A 'The next chapter: creating an understanding of Special Purpose Vehicles', available at https://www.pwc.com/gx/en/banking-capital-markets/publications/assets/pdf/next-chapter-creating-understanding-of-spvs.pdf, accessed on 22 August 2018. See also Baudistel JK (2013) 1311.

[59] Carpenter H (2002) 1070; Baudistel JK (2013) 1314; *In Re General Growth Properties, Inc*., 409 B.R. 43 (Bankr. S.D.N.Y. 2009) 46-8; Parkins, Foreman, & Hoffmann (2009) 485.

[60] Muñoz DR (2015) 3.

[61] Resnick BM & Krause SC 'Not So Bankruptcy-Remote SPEs and *In re General Growth Properties Inc.*' (2009), available at https://www.davispolk.com/files/uploads/Insolvency/NotSoBankruptcy-RemoteSPEs_InreGeneralGrowthPropertiesInc.pdf, accessed on 30 September 2018.

[62] Parkins, Foreman, & Hoffmann (2009) 485; Nasr A (2017) 178; Rothman SJ (2012) 245-7; Baudistel JK (2013) 1314; Pearce & Lipin (2011) 178-9.

[63] Gorton & Souleles (2007) 549. See also Fitch Ratings 'Global Structured Finance Rating Criteria' (2016) 12, available at https://fitchratings.co.jp/ja/images/RC_20160627_Global%20Structured%20Finance%20Rating%20Criteria_EN.pdf, accessed on 31 August 2018.

[64] Pearce & Lipin (2011) 178.

The popularity of using SPVs to structure company financing means that investors must be acutely aware of the potential threats to the overall success of the scheme.[65] However, even though structured finance transactions make use of SPVs, the use of separate entities to isolate and allocate risk is not a new phenomenon, and it is not unique to structured finance.[66] Using SPVs can be beneficial whenever an entity wishes to insulate certain assets from other risks.[67] For example, an SPV could be used as a factoring vehicle.[68] An SPV is also used in project finance transactions.[69] In a project finance transaction, an intermediary SPV is set up to protect a specific project (usually, the investor-funded production of an income-producing asset) from the risk of the sponsor's insolvency.[70] Similar to the motivations behind asset securitisations, project finance transactions are primarily aimed at removing risk from the originator.[71] Muñoz describes the financing of large, expensive assets like aircraft, in terms of which actual ownership of the asset vests in an SPV on behalf of the manufacturer of the asset, which then lets the asset to an airline, as examples of project finance transactions.[72] It has also been noted that SPVs have been used in merger and acquisition transactions.[73] The use of SPVs in venture capital transactions has also been observed.[74]

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[65] Pearce & Lipin (2011) 181.
[66] Plank TE (2004) 1679.
[67] Muñoz DR (2015) 3.
[68] *Factoring SPV (Pty) Ltd v Matjabeng Local Municipality* [2017] ZAFSHC 100 (26 June 2017). On factoring generally, see Willis N 'Factoring Agreements' (1982) 99 *South African LJ* 667, Joubert N 'The Legal Nature of the Factoring Contract' (1987) 104 *South African LJ* 88, Scott S 'Sessie en Factoring in die Suid-Afrikaanse Reg' (1987) 20 *De Jure* 15, Sunkel KD 'A comprehensive suggestion to bring the *pactum de non cedendo* into the 21st century' (2010) 3 *Stellenbosch LR* 463 473-6, and Burgess R *Corporate Finance Law* (1985) 195-6.
[69] Muñoz DR (2015) 4.
[70] Muñoz DR (2015) 4; Wallenstein S 'Situating Project Finance and Securitization in Context—A Comment on Bjerre' (2002) 12 *Duke Journal of Comparative & International Law* 449 449; Visconti RM 'Evaluating a Project Finance SPV: Combining Operating Leverage with Debt Service, Shadow Dividends and Discounted Cash Flows' (2013) 1(1) *International Journal of Economics, Finance and Management Sciences* 9 9; 'Special Purpose vehicles SPV for building development' available at https://www.designingbuildings.co.uk/wiki/Special_purpose_vehicles_SPV_for_building_development accessed on 1 October 2018.
[71] Wallenstein S (2002) 451.
[72] Muñoz DR (2015) 3.
[73] Riemer DS 'Special Purpose Acquisition Companies: SPAC and SPAM or Blank Check Redux? (2007) 85 *Washington University LR* 931 931; Muñoz DR (2015) 3.
[74] Mannes J 'An oasis in the desert: Special purpose vehicles and behavioural economics' (2016), available at https://techcrunch.com/2016/04/01/an-oasis-in-the-desert-special-purpose-vehicles-and-behavioral-economics/, accessed on 18 August 2018.

It is important to note that an SPV need not be structured as a subsidiary of a holding company at all. Indeed, the advantages of using SPVs to isolate risk where the originating company is not required to consolidate the assets and liabilities of the SPV onto the group's balance sheet, are well known.[75]

4.6 INSOLVENCY-REMOTENESS

Usually, SPVs are created and managed so as to be "insolvency-remote". The term "insolvency-remoteness" is not a legal term,[76] but one that has arisen out of commercial practice.[77] It means that steps have been taken to reduce the risk of the entity and its assets being subject to insolvency proceedings.[78] In *In Re Doctors Hospital of Hyde Park Inc.*,[79] Schmetterer J remarked:

> 'No authoritative precedence or statute appears to exist for bankruptcy remote entities. Some courts have accepted the existence of "bankruptcy remote" entities, and typically rely on outside commentary and literature as to the characteristics of those entities…it is recognized in the business world and literature as a structure designed to hold a defined group of assets and to protect those assets from being administered as property of a bankruptcy estate in event of a bankruptcy filing'.[80]

As a starting point, it is evident that insolvency-remoteness is a desirable characteristic for any activity that makes use of an SPV. A common feature of SPV structures is the desire to isolate the risk of an enterprise by creating and using an entity that is insulated against the operation of separate entities. Therefore, whatever the purpose of the ringfencing is, the relevant activity will benefit from the SPV being as insolvency-remote as possible.

According to Muñoz, insolvency-remoteness comprises at least two potential concepts: the effective separation of the assets of the sponsor from those of the SPV

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[75] It has been observed that 'SPEs are normally designed so that no single entity holds the majority interest and therefore no group financial statements are considered necessary.' Lubbe, Moddack & Watson (2011) 555-6.
[76] Bridson JL (2013) 4.
[77] Muñoz DR (2015) 4; Philips S et al 'Bankruptcy remoteness - a remote prospect?' (2013) available at https://www.lexology.com/library/detail.aspx?g=9af5bc2d-cf8b-4bfc-88e9-13463ce56279, accessed on 17 August 2018.
[78] Baudistel JK (2013) 1314-5; Pearce & Lipin (2011) 179.
[79] 507 B.R. 558 (2013).
[80] *In Re Doctors Hospital of Hyde Park Inc.* 701.

(what the author terms 'basic' insolvency-remoteness),[81] and contractual provisions aimed at eliminating the possibility of the SPV undergoing insolvency proceedings at all (what the author terms 'enhanced' insolvency-remoteness).[82] In other words, on the one hand an SPV should be unaffected by the insolvency of the sponsor, and on the other hand the SPV itself should be structured so as to make its voluntary or compulsory liquidation as unlikely as possible. Baudistel explains that structuring the SPV to be insolvency-remote in the basic sense is a way of reassuring the investors in the SPV that the financial misfortunes of the parent and of other companies within the group will not affect the returns on the investment made through the SPV.[83] The techniques used to achieve enhanced insolvency-remoteness serve a similar purpose: investors would arguably be more likely to invest in a scheme operated through an SPV if safeguards were put in place to guard against the SPVs insolvency, than they would be if no such safeguards existed.

The consensus in the USA appears to be that it is not possible for the SPV itself to be completely *prohibited* from filing for bankruptcy, as any provision that attempted to do so would in all probability be viewed as contrary to public policy.[84] Parkins, Foreman and Hoffmann write that the parties to transactions involving SPVs acknowledge that American law does not permit a company to waive its right to file for bankruptcy.[85] Likewise, it is doubtful whether an absolute liquidation prohibition would be valid in South Africa. A provision in a company's MOI that purported to bar the company from applying for its own liquidation would in all probability amount to avoidance and could be declared void for being inconsistent with the Act.[86] The right to apply for the liquidation of both solvent companies and insolvent companies are not alterable provisions.[87] Therefore, there does not seem to be a way to absolutely bar a voluntary liquidation application in South African law either.

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[81] Muñoz DR (2015) 5.
[82] Muñoz DR (2015) 5.
[83] Baudistel JK (2013) 1315.
[84] Baudistel JK (2013) 1316; Schwarcz SL et al (2004) 55; Cohn MJ 'Asset Securitization: How Remote is Bankruptcy Remote?' (1998) 26 *Hofstra LR* 929 950.
[85] Parkins, Foreman & Hoffmann (2009) 483-4.
[86] In terms of s 6(1) of the Act, courts are empowered to declare void any agreement, resolution or any provision in a company's MOI or rules that is intended to defeat or reduce the effect of an unalterable provision in the Act.
[87] See s 80 & 81 of the Act and Items 9(1) and (2) of Schedule 5 to the Act read with s 345 of the Companies Act 61 of 1973.

It should be possible to impose certain restrictions on a company's right to apply for its own winding up. Schwarcz et al suggest that an originator could design an SPV to be insolvency-remote by including provisions in the SPVs constitutional documents that restrict the filing of liquidation proceedings to certain circumstances only.[88] In South Africa, a company may file for the liquidation of a solvent company by way of a shareholders' special resolution.[89] This is not an alterable provision, and therefore, a company's MOI cannot broadly make the right to apply for liquidation subject to certain conditions or limit it to certain situations. However, a company's MOI *may* deviate from an unalterable provision by imposing a more onerous standard than the one required by the Act.[90] Therefore, a company could, for instance, impose a unanimous shareholder resolution requirement regarding the approval of a voluntary filing for liquidation. However, when the company is insolvent, or when a court orders liquidation of a solvent company in terms of s 81 of the Act, the choice is largely out of the company's hands.

Credit ratings agencies regularly publish guideline documents explaining the importance of the insolvency-remoteness of the SPV involved in structured finance transactions, and discussing the methods used to enhance insolvency-remoteness. For example, Fitch Ratings expects that the assets of a securitisation SPV should be kept separate from its parent and other companies in the event of their insolvency.[91] In addition, it is recommended that the SPV should be a new entity specially formed for the specific transaction, be managed independently from other entities, and that limitations should be put in place to maintain the SPVs independence.[92] According to Fitch Ratings:

> 'It is also expected that these restrictions will limit the business the SPV may engage in to only what is necessary for it to perform its obligations under the transaction documents. This reduces the risk of new liabilities and creditors being created, which

[88] Schwarcz SL et al (2004) 55.
[89] Section 80(1) of the Act.
[90] Section 15(2)(*a*)(iii) of the Act.
[91] Fitch Ratings 'Criteria for Special-Purpose Vehicles in Structured Finance Transactions' (2012), available at https://www.fitchratings.com/site/500, at 6.
[92] Fitch Ratings Criteria (2012) 3-6.

may impact adversely on the transaction or the solvency or bankruptcy remoteness of the SPV.'[93]

Standard and Poor's also emphasises the importance of insolvency-remoteness, and observes that the following types of separateness provisions are often used in securitisation transactions:

1) The SPV should maintain separate accounting records and financial statements;
2) The SPV should do business in its own name;
3) The SPV should comply with any formal requirements stipulated by its founding documents;
4) The SPV should be prohibited from pledging its assets, or providing any loans or other financial assistance, for the benefit of or to any entity not specified in the transaction documents;
5) The SPV should use separate invoices and cheques; and
6) The SPV should clearly hold itself out as a separate legal person.[94]

Moody's Investors Service (Moody's) recommends that the activities of an SPV involved in structured finance transactions should be restricted, the company should be managed and owned independently, should have no liability from activities unrelated to the structured finance transaction, and the SPV should be prohibited from incurring secondary liabilities.[95]

Several insolvency-remoteness techniques have been observed in literature on structured finance.[96] For example, the contracts creating the SPV could include a "formal separateness requirement" that compels the SPV and the holding company to maintain their respective independence by, for instance, the separate management of debts and other obligations.[97] Another common technique is to require at least one board member of the SPV to be independent and unaffiliated to the parent company

[93] Fitch Ratings Criteria (2012) 6.
[94] Bridson JL (2013) 7.
[95] Moody's 'Methodology for assessing bankruptcy remoteness of special purpose vehicles', available at https://www.moodys.com/research/Moodys-publishes-methodology-for-assessing-bankruptcy-remoteness-of-special-purpose--PR_310025, accessed on 31 August 2018.
[96] Rothman S (2012) 230.
[97] Baudistel JK (2013) 1315; Rothman S (2012) 257; Bridson JL (2013) 7.

or any of its other subsidiaries.[98] There does not seem to be a reason why these separateness provisions could not be used outside the sphere of structured finance, wherever there is a need to operate and maintain a separate legal entity for a specific purpose.

Another technique is to make the SPV's power to enter into liquidation proceedings subject to the unanimous approval of its directors.[99] Klee and Butler note that incorporated SPVs often have constitutive provisions denying the board the right to file for liquidation proceedings subject to the fulfilment of certain obligations owed to creditors.[100] The rationale for these types of provisions is to prevent the SPV acting in the best interests of the parent instead of in its own. Baudistel contemplates the potential scenario where the parent company is undergoing financial difficulties while the SPV (of which, perhaps, one or more of the directors are members of the board of both companies) has sufficient liquidity to assist the interests of the parent or group as a whole.[101] Such conflicts of interest are undesirable.

Restricting the capacity of the SPV to the transactions required to fulfil the company's limited purpose is another insolvency-remoteness technique; these clauses can be inserted in the SPV's constitution and in the transaction documents.[102] Pearce and Lipin remark that limited capacity clauses can be used to stipulate what type of assets a company may own, the kind of liabilities it may incur, and the type of transactions it may enter into.[103] Common provisions include limiting the SPVs capacity to owning and managing assets, entering into a particular transaction, or engaging in finance-related activities.[104]

Moody's recommends that the SPV's transaction documents should prohibit creditors from filing insolvency proceedings.[105] Therefore, the use of pacta de non petendo is

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[98] Baudistel JK (2013) 1315; Rothman S (2012) 258; Parkins, Foreman, & Hoffmann (2009) 486; Pearce & Lipin (2011) 196.
[99] Pearce & Lipin (2011) 196; Baudistel JK (2013) 1316.
[100] Klee KN & Butler BC 'Asset-Backed Securitization, Special Purpose Vehicles and Other Securitization Issues' (2002) 35 *Uniform Commercial Code LJ* 23, available at https://www.ktbslaw.com/news-publications-17.html, accessed on 1 October 2018, at 14.
[101] Baudistel JK (2013) 1315.
[102] Baudistel JK (2013) 1316.
[103] Pearce & Lipin (2011) 227. See also Plank TE (2004) 1664-6.
[104] Pearce & Lipin (2011) 195. Footnotes omitted.
[105] Moody's 'Methodology for assessing bankruptcy remoteness of special purpose vehicles'.

encouraged.[106] Other insolvency-remoteness techniques include the insertion of subordination clauses and limited recourse provisions in the SPV's transaction documents.[107] Pearce and Lipin suggest that the amendment of a securitisation SPV's constitution must be made subject to the approval of the *investors* in the scheme.[108] It should be permissible to do this in terms of the South African Act. It is possible for an MOI to stipulate an amendment requirement in addition to the statutory amendment requirements contained in s 16 of the Act.[109]

In conclusion, it is clear that several types of contractual and constitutional provisions are commonly used to reduce the insolvency risk of an SPV.[110]

4.7 FINANCIAL REPORTING

Before analysing the techniques involved in off-balance sheet (OBS) transactions, it may serve to briefly contextualise the issue. This requires reflection on the practice and principles of financial reporting.

The general purpose of financial reporting is to provide sufficient information to the creditors of and potential investors in a company, so that these parties can make informed decisions regarding future dealings with the company.[111] This is why a company's board of directors is required to have financial statements prepared and included in the company's annual report to its shareholders.[112] The information provided in the financial statements include details about the company's assets and liabilities and the effect of events that change the entity's assets and liabilities.[113]

The International Accounting Standards Board (IASB) is an independent organisation that sets accounting standards on behalf of the International Financial Reporting Standards (IFRS) Foundation, a non-profit corporation registered in the State of

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[106] See Boshoff & Krisch 'Structured finance and securitisation in South Africa: overview'. A pactum de non petendo, also known as a non-petition clause, is a creditor's promise not to initiate insolvency proceedings against a debtor. See 5.2.5 below.
[107] Boshoff & Krisch 'Structured finance and securitisation in South Africa: overview'.
[108] Pearce & Lipin (2011) 180-1.
[109] Locke argues that it is possible to make the amendment of a particular provision in a company's MOI subject to the prior approval of the holders of the company's debt instruments. Locke N (2016) 163.
[110] Besides the insolvency-remoteness techniques, 'the parties' goals and incentives align such that bankruptcy is undesirable or impossible for either of them'. Baudistel JK (2013) 1316.
[111] Paragraph 1.2 of the Framework and para 9 of IAS 1. See also Lubbe, Moddack & Watson (2011) 551.
[112] Kolitz DL (2015) 11-2 & 484.
[113] Paragraph 1.12 of the Framework.

Delaware. In March 2018, the IASB re-issued the *Conceptual Framework for Financial Reporting* (hereinafter the Framework).[114] The Framework is a collection of accounting standards.[115] Inter alia, the Framework explains the basic principles and elements that comprise the preparation and presentation of financial statements.[116]

The Framework assists the IASB in developing and maintaining IFRS, and serves as a guide with respect to the interpretation of its provisions.[117] IFRS are made up of two sets of enumerated rules, International Accounting Standards (IAS), and IFRS.[118] In South Africa, all public companies and larger private companies are required to use IFRS in their financial reporting.[119]

All companies must prepare annual financial statements every year.[120] The compilation of financial statements is aimed at providing adequate information about a company's assets, liabilities, equity, income and expenses, so that interested persons may make an assessment regarding the future economic prospects of the company and the performance of management in managing the company's resources.[121]

Financial statements must consist of four elements: the statement of financial position,[122] the income statement (also known as the statement of profit or loss, or

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[114] IFRS '*Conceptual Framework for Financial* Reporting, available at http://www.ctcp.gov.co/_files/documents/1522788753-5849.pdf, accessed on 1 October 2018.

[115] Kolitz explains that '[a]ccounting standards are authoritative documents, and specify how transactions and other events are to be recognised, measured and disclosed in financial statements'. Kolitz DL (2015) 13. The two main sets of accounting standards in the Western world are United States Generally Accepted Accounting Principles (US GAAP) and International Financial Reporting Standards (IFRS). See Schmid D et al, 'IFRS and US GAAP: similarities and differences' (2019), available at https://www.pwc.com/us/en/cfodirect/assets/pdf/accounting-guides/pwc-ifrs-us-gaap-similarities-and-differences.pdf, accessed on 6 November 2019 1-2.

[116] Kolitz DL (2015) 13. See para 3.2 and ch 4 of the Framework.

[117] Paragraph 1.1 of the Framework.

[118] Kolitz DL (2015) 19. See ch 2 of Lubbe, Moddack & Watson (2011) for a review of the interaction between Generally Accepted Accounting Practices (GAAP), IFRS, and US GAAP.

[119] Section 29(1)(*a*) and s 29(5)(*b*) of the Act read with Regulation 27. See also 4.9 herein.

[120] Section 30(1) of the Act. Section 30(2)(*a*) stipulates that a public company's financial statements must be audited, while s 30(2)(*b*) stipulates that the financial statements of other companies must either be audited or independently reviewed under the circumstances envisioned by the Companies Regulations.

[121] Paragraph 1.2 of the Framework and para 9 of IAS 1.

[122] Paragraph 3.3(a) of the Framework and para 10(a) of IAS 1. See also Lubbe, Moddack & Watson (2011) 48.

statement of financial performance),[123] the change in equity statement,[124] and the cash flows statement.[125]

The statement of financial position captures the financial position of a company at a given time;[126] the "balance sheet", as it was previously known, must recognise all the assets, liabilities and equity of the company.[127] According to Lubbe, Moddack and Watson:

> 'The statement of financial position presents information about the status of the entity's main financial indicators, thereby helping users to assess the financial position of the entity on a particular day, the reporting date. The financial indicators included in the statement of financial position are the entity's net asset value, the liquidity of the entity, the solvency of the entity and, to some extent, its financial risk.'[128]

The Framework defines an "asset" as 'a present economic resource controlled by the entity as a result of past events', explaining further that an "economic resource" is 'a right that has the potential to produce economic benefits'.[129] A "liability" is defined as 'a present obligation of the entity to transfer an economic resource as a result of past events'.[130]

The Framework defines "equity" as 'the residual interest in the assets of the entity after deducting all its liabilities", explaining further that:

> 'Equity claims are claims on the residual interest in the assets of the entity after deducting all its liabilities…they are claims against the entity that do not meet the definition of a liability. Such claims may be established by contract, legislation or similar means…'.[131]

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[123] Paragraph 3.3(b) of the Framework and para 10(b) of IAS 1. See also Kolitz DL (2015) 5.
[124] Paragraph 3.3(c)(iv) of the Framework and para 10(c) of IAS 1.
[125] Paragraph 3.3(c)(iii) of the Framework and para 10(d) of IAS 1.
[126] Kolitz DL (2015) 5. "Recognise" in this context simply means to record and confirm an item or entry as either an asset, a liability, or equity.
[127] Paragraph 3.3(a) of the Framework. See para 54 of IAS 1 for a more comprehensive description of the possible line items that may be included in a statement of financial position.
[128] Lubbe, Moddack & Watson (2011) 48.
[129] Paragraphs 4.3 and 4.4 of the Framework, respectively.
[130] Paragraph 4.26 of the Framework. See also Lubbe, Moddack & Watson (2011) 254.
[131] Paragraphs 4.63 & 4.64 of the Framework, respectively.

Therefore, equity is equal to total assets minus total liabilities.[132] A company's equity, "owner's equity", "stockholders' equity", or "net worth" as it is also known, must be recorded on the company's statement of financial position, and reflects, roughly, the value of the ordinary, preference, and treasury shares held in the company, and the reserve and retained earnings of the company.[133]

Paragraph 4.68 of the Framework defines "income" as 'increases in assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from holders of equity claims'. The Framework defines "expenses" as 'decreases in assets, or increases in liabilities, that result in decreases in equity, other than those relating to distributions to holders of equity claims', explaining further that 'contributions from holders of equity claims are not income, and distributions to holders of equity claims are not expenses'.[134]

An item should not appear on a company's statement of financial position as an asset or as a liability if the item does not meet the definition of either an asset because, for example, the entity has no control over the item, or if it does not meet the definition of a liability because, for example, the company has no obligation for repayment in respect of the item.[135]

4.8 OFF-BALANCE SHEET FINANCING

OBS financing is a financing technique that makes use of an SPV. In terms of an OBS transaction, financial assets are transferred to a separate entity to enable the sponsor company to avoid recording the accompanying debt as a liability on its balance sheet.[136] Instead, the finances generated will be reflected as income as a result of a sale.[137] Investors invest in securities issued by the SPV, thereby providing the cash to

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[132] Lubbe, Moddack & Watson (2011) 380.

[133] See paras 6.87-90 of the Framework for guidelines regarding the measurement of owner's equity. See also PWC 'Share capital and reserves (equity)', available at https://inform.pwc.com/?action=informContent&id=0906082003182698, accessed on 14 September 2018, Kolitz DL (2015) 428, and Lubbe, Moddack & Watson (2011) 380.

[134] Paragraphs 4.69 and 4.70 of the Framework, respectively.

[135] See para 5.26 of the Framework titled 'Derecognition' for an explanation of when items should be wholly or partially removed from a company's statement of financial position. See also the discussion of IFRS 10 below.

[136] Schwarcz SL 'The Use and Abuse of Special-Purpose Entities in Public Finance' (2012) 97 *Minnesota LR* 369 371-2.

[137] Schwarcz SL 'The Parts are Greater than the Whole: How Securitization of Divisible Interests can Revolutionize Structured Finance and Open the Capital Markets to Middle-Market Companies' (1993)

pay for the SPV's purchase of the assets. As long as the transfer of assets to the SPV constitutes a "true sale" for accounting purposes, the sponsor would not be required to record the assets on its own statement of financial position.[138]

OBS financing has many advantages for the sponsoring company. For instance, if a company receives a credit rating from a credit ratings agency, that rating will be affected by the company's debt to equity ratio.[139] In South Africa, credit rating services are regulated by the Credit Rating Services Act.[140] This Act defines a "credit rating" as 'an opinion regarding the creditworthiness of an entity; a security or a financial instrument; or an issuer of a security or a financial instrument, using an established and defined ranking system of rating categories'.[141] The debt to equity ratio measures the relative contributions of debt and equity financing to a company's capital structure.[142] The appearance of large, long-term liabilities on a company's statement of financial position may negatively affect the company's debt to equity ratio and credit rating. Kolitz highlights the importance of a company's debt levels relative to its equity, remarking that '[a] greater proportion of debt funding than equity funding can also be regarded by potential suppliers and lenders as a lack of commitment on the part of the owners of the business entity.'[143] OBS financing enables an entity to borrow and lend without affecting its own debt to equity ratio.

OBS financing also enables a firm to manage its earnings.[144] Kim, Song, and Wang, on the basis of an empirical study, were able to conclude that 'banks and other private

Columbia Business LR 139 141 note 6; Locke N 'The role of rating agencies in the course of a securitisation scheme' (2008) 41 *De Jure* 545 548.

[138] Schwarcz SL (1994) 142; Schwarcz SL 'The Universal Language of International Securitization' (2002) 12 *Duke Journal of Comparative & International Law* 285, 287 & 291; Itzikowitz A & Malan FR 'Asset Securitisation in South Africa' (1996) 8 *SA Merc LJ* 175 187-8.

[139] Schwarcz SL (1994) 142-3; Schwarcz SL (2005) 3; White W *The role of securitisation and credit default swaps in the credit crisis: A South African perspective* (unpublished MCom thesis, Potchefstroom University, 2011) 15-20; Karoly V *A case study of South African Commercial Mortgage Backed Securitisation* (unpublished MCom thesis, University of South Africa, 2006) 78-80. On the use of ratios as financial indicators in general, see Kolitz DL (2015) 585.

[140] 24 of 2012. See s 3(1) of the Credit Rating Services Act.

[141] Section 1 of the Credit Rating Services Act.

[142] Kolitz DL (2015) 593.

[143] Kolitz DL (2015) 593.

[144] Schwarcz SL (1994) 141 note 6; Schwarcz SL (2005) 3 note 9.

lenders perceive SPVs as an earnings management tool.'[145] In addition, raising capital may be less expensive when done through an SPV.[146]

OBS financing has come to be termed 'creative accounting'[147] and a form of 'shadow banking'.[148] Schwarcz defines "shadow banking" as 'the decentralized provision of financing outside of traditional banking channels'.[149] In other words, shadow banking refers to disintermediated financing, i.e. financing 'without the need for traditional modes of bank intermediation between capital markets and the users of funds'.[150] Carpenter's description of OBS techniques as 'cosmetic surgery' of financial statements, while unflattering and potentially unfair towards executive and financial officers that work under tremendous pressure and may perhaps be incentivised to maintain certain debt levels within a company, is not far off the mark.[151]

IFRS 10 is a significant accounting rule for OBS SPVs: it requires the presentation of consolidated financial statements where a parent controls subsidiaries. According to IFRS 10, an SPV need not be consolidated if its originator is not its holding company, and has relinquished control of the assets to the SPV in a true sale. Control for the purpose of consolidation is measured by the considerations stipulated in para 5 of IFRS 10: an originator need only include the financial assets and liabilities of an SPV in its consolidated financial statements if the SPV is its subsidiary; subsidiary status depends on whether the originator has power over the SPV,[152] whether the originator has 'exposure, or rights, to variable returns from its involvement with the [SPV]'[153], and whether it has the ability to use its power over the SPV to affect its own returns.[154]

In an OBS transaction, it may not be desirable for the sponsoring company to use a subsidiary, as the group would be required to present consolidated financial

[145] Kim, Song & Wang (2014) 8-9 and 36.
[146] Kim, Song & Wang explain that '[s]ince SPVs isolate and homogenize cash flows and business risks related to a specific class of assets, the sponsor can obtain external financing through SPVs at a lower cost.' Kim, Song & Wang (2014) 8.
[147] Shev J and Jooste R 'The Auditor, Financial Records and Reporting' in Cassim FHI (ed.) et al *Contemporary Company Law* 2 ed (2012) 599.
[148] Schwarcz SL 'The Governance Structure of Shadow Banking: Rethinking Assumptions About Limited Liability (2014) 90 *Notre Dame LR* 1 1.
[149] Schwarcz SL (2014) 2.
[150] Schwarcz SL (2014) 2.
[151] Carpenter H (2002) 1073.
[152] Paragraphs 7(a) & 10-14 of IFRS 10.
[153] Paragraphs 7(b) & 15-16 of IFRS 10.
[154] Paragraphs 7(c) & 17-18 of IFRS 10.

statements in any event. A truly separate vehicle may better serve the earnings and balance sheet management goals of structured finance. Kim, Song & Wang explain:

> 'By not consolidating an SPV in its financial statements, a sponsor company can borrow through the SPV and make its leverage ratio still appear healthy. Furthermore, by engaging in related party transactions with the SPV under control, a sponsor company can manipulate its earnings and profitability as well.'[155]

IFRS does not prohibit such conduct.[156] It is possible to structure an OBS transaction so that the SPV's liabilities need not be recorded in the originator's consolidated financial statements: this can be achieved by not establishing a parent-subsidiary relationship, and avoiding the accounting rules that would compel consolidation of the SPV onto the sponsor's balance sheet. However, it remains possible to control the activities of such an "unconsolidated structured entity" to some degree, as these types of SPVs are usually structured to be managed not by the voting rights attached to their securities, nor by resolutions of their boards, but instead by the terms of the constitutive and transaction documents as entered into before or at their incorporation.[157]

A big risk for investors in companies is that OBS financing and SPV structures can be used to disguise a company's true liabilities until the point of its insolvency. Schwarcz argues that a diligent investor would know about structured entity liabilities by reading the notes to the company's financial statements.[158] However, the financial reporting of large multinational corporate groups is a complex task, and the accounting notes to a company's financial statements are not easy for the ordinary, untrained investor to comprehend. For instance, the Powers Report remarked that in Enron's case, many of the footnote disclosures 'did not communicate the essence of the transactions in a

[155] Kim, Song & Wang (2014) 4.
[156] Schwarcz SL (2005) 4.
[157] Schwarcz SL (2005) 4. See also Hewer J, Davis M, & Haley D 'Structured finance – accounting developments: Special purposes entities - Consolidation and Disclosure' (2011) 1, available at https://www.pwc.com/gx/en/structured-finance/pdf/structured_finance_consolidation_special_purpose_entities_2.pdf, accessed on 21 September 2018.
[158] Schwarcz SL (2005) 7 & 30.

sufficiently clear fashion to enable the reader of the financial statements to understand what was going on.'[159]

Schwarcz correctly points out that '[t]here is nothing per se wrongful, however, about a company engaging in a transaction to achieve accounting results that are permitted.'[160] However, the world of OBS financing is opaque and fraught with moral hazard, as demonstrated in high profile accounting scandals at Enron and Steinhoff International Holdings (NV) (Steinhoff).[161] Schwarcz concedes that the prevalence of SPV use is concerning in light of the reduced financial transparency that OBS financing causes, remarking that the practice 'undermines financial integrity and creates a potential for abuse…'.[162] It must be acknowledged that the practice of structured finance has been tainted as a result of several corporate failures that, inter alia, have highlighted the risk of abuse with regards to SPVs, OBS techniques, and the non-disclosure of related party transactions.[163]

The corporate failure of Enron in 2001 remains worthy of analysis, as it showed the danger that the complex world of structured finance and non-consolidated SPVs poses to the investing public.[164] Enron had entered into a range of structured finance transactions that removed liabilities from its balance sheet in an improper manner.[165] Several of these transactions were characterised by complex guarantees, the use of Enron's own shares, and conflicts of interest on the part of Enron's executives.[166] Many of these transactions involved SPVs.[167] These transactions raised a number of accounting issues.[168]

[159] Powers Report (2002) 197.
[160] Schwarcz SL (2005) 49.
[161] On the initial repercussions of the accounting irregularities at Steinhoff, see Business Report 'Steinhoff shares nosedive after CEO Markus Jooste resigns' (2017), available at https://www.iol.co.za/business-report/steinhoff-shares-nosedive-after-ceo-markus-jooste-resigns-12286137, accessed on 10 April 2019.
[162] Schwarcz SL (2012) 371-2.
[163] Kim, Song & Wang (2014) 2.
[164] For a discussion of the factors and practices that lead to the demise of Enron, see Carpenter H (2002) 1065.
[165] Carpenter H (2002) 1067; Schwarcz SL (2004) 96.
[166] Schwarcz SL (2001) 1312.
[167] Powers Report (2002) 5.
[168] Powers Report (2002) 83.

Enron's direct motivations seemed to be the manipulation of financial statements by maximising, consolidating, and accelerating profits.[169] Enron's transactions allowed it to shift debt off balance sheet, thereby preserving its credit rating. The remuneration of senior Enron executives and employees through bonuses, incentives, and management fees, was an indirect result.[170] According to the Powers Report, many of these transactions lacked economic substance.[171] Furthermore, Enron incorrectly treated many SPVs as independent entities.[172]

In certain cases, Enron had sold assets to SPVs but had simultaneously agreed to guarantee the SPV's losses on those assets. For instance, Enron would sell a long-term financial asset to an SPV in exchange for cash.[173] The SPV would acquire the cash through the issue of securities to investors.[174] This allowed Enron to shift non-performing assets off its balance sheet. These transactions would have amounted to perfectly acceptable asset securitisations if it was not for the fact that Enron had agreed to guarantee payment on the investors' securities if the SPV had insufficient cash to do so.[175] Such a guarantee strikes at the heart of the true sale requirement, as Enron retained the risk of the assets sold to the SPV.[176] The Powers Report remarked that where a seller bears the risk of an asset after its sale, it is probably incorrect to account for the transaction as a sale.[177]

Enron and its SPVs also entered into a series of "hedging" transactions. The Powers Report explains that a "hedge" is a 'contract with a creditworthy outside party that is prepared—for a price—to take on the economic risk of an investment'.[178] In a basic hedging transaction, Enron would transfer its own shares (often through a wholly-owned subsidiary) to an SPV in exchange for either cash or a note.[179] The SPV would

[169] Powers Report (2012) 4; Schwarcz SL 'Structuring Commercial & Financial Transactions: Enron' (2002), lecture at Duke University School of Law, available at https://www.youtube.com/watch?v=jf6BbjG_91w&t=5146s, accessed on 16 April 2019.
[170] Schwarcz SL 'Structuring Commercial & Financial Transactions: Enron' (2002), Powers Report (2012) 3-4.
[171] Powers Report (2012) 5.
[172] Powers Report (2012) 5.
[173] Schwarcz SL 'Structuring Commercial & Financial Transactions: Enron' (2002).
[174] Schwarcz SL 'Structuring Commercial & Financial Transactions: Enron' (2002).
[175] Schwarcz SL 'Structuring Commercial & Financial Transactions: Enron' (2002).
[176] Schwarcz SL 'Structuring Commercial & Financial Transactions: Enron' (2002).
[177] Powers Report (2012) 12.
[178] Powers Report (2012) 13.
[179] Schwarcz SL 'Structuring Commercial & Financial Transactions: Enron' (2002).

then hedge the risk that certain Enron assets would fall in value. This hedge was effectively a guarantee that the SPV would pay Enron in the event that the identified assets declined in value.[180] However, the only assets with which the SPV could satisfy the hedge was Enron's own shares. This arrangement was risky, because if the value of Enron's assets and its share price simultaneously dropped below a certain level, the SPV would not be able to satisfy the hedge. This is precisely what happened.[181]

In other transactions, Enron would transfer its own shares to an SPV in exchange for cash acquired from investors, or simply a note issued by the SPV in Enron's favour.[182] The SPV would then take on the risk that certain Enron investments would decline in value by entering into a derivative transaction (a hedge).[183] Therefore, if the value of the relevant investment fell past a certain level, the SPV would make payments to Enron.[184] Again, the problem was that the SPV was capitalised solely with Enron shares.[185] Enron would then also guarantee the value of the SPV's assets.[186] These transactions enabled Enron to use the value of its own shares to protect itself against devaluations of its assets.[187] Enron had been gambling with its own share price to achieve off balance sheet treatment of its debt.[188] The Powers Report was of the view that these transactions were not true hedges as Enron always retained the risk of the assets.[189]

It is clear that the transactions entered into by Enron are not typical of OBS structured finance transactions. A distinguishing feature in Enron's case was the use of Enron's own shares to finance the SPVs.[190] OBS transactions and payment on the underlying guarantees were made dependant on the value of Enron's shares. The hedges were also innovative.

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[180] Schwarcz SL 'Structuring Commercial & Financial Transactions: Enron' (2002).
[181] Powers Report (2012) 14; Schwarcz SL et al (2004) 96.
[182] Schwarcz SL 'Structuring Commercial & Financial Transactions: Enron' (2002).
[183] Schwarcz SL 'Structuring Commercial & Financial Transactions: Enron' (2002).
[184] Schwarcz SL 'Structuring Commercial & Financial Transactions: Enron' (2002).
[185] Schwarcz SL 'Structuring Commercial & Financial Transactions: Enron' (2002).
[186] Schwarcz SL 'Structuring Commercial & Financial Transactions: Enron' (2002).
[187] Powers Report (2012) 13.
[188] Schwarcz SL 'Structuring Commercial & Financial Transactions: Enron' (2002).
[189] Powers Report (2012) 14 & 82.
[190] Schwarcz SL (2001) 1315-6.

When regulatory bodies began investigating these transactions, it was determined that in many cases, the SPVs were actually subsidiaries and should have been consolidated.[191] By then, Enron had managed to remove a large amount of debt from its balance sheet by transferring it to SPVs. In October 2001, Enron announced that it was restating its financial statements for the preceding five financial years due to "accounting errors".[192] The restatements erased hundreds of millions of dollars of value from Enron's financial statements and over a billion dollars in equity.[193] Shortly thereafter, Enron filed for bankruptcy.[194]

The more recent tale of Steinhoff International Holdings (NV) (Steinhoff), dual-listed multinational retailer with South African roots, is also worth mentioning. On 15 March 2019, Steinhoff released a summary of a report by auditors PriceWaterhouseCoopers (PWC) into accounting irregularities first brought to the market's attention in December 2017 with the sudden resignation of Steinhoff's Chief Executive Officer (CEO).[195] Before the CEO's resignation, auditing firm Deloitte had refused to approve Steinhoff's financial statements for its 2016/17 financial year.[196] These events caused great uncertainty in the market, causing the company's share price to plunge, thereby erasing equity to the value of billions of rand.[197]

After the CEO's resignation, Steinhoff instructed PWC to conduct a forensic investigation into its potential accounting irregularities.[198] Steinhoff has declined to

[191] Lubbe, Moddack & Watson (2011) 556; Powers Report (2012) 7.
[192] Powers Report (2012) 3.
[193] Powers Report (2012) 3.
[194] Powers Report (2002) 2. See also Segal T 'Enron Scandal: The Fall of a Wall Street Darling' (2018), available at https://www.investopedia.com/updates/enron-scandal-summary/, accessed on 29 September 2018.
[195] Business Report 'Steinhoff shares nosedive after CEO Markus Jooste resigns' (2017), available at https://www.iol.co.za/business-report/steinhoff-shares-nosedive-after-ceo-markus-jooste-resigns-12286137, accessed on 10 April 2019.
[196] See Kew J 'Steinhoff seeks fresh start, nominates new auditor' (2019), available at https://www.fin24.com/Companies/Retail/steinhoff-seeks-fresh-start-nominates-new-auditor-20190831, accessed on 29 October 2019.
[197] See Ensor L 'Pension funds lost billions over Steinhoff' (2018), available at https://www.timeslive.co.za/sunday-times/business/2018-01-31-pension-funds-lost-billions-over-steinhoff/, accessed on 29 October 2019.
[198] Reuters 'Steinhoff share price plunges as PwC forensic report, audited results delayed' (2018), available at https://www.cnbcafrica.com/insights/steinhoff/2018/12/06/steinhoff-share-price-plunges-as-pwc-forensic-report-audited-results-delayed/, accessed on 10 April 2019.

release the actual forensic report, but has published a summation of PWC's findings.[199]

It appears that Steinhoff engaged in a series of undisclosed related party transactions characterised by fraud and overstated valuations which had the effect of dramatically improving the financial position of the global retailer.[200]

First, Steinhoff recorded income from transactions with purportedly independent third parties.[201] These irregular or fictitious transactions with undisclosed related parties would inflate the group's profits and net asset value (NAV).[202] However, no actual income was received by Steinhoff.[203] This resulted in the existence of large non-recoverable receivables.[204] The receivables were not recoverable because the transactions had no substance, many of them involving grossly overstated asset valuations of, for example, brands, intellectual property, and expertise.[205] More irregular or fictitious transactions were entered into to hide the deception and further inflate the group's profits: the fictitious non-recoverable income was set off against or assigned to other entities within the group and to other purportedly independent third parties.[206] These set-offs or assignments were then recorded as income by Steinhoff.[207] Together, the irregular transactions created 'a cycle of income creation'.[208]

The Steinhoff accounting irregularities share some similarities with those that occurred at Enron. In both cases, the transactions involved SPVs and shifting assets off balance sheet, and in both cases the transactions were aimed at improving the financial position of the company. In addition, both sets of accounting problems were

[199] Steinhoff International Holdings NV 'Overview of Forensic Investigation' available at http://www.steinhoffinternational.com/downloads/2019/overview-of-forensic-investigation.pdf (accessed on 10 April 2019).
[200] 'Overview of Forensic Investigation' 3.1.1. See also Cohen C 'PWC's Steinhoff report suggests profit was boosted by R106bn in seven years' (2019), available at https://www.dailymaverick.co.za/article/2019-03-17-pwcs-steinhoff-report-suggests-profit-was-boosted-by-r106bn-in-seven-years/ (Accessed on 10 April 2019).
[201] 'Overview of Forensic Investigation' 4.2.1.
[202] 'Overview of Forensic Investigation' 4.2.
[203] 'Overview of Forensic Investigation' 4.2.1.
[204] 'Overview of Forensic Investigation' 4.2.1.
[205] 'Overview of Forensic Investigation' 4.2.1.
[206] 'Overview of Forensic Investigation' 4.2.2.
[207] 'Overview of Forensic Investigation' 4.2.2.
[208] 'Overview of Forensic Investigation' 4.2.

characterised by what was subsequently deemed to be insufficient or inaccurate disclosure of related party transactions.[209]

What distinguishes Steinhoff from Enron is the alleged fictitious nature of many transactions and the alleged overstated valuations of assets used to "pay" Steinhoff. Furthermore, several unrecoverable claims arising from Steinhoff's fictitious transactions were "reclassified" into other assets. The summarised report explains:

> '[O]ften through purportedly independent entities, the non-recoverable receivables were reclassified into different classes of assets, for example, cash equivalents, increases in the value of fixed properties, increases in the value of trademarks or increases in the value of acquired goodwill. These reclassifications created the impression that the non-recoverable receivable had been settled and resulted in other asset values being inflated.'[210]

If the allegations contained in the PWC Report are true, then the identified transactions at Steinhoff did not amount to true OBS financing. Steinhoff's irregular or fictitious transactions seem crude in comparison to Enron's SPV transactions. It is submitted that a major difference between Enron and Steinhoff is in the degree of alleged accounting fraud. The decision to use Enron's shares to financially support its SPVs was reckless, perhaps even grossly negligent, and was arguably influenced by conflicts of interest that should, in hindsight, have been avoided. However, at least Enron's shares *had* value.[211] In addition, it is important to note that many of Enron's SPV transactions were structured with the approval of independent auditors and legal counsel, and were disclosed to the market.[212] The Steinhoff transactions in no way could be referred to as 'exquisitely fine judgment calls' or 'shades of gray', as one commentator characterised the Enron transactions.[213]

The revelations in the Powers Report and the PWC Report are unsettling, to say the least, and indicate the ease with which creative accounting can fool the investing public over an extended period of time. This danger is exacerbated in the case of large

[209] Powers Report (2002) 17, 178 & 186.
[210] 'Overview of Forensic Investigation' 4.2.2.
[211] Schwarcz SL (2002) 1313.
[212] Schwarcz SL 'Structuring Commercial & Financial Transactions: Enron' (2002).
[213] Schwarcz SL (2002) 1313.

multinational companies with several subsidiaries and controlled entities across various jurisdictions; regulation and oversight naturally becomes more difficult in such a scenario.

It is clear that OBS financing techniques can raise capital and unlock opportunities in a way that traditional bank borrowing cannot. However, OBS finance can also be used as an earnings manipulation tool. Great care, disclosure, and scrutiny is needed to ensure that the investing public is not deceived and prejudiced by "creative accounting".[214]

4.9 THE AVAILABLE CORPORATE VEHICLES FOR THE SPECIAL PURPOSE

The needs of an SPV used for one purpose may differ quite substantially from those of one used for another purpose. Therefore, there can be no blanket suggestion as to the perfect type of company to act as an SPV. However, what *can* be done is to identify some important characteristics of the various types of South African corporations. It is hoped that this analysis will guide practitioners in choosing the appropriate corporate vehicle for the chosen venture.

As a starting point, it may serve to re-emphasise that a corporation is a separate legal entity.[215] A corporation may bear rights and duties in its own name, and has an existence distinct from its members.[216] The juristic personality of companies is confirmed in s 19(1)(*b*) of the Act. An equivalent rule is applicable to close corporations.[217] All corporations have perpetual existence.[218] The directors and shareholders of a company, and the members of a close corporation, will generally not be liable for the corporation's debts.[219]

A comparison between business forms requires an appreciation of their respective financial reporting obligations. A concept worth explaining at this juncture is the "public interest score" (PIS) of an entity. The basic principle with the PIS and its relationship

[214] Lamprecht I 'Fund Managers open up about the 'landmines' of 2018' (2019), available at https://www.moneyweb.co.za/investing/equities/fund-managers-open-up-about-the-landmines-of-2018/, accessed on 11 April 2019.
[215] Williams RC (2012) para 62.
[216] Cassim R 'The Legal Concept of a Company' (2012) 36 & 39; Williams RC (2011) 62.
[217] Section 2(2) of the Close Corporations Act.
[218] Section 19(1)(*a*) of the Act and s 2(2) of the Close Corporations Act.
[219] See s 19(2) of the Act and s 2(3) of the Close Corporations Act.

to financial reporting in South Africa is that larger entities that have a greater impact on the economy (i.e. those with a PIS above the stipulated thresholds) are subject to higher financial reporting standards, including the audit requirement.[220] Shev explains:

> 'Reporting standards differ for the various company categories. More rigorous standards are required for some companies, such as those in which there is a public interest. Consequently, most state-owned and listed public companies are required to prepare financial statements in accordance with IFRS, whereas many private companies are subject to less stringent standards, such as IFRS for SMEs.'[221]

For instance, when a private company has no 'public accountability' in terms of its PIS, it does not need to submit its financial statements for audit.[222] An audit is a financial reporting review that assesses a company's presentation of financial statements and provides an opinion as to whether these statements have been prepared according to the prescribed company law and accounting regulations.[223] The South African Institute of Chartered Accountants (SAICA) has applauded the Regulations pertaining to audit for removing a significant cost burden that smaller businesses were previously compelled to bear.[224]

Several factors determine the PIS of a company, including:

- the number of employees;
- the company's liabilities;
- the company's annual turnover;
- the number of securities holders in a company; and
- the number of members of a non-profit company (NPC).[225]

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[220] See s 30(2)(*b*)(i) of the Act.
[221] Shev & Jooste 'The Auditor, Financial Records and Reporting' (2012) 600.
[222] Kolitz DL (2015) 20.
[223] Kolitz DL (2015) 20 & 484. See also the definition of "audit" in s 1 of the Auditing Profession Act 26 of 2005.
[224] South African Institute of Chartered Accountants 'The revised Companies Act is good news for SMEs' (2012), available at https://www.saica.co.za/News/NewsArticlesandPressmediareleases/tabid/695/itemid/3443/language/en-ZA/Default.aspx?language=Default.aspx, accessed on 10 September 2018.
[225] Section 30(2)(*b*)(i) read with Regulation 26(2) to the Companies Act. See also Companies and Intellectual Property Commission (CIPC) 'How to calculate the Public Interest Score (PIS) of a company or close corporation', available at http://www.cipc.co.za/index.php/manage-your-business/compliance-and-recourse, accessed on 10 September 2019.

4.9.1 Companies

The Act makes a broad distinction between two categories of companies that may be incorporated in South Africa: profit companies and NPCs.[226] Profit companies are formed to achieve financial gain for the company's shareholders.[227] NPCs are formed to achieve a public benefit object.[228]

One common procedural requirement to take note of is that every company must complete and submit an annual return to the Companies and Intellectual Property Commission (CIPC).[229]

4.9.1.1 Non-profit companies

An NPC must utilise all its assets and income strictly for the achievement of its stated social benefit objective.[230] The Act defines "securities" as 'any shares, debentures or instruments…issued or authorised to be issued by a profit company.'[231] Therefore, NPCs can have no shareholders and cannot issue debt securities.

MF Cassim correctly points out that even though an NPC may not have a purely commercial purpose, the company is not prohibited from making a profit.[232] An NPC is allowed to conduct any business, trade or undertaking 'consistent with or ancillary to its stated objects'.[233] MF Cassim suggests that the words 'consistent with or ancillary to' implies that the relevant business or activity must be related to the stated non-profit objects of the NPC.[234] With respect, such an interpretation ignores the effect of the word 'or'. It is submitted that the phrase 'consistent with' is so broad that an NPC may conduct any lawful business that does not directly conflict with its objects. The result of Item 1(2)(*b*) of Sch 1 is that an NPC may conduct virtually any lawful activity,

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[226] Cassim MF 'Types of Companies' in Cassim FHI (ed.) et al *Contemporary Company Law* 2 ed (2012) 69.
[227] Section 8(1) read with the definition of "profit company" in s 1 of the Act.
[228] The definition of an NPC in s 1 is expanded by item 1(1) of Schedule 1 to the Act, which stipulates that the MOI of an NPC must state its object/s, which must be either a public benefit object, or an object related to 'one or more cultural or social activities, or communal or group interests…'.
[229] Section 33(1) of the Act. See CIPC 'Annual Returns', available at http://www.cipc.co.za/index.php/manage-your-business/manage-your-company/private-company/compliance-obligations/annual-returns/, accessed on 11 September 2018.
[230] Item (1)(2)(*a*) of Sch 1. See Cassim MF 'The Contours of Profit-Making Activities of Non-Profit Companies: An Analysis of the New South African Companies Act' (2012) 56(2) 243 254-5.
[231] Section 1 of the Act.
[232] Cassim MF (2012) 254.
[233] Item 1(2)(*b*) of Sch 1.
[234] Cassim MF 'Types of Companies' (2012) 87-8.

from trading in and holding financial or real assets to operating a tuck shop, provided that the commercial activity is not the stated main object of the company, nor directly in conflict with its public benefit object.[235] MF Cassim explains the reasonableness of allowing NPCs to make profit from regular business undertakings:

> 'As a matter of policy, by permitting non-profit companies to make profits from an ancillary business, trade or undertaking and to use those profits to promote their non-commercial purpose or object, the New Act ensures that non-profit companies are not exclusively reliant on external sources of funding, such as donations or some form of public funding (or in some cases membership payments), bearing in mind that such sources of funding are often irregular, unpredictable or even insufficient. This sort of flexibility enables non-profit companies to carry out their stated non-commercial objects more effectively, and to maintain their operations, facilities and staff.'[236]

An NPC does not have to be audited, unless it falls within the parameters of Regulation 28(1)(*b*), its PIS in a financial year is 350 or more, or if its PIS is at least 100 and its annual financial statements for that year had been internally complied.[237] The financial statements of an NPC that is required to have its annual financial statements audited must use IFRS, unless IFRS conflict with a standard set by the Public Finance Management Act,[238] in which case the latter set of standards should prevail.[239] NPCs that are not subject to audit, but whose PIS is between 100 and 350 for a particular financial year, and NPCs with a PIS for the financial year of less than 100 whose financial statements are independently compiled, may make use of IFRS or IFRS for SMEs (if applicable).[240] Although Regulation 27(4) stipulates that the South African Statements of Generally Accepted Accounting Practice (SA GAAP) may also be used, that set of standards has been withdrawn by the Financial Reporting Standards Council (FRSC) for financial years commencing on or after 1 December 2012.[241]

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[235] Cassim MF (2012) 254.
[236] Cassim MF (2012) 255.
[237] Regulation 28(c) to the Act.
[238] 1 of 1999.
[239] Regulation 27(4) to the Act.
[240] Regulation 27(4) to the Act.
[241] See 'Joint Announcement by the Accounting Practices Board (APB) and the Financial Reporting Standards Council (FRSC) Regarding SA GAAP', available at http://www.syncbs.co.za/wp-content/uploads/2012/03/Withdrawel-of-SA-Gaap.pdf, accessed on 10 September 2018. The FRSC was established by s 203(1) of the Act. See Shev & Jooste 'The Auditor, Financial Records and Reporting' (2012) 602. Effectively, IFRS has replaced SA GAAP and the FRSC has replaced the

NPCs that are not required to be audited may use IFRS or IFRS for SMEs (if applicable).[242] An NPC that is not required to be audited and whose PIS for the financial year is less than 100, and whose financial statements are internally compiled, may make use of any financial reporting standard, unless a particular standard is prescribed for that NPC.[243]

An NPC is prohibited from directly or indirectly distributing any of its income or assets to an incorporator, member, or director, or indeed to any person capable of appointing a director.[244] An NPC may, however, make the following distributions:

- reasonable payment for goods delivered or services rendered, or expenses incurred in advancing the NPC's objects;
- payment in respect of a due and payable contractual debt;
- payment to an incorporator, member or director, or person appointing a director, in respect of any rights of that person, to the extent that such rights are administered by the company to advance the company's objects (Presumably, what is being contemplated here is remuneration for employment); and
- payment in respect of any legal obligation binding upon the company.[245]

An NPC is required to have an objects clause, but it is prohibited from having an objective other than one of social upliftment or public benefit related to social or cultural activities, or communal or group interests.[246] This suggests that the restricted object of an NPC is not necessarily equivalent to a restriction on corporate capacity. The fact that the CIPC has indicated that the limited object of an NPC, on its own, should not be regarded as a restrictive condition,[247] would seem to support this view.

Accounting Practices Board. See SAICA 'The Accounting Practices Board' (2018), available at https://www.saica.co.za/Technical/FinancialReporting/APB/tabid/530/language/en-ZA/Default.aspx, accessed on 26 October 2019.

[242] Regulation 27(4).

[243] Regulation 27(4).

[244] Item 1(3) of Sch 1. See Cassim MF 'Types of Companies' (2012) 90.

[245] Item 1(3) of Sch 1.

[246] Item (1)(i)(*a*) of Sch 1.

[247] See Item 7 of Practice Note 4 of 2012 in terms of Section 188(2)(*b*) of the Companies Act, 2008, available at http://www.cipc.co.za/files/9613/9565/1718/PracticeNote4of2012.pdf, accessed on 29 September 2018.

MF Cassim suggests that the phrase 'communal or group interests' be interpreted as referring to transactions related to cultural or social activities, to the exclusion of purely commercial activities.[248] An NPC must at all times work for and towards its public benefit object. It is doubtful that financial engineering, isolation of commercial and insolvency risk, or ease of transferability of assets, can qualify as such an object. Therefore, it is doubtful whether the NPC structure is appropriate for the activities for which commercial SPVs are primarily established.

Another negative aspect is that NPCs cannot issue securities. As will be shown in the next chapter, the ability of an SPV to issue securities is essential to the operation of structured finance transactions.

4.9.1.2 Profit companies

The objective of a profit company is to generate financial gain for the company's shareholders. There are four types of profit companies: the public company, the state-owned company, the private company, and the personal liability company.[249]

4.9.1.2.1 Public companies

A public company is a profit company that may offer its securities to the public.[250] The most stringent safeguards and requirements are imposed on public companies precisely because they can raise capital from the general public.[251] Chapter 3 of the Act imposes certain accountability and transparency requirements on public companies.[252] Inter alia, a public company must appoint a company secretary,[253] an audit committee,[254] and an independent auditor.[255] The annual financial statements of a public company must be audited every year,[256] and it must convene annual general meetings of shareholders where several items of business must be completed, including presentation to the shareholders of the directors' report, audited financial statements for the preceding financial year, the audit committee's report, the

[248] Cassim MF 'Types of Companies' (2012) 87; Cassim MF (2012) 247.
[249] See s 8(2) of the Act.
[250] Cassim MF 'Types of Companies' (2012) 73 & 78.
[251] Cassim MF 'Types of Companies' (2012) 78.
[252] Section 34(1) read with s 84(1)(*a*) of the Act.
[253] Section 84(4)(*a*) of the Act.
[254] Section 84(4)(*c*) of the Act.
[255] Section 84(4)(*b*) of the Act. See also Cassim MF 'Types of Companies' (2012) 79.
[256] Section 30(2)(*a*) of the Act.

appointment of an auditor for the next financial year, appointment of an audit committee, and any other matters raised by the company's shareholders.[257]

As a matter of procedure, the name of the company must be followed by the expression "Limited", or its abbreviation "Ltd".[258] The company may be incorporated by a single individual but must appoint at least three directors, although, for practical purposes, more than three may be required.[259] Furthermore, a public company must attach a copy of its audited financial statements to the annual return submitted to the CIPC.[260]

From a financial reporting perspective, public companies whose securities are listed on an exchange must use IFRS.[261] Public companies without listed securities may use either IFRS or IFRS for SMEs (if applicable).[262]

A public company could be used as an SPV in most cases, and is especially appropriate if the incorporators desire to list the SPV's issued securities on an exchange. However, public companies that wish to offer their securities for subscription by the public must comply with Chapter Four of the Act and the rules regarding public offers stipulated therein.

4.9.1.2.2 State-owned companies

A state-owned company is a public company that is either listed as a public entity in terms of Schedule 2 or 3 of the Public Finance Management Act or is owned by a municipality.[263] The expression "SOC Ltd" must appear at the end of the name of a state-owned company.[264] Essentially, state-owned companies are profit companies that do business and are owned by the South African state. An example of such an entity is Transnet SOC Ltd, which operates railways, ports and pipelines in South Africa.[265]

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[257] Section 61(7) read with s 61(8) of the Act.
[258] Section 11(3)(*c*)(iii) of the Act.
[259] Cassim argues that the need to appoint an audit committee and a social and ethics committee means that more than three directors would need to be on the board of a public company. Cassim MF 'Types of Companies' (2012) 79.
[260] Section 33(1)(*a*) of the Act.
[261] Regulation 27(4).
[262] Regulation 27(4).
[263] According to the definition of "state-owned company" in s 1 of the Act.
[264] Section 11(3)(*c*)(iv) of the Act.
[265] See 'Transnet', available at https://en.wikipedia.org/wiki/Transnet, accessed on 11 September 2018.

Since a state-owned company is a separate legal person and can raise capital from the public, it can be a suitable entity to act as an SPV. However, although a state-owned company is a public company, and is subject to substantially the same rules, certain provisions in the Act that apply to public companies are not applicable to state-owned companies. For example, the governance matters regulated by ss 57(1)-(4) and 66(4) of the Act are not applicable to state-owned companies. Furthermore, the Minister of Trade and Industry may grant exemptions for state-owned companies in respect of provisions that would normally have applied to public companies.[266] For example, the enhanced accountability measures contemplated by s 34(1) of the Act *are* applicable to state-owned companies, unless the company has been exempted therefrom in terms of s 9(1).[267] Finally, the financial reporting of a state-owned company must comply with IFRS or the standards set by the Public Finance Management Act,[268] if the latter deviate from IFRS.[269]

4.9.1.2.3 Private companies

A private company may be a suitable entity to act as an SPV. A private company is a profit company that complies with the requirements of s 8(2) of the Act. In terms of s 8(2)(i), a private company shall be prohibited from offering its securities to the public, and must restrict the transferability of its securities. These two features can be regarded as the essential elements of a private company: the company is unable to make an offer of its securities to the public, and its MOI must impose some limitation to the way in which the company's securities are transferred by their holders.[270] A common way in which the transferability of securities in a private company is restricted is the shareholders' pre-emptive right.[271] In terms of s 39(2) and (3) of the Act, a private company is prevented from issuing new shares to the public without first offering subscription in the new shares to its existing shareholders; this restriction will apply automatically unless excluded by the MOI. If the MOI does exclude the statutory pre-emptive rights, it must impose some other limitation on transferability. A common

[266] See ss 9(1)-(3) of the Act.
[267] Section 84(1)(*b*) of the Act.
[268] Act 1 of 1999.
[269] Regulation 27(4).
[270] Cassim MF 'Types of Companies' (2012) 73.
[271] Jooste R 'Corporate Finance' in Cassim FHI et al (ed.) *Contemporary Company Law* 2 ed (2012) 352.

provision in this context is to make all transfers of securities subject to prior approval by the company's board.[272] The Act does not restrict the ways in which the transferability of securities can be limited. As long as the restriction is consistent with the Act and is not unlawful in any way, it should be acceptable.

A private company has been said to be the 'most common and simplest form of company to be registered.'[273] This type of company may be incorporated by at least one person,[274] and must have at least one director.[275] These individuals may be the same person,[276] allowing for a single person to establish and manage the company. Of course, that person would have to be a natural person, as a juristic person is ineligible to be a director of a company.[277] A further requirement is that the name of a private company must end in the expression "Proprietary Limited" or its abbreviation, "(Pty) Ltd".[278]

A private company, in its financial reporting, only needs to apply IFRS if its PIS equals or exceeds 350.[279] A private company is only required to have its annual financial statements audited for a particular financial year in two situations:

(1) where the company's primary business is the holding of assets in a fiduciary capacity for persons not related to the company, where the aggregate value of those assets exceed R5 million at any time during a financial year;[280] or
(2) if the company's PIS in that financial year is 350 or more, or at least 100 and its annual financial statements for that year had been internally compiled.[281]

A private company is not required to appoint a company secretary or audit committee, social and ethics committee, or an independent auditor, unless its PIS is above a

[272] Cassim MF 'Types of Companies' (2012) 75 and the cases cited therein at note 54.
[273] CIPC 'Register a Private Company with a Standard MOI', available at http://www.cipc.co.za/index.php/register-your-business/companies/register-private-company/, accessed on 11 September 2018.
[274] Section 13(1) of the Act. Since s 1 of the Act defines the word "person" as inclusive of a juristic person, a company or trust may act as an incorporator of a company in terms of the Act. See also CIPC 'Register a Private Company with a Standard MOI'.
[275] Sections 66(2) and (3) of the Act.
[276] See CIPC 'Register a Private Company with a Standard MOI'.
[277] Section 69(7)(*a*) of the Act.
[278] Section 11(3)(*c*)(ii) of the Act.
[279] Regulation 27(4).
[280] Regulation 28(2)(a) read with s 30(2)(*b*) and s 30(7) of the Act.
[281] Regulation 28(2)(c) read with s 30(2)(*b*) and s 30(7) of the Act. See also Cassim MF 'Types of Companies' (2012) 74.

certain level. The enhanced accountability and transparency standards set out in Chapter 3 of the Act apply to private companies that are required to have their annual financial statements audited, except the requirement to appoint a company secretary in terms of s 86(1) and an audit committee in terms of s 94(2). A private company is also not required to have an annual general meeting.[282]

A negative characteristic of a private company for SPV purposes is that it may not offer its securities to the public. If public offerings of securities are desired, a private company would not be as suitable as a public company to act as the SPV.

4.9.1.2.4 Personal liability companies

A personal liability company is a distinct type of private company.[283] These entities are somewhat comparable to an ordinary partnership in South African law. The similarity with an ordinary partnership lies in the fact that just as partners are jointly and severally liable for partnership debts, the past and present directors of a personal liability company are jointly and severally liable with the company for the debts contracted during their respective periods of office.[284] In *Fundstrust (Pty) Ltd (In Liquidation) v Van Deventer*,[285] the Appellate Division confirmed that the liability envisioned by the similarly-worded s 53(b) of the 1973 Act is contractual in nature; the rule should not apply to other types of liability. In casu, Hefer JA remarked:

> 'It is clear that Parliament intended to impose on them an entirely new statutory liability and to provide creditors with an entirely new remedy not hitherto available to them which would enable them to hold the directors liable *singuli et in solidum* for company debts and liabilities before the company's liquidation.'[286]

The company must meet the criteria of a private company, and its MOI must state that it is a personal liability company.[287] The name of the company must end with the expression "Incorporated" or its abbreviation "Inc."[288] A quirky feature of personal liability companies is the application of a statutory doctrine of constructive notice in

[282] Cassim MF 'Types of Companies' (2012) 79.
[283] Cassim MF 'Types of Companies' (2012) 81.
[284] Section 19(3) of the Act.
[285] 1997 (1) SA 710 (A) 715.
[286] *Fundstrust* 731G. See also *Spiro McLoughlin Inc v Spiro* 2004 (1) SA 90 (C) 97 and Cassim MF 'Types of Companies' (2012) 83.
[287] Section 8(2)(*c*) of the Act.
[288] Section 11(3)(*c*)(i) of the Act.

respect of the effect on the company of the joint and several liability of the past and present directors.[289]

The characteristics of personal liability companies suggest that they are not suitable for commercial, risk-taking ventures, nor for special financing projects. It may be difficult to convince a person to act as a director of a personal liability company that engages in risky commercial activities, or to assume joint and several liability for the debts of a securitisation SPV. Personal liability companies are probably most appropriate for use by professional associations such as firms of attorneys, auditors, and doctors.[290]

4.9.1.3 Close corporations

A close corporation (CC) is a distinct corporate vehicle regulated by its own Act. These entities were initially designed to fulfil the needs of smaller enterprises by removing the complexity and cost involved with operating a company formed under the 1973 Act.[291] The legal position brought about by the Act is that no new CCs may be incorporated, but existing ones will continue to be allowed to operate,[292] and may choose to convert to companies.[293]

A CC is a juristic person.[294] Section 2(4) of the Close Corporations Act[295] provides that a CC has 'the capacity and powers of a natural person of full capacity'. Unlike the comparable s 19(1)(*b*) of the Act, and notwithstanding the fact that the Founding Statement of a CC is required to state 'the principal business to be carried on by the corporation',[296] s 2(4) contains no provisos except the general one relating to acts that juristic persons are incapable of performing. Therefore, there does not seem to be a way to limit the contractual powers of a CC in a comparable manner to a restrictive condition in terms of the Act. However, authority restrictions or variations of the

[289] Section 19(5)(*b*) read with s 19(3) of the Act.
[290] Cassim MF 'Types of Companies' (2012) 82.
[291] Mongalo T (2003) 21.
[292] Item 3 of Schedule 5 to the Act. See also Delport P *New Entrepreneurial Law* (2014) 344.
[293] Item 1 of Schedule 2 of the Act. See Cassim FHI 'Introductions to the New Companies Act: General Overview of the Act' in Cassim FHI (ed.) et al *Contemporary Company Law* 2 ed (2012) 10.
[294] Section 2(2) of the Close Corporations Act.
[295] 69 of 1984.
[296] Section 12(*b*) of the Close Corporations Act.

consequences brought about by the capacity provisions could be inserted in a CC's Association Agreements.[297]

A CC cannot issue shares. Instead, the proprietary interest in a CC is divided into Members' Interests, which are expressed as a percentage.[298] The number of members is limited to ten.[299] Only natural persons, or a trustee of a trust, the beneficiaries of which are all natural persons, are allowed to be members of a CC.[300] A juristic person would be entitled to act as a member of a CC if it, nominee officii, represents as trustee, curator, or executor a member that had deceased, become insolvent, mentally ill or otherwise incompetent.[301]

Every CC must have a Founding Statement registered with the CIPC.[302] A CC may also enter into Association Agreements to regulate its internal management.[303] A CC must appoint an accounting officer.[304] In addition, the entity is required to compile accounting records and annual financial statements.[305] In terms of s 10(3) of the amended Close Corporations Act, the Act's regulations pertaining to financial reporting are made applicable to CCs.[306] Therefore, the rules regarding PIS and its relation to financial reporting and the audit requirement are as applicable to CCs as they are to private companies. A CC whose PIS is equal to or above the relevant thresholds, will be required to use IFRS or IFRS for SMEs, and a CC whose PIS is equal to or above the relevant thresholds, will be required to have its financial statements audited.

A CC can be a holding company, as it is a juristic person that may be able to control a subsidiary as contemplated by the Act.[307] Furthermore, it is worth noting that a CC may be a "related or inter-related person" for the purpose of the Act if a single person

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[297] See s 44(1) of the Close Corporations Act.
[298] Section 12(e) of the Close Corporations Act.
[299] Section 28 of the Close Corporations Act.
[300] Section 29(1) read with s 29(2)(*b*) of the Close Corporations Act.
[301] Section 29(2)(*c*) of the Close Corporations Act.
[302] Section 12 of the Close Corporations Act. This document must be signed by all of the members of the CC.
[303] Section 44(1) of the Close Corporations Act.
[304] Section 59(1) of the Close Corporations Act. The required qualifications for this individual is stipulated in s 60.
[305] Section 56(1) and s 58(1) of the Close Corporations Act, respectively.
[306] See SAICA 'Companies Act Regulations applicable to Close Corporations', available at https://www.saica.co.za/Portals/0/Technical/LegalAndGovernance/Companies%20Act/Summary%20of%20audit%20requirement%20in%20terms%20of%20Regulations%20for%20CCs%20v5.pdf, accessed on 14 October 2018.
[307] Definition of "juristic person" in s1 read with ss 2(2)(*a*) and 3(1)(*a*) of the Act.

controls the majority of the members' interest or members' votes in the CC,[308] or otherwise has the ability to materially influence the CC's policy in a manner comparable to a person who, in ordinary commercial practice, would be able to exercise one of those elements of control.[309] The Act stipulates certain rules and procedures for transactions involving related persons.[310]

A CC may be able to fulfil some of the general requirements of an SPV, notwithstanding the fact that it may not be a subsidiary.[311] Since a CC is a separate legal person, the members generally enjoy limited liability. A members' interest in a CC is comparable to a share in a company. However, a CC cannot issue securities to the public. Section 1 of the Act defines "securities" with reference to the Securities Services Act 36 of 2004, which has since been repealed by the Financial Markets Act 19 of 2012. The definition of "securities" in s 1 of the Financial Markets Act includes the phrases 'equities in public companies' and 'debentures, and bonds issued by public companies', indicating that a CC may not issue debt instruments to the public. Therefore, if the intention is to issue debt securities to the public, it would be better to incorporate the SPV as a public company.

4.10 CONCLUSION

Chapter Four investigated the use of corporate SPVs in a commercial setting, against the backdrop of South African corporation regulation.

A company is the most suitable type of business entity for SPV purposes, as risk isolation is more easily achievable in an environment where assets can be transferred to a completely separate entity. In theory, a private company or a close corporation can act as an SPV, but the most suitable type of company for all SPV activities is a public company, as the latter type of company can issue debt instruments and list them on an exchange, while the former two cannot.

South African law allows for an SPV to be created as a subsidiary company within a group of companies. The holding company-subsidiary relationship is an important aid

[308] Section 2(2)(*b*) of the Act.
[309] Section 2(2)(*d*) of the Act.
[310] Jooste R 'Groups of Companies and Related Persons' (2012) 208. See, for example, ss 45(2) and (3) of the Act.
[311] Only a "company", as defined by s 1 of the Act, can be a subsidiary in terms of s 3.

to the isolation of risk in diverse enterprises. As long as legal and practical separation is observed, the assets and liabilities of a subsidiary SPV are distinct from those of its holding company.

SPVs can be used for any lawful commercial purpose, including structured finance transactions that result in OBS financing.

Using SPVs in OBS techniques like securitisation of receivables makes it possible for an entity to avoid recording debt on its own statement of financial position, and instead to record the financed debt as income. There are several potential advantages of OBS financing, including cheaper access to finance, earnings management, financial indicator manipulation, and risk management. The holding company-subsidiary relationship allows for the use of subsidiary SPVs to isolate risk and achieve OBS treatment. However, it is important to note that an SPV need not be a subsidiary of the sponsor for OBS purposes.

OBS financing techniques can raise capital and unlock opportunities in a way that traditional bank borrowing cannot. However, OBS finance can also be used as an earnings manipulation tool. Since OBS transactions are often complex, great care, disclosure, and scrutiny is needed to ensure that the investing public is not deceived and prejudiced by "creative accounting".[312]

The success of an OBS arrangement will be influenced by the insolvency-remoteness of the SPV or SPVs used. "Insolvency-remoteness" is a desirable characteristic for any SPV, subsidiary, or controlled entity. South African law does not allow for companies to be completely protected from liquidation proceedings. At best, the risk of an SPV's liquidation can be reduced through appropriate contractual provisions and other techniques.

Ideally, subsidiary SPVs should be independent from the holding company and it should be unlikely for an SPV to be able to be influenced by claims or insolvency proceedings against its parent. In addition, appropriate contractual provisions should

[312] See Lamprecht I 'Fund Managers open up about the 'landmines' of 2018' (2019), available at https://www.moneyweb.co.za/investing/equities/fund-managers-open-up-about-the-landmines-of-2018/, accessed on 11 April 2019.

be concluded that reduce the risk of the SPV itself acquiring unexpected liabilities that may result in liquidation proceedings.

Chapter Five will analyse the effect of the capacity provisions in the Act in the context of the insolvency-remoteness of SPVs used in traditional securitisation schemes.

CHAPTER FIVE: THE IMPACT OF THE CAPACITY PROVISIONS IN THE COMPANIES ACT 71 OF 2008 ON THE INSOLVENCY-REMOTENESS OF SPECIAL PURPOSE VEHICLES USED IN TRADITIONAL SECURITISATION SCHEMES

5.1 INTRODUCTION

The thesis investigates whether the capacity provisions in the Companies Act 71 of 2008 (the Act) create a suitable framework to facilitate the activities of special purpose vehicles (SPVs) used in traditional securitisation schemes (TSSs).

Chapter Four discussed SPVs in general, their benefits, the uses to which they can be put, and the South African regulatory framework in respect of incorporated SPVs. This was done because the financial engineering technique of traditional securitisation makes use of SPVs to facilitate the necessary transactions.

This chapter will respond to research sub-question 4 that questioned whether the capacity provisions in the Act promote and protect the characteristic of insolvency-remoteness on the part of an SPV used in a TSS.[1]

Chapter Five will first define the concepts of corporate finance, structured finance, and securitisation. Thereafter, the role of SPVs in a TSS and the techniques used to ensure that the entity is insolvency-remote will be discussed. The chapter will distinguish between traditional securitisation, the focus of this thesis, and synthetic securitisation, a similar but fundamentally different financing arrangement. Thereafter, the chapter will discuss the legal guidelines applicable to TSS SPVs in South Africa, and briefly discuss the development of the securitisation market in South Africa. The chapter will then analyse the effect of the Act on the insolvency-remoteness of TSS SPVs.

Finally, to provide some practical context to the discussion, the chapter will analyse the operation and MOI of an established TSS SPV as a case study. The selected SPV will be evaluated because of the company's adoption of the RF provisions in the Act and its involvement in a TSS. This analysis will contribute to determining whether the capacity provisions in the Act are commercially desirable for TSS SPVs.

[1] See 1.4 above.

5.2 SECURITISATION

A discussion of securitisation will benefit from contextualisation through an evaluation of the concepts of corporate finance and structured finance.

5.2.1 Corporate finance

The term "corporate finance" is not capable of precise definition, because it is used in several ways.[2] Corporate finance has been described as referring to the legal principles that relate to the provision, facilitation, and regulation of the means to raise capital through a company.[3] In essence, what is being referred to is capital financing of a company, the two broad classifications thereof being equity financing and debt financing.[4] However, the term corporate finance has also been used to refer to *any* financial activity related to the operation of a business.[5] If the term corporate finance is used during the course of this thesis, the reader should interpret it narrowly so as to refer to the raising of capital by a company.

The Preamble to the Act makes mention of "the capitalisation of companies", and s 7 of the Act identifies as being among its purposes the need to 'create optimum conditions for the aggregation of capital for productive purposes, and for the investment of that capital in enterprises and the spreading of economic risk' and the creation of an environment in which companies are used to benefit the economic welfare of South Africa.[6] It is submitted that both debt and equity financing, as forms of corporate finance, can be used to give effect to these purposes of the Act.

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[2] Viviers and Alsemgeest regard corporate finance as one field of finance and and identify the financial function as an aspect of corporate finance. Viviers S & Alsemgeest L 'Introduction to Financial Management' in Els G (ed.) et al *Corporate Finance: a South African Perspective* 2 ed (2014) 2.

[3] Ferran E *Company Law and Corporate Finance* (1999) 1; Burgess R *Corporate Finance Law* (1985) 1; Mongalo T *Corporate Law and Corporate Governance* (2003) iii.

[4] Jooste R & Yeats J 'Shares, Securities and Transfer' in Cassim FHI (ed.) *Contemporary Company Law* 2 ed (2012) 213; Thomas K 'Sources of Finance and Capital Structure' in Els (ed.) et al *Corporate Finance: A South African Perspective* 2 ed (2014) 366-87; Firer C et al *Fundamentals of Corporate Finance: South Africa* 5 ed (2012) 464; Davies PL and Worthington S *Gower's Principles of Modern Company Law* 10 ed (2016) 1069-70; Lubbe I, Moddack G, & Watson A *Financial Accounting: GAAP Principles* 3 ed (2011) 380; Kolitz DL *A Concepts-Based Introduction to Financial Accounting* 5 ed (2015) 428.

[5] Spence RA 'Corporate Finance and the Role of Lawyers' (2017) 3(2) *Edinburg Student LR* 102 102, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3120345, accessed on 11 April 2018.

[6] Sections 7(*g*) and (*e*) of the Act.

5.2.2 Structured finance

The raising of funds for a company's operations may involve a range of highly complicated transactions, collectively known as 'structured finance'.[7] Structured finance is a form of corporate finance. The terms "structured finance" and "securitisation" are often used interchangeably.[8] However, it is probably better to regard securitisation as a form of structured finance.[9] This understanding would include project finance as a form of structured finance.[10]

Structured financing transactions often involve the issuing of debt instruments by an SPV created by the originator. The holders of the debt instruments issued by a company are creditors of that company.[11]

There are several benefits to raising capital by way of structured finance instead of traditional methods.[12] These benefits accrue because these financing arrangements are "structured" in such a way that the investors (who are effectively making a loan to the originating company) can rely on the credit quality of the specific assets securing the receivables, instead of having to focus on and be guided by the financial stability of the originating company.[13]

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[7] Chen J 'What is Structured Finance' (2018), available at www.investopedia.com/terms/s/structuredfinance.asp (accessed on 9 January 2017); Locke N 'The Legal Nature of the Trust for Debenture-Holders in South African Law: An Efficacy-Based Approach (2013) 130 *South African LJ* 621 622 note 7; Schwarcz SL 'The Use and Abuse of Special-Purpose Entities in Public Finance' (2012) 97 *Minnesota LR* 369 371 note 9; Bjerre CS 'Project Finance, Securitization and Consensuality' (2002) 12 *Duke Journal of Comparative and International Law* 411 411.

[8] Schwarcz SL 'Securitization and Structured Finance' (2011) *Elsevier's Encyclopedia of Financial Globalization* 1, available at http://masonlec.org/site/rte_uploads/files/SCHWARCZ_Encyclopedia-of-Financial-Globalization-Elsevier.pdf, accessed on 6 April 2018; Yeoh P 'Structured Finance: A Matter of Gatekeeping' (2010) 4 *Law and Financial Market Review* 499 499; Glover SI 'Structured Finance Goes Chapter 11: Asset Securitization by Reorganizing Companies' (1991) 47 *The Business Lawyer* 611 611.

[9] Schwarcz SL 'Securitization and Structured Finance' (2011) 1. See also Locke N *Aspects of traditional securitisation in South African law*, (unpublished LLD thesis, UNISA, 2008) 89-91.

[10] See Schwarcz SL 'Securitization and Structured Finance' 1.

[11] Jooste & Yeats 'Shares, Securities and Transfer' (2012) 232; Cillers HS et al *Cilliers and Benade Corporate Law* 3 ed (2000) 237; Lombard S & Renke S 'The Impact of the National Credit Act on Specific Company Transactions' (2009) 21 *SAMLJ* 486 505.

[12] Schwarcz SL 'The Parts are Greater than the Whole: How Securitization of Divisible Interests can Revolutionize Structured Finance and Open the Capital Markets to Middle-Market Companies' (1993) *Columbia Business LR* 139 140.

[13] Schwarcz SL (1994) 140-1.

5.2.3 Traditional securitisation schemes

The regulatory instrument of securitisation schemes in South Africa takes the form of a Schedule to the Banks Act 94 of 1990 (hereafter "Securitisation Notice").[14] The Securitisation Notice defines a "traditional securitisation scheme" as follows:

'[A] scheme whereby a special-purpose institution-

(a) issues commercial paper to investors; and

(b) uses the proceeds of such issue primarily to obtain or invest in assets; and

(c) makes payments primarily-

(i) in respect of the commercial paper so issued; or

(ii) to an institution acting in a secondary role,

which payments are made from-

(A) the cash flows arising or proceeds derived from the assets transferred to such a special-purpose institution by an originator or a repackager;

(B) the cash flows arising or proceeds derived from assets in which the special-purpose institution invested; or

(C) facilities granted to the special-purpose institution by an institution in accordance with the provisions of this Schedule'.[15]

Asset securitisation is a complex financing technique that involves a range of parties, at least one of which is an SPV. At its core, securitisation is the process of issuing a debt instrument that is linked to, and derives its value and performance from, an income-producing asset.[16] The technique of traditional asset securitisation emerged in the United States of America (USA) in the 1970s with the introduction of the first residential mortgage-backed securities (RMBS) programmes.[17] It has been observed

[14] Schedule to the Banks Act 94 of 1990: Designation of an activity not falling within the meaning of "The Business of a Bank" (Securitisation scheme) *GG* 30628 of 1 January 2008 (hereafter "Securitisation Notice").

[15] Paragraph 1 of the Securitisation Notice.

[16] See the definition of "traditional securitisation schemes" in para 1 of the Securitisation Notice, and *Sanlam Capital Markets (Pty) Ltd v Mettle Manco (Pty) Ltd and Others* 2014] 3 All SA 454 (GJ) para 3. See also Cohn MJ 'Asset Securitization: How Remote is Bankruptcy Remote?' (1998) 26 *Hofstra LR* 929 929; Schwarcz SL 'What is Securitization? And for What Purpose?' (2012) 85 *Southern California LR* 1283 1298; and Lipson JC 'Re: Defining Securitization' (2012) 85 *Southern California LR* 1231 1233.

[17] Saayman A & Styger P 'Securitisation in South Africa: Historic Deficiencies and Future Outlook' (2003) 6(4) *South African Journal of Economic and Management Sciences* 744 744-6; Petersen CL 'Predatory Structured Finance' (2007) 28 *Cardozo LR* 2185 2191-2206; Committee on Bankruptcy and

that the traditional securitisation structures in South Africa replicate those in the USA and United Kingdom (UK).[18]

The raising of capital to fund operations is an important component of managing a business. It may be that a firm requires or desires an alternative means of financing to traditional methods. It may be that a firm wishes to alter its balance sheet to stabilise debt levels and/or comply with capital adequacy requirements. Securitisation may be the answer. By making use of securitisation, a firm can use its receivables to obtain financing directly from the capital markets.[19] The technique of securitisation enables a firm to insulate a particular pool of assets from other assets owned by it.[20] This allows a firm to separate itself from the risk attached to certain assets.[21] Therefore, securitisation can be used as a risk management tool.[22]

In a TSS, a similar group of income-producing assets is pooled by an originator.[23] The originator then sells the assets to an SPV. The SPV will issue debt instruments to finance the purchase of the assets. If a "true sale" is achieved and the parties comply with accounting rules, the assets will be removed from the originator's balance sheet.[24] Thereafter, the income received from the transferred assets provide the cash flow to fulfil the obligations under the issued debt instruments, the SPV using those income streams to repay the investors.[25]

The issued securities will be called mortgage-backed securities (MBSs) in the case of mortgaged property loans, or asset-backed securities (ABSs) in the case of, for

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Corporate Reorganisation of The Association of the Bar of the City of New York 'Structured Financing Techniques' (1995) 50 *The Business Lawyer* 527 537-40.

[18] Locke N 'Die oordrag van saaklike sekerheidsregte aan die spesiale doelwitmaatskappy tydens tradisionele sekuritisasie' (2010) *SALJ* 450 451.

[19] Schwarcz SL *Structured Finance: A Guide to the Principles of Asset Securitization* 3 ed (2002) 2.

[20] Cohn MJ (1998) 931.

[21] See 4.8 above and 5.2.4 herein.

[22] See 5.2.4 herein for a discussion of the concept of risk management.

[23] The originator is the entity? that initially held the assets and executes the securitisation. See Saayman & Styger (2003) 747.

[24] See 4.8 above. The Securitisation Notice identifies the removal of assets from the institution's balance sheet as a key component of what constitutes an "originator". See definition of "originator" in para 1 of the Securitisation Notice.

[25] Schwarcz SL 'The Alchemy of Asset Securitization' (1994) 1 *Stanford Journal of Law, Business & Finance* 133 136; Locke N 'Die oordrag van saaklike sekerheidsregte aan die spesiale doelwitmaatskappy tydens tradisionele sekuritisasie' (2010) *Journal of South African Law* 450 450. The Securitisation Notice recognises that TSSs usually involve a transfer of assets to an SPV 'that issues commercial paper that are claims against the said assets transferred…'. Paragraph 4(1)(a)(i) of the Securitisation Notice.

example, securitised credit card receivables, rental income, motor vehicle loan instalments, and trade receivables.[26] Depending on the type of property loans pooled and securitised, the resulting MBSs may further be subdivided into RMBSs, i.e. securities backed by income deriving from residential property loans (home loans), and commercial MBSs (CMBSs), i.e securities backed by income deriving from commercial property loans.[27] The term "asset-backed securitisation" is sometimes also used broadly to refer to all securitisations.[28]

The pool of income-producing assets will usually be personal rights arising from credit agreements.[29] However, the type of claims that can be securitised seem to be limited only by the imagination of those structuring these agreements, and by the applicable regulatory environment. For instance, the practice of future cash flows securitisation is well-established in the USA and the UK.[30] The 1990s saw the emergence of football clubs securitisation in the UK, whereby the future claims for stadium gate receipts and hospitality packages would be transformed into bonds, with the goal either of funding future stadium or infrastructure upgrades, or refinancing existing debt for completed stadium upgrades.[31] "Whole business securitisations", whereby a firm's entire business, including all its assets, is securitised, have also been executed.[32] The securitisation of artist David Bowie's future income for album sales and royalty payments still seems to be the most remarkable.[33]

In order for traditional securitisation to be legitimate and effective, the transfer of the assets from the originator to the SPV must amount to a "true sale".[34] This means that the assets must have been completely and permanently removed from the estate of

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[26] Scott S 'An Introduction to the Securitisation of Claims Incorporating a Collective Security Arrangement' (2006) 18 *SAMLJ* 397 403-4.
[27] Karoly V *A Case Study of South African Commercial Mortgage Backed Securitisation* (unpublished MCom thesis, University of South Africa, 2006) 10.
[28] Cohn MJ (1998) 929.
[29] A "credit agreement" is defined in s 8 of the National Credit Act 34 of 2005.
[30] Raines M & Wong G 'Aspects of Securitization of Future Cash Flows under English and New York Law' (2002) 12 *Duke Journal of Comparative & International Law* 453 453-64.
[31] Newcastle United, Tottenham Hotspur, and Leeds United, are among the larger football clubs that have made use of securitisation to obtain finance. See Burns T 'Structured Finance and Football Clubs: an Interim Assessment of the use of Securitisation' (2006) 4 *Entertainment and Sports LJ* 1 3-6 & 9-10.
[32] Hill CA 'Whole Business Securitization in Emerging Markets' (2002) 12 *Duke Journal of Comparative & International Law* 521 521; Burns T (2006) 4-5.
[33] See Chen J 'Bowie Bonds' (2018), available at https://www.investopedia.com/terms/b/bowie-bond.asp (accessed on 27 November 2018).
[34] Schwarcz SL 'Alchemy' (1994) 135.

the originator.[35] This is especially important for banks and their capital adequacy requirements.[36] Banks are allowed to exclude securitised assets from the calculation of their required capital and reserve funds only if the assets have been transferred via a true sale.[37]

Despite the true sale requirement, the originator of a TSS will be allowed to act in a secondary role as servicer on the SPVs behalf, or by providing credit enhancement, underwriting or liquidity facilities to the SPV, or underwriting or servicing functions within the TSS.[38] It has been noted that the originator often continues to administer the claims on behalf of the SPV, either directly as the SPV's agent in terms of a master servicing agreement, or representing a manager appointed by the SPV.[39] Paragraph 9 of the Securitisation Notice sets regulations for an originator's servicing of securitised claims in a South African TSS.

The assets transferred in a securitisation scheme can be secured by way of various real and personal security rights, including mortgages, pledges, security cessions, and suretyships.[40] The issuer SPV may transfer these security rights to serve as collateral for the repayment of the debt owed to the securities-holders.[41] In other words, the debt owed by the SPV to the investors can be secured by the security rights attached to the securitised receivables. It has been observed that the investors' claims against a TSS SPV are usually secured by a cession or a delegation of the transferred security rights by the SPV in favour of the investors.[42] To provide further protection to investors, a separate intermediary vehicle may also be created to hold the security and guarantee the obligations of the issuer SPV; this entity is known as the "security SPV".[43]

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[35] Locke N (2010) 452; Locke N 'The role of rating agencies in the course of a securitisation scheme' (2008) 41 *De Jure* 545 548.
[36] On a bank's capital adequacy requirements, see Nickolas S 'What Is the Minimum Capital Adequacy Ratio Under Basel III?' (2019), available at https://www.investopedia.com/ask/answers/062515/what-minimum-capital-adequacy-ratio-must-be-attained-under-basel-iii.asp, accessed on 4 November 2019.
[37] Paragraph 4(1)(c) of the Securitisation Notice.
[38] Paragraph 4(2)(a) of the Securitisation Notice. See also para 1 definition of "secondary role".
[39] Locke N (2008) 57-8. Firer et al provide as examples, the securitisation and continued administration of store card receivables by Edcon Ltd and the securitisation schemes used by Avis in respect of car rental receivables. Firer C et al (2012) 196.
[40] Scott S (2006) 404.
[41] Scott S (2006) 404.
[42] Locke N (2010) 453-5.
[43] Locke N (2008) 62-3; Locke N (2013) 623; Scott S (2006) 405.

The securities issued by the SPV, as well as the overall structure of a TSS, receive ratings by credit ratings agencies.[44] In terms of para 1 of the Securitisation Notice, a "credit rating" is 'a rating assigned by an eligible institution to commercial paper issued in respect of a traditional or synthetic securitisation scheme'. In South Africa, credit rating services are regulated by the Credit Rating Services Act.[45] This Act defines a "credit rating" as 'an opinion regarding the creditworthiness of an entity; a security or a financial instrument; or an issuer of a security or a financial instrument, using an established and defined ranking system of rating categories'.[46] Credit ratings are assigned at inception and during the existence of the securitisation scheme.[47] The overall efficacy of a securitisation scheme is largely dependent on the rating that can be obtained from one of the established ratings agencies.[48]

The risk of the SPV's insolvency is an important consideration for ratings agencies. It has been observed that the legal framework and techniques employed to securitise the assets and insulate the SPV against insolvency play an important role in a credit rating agency's determination of a rating of securities created through securitisation.[49] Insolvency-remoteness of the SPV in a securitisation scheme is valued because of the goals and risks of such transactions. Securitisation SPVs are structured to be insolvency-remote because insolvency is an undesirable event for the holders of the securities issued by the SPV.[50] Therefore, ratings agencies place emphasis on the insolvency-remoteness of the SPV as a critical component of a suitable regulatory framework for securitisations.[51]

A credit rating is an assessment of an entity's ability to repay debt.[52] An entity's creditworthiness can affect the rate of interest charged on loans. A favourable rating

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[44] Locke N 'Rating Agencies' (2008) 546; Locke N (2008) 30.
[45] 24 of 2012. See s 3(1) of the Credit Rating Services Act.
[46] Section 1 of the Credit Rating Services Act.
[47] Locke N (2008) 30.
[48] Scott S (2006) 405.
[49] Scott S (2006) 405.
[50] Cohn MJ (1998) 933; Scott S (2006) 405. Liquidation proceedings may interrupt the payment streams due to the investors.
[51] See Fitch Ratings 'Criteria for Special-Purpose Vehicles in Structured Finance Transactions' (2012), available at https://www.fitchratings.com/site/500, at 6. See also Reuters 'Fitch updates structured finance special-purpose vehicles criteria; no rating impact', available at https://www.reuters.com/article/idUSWLB049520120530, accessed on 22 November 2019.
[52] Terblanché JR *The Legal Risks Associated with Trading in Derivatives in a Merchant Bank* (unpublished LLM thesis, Stellenbosch University, 2006) 64.

may enable the SPV to issue the debt instruments at a more favourable interest rate than the originator itself would have been able to achieve.[53] Since the risk related to the characteristics of the securitised assets is separated from the creditworthiness of the originator, interest repayments will be based on the credit rating assigned to the securitised assets, which may be substantially more favourable than the interest rate the institution would have obtained had it acquired finance against its own credit rating.[54] Cohn goes as far as arguing that that 'the underlying force which drives the securitization process is the desire of the originator to obtain access to low-cost capital…'.[55]

However, the outcomes and goals of securitisation are broader than mere cost saving.[56] An institution may wish to execute a TSS for a variety of reasons, as the practice has several advantages.[57] Accounting benefits can be derived from securitisation, primarily those linked to the removal of the assets from the originator's statement of financial position.[58] Securitisation can also assist with risk management.[59]

When credit providers securitise their receivables they achieve what is called "disintermediation". Disintermediation refers to the removal of intermediaries from a supply chain or transaction.[60] Disintermediation takes place when credit providers remove themselves from the traditional lending role by not directly making loans to the public, but instead facilitating lending between borrowers and investors by acting as

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[53] Cohn MJ (1998) 933-4; Schwarcz SL 'Alchemy' (1994) 136.
[54] Itzikowitz & Malan 'Asset Securitisation in South Africa' (1996) 8 *SAMLJ* 175 186; Locke N 'Rating Agencies' (2008) 548; Competition Commission South Africa 'The application of merger provisions of the Competition Act 89 of 1998, as amended, to asset securitisation schemes' 4.1, available at http://www.compcom.co.za/wp-content/uploads/2014/09/Practitioner-Update-Asset-Securitisation-Schemes.doc, accessed on 20 November 2018.
[55] Cohn MJ (1998) 933. See also Zuckerman AM 'Securitization Reform: A Coasean Cost Analysis' (2011) 1 *Harvard Business LR* 303 306-7.
[56] White W *The role of securitisation and credit default swaps in the credit crisis: A South African perspective* (unpublished MCom thesis, North West University, 2011) 8 & 15.
[57] Schwarcz SL 'Alchemy' (1994) 133 & 136-7; Itzikowitz & Malan (1996) 185-6; Scott S (2006) 398; Locke N (2008) 30-36.
[58] Competition Commission 'Asset Securitisation' 4.2. See also Gosrani N & Gray A 'Creating an Understanding of Special Purpose Vehicles' 6-7, available at https://www.pwc.com/gx/en/banking-capital-markets/publications/assets/pdf/next-chapter-creating-understanding-of-spvs.pdf, accessed on 4 February 2019.
[59] Schwarcz SL (2002) 2. For a discussion of risk management, see 5.2.4 below.
[60] See Kenton W 'Disintermediation' (2019), available at https://www.investopedia.com/terms/d/disintermediation.asp, accessed on 22 November 2019.

brokers and underwriters.[61] This disintermediation allows entities to acquire funding directly from the investing public, instead of through traditional loans or equity issuances. For banks, disintermediation can contribute significantly to the isolation and mitigation of risk.[62]

Investor protection is an indirect benefit: since securitisation separates asset default risk from originator default risk, investors in ABSs and MBSs are not exposed to as much risk, in comparison to equity issuances.[63]

From the originator's perspective, securitisation transforms claims (illiquid assets) into cash flow (liquid assets). It is this transformation that has caused securitisation to be described as "alchemy" — implying some mystical process of transformation.[64] Through a TSS, a company's receivables are transformed into cash that can be used for the company's operations.[65] Therefore, securitisation of loans enhances liquidity that enables the provisions of more credit.[66] Securitisation of home loans can, for instance, result in a considerable expansion in the size of the market.

5.2.4 Traditional securitisation distinguished from synthetic securitisation

A basic understanding of both traditional securitisation and credit derivative instruments is necessary for one to appreciate the technique of synthetic securitisation. Traditional securitisation was described above.[67]

Section 1 of the Financial Markets Act[68] defines a "derivative instrument" as 'any—

(a) financial instrument; or

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[61] Itzikowitz & Malan (1996) 176. See also Locke N (2008) 261, Klee KN & Butler BC 'Asset-backed Securitization, Special Purpose Vehicles and Other Securitization Issues' (2002) 35 *U.C.C. LJ* 1 1, and Schwarcz SL 'Intermediary Risk in a Global Economy' (2001) 50 *Duke LJ* 1541 1544.
[62] Itzikowitz & Malan (1996) 176; Boshoff & Krisch 'Structured Finance and securitisation in South Africa: overview' (2017), available at https://uk.practicallaw.thomsonreuters.com/4-521-4150?transitionType=Default&contextData=(sc.Default)&firstPage=true&comp=pluk&bhcp=1, accessed on 19 November 2018.
[63] Schwarcz SL 'Alchemy' (1994) 134 & 136.
[64] Schwarcz SL 'Alchemy' (1994) 134. See also Locke N (2008) 548.
[65] Firer C et al (2012) 196; SA Home Loans 'Securitisation as a Funding Tool' available at https://www.sahomeloans.com/content/uploads/2016/11/Securitisation-A-Funding-Tool.pdf, accessed on 19 November 2018; Itzikowitz & Malan (1996) 185.
[66] Partnoy F & Skeel DA 'The Promise and Perils of Credit Derivatives' (2007) 75 *University of Cincinnati LR* 1019 1025.
[67] At 5.2.3 .
[68] 19 of 2012.

(b) contract,

that creates rights and obligations and whose value depends on or is derived from the value of one or more underlying asset, rate or index, on a measure of economic value or on a default event.'

The use of derivative instruments is commonplace in commerce. The reasons why they exist and are traded has much to do with a concept known as "risk". The word "risk" generally refers either to the chance of bad things happening or to something that creates a situation where bad things could occur.[69] In business, the word "risk" has developed a narrower meaning to refer to something that is identifiable, quantifiable, and tradeable:

> 'Risk is no longer an obscure concept. There is widespread agreement by economists that the risk of financial transactions can be measured…using computer-aided quantitative techniques.'[70]

Instead of completely avoiding risk, business entities carefully manage how much and what type of risk they are exposed to; this is known as risk management.[71] The use of derivatives is a valuable risk management technique.[72] Derivatives are financial instruments, like shares and bonds.[73]

Derivatives allow for the transfer of risk from a party not willing to bear it to a party that is prepared to do so (for a price).[74] Derivative instruments can be used for hedging,[75]

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[69] See definition of 'risk' at https://www.merriam-webster.com/dictionary/risk, accessed on 2 August 2019. See also Miller RT 'Oversight Liability for Risk-Management Failures at Financial Firms' (2010) 84 *Southern California Law Review* 47 121-2, who remarks that the general concept of risk, among politicians and lawyers alike, has predominantly negative connotations, while risk in financial theory does not.

[70] Karol BJ 'An Overview of Derivatives as Risk Management Tools' (1995) 1 *Stanford Journal of Law, Business & Finance* 195 196.

[71] According to Terblanché, '[t]he objective of risk management is to minimise losses and to ensure that the appropriate level of risk is accepted in order to maximise profits.' Terblanché JR (2006) 48.

[72] Karol BJ (1995) 196.

[73] 'A financial instrument is a contract involving some form of a financial obligation.' Latysheva DS 'Taming the Hydra of Derivatives Regulation: Examining New Regulatory Approaches to OTC Derivatives om the United States and Europe' (2012) 20 *Cardozo Journal of International & Comparative Law* 465 471. See also Oguttu AW 'Challenges in Taxing Derivative Financial Instruments: International Views and South Africa's Approach' (2012) 24 *SA Merc LJ* 385 385.

[74] Karol BJ (1995) 196; Tijoe L 'Credit Derivatives: Regulatory Challenges in an Exploding Industry (2007) 26 *Annual Review of Banking & Financial Law* 387 389.

[75] A person can protect and insure a position in a particular market by offsetting some or all of the risk attached to that position through entering into a derivative transaction. Karol BJ (1995) 197.

speculation,[76] or arbitrage.[77] Derivatives are traded on organised exchanges and over the counter (OTC).[78] The derivatives market is dominated by a select number of large investment banks as "risk dealers".[79] Other participants are companies and mutual funds, including hedge funds and pension funds.[80] Individuals can also trade in financial derivatives.[81] However, most OTC derivative trading is conducted between sophisticated institutional investors.[82]

Options and forwards are the two most basic forms of derivatives and 'are the building blocks for nearly all other derivatives'.[83] In terms of an option contract, the option holder (the buyer of the option) buys from the option writer (the seller of the option) a right to buy (call) or sell (put) an asset at an agreed price at or before an agreed time.[84] In terms of a forward contract, one party agrees to buy an asset from another who agrees to sell it at an agreed price with "delivery" postponed to a future date.[85] Both options and forwards may be used to achieve similar goals.[86] Derivatives can also be classified according to the underlying asset, e.g. "interest rate derivatives", "currency derivatives", "equity derivatives",[87] "commodity derivatives", and "credit derivatives".[88]

The use of derivatives may expose a firm to numerous risks, including market risk (risk of adverse price movements of the underlying assets),[89] counterparty credit risk, and

[76] "Speculation" in this context refers to the voluntary assumption of risk with the goal of benefitting from price movements. Karol BJ (1995) 197; Swantek MA 'A Brave New World: Credit Default Swaps and Voluntary Debt Exchanges' (2012) 45 *The John Marshall LR* 1277 1237; Partnoy & Skeel (2007) 1022.
[77] "Arbitrage" refers to the practice of taking advantage of differences in pricing between similar instruments in different markets and jurisdictions. Oguttu AW (2012) 389; Partnoy F 'Financial Derivatives and the Costs of Regulatory Arbitrage' (1997) 22 *Journal of Corporate Law* 211 226.
[78] Latysheva DS (2012) 472.
[79] Partnoy & Skeel (2007) 1025; Cohen SS 'The Challenge of Derivatives' (1995) 63 *Fordham LR* 1993 2003.
[80] Tijoe L (2007) 394; Cohen SS (1995) 2003.
[81] Of course, an individual would need to instruct a broker to do this. For example, see Standard Bank OST 'Products', available at https://securities.standardbank.co.za/ost/, accessed on 28 September 2019.
[82] Latysheva DS (2012) 478.
[83] Partnoy F (1997) 216.
[84] Karol BJ (1995) 195.
[85] Karol BJ (1995) 196; Dolan K & DuPuy C 'Equity Derivatives: Principles and Practice' (1995) 15(2) *Virginia Tax Review* 161 174. The word delivery is placed in inverted commas because derivatives may either be cash-settled or physically-settled. See Feder NM 'Deconstructing Over-The-Counter Derivatives' (2002) *Columbia Business LR* 677 682.
[86] Karol BJ (1995) 196.
[87] See Dolan & DuPuy (1995) 163.
[88] Karol BJ (1995) 200.
[89] Karol BJ (1995) 204.

legal risk.[90] It has often been argued that the use of derivatives by financial institutions causes systemic risk, which is the risk of the proverbial domino effect of collapsing financial markets and institutions taking place in the event of failed derivative contracts.[91] Systemic risk has been described as 'the risk that the walls of the financial markets will come tumbling down because of an ill-appreciated or unaddressed fault in the system itself'.[92] At the very least, it is not controversial to suggest that the interconnectedness of the large banks and financial institutions has the potential to result in knock-on effects in respect of market shocks and crashes.[93]

Credit derivatives are contracts that are used to manage exposure to default risk of assets.[94] The value of the contract depends on the value of debt instruments issued by one or more entities.[95] Credit derivatives allow a bank to remove credit risk as a means of complying with capital adequacy requirements.[96] Credit derivatives allow lenders to remove credit risk from their balance sheets, enabling further lending.[97] Banks that had made loans to Enron had limited their exposure to its implosion by using credit derivatives.[98] Lenders can achieve disintermediation by using credit derivatives to transfer risk to other parties.[99]

Credit derivatives are usually traded OTC,[100] are highly illiquid, and are valued using complex mathematical and computer models.[101]

The two most common forms of credit derivatives are credit default swaps (CDSs) and collateralised debt obligations (CDOs).[102] A "swap" is a forward contract that

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[90] In the context of derivatives, legal risk refers to the risk that the contract between derivatives counterparties is or becomes unenforceable, particularly in the event of the insolvency of one of the parties. Dugan JC 'Derivatives: Netting, Insolvency, and End Users' (1995) 112 *Banking LJ* 638 638.
[91] Karol BJ (1995) 205; Miller RT (2010) 115-7.
[92] Cohen SS (1995) 2009. See also Terblanché JR (2006) 56-9.
[93] Schwarcz SL 'Derivatives and Collateral: Balancing Remedies and Systemic Risk' (2015) 2015 *University of Illinois LR* 699 706-707.
[94] Chen J 'Derivative' (2019). The terms 'default risk' and 'credit risk' have similar meanings. See Terblanché JR (2006) 59-61.
[95] Swantek MA (2012) 1232.
[96] Swantek MA (2012) 1232.
[97] Tijoe L (2007) 394.
[98] Partnoy & Skeel (2007) 1024.
[99] Partnoy & Skeel (2007) 1020. The authors define "credit derivatives" as 'financial instruments whose payoffs are linked in some way to a change in credit quality of an issuer or issuers.' Partnoy & Skeel (2007) 1021.
[100] Tijoe L (2007) 390.
[101] Tijoe L (2007) 412; Cohen SS (1995) 2011.
[102] Tijoe L (2007) 390.

contemplates exchanges of payments.[103] Parties to a swap agree to exchange payments/payment streams at certain future dates and according to an agreed method of determination that typically is subject to the occurrence of an uncertain future event.[104]

A CDO is a pool of claims, commonly debt instruments issued by companies, that is purchased and held by an SPV on behalf of investors.[105] Like securitisation of "normal" receivables, the creation of a CDO provides investors with an opportunity to invest in a diversified portfolio of fixed-income assets.[106] Creating a CDO of debt securities is comparable to the securitisation of debt instruments, as in both cases, an SPV is used to "complete the market" by purchasing the assets and funding it with investors' contributions.[107]

The traditional distinction between securitised ABSs and CDOs was that a CDO would reference a pool of debt instruments, while an ABS would reference a pool of non-bond claims.[108] However, while CDOs were at first compiled exclusively of corporate bonds, CDOs containing ABSs, CDSs, and other CDOs (CDO squared), have become more common.[109] Therefore, the distinction in terminology may be meaningless: both CDOs and ABSs are pools of securitised income-producing assets.

A CDS is the most common type of credit derivative.[110] In simple terms, a CDS is a contract in terms of which a premium is paid in exchange for guarantee of a payment in the event of a default event in respect of underlying assets.[111] The parties are commonly referred to as "protection buyer" and "protection seller".[112] In terms of a CDS, parties agree to exchange payments, (premium for protection payment) in the event of something happening to the underlying assets. The protection buyer's

[103] Karol BJ (1995) 196.
[104] Adams ES & Runkle DE 'The Easy Case for Derivatives Use: Advocating a Corporate Fiduciary Duty to Use Derivatives' (2000) 41 *William and Mary LR* 612; Dugan JC (1995) 639; Partnoy F (1997) 219; Latysheva DS (2012) 472.
[105] Partnoy & Skeel (2007) 1022.
[106] Partnoy & Skeel (2007) 1030.
[107] Partnoy & Skeel (2007) 1028. Therefore, Tiljoe remarks that '[a] CDO is the securitization of a pool, or a collection, of debt instruments.' Tijoe L (2007) 392.
[108] Partnoy & Skeel (2007) 1027.
[109] Partnoy & Skeel (2007) 1027 & 1044.
[110] Swantek MA (2012) 1232; Terblanché JR (2006) 74.
[111] Swantek MA (2012) 1233. 'Triggering events may include defaults, credit-rating downgrades, or debt restructurings on the reference assets.' Tijoe L (2007) 391.
[112] Swantek MA (2012) 1233.

obligation is subject to a suspensive condition, commonly the occurrence of a default event, like insolvency.[113] CDSs are invariably traded OTC so as to enable individualised contract terms.[114]

A CDS can fulfil a hedging or insurance-like function.[115] However, such transactions are not dissimilar to gambling.[116] By entering into a CDS, a business can remove the credit risk attached to its receivables and transfer that risk to another party.[117]

Credit derivatives are essential to synthetic securitisations. An SSS shares some similarities with a TSS, but there are some important differences. During synthetic securitisations, no assets are actually transferred to the SPV. An institution uses an SSS to transfer the credit risk related to an underlying receivable or pool of receivables by effectively hedging these claims while keeping the assets on balance sheet. The originator will enter into a credit derivative agreement (the CDS) to transfer to an SPV default risk related to a claim or group of assets.[118] In terms of the CDS, the originator agrees to pay a premium to the seller of the CDS for its assumption of the default risk.[119] Depending on the terms of the CDS, the instrument can be "unfunded" in the sense that no cash will change hands up front.[120] The SPV will issue securities, commonly termed "credit linked notes" (CLNs) to finance the CDS.[121] The CLNs would be "funded" if investors pay cash to the SPV in exchange for the securities.[122]

The amounts collected by the investors will typically be invested in low-risk instruments like government bonds; these bonds would then serve as security for the payment to

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[113] Karol BJ (1995) 204.
[114] Although much of the content of OTC contracts can be regulated by the International Swaps and Derivatives Association (ISDA) Master Agreement. Swantek MA (2012) 1234-5.
[115] Terblanché JR (2006) 74.
[116] Partnoy & Skeel (2007) 1021; Terblanché JR (2006) 106-9.
[117] Swantek MA (2012) 1236.
[118] Locke N (2010) 450.
[119] Locke N (2010) 450-1; Locke N 'Rating Agencies' (2008) 547 note 10. See also the definition of "synthetic securitisation scheme" in para 1 of the Securitisation Notice, and Kaya O 'Synthetic Securitisation Making a Silent Comeback' (2017) 2, available at https://www.dbresearch.com/PROD/RPS_EN-PROD/PROD0000000000441788/Synthetic_securitisation%3A_Making_a_silent_comeback.PDF (accessed on 12 April 2019).
[120] Loddo L 'Synthetic Securitization' (2014) 13, available at https://www.slideshare.net/LauraLoddo1/synthetic-securitization-54551800, (accessed on 23 August 2019).
[121] Loddo L (2014) 8.
[122] Loddo L (2014) 13.

the originator in the event of default on the underlying reference entity.[123] If defaults occur in respect of the underlying assets, the seller of the CDS compensates the originator for the loss.[124] In this way, the investors effectively make a guarantee in respect of the originator's risk. The investors promise to reimburse the originator in the event of a default on the underlying receivables or reference entity.[125]

Both TSSs and SSSs make use of SPVs, and both can be used to manage and transfer risk. An important difference between a TSS and an SSS is the way in which default risk of the underlying receivable is transferred. In a TSS, the originator transfers default risk of a pool of receivables via a true sale of those receivables to an SPV that issues debt instruments linked to the pool of receivables. In an SSS, the originator transfers credit risk of an underlying reference entity or pool of receivables by entering into a swap agreement with investors through an SPV.[126]

5.2.5 The insolvency-remoteness of TSS SPVs

In a South African TSS, the SPV may take the form of a corporation or a trust. Instead of SPV, the Securitisation Notice makes use of the term "special-purpose institution." Paragraph 1 of the Securitisation Notice defines this entity as 'a company or trust, insolvency remote, incorporated, created or used solely for the purpose of the implementation and operation of a traditional or synthetic securitisation scheme'.

The SPV plays an important role in a traditional securitisation transaction.[127] The SPV is legally responsible for the collection of income from the securitised claims and for the making of payments to the investors in the issued securities.[128] However, the SPV will often appoint a manager or servicing agent to perform these functions.[129]

The SPV in a securitisation scheme must be incorporated and structured in such a manner that its insolvency is very unlikely.[130] The concept of insolvency-remoteness

[123] Loddo L (2014) 11.
[124] Kaya O (2017) 2.
[125] Kaya O (2017) 2.
[126] Wessels FC *Synthetic Securitisation in South African law*, (unpublished LLD thesis, University of Pretoria, 2015) 47.
[127] Scott S (2006) 408.
[128] Scott S (2006) 409.
[129] Scott S (2006) 409.
[130] Locke N 'The legislative framework determining capacity and representation of a company in South African law and its implications for the structuring of special purpose companies' (2016) 133 *SALJ* 160 162; Locke N (2008) 37; Schwarcz SL (1994) 135-6.

encompasses two meanings: (i) separateness from the originator to avoid the SPV's assets being subject to claims against the originator, and (ii) a reduced risk of the SPV itself filing for voluntary surrender or being subject to compulsory liquidation proceedings.[131] Therefore, a TSS SPV must be incapable of being affected by the insolvency of the originator, and should ideally be managed as a completely separate entity.[132] Transaction parties often include "separateness provisions" in the contracts to achieve this.[133]

According to the Securitisation Notice, "insolvency remote" means that the SPV's assets shall not be subject to any claim of the originator of the scheme as a result of the originator's insolvency.[134] Despite this limited definition of the term, it is probably preferable that further measures should be taken to reduce the risk of the SPV itself being subject to insolvency proceedings. These additional measures can be inserted in the transaction documents of a TSS.[135]

Veil-piercing and/or substantive consolidation is a threat to securitisation structures.[136] When a court pierces the corporate veil, it can impose a company's liability on its owners or managers.[137] When the assets of two entities are substantively consolidated, the assets and liabilities of the two entities will be considered to be those of one entity.[138] Therefore, it is critically important to maintain the SPV's separation from the originator.[139] This is why it is recommended that the SPV's board of directors

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[131] Muñoz DR 'Bankruptcy-remote transactions and bankruptcy law—a comparative approach (part 1): changing the focus on vehicle shielding' (2015) *Capital Markets Journal* 10(2) 239-274, available at SSRN https://ssrn.com/abstract=2733613 (accessed on 17 August 2018) 5; Locke N (2010) 452. See also Baudistel JK (2013) 1314-5; Pearce & Lipin (2011) 179; *In Re Doctors Hospital of Hyde Park Inc.* 507 B.R. 558 (2013) 701.
[132] Cohn MJ (1998) 932.
[133] Baudistel JK (2013) 1315; Rothman S (2012) 257; Bridson JL (2013) 7.
[134] Definition of "insolvency remote" in para 1 of the Securitisation Notice.
[135] See 4.6 above for common insolvency-remoteness provisions.
[136] Pearce & Lipin (2011) 227.
[137] See *Hülse-Reutter v Gödde* (2001) (4) SA 1336 (SCA) para 20, Cassim R 'The Legal Concept of a Company' in Cassim FHI (ed.) et al *Contemporary Company Law* 2 ed (2012) 48-50, Cassim R 'Piercing the Veil under Section 20(9) of the Companies Act 71 of 2008: A New Direction' (2014) 26 *SA Merc LJ* 307; *Ex Parte Gore and Others NNO* 2013 (3) SA 382 (WCC) paras 27-8 and Siebritz K *Piercing the corporate veil: a critical analysis of section 20(9) of the Companies Act 71 of 2008* (unpublished LLM mini-thesis, University of the Western Cape, 2016).
[138] Brashar A 'Substantive Consolidation: A Critical Examination' (2006), available at http://www.law.harvard.edu/programs/corp_gov/papers/Brudney2006_Brasher.pdf (accessed on 27 November).
[139] Pearce & Lipin (2011) 226-7.

exhibit a measure of independence from the originator.[140] Cohn explains that the boards of securitisation SPVs usually have one or more independent directors that attempt to act in the best interests of investors.[141]

The risk of the SPV's insolvency for reasons not related to the originator should also be minimised.[142] Practitioners attempt to achieve these goals by way of contractual provisions in the transaction documents. According to Boshoff and Krisch, there are four common methods used in South African securitisation transactions to protect the SPV from being impacted by liquidation proceedings not related to the insolvency of the originator: subordination clauses, limited recourse provisions, pacta de non petendo (also known as non-petition clauses), and restrictions to the capacity of the SPV.[143]

A subordination clause is a type of suspensive condition. In terms of a subordination clause, a creditor agrees to defer his right to claim payment from a debtor until the other creditors have satisfied their claims.[144] Subordination clauses in securitisation schemes are often structured to postpone claims in favour of senior creditors in a payment "waterfall" as set out in the transaction documents.[145]

A limited recourse clause is a provision in terms of which a creditor agrees to limit the source of repayment of his debt to certain identified assets.[146] In a securitisation scheme, parties typically structure the transaction so as to limit the rights of the transaction creditors to the assets of the SPV; creditors can 'acknowledge that their claims are limited to the amount actually recovered by the issuer SPV pursuant to the

[140] Pearce & Lipin (2011) 227.
[141] Cohn MJ (1998) 932.
[142] Muñoz DR (2015) 5.
[143] Boshoff A and Krisch K 'Structured finance and securitisation in South Africa: overview', available at https://uk.practicallaw.thomsonreuters.com/4-521-4150?transitionType=Default&contextData=(sc.Default)&firstPage=true&comp=pluk&bhcp=1, accessed on 13 January 2017. The effect of capacity restrictions will be discussed at 5.3 below.
[144] See *Ex parte De Villiers & Another NNO: In re Carbon Developments (Pty) (Ltd) (in liquidation*) [1993] 1 All SA 441 (A) 447.
[145] Boshoff & Krisch (2017); Shiren N & Corisignani M 'Structured Finance Subordination Provisions Upheld by High Court' (2009) 5 *Pratt's Journal of Bankruptcy Law* 456 456.
[146] Boshoff & Krisch (2017).

security arrangements'.[147] Project finance transactions also make use of limited recourse provisions.[148]

In terms of a pactum de non petendo, a creditor promises not to institute proceedings for the sequestration of a debtor.[149] The Appellate Division (now the Supreme Court of Appeal) has shown a willingness to accept the validity of pacta de non petendo, regarding such clauses as waivers of contractual rights.[150] However, some practitioners have expressed concern that such provisions may be struck down for violating public policy.[151] The argument is made that a non-petition clause deprives a creditor of the right to enforce his claim.[152]

South African common law recognises that contracts that violate public policy are unlawful and void.[153] In *Bafana Finance Mabopane v Makwakwa and Another*,[154] a clause that attempted to waive a debtor's right to apply for an order placing his estate under administration in terms of s 74(1) of the Magistrate's Court Act[155] was declared to be against public policy and unenforceable.[156] The Supreme Court of Appeal (SCA) held that the clause was unjust and contrary to public interest.[157] The SCA reasoned that the clause deprived a person of his right to apply for an order to rescue him from a precarious financial position.[158] In reaching its decision, the SCA referred with

[147] Boshoff & Krisch (2017). See also Fitch Ratings 'Global Structured Finance Rating Criteria' (2016) 20, available at https://fitchratings.co.jp/ja/images/RC_20160627_Global%20Structured%20Finance%20Rating%20Criteria_EN.pdf, accessed on 31 August 2018.
[148] Muller M 'Limited Recourse Project finance for Successful Infrastructure Investments – The Case of TCTA', available at http://forum.tips.org.za/images/Limited_recourse_project_finance_for_successful_public_infrastructure_investments_-_the_case_of_TCTN_Mike_Muller.pdf (accessed on 19 November 2018).
[149] Locke N (2008) 44; *Total South Africa (Pty) Ltd v Bekker NO* 1992 (2) SA 617 (A) 626F-G; Anderson H 'Non-Petition Clauses' (2014) 23 *Nottingham LJ* 85 85.
[150] *Total SA* 626F-G.
[151] Roothman R & Janse van Rensburg T 'South Africa' in *The International Comparative Legal Guide to Securitisation* (2012) 326, available at https://www.lw.com/thoughtLeadership/international-comparative-legal-guide-to-securitisation-2012 (accessed on 23 August 2019). The concept of public policy can be understood as referring to what a court considers to be in the interests of the community. See Mupangavanhu BM 'Yet another Missed Opportunity to Develop the Common Law of Contract? An Analysis of *Everfresh Market Virginia (Pty) Ltd v Shoprite Checkers (Pty) Ltd* [2011] ZACC 30' (2013) *Speculum Juris* 148 155.
[152] Roothman R & Janse van Rensburg T (2012) 326.
[153] *Sasfin (Pty) Ltd v Beukes* [1989] 1 All SA 347 (A) para 12; *Bafana Finance* para 11.
[154] 2006 (4) SA 581 (SCA).
[155] 32 of 1944.
[156] *Bafana Finance* para 21.
[157] *Bafana Finance* para 21.
[158] *Bafana Finance* para 21.

approval to several cases denying the enforceability of a debtor's contractual waiver of statutory rights that enable court redress.[159]

It is uncertain whether the reasoning in *Bafana Finance* would apply equally to clauses where a *creditor* waives statutory rights to seek judicial redress in respect of a debt. Fortunately, the case of *Barkhuizen v Napier*[160] provides further guidance. In *Barkhuizen,* the Constitutional Court (CC) set out the approach to assessing the validity of contractual terms that limit the right to seek the assistance of a court.[161]

The CC declared that the concept of public policy in the context of contractual terms finds meaning in the constitutional values, particularly those of human dignity, equality and freedom.[162] The CC held that public policy represents the boni mores and is informed by the concept of Ubuntu.[163] The CC remarked that '[n]otions of fairness, justice and equity, and reasonableness cannot be separated from public policy'.[164]

In *Barkhuizen*, the CC considered the constitutionality of a time-bar clause in a contract between insurer and insured that limited the period of time in which the insured could institute legal proceedings against the insurer after denial of a claim.[165] In terms of such a clause, the insured, having the right to sue for performance of the insurance contract, would technically be the creditor. The time-bar clause restricted the creditor's right to seek judicial redress against the debtor. For this reason, it is submitted that *Barkhuizen* is distinguishable from *Bafana Finance*, and that the time-bar clause at play in the former case is more comparable to a pactum de non petendo than to the type of waiver considered in the latter case.

The CC stressed that its approach to contractual terms that may violate public policy still affords primacy to the principle of pacta sunt servanda, but that it will allow a court to refuse to enforce a contractual term on the basis that its enforcement would violate

[159] *Bafana Finance* paras 20 & 23.
[160] 2007 (5) SA 323 (CC).
[161] *Barkhuizen* para 1.
[162] *Barkhuizen* paras 28 & 29.
[163] *Barkhuizen* para 51.
[164] *Barkhuizen* para 51.
[165] *Barkhuizen* para 1.

constitutional values.[166] The CC held that courts should be prepared to refuse to enforce a contractual provision where it would be unjust or unfair to do so.[167]

The CC held that the public policy implications of the time-bar clause must be considered in the context of s 34 of the Constitution.[168] Section 34 of the Constitution provides:

> 'Everyone has the right to have any dispute that can be resolved by the application of law decided in a fair public hearing before a court or, where appropriate, another independent and impartial tribunal or forum.'

The CC held that s 34 is a component of public policy that gives effect to the value of the rule of law.[169] The CC accepted that the time-bar clause limited the insured's right to seek judicial redress.[170] However, the CC remarked that whether public policy would accept such clauses must be considered in light of the fact that these clauses are common in statutes and in contracts.[171] This is due to the 'well settled' principle that the particular circumstances of a contract and of its parties should be considered when deciding whether a contractual term violates public policy.[172] On the facts, the CC held that the enforcement of the time-bar clause would not be unfair and against public policy.[173]

Therefore, an inquiry into whether a clause that limits the right to pursue judicial redress (for example, a pactum de non petendo) violates public policy must determine whether the clause would unreasonably offend the constitutional values, whether the enforcement of the term would be unfair or unjust in the circumstances, and whether such clauses are common terms in the relevant type of agreement.

A non-petition clause amounts to a limitation on the right to pursue judicial redress through applicable insolvency or liquidation legislation and on the rights conferred in s 34 of the Constitution. It is difficult to imagine many commercial circumstances where

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[166] *Barkhuizen* paras 30, 57 & 70.
[167] *Barkhuizen* para 73.
[168] Constitution of the Republic of South Africa, 1996. See *Barkhuizen* para 31.
[169] *Barkhuizen* para 31-33.
[170] *Barkhuizen* para 45.
[171] *Barkhuizen* para 46.
[172] *Barkhuizen* para 99. See also *Bafana Finance* para 21.
[173] *Barkhuizen* para 84.

a creditor would voluntarily forego his right to initiate insolvency proceedings. However, there does not seem to be anything constitutionally objectionable to such provisions. Even though a pactum de non petendo limits a creditor's right to pursue judicial redress, it does not necessarily follow that freedom and sanctity of contract should be disregarded. In fact, the CC has remarked that upholding pacta sunt servanda (sanctity of contract) gives effect to the values of freedom and dignity.[174] Pacta de non petendo are common terms in the transaction documents of securitisation schemes and are recommended by credit ratings agencies.[175] Furthermore, the parties to these transactions are generally the SPV, the originator, institutional investors, and providers of credit enhancement facilities; none of these parties should be unsophisticated or incapable of appreciating the effects of the relevant clauses. For these reasons, it is submitted that South African courts should protect freedom and sanctity of contract with regards to pacta de non petendo in a TSS. Insolvency-remoteness provisions are freely entered into and are of great importance to securitisation transactions. Therefore, they should be upheld, unless some extraordinary circumstances arise that would suggest that their enforcement would be unfair or unjust in a particular case.[176]

The creation of a trust and appointment of a trustee for the debenture-holders may also serve to minimise the risk of those creditors instituting insolvency proceedings.[177] Furthermore, it may ease the administrative burden to do so where several secured debentures are issued, as in the case of mortgage-backed securitisation.[178] It is submitted that the trust arrangement makes a great deal of sense and can provide protection for the parties to a securitisation transaction. Where the investors are represented by a trustee in terms of a trust arrangement, enforcement of rights would be centralised and the trustee's powers would be clearly stipulated. The transaction could be structured so that no individual creditor would be entitled to initiate insolvency proceedings against the SPV.

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[174] *Barkhuizen* para 57. See also *Brisley v Drotsky* 2002 (4) SA 1 (SCA) para 94.
[175] See 4.6 above.
[176] These arguments may be equally applicable to other insolvency-remoteness clauses that implicitly limit a creditor's right to dispute resolution and claim enforcement mechanisms.
[177] Locke N (2008) 44.
[178] Itzikowitz & Malan (1996) 184 note 71.

A securitisation SPV will usually be incorporated specifically for the securitisation scheme.[179] The fact that the SPV will have had no previous creditors further reduces insolvency risk;[180] credit rating agencies also recommend the use of newly incorporated SPVs for securitisation purposes.[181] Furthermore, the securitisation SPV will usually be no more than a shell, with a nominal share capital, no employees, and an inability to fulfil contractual duties.[182]

The SPV's constitution is also used to attempt to reduce insolvency risk.[183] Ideally, the SPV should have no other duties except for its duties to the investors. Since unexpected creditors increase the risk of insolvency, the purpose of a securitisation SPV will be frustrated if it can regularly create creditors other than the holders of the debt instruments.[184] Therefore, it has become common practice for the constitution of a securitisation SPV to include a clause restricting the powers of the SPV to administering the securitisation scheme and fulfilling the duties attached thereto.[185]

There are also several external motivations and factors that reduce the risk of a TSS SPV concluding contracts unrelated to the TSS. The reputational and liability risk of the companies and individuals involved is an important factor. The originator of a TSS is usually a bank or other large financial institution. A failure of a TSS will have a negative impact on the originator's reputation. In effect, the originator's reputation is tied to the insolvency risk of a TSS SPV. Locke identifies another important consideration that may urge shareholders and directors to uphold the restrictions to the capacity of the securitisation SPV:

> 'Market forces will also urge shareholders and directors of an SPV to uphold the limitations on the powers and capacity of an SPV. Rating of the securities issued by the SPV will continue throughout the existence of the scheme. A contravention of the

[179] Locke N (2010) 455.
[180] Locke N 'Rating Agencies' (2008) 551.
[181] See, for example, Moody's 'Methodology for assessing bankruptcy remoteness of special purpose vehicles', available at https://www.moodys.com/research/Moodys-publishes-methodology-for-assessing-bankruptcy-remoteness-of-special-purpose--PR_310025, accessed on 31 August 2018.
[182] Locke N (2010) 455.
[183] Locke N (2008) 43; Scott S (2006) 408; Locke N (2010) 455.
[184] Cohn MJ (1998) 933; Schwarcz SL (1994) 135-6.
[185] Locke N (2008) 43.

terms of the memorandum of incorporation will reflect negatively on the insolvency insulation of the SPV and may lead to a downgrade in the rating.[186]

As discussed above, no company can be absolutely incapable of undergoing liquidation proceedings.[187] However, there are several legitimate techniques available in South African law that can contribute to ensuring that a TSS SPV remains separate from the originator and other entities and only concludes the contracts contemplated by the transaction documents. The techniques employed to reduce the risk of a TSS SPV's insolvency reduce the risk of the interest repayments from the SPV to the investors being interrupted. Therefore, the validity and efficacy of the insolvency-remoteness clauses are of great importance.

5.2.6 Traditional securitisation schemes in South Africa

The securitisation market in South Africa was comparatively slow to emerge.[188] By the mid-1990s, the South African securitisation market was relatively small and limited to the securitisation of mortgage loans.[189] However, Itzikowitz and Malan note that while securitisation was still relatively new in the 1990s, the underlying concepts were well-established in South African law and applied in the practice of factoring.[190]

The first securitisation scheme in South Africa was initiated by the United Building Society (UBS) in 1989.[191] The scheme was a relatively straightforward RMBS TSS,[192] similar to the schemes launched in the USA in the 1970s.[193] Mortgage bonds were registered over residential property with the purpose of providing the building society with long-term funding to make home financing accessible to the general public.[194]

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[186] Locke N (2008) 303.
[187] See 4.6 above.
[188] Itzikowitz & Malan (1996) 182.
[189] Itzikowitz & Malan (1996) 182; Falkena HB et al *Mechanics of the South African Financial System* 3 ed (1991) 400-6.
[190] Itzikowitz & Malan (1996) 175 note 1. On factoring generally, see Willis N 'Factoring Agreements' (1982) 99 *South African LJ* 667, Joubert N 'The Legal Nature of the Factoring Contract' (1987) 104 *South African LJ* 88, Scott S 'Sessie en Factoring in die Suid-Afrikaanse Reg' (1987) 20 *De Jure* 15, and Sunkel KD 'A comprehensive suggestion to bring the p*actum de non cedendo* into the 21st century' (2010) 3 *Stellenbosch LR* 463 473-6.
[191] Itzikowitz & Malan (1996) 183; Saayman & Styger (2003) 751-2.
[192] Itzikowitz & Malan (1996) 183.
[193] For a discussion of the origin of the securitisation market in the USA, see Petersen C 'Predatory Structured Finance' (2007) 28 *Cardozo LR* 2191-2206, and Committee on Bankruptcy and Corporate Reorganisation of The Association of the Bar of the City of New York 'Structured Financing Techniques' (1995) 50 *The Business Lawyer* 527 537-40.
[194] Itzikowitz & Malan (1996) 183.

The claims secured by the mortgage bonds were then sold to an SPV.[195] The funds for the purchase of the assets were raised via the issuing of debentures tied to a floating rate.[196] UBS administered the debt as the agent of the SPV, and a company manager was appointed to manage the SPV in the interests of the debenture holders.[197] The debenture issue was underwritten, and Volkskas was appointed as Trustee for the debenture holders.[198]

In 1991, instalment loans were pooled in an ABS securitisation deal initiated by Sasfin (Pty) Ltd,[199] but no further securitisation schemes arose until this method of financing started to receive serious attention in 1999, a year in which the numbers of securitisation schemes in South Africa increased dramatically.[200] The assets that formed the subject matter of securitisations started to become more and more exotic: securitisation of book debts, term loans, corporate bonds and other corporate debt obligations, as well as the first international securitisation transaction (receivables flowing from credit cards, debit cards, and vouchers) were all introduced in South Africa at the turn of the millennium.[201] In 2001, South African Home Loans Investment Holdings (Pty) Ltd (hereinafter SAHL) launched its first RMBS TSS, issuing notes and listing them on the former Bond Exchange of South Africa.[202] The year 2002 saw a further explosion in the number of securitisation schemes, with automobile instalment receivables being among the many types of claims securitised in South Africa.[203]

By the end of 2008, 'the total outstanding portfolio balance of RMBS transactions rated by Moody's was ZAR31.8billion'.[204] According to Boshoff & Krisch, the value of ABS

[195] Itzikowitz & Malan (1996) 183.
[196] Itzikowitz & Malan (1996) 183.
[197] Itzikowitz & Malan (1996) 184.
[198] Itzikowitz & Malan (1996) 184.
[199] Saayman & Styger (2003) 752.
[200] Saayman & Styger (2003) 752.
[201] Saayman & Styger (2003) 752; Wessels FC (2015) 58.
[202] In 2008, JSE Ltd announced its acquisition of the Bond Exchange of South Africa. See https://www.jse.co.za/content/JSEAnnouncementItems/BESA%20announcement%2010%20December%202008.pdf, accessed on 2 May 2018. Debt instruments, including bonds, are now listed and traded on the JSE's Debt Market. See https://www.jse.co.za/trade/debt-market, accessed on 2 May 2018.
[203] Saayman & Styger (2003) 752; Van Vuuren N 'The Awakening of Securitisation in South Africa', available at http://www.sasf.co.za/aboutsecuritisation/The%20awakening%20of%20securitisation%20in%20South%20Africa.pdf, accessed on 16 January 2017.
[204] Syndicate One 'SWOT Analysis of Securitization within the South African Financial Sector' (2009), on file with author, at 8.

issues reached a high point in 2011 at approximately ZAR23.02 billion, and in 2016 the value of issued securitisation securities was approximately ZAR11.7 billion.[205] Like in other parts of the world, RMBS schemes have been the most common type of securitisation in South Africa.[206] Yet, it has been noted that the size of the RMBS market in South Africa remains relatively small.[207]

5.3 THE EFFECT OF THE CAPACITY PROVISIONS IN THE ACT ON THE INSOLVENCY-REMOTENESS OF LIMITED CAPACITY SECURITISATION SPVS

The Securitisation Notice describes securitisation activities and prescribes requirements and guidelines in respect of such schemes.[208] Importantly, the SPV in a TSS will be released from the requirements pertaining to deposit-taking institutions (i.e. its activities will not be considered to be the business of a bank and will not be subject to the provisions of the Banks Act) if it complies with the requirements of paras 4 to 17 of the Securitisation Notice.[209]

Locke explains that the risk of being regarded as conducting the business of a bank, in particular the characteristic of taking deposits, will only arise when the SPV actually accepts deposits from the public, and therefore, she argues that only SPVs that issue securities to the public are at risk of being classified as a bank.[210] In other words, SPVs that do not make public offers in respect of their ABSs are not compelled to comply with the provisions of the Securitisation Notice.[211]

An offer made by an SPV for subscription to its securities will arguably not accord with the narrow meaning of "offer to the public" as contemplated by s 95(1)(*h*) of the Act. The effect of not amounting to an offer to the public in terms of the Act is that a TSS SPV would not have to comply with, for instance, s 99(2) of the Act, which requires every company making an initial public offering of its securities to compile and register a prospectus. Section 96(1) of the Act provides that an offer will not be regarded as an offer to the public where the offer is made only to institutional investors, the Public

[205] Boshoff & Krisch (2017).
[206] Boshoff & Krisch (2017).
[207] Syndicate One (2009) 8.
[208] Paragraphs 1 & 4-16 of the Securitisation Notice, respectively.
[209] Paragraph 2(1)(a)(i) of the Securitisation Notice. The Minister of Trade and Industry is entitled to make such exclusionary notices by virtue of the power conferred on him in s 2(b)(vii) of the Banks Act.
[210] Locke N (2010) 451.
[211] Locke N (2010) 451.

Investment Corporation, pension funds, collective investment schemes, authorised financial services providers and other financial institutions. These are precisely the entities to whom ABSs and MBSs are regularly offered.[212] Securitised assets are generally not offered directly to retail investors. Therefore, it is unlikely that a TSS SPV's issue of securities would amount to an offer to the public for the purposes of the Act.

The Securitisation Notice does not stipulate that the MOI of a TSS SPV must include a provision restricting its powers to the operation of the TSS. However, the Securitisation Notice *does* state that an SPV in a securitisation scheme may conclude no transactions other than those directly related to the scheme.[213] While para 2(1)(*c*) of the Securitisation Notice implicitly acknowledges that an SPV's MOI *may* contain capacity restrictions, the literal meaning of the words cannot reasonably be interpreted as actually *requiring* TSS SPVs to have capacity restrictions in their MOIs. There does not appear to be any direct rule in the Securitisation Notice that requires a TSS SPV to include a capacity restriction in its MOI, and/or to register as an RF company in terms of ss 11(3) and 13(3) of the Act. It would seem that capacity restrictions and adoption of the RF provisions is voluntary.[214] Legal advisers structuring these transactions will have to guide themselves by an appreciation of the effect of the capacity provisions in the Act and the guidelines laid down by the CIPC in assessing whether they should include restrictive conditions in the MOI of an SPV and whether the SPV should be registered as an RF company.

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[212] As at 31 October 2018, the Allan Gray Money Market Fund had a total exposure of approximately 0,9% to securities issued by The Thekwini Warehousing Conduit (RF) Limited. See https://www.allangray.co.za/globalassets/documents-repository/fund/factsheet/Allan%20Gray%20Money%20Market%20Fund/Latest/Allan%20Gray%20Money%20Market%20Fund%20Latest.pdf, accessed on 29 November 2018. The Thekwini Warehousing Conduit (RF) Limited is a conduit RMBS issuer controlled by SAHL. See 'Controlled Entities' in SAHL Annual Financial Statements (2016) 7. A "conduit", also known as a "multi-seller vehicle", buys pooled assets from numerous securitisation originators and issues securities backed by those assets. See Locke N (2008) 24 & 39-40, and 'Thekwini Programme Memorandum' 10-33, available at https://www.sahomeloans.com/content/documents/Thekwini/Transaction%20documents/Thekwini%20Warehousing%20Conduit/Programme%20Memorandum/Thekwini%20Programme%20Memorandum-execution%20(1%20February%202013).pdf, accessed on 29 November 2018.

[213] Paragraph 2(1)(*c*) of the Securitisation Notice.

[214] The wording of s 15(2)(*b*) of the Act, particularly the word 'may', indicates that restrictive conditions are not mandatory.

At first glance, the capacity provisions in the Act seem to lend themselves well to SPVs used in a TSS. The Act allows for the inclusion of provisions in an MOI that limit the capacity of an SPV, and this prima facie gives effect to the ideal of insolvency-remoteness. Separateness provisions can form part of capacity restrictions in the MOIs of these vehicles to promote the type of insolvency-remoteness contemplated by the Securitisation Notice.[215] For example, the issuer SPV's MOI could prohibit the company from entering into contracts with the originator save for the transactions needed to fulfil the servicing agreement, and the security SPV's MOI could prohibit it from concluding any transactions besides the holding of the relevant security rights and the making of the guarantee to the investors.[216] The MOI of the SPV could also restrict its powers to the fulfilment of specific transactions identified at the beginning of the TSS. The SPV's MOI could prohibit it from contracting otherwise than as intended by the transaction documents.

A restrictive condition could also be used to ensure compliance with other provisions of the Securitisation Notice.[217] For example, a TSS SPV's MOI could prohibit the company from issuing more than twenty per cent of its shares to the originator.[218] Such a provision may also contribute to avoiding findings of implied agency or of circumstances that would justify piercing of the corporate veil.

However, s 20(2) of the Act could prejudice the investors in securitised securities. The fact that a company's shareholders may rely on s 20(2) to ratify an ultra vires contract may have an important impact on the activities of limited capacity securitisation SPVs.

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[215] Baudistel JK 'Bankruptcy-remote Special Purpose Entities: An Opportunity for Investors to Maximize the Value of Their Returns While Undergoing More Careful and Realistic Risk Analysis' (2013) 86 *Southern California LR* 1309 1315; Rothman SJ 'Lessons from General Growth Properties: The Future of the Special Purpose Entity' (2012) 17 *Fordham Journal of Corporate & Financial Law* 227 257; Bridson JL 'S&P Global Ratings: Europe Asset Isolation and Special-Purpose Entity Criteria—Structured Finance' (2013) 4-7, available at https://www.standardandpoors.com/ja_JP/delegate/getPDF?articleId=1832489&type=COMMENTS&subType=CRITERIA (accessed on 31 August 2018).

[216] Such a prohibition could be phrased in the form of a restrictive condition that limits the purposes, powers or activities of the company as contemplated by s 15(2)(*b*) and s 20(1) of the Act.

[217] For instance, the Securitisation Notice prohibits an originator from being entitled to determine the outcome of voting at the SPV's general meeting. Paragraph 4(2)(p)(i)(B) of the Securitisation Notice. A TSS SPV may also not have a name that includes reference to the originator. Paragraph 4(2)(r) of the Securitisation Notice.

[218] The Securitisation Notice prohibits a TSS originator from directly or indirectly holding twenty per cent or more of the nominal value of the SPV's issued share capital. Paragraph 4(2)(p)(i)(A) of the Securitisation Notice.

It is questionable whether s 20(2) is desirable in the context of TSS SPVs. Locke argues that legislation should acknowledge the reality that the ultimate beneficiaries of a TSS SPV are not its shareholders, but the holders of its issued debt instruments, and extend rights like the right to ratify ultra vires actions to the holders of the debt instruments instead of to the company's shareholders.[219] Indeed, an SPV is not generally designed to make profit for the shareholders; it is often merely a conduit. Locke explains that the shareholders of a TSS SPV usually fulfil a nominal role and do not expect to receive dividends.[220] In a securitisation scheme, the SPV's shareholders generally have no financial interest in the business of the SPV.[221]

Locke explains that the shareholders of an SPV will not be members of the general public; instead, management companies or trusts are established with the sole object of holding shares in the SPV, and it is also possible for the originator of the scheme to be a shareholder of the SPV.[222] Locke argues that the desire to maintain a good reputation could motivate the SPV's shareholders to monitor the activity of the board, depending on the circumstances.[223] That may be, but there does not seem to be a comparable direct financial incentive for the shareholders to monitor the conduct of the SPVs board, the way that the holders of the debt instruments issued by the SPV would have. For this reason, Locke's proposal to extend greater control rights to the debenture-holders issued by a securitisation scheme may have merit.

Section 20(5) of the Act does not include the holders of a limited capacity company's debt instruments as holders of the right to restrain ultra vires transactions. Interestingly, s 25(4)(*b*) of Ghana's Companies Act[224] and s 39(4)(*b*) of Nigeria's Companies and Allied Matters Act 1990 permit a company's debenture holders to restrain the company from acting ultra vires.[225] In theory, such a provision provides greater protection to the holders of a limited capacity company's issued debentures. Neither the United Kingdom (UK) Companies Act 2006 nor the USA's Revised Model

[219] Locke N (2016) 184.
[220] Locke N (2016) 184.
[221] Locke N (2016) 184.
[222] Locke N (2016) 184 note 122.
[223] Locke N (2016) 184.
[224] 179 of 1963.
[225] See Obadina DA 'The New Face of *Ultra Vires* and Related Agency Doctrines in the Commonwealth and USA' (1996) 8 *African Journal of International & Comparative Law* 309 321.

Business Corporation Act (RMBCA) confer on a company's creditors the right to restrain ultra vires contracts.[226] It is submitted that a statutory right of a creditor to restrain ultra vires contracts concluded by its debtor is not a good idea. Such arrangements are best left to the parties to structure in contractual provisions.

In theory, restrictive conditions limit the activities of a company, either through restricting the line of business or the types of contracts that the company may conclude.[227] However, this cannot fully be achieved by the insertion in a company's MOI of restrictive conditions in terms of the Act.[228] Since ultra vires contracts concluded on behalf of a limited capacity company would not automatically be void, the restrictive conditions would not create an absolute barrier to contracts that undermine the independence of the SPV from the originator or that otherwise increase the SPV's insolvency risk. The restrictive condition would create an indirect internal restriction on the authority of the SPV's agents,[229] provide the shareholders with a right to ratify such actions,[230] and empower both the board and the shareholders to take steps to restrain ultra vires conduct.[231] By adopting the RF provisions (i.e. coupling a restrictive condition to an additional amendment requirement and complying with the requirements of ss 11(3) and 13(3)), a limited capacity SPV can impose on outsiders a statutory doctrine of constructive notice.[232] However, nothing in the Act suggests that the doctrine of constructive notice can overrule the rule in s 20(1) that ultra vires contracts are not void.[233] Even if a limited capacity company adopts the RF provisions and imputes constructive notice of its restrictive conditions on outsiders, ultra vires contracts concluded on behalf of the RF company will not automatically be void.[234]

It is doubtful whether the capacity provisions in the Act reduce the risk of a limited capacity company's insolvency. Capacity restrictions are externally meaningless if

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[226] See 3.5.5 above.
[227] This interpretation of "restrictive conditions" accords with the common law understanding of a company's objects and powers. See 3.4.2 above.
[228] See 3.6 above.
[229] Because of the inextricable link at common law between a company's capacity and the authority of its directors and other agents; that link lies in the fact that the latter cannot exceed the former.
[230] By virtue of s 20(2) of the Act.
[231] In terms of s 20(5) of the Act.
[232] Section 19(5)(*a*) of the Act. See 3.5.8 above.
[233] See 3.5.8 above.
[234] However, the insiders of an SPV may take proceedings to restrain the company from acting ultra vires. Section 20(5) of the Act.

ultra vires contracts are valid. It is submitted that the capacity provisions do not contribute to the achievement of insolvency-remoteness in any meaningful way, as ultra vires contracts concluded by such an entity would be valid,[235] perhaps irrevocably so.

Arguably, greater control over the actions of the board could be achieved by way of ordinary authority restrictions. The effect of violated restrictive conditions would be fundamentally different to non-compliance with authority restrictions: executory ultra vires contracts in terms of the Act are provisionally valid,[236] while unauthorised contracts that are unauthorised for a reason not related to the company's lack of capacity will be provisionally void. Unauthorised contracts are provisionally void because no person may validly contract on behalf of another person without actual authority to do so.[237] However, the unauthorised contract may be rendered valid and enforceable through application of the principles of ratification, agency by estoppel, or apparent authority.[238] These basic agency principles remain applicable to companies.

The MOI of a TSS SPV could simply prohibit the SPV's agents from entering into agreements not related to the TSS. Failing estoppel, apparent authority, or ratification, unauthorised contracts purportedly entered into by those agents would be void and could result in personal liability on the part of the unauthorised representative.[239] The fact that the SPV could ratify unauthorised contracts means that the SPV's shareholders would retain ultimate control in a manner not dissimilar to the framework created by the capacity provisions in the Act.

5.4 CASE STUDY

SAHL is an investment holding company that operates in South Africa. The primary business of the group is the origination, securitisation, and servicing of residential

[235] As a result of s 20(1) of the Act.
[236] It seems that executory ultra vires contracts may be restrained by the persons contemplated in s 20(5) of the Act. See 3.5.5 above.
[237] Locke N (2016) 177; Kerr AJ *The Law of Agency* (2006) 4-5.
[238] Dendy M 'Agency and Representation' in *The Law of South Africa* vol 1 3 ed (2014) at para 137. On apparent authority as source of liability for unauthorised contracts, see *Makate v Vodacom (Pty) Ltd* 2016 (4) SA 121 (CC) paras 46-58.
[239] The CC in *Makate* at paras 46-58 declared that apparent authority is a distinct concept to agency by estoppel. See Sharrock RD 'Authority by Representation – A New Form of Authority?' *PELJ* 2016 (19) 1 14-5.

mortgage loans.[240] SAHL has several wholly-owned subsidiaries, including SA Home Loans (Pty) Ltd, SAHL Insurance Company Limited, and SAHL Office Park (Pty) Ltd. In turn, SAHL has three shareholders: Standard Bank Group Limited, the Public Investment Corporation (on behalf of the Government Employees Pension Fund), and Bolatja Hlogo Consortium.[241]

Every incorporated SPV involved in an active TSS launched by SAHL is a registered RF company.[242]

The Thekwini Fund 14 (RF) Ltd (Thekwini 14) is one of SAHL's controlled (non-subsidiary) TSS entities.[243] Thekwini 14 is an SPV that issues RMBSs created through a TSS. The Thekwini Fund 14 Securitiy SPV (RF) (Pty) Ltd (Thekwini 14 Security SPV) is a private company that fulfils the security SPV role in the TSS.[244] Both Thekwini 14 and Thekwini 14 Security SPV are RF companies.

The MOI of Thekwini 14 Security SPV states that the main purpose of the company is to enter into a range of transactions including the making of guarantees to secured creditors, the holding of security rights, and the realising of security.[245] Thereafter, in a voluminous list, the MOI proceeds to prohibit the company and its directors or other officers from entering into a range of transactions, including those that are not contemplated by the MOI or transaction documents and those in respect of which the company has no capacity.[246] These provisions amount to capacity and authority restrictions in respect of contracts other than those contemplated in the TSS's transaction documents.

The MOI also contains separateness provisions. For example, the MOI prescribes that the company shall only do business in its own name, always hold itself out as a

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[240] 'Directors' Report' in SAHL Investment Holdings Proprietary Limited *Audited Consolidated Annual Financial Statements for the year ended 31 December 2016* 6, on file with the author.
[241] 'SA Home Loans Company Information', available at https://www.sahomeloans.com/about/company-information, accessed on 25 November 2018.
[242] At least up until 31 December 2016. See 'Controlled Entities' in SAHL Annual Financial Statements (2016) 7.
[243] See 'Notes to the Audited Annual Financial Statements' in SAHL Investment Holdings Proprietary Limited *Audited Consolidated Annual Financial Statements for the year ended 31 December 2016* 16.
[244] CIPC 'eServices', available at https://eservices.cipc.co.za/Search.aspx (accessed on 12 April 2019).
[245] Clause 9.1 of the MOI of The Thekwini Fund 14 Security SPV (RF) (Pty) Ltd.
[246] Clauses 9.2, 9.3, & 10 of the MOI of The Thekwini Fund 14 Security SPV (RF) (Pty) Ltd.

separate entity, and maintain separate accounting records and bank accounts.[247] As an additional insolvency-remoteness measure, the MOI contains a conditional pactum de non petendo: the company, its directors, and its shareholder are prohibited from taking steps for the liquidation or business rescue of the company, unless the secured creditors have consented to such proceedings or if a senior advocate expresses the view that the directors or shareholder are at risk of incurring personal liability for failing to institute such proceedings.[248]

The company's MOI also contains an additional requirement for the amendment of the MOI as contemplated by s 15(2)(*c*) of the Act: amendments to the MOI can only be done with the prior written consent of the company's secured creditors.[249]

It is noteworthy that the MOI of Thekwini 14 Security SPV expressly includes capacity restrictions and authority limitations in respect of the same transactions, often in the same clauses and sentences. Arguably, it is possible to avoid s 20(1) of the Act by expressly restricting the authority of a company's directors to transactions intra vires the company.[250] An ultra vires contract in such circumstances may actually be void, as the relevant agent's lack of authority would have arisen not only from a capacity restriction, as envisioned by s 20(1), but also from an express authority restriction.[251] Therefore, whether by design or not, it seems that ultra vires contracts concluded by the directors and other officers of Thekwini 14 Security SPV will be void for lack of authority.

5.5 CONCLUSION

Chapter Five analysed whether the capacity provisions in the Act make a positive contribution to the insolvency-remoteness of an SPV used in a TSS.

Traditional securitisation allows credit providers to separate financing-related risk from themselves by selling their receivables to investors through an SPV, effectively

[247] Clause 9.4 of the MOI of The Thekwini Fund 14 Security SPV (RF) (Pty) Ltd.
[248] Clause 9.5 of the MOI of The Thekwini Fund 14 Security SPV (RF) (Pty) Ltd.
[249] Clause 3 of the MOI of The Thekwini Fund 14 Security SPV (RF) (Pty) Ltd.
[250] This point was discussed at 3.5.3.1 above. The argument is that if a contract is unauthorised not only because it is ultra vires but also because of its violation of an express restriction to the effect that none of the company's agents has the authority to bind the company to ultra vires contracts, s 20(1) would not find application to render the contract valid.
[251] See 3.5.3.1 above.

financing their operations via the investing public. The buyers of instruments based on securitised assets include collective investment schemes (mutual funds), banks, and insurance companies. Traditional securitisation may enable an originator to obtain financing at a cheaper cost than the cost of raising finance itself, allows for other OBS benefits (including earnings manipulation), and is a valuable risk management tool.

The risk of a TSS SPV's insolvency is an important factor that credit ratings agencies consider when compiling credit ratings of the scheme and of the securities to be issued. The insolvency-remoteness of TSS SPVs is important because anything that has the potential to interrupt the income streams arising from the pool of assets will have a negative impact on the investors.

The originator of such schemes is usually a bank or other large financial institution. Reputational risk on the part of the originator is influenced by the insolvency risk of its TSS SPV's. The risk of personal liability for the directors and reputational risk of the originator serve as supplementary safeguards against ultra vires action.

In order to provide further protection to the investors, a TSS SPV should be separate from the originator; separateness covenants in the transaction documents can be used to achieve this. Other methods are also commonly used to contribute to insolvency-remoteness: the SPV will usually be newly formed and have no existing creditors, have no employees and the board's authority will be limited to concluding the contracts specified in the transaction documents. Furthermore, the contracts that the SPV concludes typically contain subordination clauses, limited recourse provisions, and non-petition clauses, all aimed at reducing the risk of the SPV being subject to a compulsory sequestration application. In addition, capacity restrictions are included in the MOI of the SPV. The above techniques are evidently successful, judging by the lack of incidents of TSS SPV failure in South Africa.

The Securitisation Notice, the regulatory instrument of securitisation schemes in South Africa, does not expressly require the MOI of a TSS SPV to include a clause limiting the company's capacity to transactions related to the TSS; the Securitisation Notice merely requires TSS SPVs to act within their stated powers. However, a restrictive condition could be used to encourage compliance with the SPV requirements set by the Securitisation Notice.

Capacity restrictions in terms of the Act do not add to the insolvency-remoteness of the SPV, because ultra vires contracts concluded with outsiders are provisionally valid. Capacity restrictions in the MOI of a limited capacity company will not be an absolute bar to the conclusion and enforcement of ultra vires contracts. A restrictive condition will not completely control the actions of directors by limiting the company's capacity, indicating that the current capacity approach in the Act may not be as effective as normal authority restrictions inserted in a company's MOI.

Section 20(2) of the Act may prejudice the investors in the TSS by allowing the shareholders of the SPV to ratify ultra vires contracts. The provision allows the SPV's shareholders to affect the return of the end beneficiaries of the TSS. However, it is submitted that Parliament was correct in not extending the right to restrain ultra vires contracts of limited capacity companies to the creditors of the company. Contracting parties could construct such a provision in a contractual term if they desired it.

In their current form, the capacity provisions in the Act do not add to the insolvency-remoteness of a limited capacity company. It is not clear that restrictive conditions reduce insolvency risk any more than the other methods commonly used. In fact, the capacity provisions may have the opposite effect.

Chapter Six will conclude the thesis and make recommendations for reform.

CHAPTER SIX: CONCLUSIONS AND RECOMMENDATIONS

6.1 INTRODUCTION

This chapter will conclude the thesis and make recommendations for reform, thereby responding to research sub-questions 5 and 6.[1] First, the various conclusions made by the thesis will be summarised. Thereafter, some general remarks on corporate capacity and the related interests will be made. Finally, the chapter will conclude the thesis by making recommendations for reform of the South African approach to corporate capacity.

6.2 CONCLUSIONS

This thesis questioned whether the capacity provisions in the South African Companies Act 71 of 2008 (the Act) facilitate the operation of special purpose vehicles (SPVs) used in traditional securitisation schemes (TSSs). It is hoped that the arguments made and conclusions reached herein will be of assistance to any person wishing to maintain control over the activities of a company, to courts that may be called upon to interpret the evolved ultra vires doctrine, and to lawmakers that may need to reform the law.

Chapter One identified and contextualised the research problem,[2] formulated a central research question, and articulated six research sub-questions.[3]

The ultra vires doctrine emerged in England in the nineteenth century, and has gradually been modified and developed ever since. The traditional doctrine that ultra vires contracts are void was first applied to statutory companies in the United Kingdom (UK), and later extended to companies incorporated by registration. Since early South African company law followed the English approach, the ultra vires doctrine was received and applied in South Africa.[4] The motivations for the introduction of the rule

[1] These research questions asked whether the South African postion was appropriate when compared to the American and English approaches, and whether the Companies Act 71 of 2008 (the Act) could be amended so as to improve South African law in this regard. See 1.4 above.
[2] See 1.3 above.
[3] See 1.4 above.
[4] See 1.1 above.

in England were shareholder and outsider protection, according to Lord Cairns in *Ashbury Railway Carriage and Iron Co v Riche*.[5]

The traditional ultra vires doctrine was often criticised for its potential to hinder commercial expansion; businessmen did not want to restrict commercial companies to narrow activities, and soon developed drafting techniques aimed at avoiding the doctrine. The ultra vires doctrine was subject to judicial and legislative amendment in many countries during the nineteenth and twentieth centuries. In South Africa, the doctrine was substantially amended by the Companies Act 61 of 1973 (the 1973 Act), and further still, by the new Act.

It was submitted that the evolving ultra vires doctrine remains relevant because limited capacity companies are still apparently desirable, as seen in the case of SPVs used in TSSs.[6] However, there have been several points of contention among contemporary South African corporate law theorists regarding the meaning and effect of the capacity provisions in the new Act.[7]

Chapter Two described and analysed the evolution of the capacity laws in the UK and the United States of America (USA), so as to provide a point of reference and comparison for the subsequent analysis of the South African position. Chapter Two contributed to responding to the sub-question of whether foreign law can provide guidance that may aid in the refinement of the South African approach.

The ultra vires doctrine has been the subject of reform in many common law jurisdictions. Balancing the competing interests of shareholder of limited capacity company with those of a third party dealing with that company is an important consideration when analysing and reforming the ultra vires doctrine. The traditional ultra vires doctrine has been amended using various methods, including judicial expansion of the objects clause with the implied powers notion, and legislative amendment of the consequences of ultra vires acts. These modifications were seemingly aimed at achieving commercial freedom for companies and protection for third parties.

[5] (1875) LR 7 HL.
[6] See 1.3 above.
[7] See 1.5.1 above.

In English law, the locus classicus on the traditional ultra vires doctrine in respect of registered companies is *Ashbury Railway*, wherein it was stated unequivocally that ultra vires contracts are void ab initio, regardless of the shareholders' desire to ratify. However, the reach of the doctrine was easily avoided by practitioners, minimised by the courts, and severely curtailed by legislative enactments.[8]

The present incarnation of the ultra vires doctrine in England is a complete departure from the traditional approach: capacity restrictions are permitted, but they shall have no direct impact on the validity of any contract that the company concludes with a third party. The Companies Act 2006 provides no shareholder right to restrain ultra vires acts.[9] The commercial certainty and third party protection brought about by the complete abolition of the ultra vires defence is a strength of the English approach. Restraint of corporate officers is left to the law of agency, contractual provisions, and fiduciary duties. I can see no weakness in such an approach.

The ultra vires doctrine was adopted in the USA in the nineteenth century at the federal level, but was never fully embraced by state courts. In the USA, the locus classicus on the traditional ultra vires doctrine is *Central Transportation Co. v Pullman's Palace Car Co.,*[10] wherein it was stated unequivocally that ultra vires contracts are void ab initio for the company's lack of capacity. Initially, the federal courts maintained the traditional doctrine.[11] However, there was no uniformity among the state and federal courts regarding the ultra vires doctrine. State legislatures intervened by addressing the doctrine to minimise its prejudicial effect. The most notable instrument in this regard is the Model Business Corporation Act (MBCA). Section 7 of the MBCA was adopted by the vast majority of states as a solution to the ultra vires question. The approach of the now Revised MBCA (RMBCA) was observed to be the following:

1) The purpose of a corporation is to conduct any lawful business;
2) Corporations have the same powers as individuals, as well as a lengthy list of statutory powers;
3) A limited purpose may be stated in a corporation's articles of incorporation;

[8] See 2.4 above.
[9] See 2.4.1 above.
[10] 139 US 24 (1890) 59.
[11] See 2.5 above.

4) Neither a corporation nor a third party may challenge the validity of ultra vires contract on the basis of the corporation's lack of power to act;
5) Shareholders have the right to enjoin ultra vires contracts by way of injunction;
6) The state attorney general has the right to institute proceedings for the restraint of ultra vires transactions and for the dissolution of a corporation for acting ultra vires;
7) The knowledge and good faith of the third party may be relevant to the application of the right to restrain ultra vires contracts;
8) A director of a corporation cannot enjoin the corporation from acting ultra vires; and
9) Courts have the power to set aside executory ultra vires contracts.[12]

Several novelties and peculiarities are present in the American treatment of the doctrine, particularly the acknowledgment of state interest in the maintenance of corporate capacity and the state's right to sue for the dissolution of a corporation for ultra vires acts. Therefore, in the USA, the internal consequences of ultra vires acts exceed those in the UK.

The existence of both the states' and shareholders' right to intervene in ultra vires transactions has been subjected to academic criticism, with one commentator providing sound arguments in favour of their total abolition.[13] Nevertheless, the RMBCA retains this approach to ultra vires corporate action, and it is the approach used by most, if not all, states in the USA.

Evidently, the ultra vires doctrine in the RMBCA attempts to balance shareholders control with third party protection. Presumably, allowing shareholders to restrain ultra vires contracts where corporations have limited purposes provides greater certainty and protection for the shareholders. One admirable aspect of the RMBCA approach is its clear explanation of the shareholder remedy and of the courts' powers in that regard. However, the shareholders' right to restrain leaves third parties in an insecure position. The risk to third parties (and indeed to limited purpose corporations) is increased by the state's right to intervene in ultra vires corporate action. Even though

[12] See 2.5.1 above.
[13] See 2.5.2 above.

there is no prevalence of states exercising these rights, it does represent a risk. The risk to third parties is a weakness of the American approach. Bona fide third parties contracting with authorised representatives of a corporation have a right to expect that the resulting contract will, all other formalities aside, be within the corporation's power to conclude. The RMBCA does not provide this certainty.[14]

It was submitted that the internal remedies that would allow for executory ultra vires transactions to be restrained go too far in protecting a corporation's shareholders at the expense of the legitimate expectations of its would-be creditors.[15] No convincing argument has been suggested to refute the submissions made in this regard by Schaeftler. In support of the learned author, it was submitted that the RMBCA should be amended so as to remove the right to restrain ultra vires contracts.[16] The intricacies of corporate decision-making should be controlled by contract and authority, not by rules clinging to an outmoded doctrine that was never truly embraced in the USA in the first place.

Thereafter, the thesis proceeded to interpret and analyse the South African solution to the ultra vires question, to assess its strengths, weaknesses, ambiguities and inconsistencies against the backdrop of modern commercial realities and comparable laws in foreign jurisdictions.

Chapter Three analysed the capacity provisions in the Act. It was established that statutory interpretation under the South African constitutional dispensation requires a consideration of more than the grammatical meaning of words as envisioned by the "golden rule". It is not possible to apply the literalist approach to a statutory provision without a consideration of its context and purpose.[17] The Act contains a robust list of individual purposes. It was submitted that s 7 of the Act does not contemplate a hierarchy of purposes, and that all of the stated purposes may be relevant to the interpretation of a particular provision within the Act.[18]

[14] See 2.5.2 above.
[15] See 2.5.2 above.
[16] See 2.5.2 above.
[17] See 3.2 above.
[18] See 3.2 above.

The governing document of South African companies, the Memorandum of Incorporation (MOI), remains contractually binding between and among the company, its shareholders, and its directors and prescribed officers.[19] All companies registered in South Africa must submit an MOI to the Companies and Intellectual Property Commission (CIPC), but objects clauses/capacity restrictions are optional.[20]

A company's constitution has always been regarded as more than a mere private agreement between parties, as shown by the mandatory publication rules applicable in some jurisdictions. In South Africa, a company's MOI is accessible for inspection by members of the public.[21]

The Act declares that companies have the same capacity as individuals. The default position is unrestricted capacity, but capacity restrictions may be included in a company's MOI. The Act adopts an approach whereby a modified version of the ultra vires doctrine will apply to limited capacity companies.[22]

It was submitted that a "restrictive condition" as contemplated by s 15(2)(*b*) of the Act should be interpreted to mean a clause that limits the capacity of a company by restricting either or both the company's main business and the types of contracts that it may and may not enter into.[23] In other words, "restrictive conditions" should be understood as referring to capacity restrictions, whether phrased as objects or powers as understood at common law.[24] It was argued that limitations to the authority of a company's board of directors or other agents should not be regarded as restrictive conditions.[25] Since the Act does not lay down specific rules regarding the content and form of restrictive conditions, such clauses could be drafted in the style of objects and powers, objects only, or powers only.[26] This flexibility was welcomed.

It was submitted that South African courts should interpret restrictive conditions in a company's MOI in terms of the established common law approach to objects clauses inherited from English law: restrictive conditions should be interpreted broadly and

[19] See 3.3 above.
[20] See 3.3 above.
[21] See 3.3 above.
[22] See 3.4.1 above.
[23] See 3.4.2 above.
[24] See 3.4.2 above.
[25] See 3.4.2 above.
[26] See 3.4.2 above.

generously, and courts should be able to infer implied powers reasonably necessary for the fulfilment of the company's objects.[27] It was suggested that this approach will reduce the risk of third parties being involved in a protracted capacity dispute with a limited capacity company.[28]

It was argued that a restrictive condition must be coupled with an additional MOI amendment requirement in order for the RF requirement to apply to the company.[29]

Chapter Three proceeded to evaluate the Act's position in respect of ultra vires contracts concluded by limited capacity companies. An ultra vires contract concluded by an otherwise authorised representative of a limited capacity company shall not be void, as a result of s 20(1) of the Act.[30] It was argued that the word "purposes" in s 20(1) should be interpreted as "objects" according to the common law understanding, to refer to the line of business or trade of an entity.[31] It was submitted that the "powers" of a company in s 20(1) should be interpreted according to the common law understanding of the word to refer to the types of juristic acts that the company has the ability to conclude.[32] Furthermore, it was suggested that the words "activities" and "action" in s 20(1) should be interpreted to refer to contractual acts only.[33]

Section 20(1) makes no mention of good faith on the part of the third party, which could be a potential avenue of abuse. However, it was submitted that the South African approach is preferable, logical, and consistent with English common law.[34]

It was submitted that the number or designation of the authorised representative/s that concluded an ultra vires contract should be irrelevant to the application of s 20(1).[35]

It was suggested that it may be possible to avoid s 20(1) by way of careful drafting of the MOI, thereby creating a company with the potential to prejudice outsiders in a manner not dissimilar to the traditional ultra vires doctrine.[36]

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[27] See 3.4.2 above.
[28] See 3.4.2 above.
[29] See 3.4.3 above.
[30] See 3.5.1 above.
[31] See 3.5.1 above.
[32] See 3.5.1 above.
[33] See 3.5.1 above.
[34] See 3.5.3.2 above.
[35] See 3.5.3.3 above.
[36] See 3.5.3.1 above.

Section 20(2) of the Act makes allowance for the shareholders of a limited capacity company to ratify ultra vires contracts by way of special resolution. It was argued that s 20(2) provides for shareholder control over the actions of a company's board in respect of ultra vires contracts, and that the special resolution requirement favours majority shareholders.[37]

The authority of the board of directors of a company is limited to acts within the company's capacity, regardless of the validity of ultra vires contracts. It was submitted that shareholders of limited capacity companies should retain their right to sue the responsible directors or other officers for damages, despite ratification of an ultra vires contract.[38]

It was argued that once an ultra vires contract has been ratified in terms of s 20(2), the agreement should be incapable of restraint in terms of s 20(5).[39] Such an approach would promote third party protection and commercial certainty.

It was suggested that the right to restrain ultra vires contracts was extended to the directors and prescribed officers of a limited capacity company to balance decision-making power.[40] A single person may rely on s 20(5). This shows that s 20(5) is capable of protecting minority interests at both shareholder and board level.

It should be possible to use s 20(5) to restrain proposed ultra vires action, but fully executed ultra vires contracts should not be at risk of being struck down in terms of s 20(5).[41]

It was submitted that s 20(5) allows for the identified parties to apply for an order restraining the performance of an executory ultra vires contract, and that once such an order has been obtained, it should not be possible for the company's shareholders to pass a special resolution ratifying the contract.[42]

The common law ground of failure of the substratum as a just and equitable ground for a company's liquidation has not been abolished, and is capable of finding

[37] See 3.5.4 above.
[38] See 3.5.4 above.
[39] See 3.5.4 & 3.5.6 above.
[40] See 3.5.5 above.
[41] See 3.5.5 above.
[42] See 3.5.6 above.

application in respect of limited capacity companies.[43] It was argued that the risk of a company being wound up on this basis can be reduced by the insertion in the company's MOI of either more than one purpose, or none at all.[44]

It was argued that the common law doctrine of constructive notice never truly supported the ultra vires doctrine.[45] It was submitted that the statutory doctrine of constructive notice created by the Act does not apply to authority restrictions.[46] It was submitted that the new doctrine of constructive notice should not be regarded as a positive doctrine, and should merely prevent third parties dealing with RF companies from alleging that they had had no knowledge of the relevant provisions.[47] It was submitted that the right to rely on the statutory doctrine of constructive notice should be available to the RF company only, not to its directors or shareholders.[48] It was argued that the statutory doctrine of constructive notice will not affect the validity of a contract rendered valid by s 20(1), and that as a consequence, the purpose of s 19(5)(*a*) is unclear.[49]

The board's conclusion of an ultra vires contract will amount to a violation of a fiduciary duty and could lead to personal liability for damages under the common law, s 77(2)(*a*), s 20(6), or s 218(2) of the Act.[50]

The extent of the control provided by restrictive conditions under the Act is questionable, as a result of s 20(1) and the uncertainty surrounding s 20(5). Parliament has drafted the right to restrain ultra vires conduct so widely that third parties cannot be completely secure when dealing with limited capacity companies.[51] It was submitted that maintaining the ultra vires doctrine, even a modified version available on an optional basis, still poses somewhat of a risk.[52] The danger to outsiders is

[43] See 3.5.7 above.
[44] See 3.5.7 above.
[45] See 3.5.8 above.
[46] See 3.5.8 above.
[47] See 3.5.8 above.
[48] See 3.5.8 above.
[49] See 3.5.8 above.
[50] See 3.5.9 above.
[51] See 3.6 above.
[52] See 3.6 above.

especially acute if the right to restrain ultra vires contracts is capable of setting aside executory contracts, which s 20(5) seems to allow.

Therefore, Chapter Three provided this answer to the question of the validity of ultra vires contracts under the Act: executory ultra vires contracts are valid, unless restrained or set aside in terms of s 20(5).

Chapter Four investigated the use of corporate SPVs in a commercial setting against the backdrop of South African corporation regulation. It was observed that a company can be used as a business entity, either directly or as an intermediary, asset-holding and/or risk-bearing entity on behalf of a sponsor; this latter type of company is commonly termed an SPV.[53]

South African law allows for an SPV to be created as a subsidiary company within a group of companies.[54] It was argued that the holding company-subsidiary relationship is an important aid to the isolation of risk in diverse enterprises.[55]

A veil-piercing action is an ever-present threat to the independence of companies from their owners and managers. A strict legal and practical separation between entities should be maintained in order to guard against the risk of veil-piercing and/or substantive consolidation.[56] A subsidiary company should be independent from its holding company/ies. Ideally, it should be unlikely for a subsidiary SPV to be influenced by claims or insolvency proceedings against the parent.[57]

SPVs can be used for any commercial purpose, including structured finance transactions that result in off-balance sheet (OBS) treatment. The achievement of OBS treatment of financial assets is a common use of SPVs.[58] The holding company-subsidiary relationship allows a parent to use a subsidiary SPV to transfer risk and achieve OBS treatment. However, an SPV need not be a subsidiary of the sponsor to serve this purpose.[59]

[53] See 4.3, 4.4, & 4.5 above.
[54] See 4.4 above.
[55] See 4.4 above.
[56] See 4.4 above.
[57] See 4.4 above.
[58] See 4.8 above.
[59] See 4.8 above.

Using SPVs in OBS techniques makes it possible for an entity to avoid recording debt on its own statement of financial position, and instead to record the financed debt as income. There are several potential advantages of OBS financing, including:

1) cheaper access to finance;
2) earnings management;
3) financial indicator manipulation; and
4) risk management.[60]

Chapter Four briefly discussed the accounting scandals at Enron Corp. and Steinhoff International Holdings NV. It was concluded that OBS financing techniques can raise capital and unlock opportunities for firms, but can also be (mis)used as an earnings manipulation tool. Since OBS transactions are often complex, great care and scrutiny is needed to ensure that the investing public is not misled. [61]

Chapter Four also discussed the desirable characteristic of "insolvency-remoteness" in respect of an SPV, and identified several methods used in practice to achieve it.[62] It was explained that the term insolvency-remoteness refers to the likelihood that an entity will be subjected to or affected by insolvency proceedings. It was argued that South African law does not allow for companies to be completely safe from liquidation proceedings.[63] At best, the risk of an SPV's insolvency can be reduced through appropriate contractual provisions and other techniques. It was observed that several methods are used to insulate an SPV against the risk of insolvency, including:

1) separateness provisions;
2) independent director requirements;
3) creditor preference clauses;
4) capacity restrictions;
5) pacta de non petendo*;*
6) subordination clauses; and
7) limited recourse provisions.

[60] See 4.8 above.
[61] See 4.8 above.
[62] See 4.6 above.
[63] See 4.6 above.

The success of an OBS arrangement will be influenced by the insolvency-remoteness that can be achieved in respect of the SPV. However, the characteristic of insolvency-remoteness is desirable for any company, SPV, subsidiary, or controlled entity.

Chapter Four also investigated the different business forms available for those wishing to make use of a corporate SPV in South Africa, and analysed the suitability of each for SPV purposes. As a starting point, it was argued that the corporate form is a particularly effective vehicle for the purpose of conducting business.[64] The characteristics of separate legal personality, limited liability, and perpetual existence, are compelling factors when contemplating the most appropriate type of business entity for a particular enterprise. An SPV may take a number of different business forms. However, a company is the most suitable type of business entity for SPV purposes because risk isolation, one of the key drivers of securitisation and the use of SPVs in structured finance transactions, is more easily achievable in an environment where assets can be transferred to a completely separate entity.[65]

The choice of the most appropriate corporate form to act as an SPV depends on the requirements of the relevant commercial activity and on a consideration of the attributes of and legal requirements applicable to each type of company.[66] A non-profit company would not be appropriate for the goals for which SPVs are commonly created.[67] Instead, private companies and public companies would be suitable for most SPV activities.[68] A public company would be especially appropriate if the intention is to list the SPV's securities on an exchange.[69] A personal liability company would not be a suitable type of company for SPV purposes, because of the default joint and several liability imposed on the directors of such entities for contracts entered into during their respective periods of office.[70] A close corporation (CC) may be a viable business form to use as an SPV in certain circumstances, but a major obstacle to using a CC is the fact that it cannot issue securities.[71]

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[64] See 4.3 above.
[65] See 4.3 above.
[66] See 4.9 above.
[67] See 4.9.1.1 above.
[68] See 4.9.1.2.3 and 4.9.1.2.1 above.
[69] See 4.9.1.2.1 above.
[70] See 4.9.1.2.4 above.
[71] 69 of 1984. See 4.9.1.3 above.

Chapter Five analysed whether the capacity provisions in the Act make a positive contribution to the insolvency-remoteness of an SPV used in a TSS.

When a company raises capital from the investing public, it exercises a power contemplated by s 7(*d*) and the Preamble to the Act.

Securitisation is not synonymous with structured finance, but should instead be regarded as a form of structured finance. It was submitted that the term "structured finance" refers to the raising of capital through a sequence of transactions that effectively transfers the risk of making a loan, holding an asset, or constructing an asset, from an originator to investors in debt securities issued by an SPV.[72] It was argued that the chief benefit of structured finance for investors is that reliance can be placed on the credit quality of a defined asset or pool of assets instead of on the credit rating of the originator.[73]

Traditional securitisation allows credit providers to separate financing-related risk from themselves by selling their receivables to investors through an SPV, effectively financing their operations via the investing public.[74] This disintermediation of function enables a bank, for instance, to originate loans at no risk to itself while collecting fee income for performing secondary and supporting roles in a TSS.[75] Those who would buy instruments based on securitised assets include collective investment schemes (mutual funds), banks, and insurance companies.

Traditional securitisation may enable the originator to obtain financing at a cheaper cost than the cost of raising finance itself.[76] A TSS allows for the OBS benefits discussed in Chapter Four, and assists strategies aimed at managing and isolating risk.[77]

[72] See 5.2.2 above.
[73] See 5.2.2 above.
[74] See 5.2.3 above.
[75] See 5.2.3 above.
[76] See 5.2.3 above.
[77] See 5.2.3 above.

The practice of asset securitisation began comparatively late in South Africa. Since the first securitisation transaction in 1989, the growth of this sector has slowly but steadily increased.[78]

The risk of a TSS SPV's insolvency is an important factor that credit ratings agencies consider when compiling ratings of the securities to be issued by the SPV.[79] The insolvency-remoteness of a TSS SPV is important because anything that has the potential to interrupt the income streams arising from the securitised assets will have a negative impact on the investors in the scheme [80]

A TSS SPV must be separate from the originator; separateness covenants in the transaction documents are usually inserted to achieve this.[81] Other methods are also commonly used to contribute to the SPV's insolvency-remoteness: the SPV will usually be newly formed and have no existing creditors, have no employees or business premises, and the board's authority will be limited to concluding the contracts specified in the transaction documents.[82] Furthermore, the contracts that the SPV concludes typically contain subordination clauses, limited recourse provisions, and pacta de non petendo; these clauses are all aimed at reducing the risk of the SPV being subject to a involuntary liquidation application.[83] In addition, capacity restrictions are included in the MOI of the SPV.[84]

The originator of a TSS is usually a bank or other large financial services provider. It was submitted that the originator's reputational risk is influenced by the insolvency risk of its controlled TSS SPV's.[85] It was suggested that the risk of personal liability for the directors for acting beyond their authority and reputational risk of the originator serve as supplementary safeguards against the SPV concluding transactions not related to the securitisation scheme.[86]

[78] See 5.2.6 above.
[79] See 5.2.5 above.
[80] See 5.2.5 above.
[81] See 5.2.5 above.
[82] See 5.2.5 above.
[83] See 5.2.5 above.
[84] See 5.2.5 above.
[85] See 5.2.5 above.
[86] See 5.2.5 above.

The Securitisation Notice[87] does not expressly require the MOI of a TSS SPV to include a clause limiting the company's capacity to transactions related to the TSS; the Securitisation Notice merely requires TSS SPVs to act within their stated powers.[88] However, it may seem beneficial for a TSS SPV to have restrictive conditions in its MOI, as capacity restrictions could be used to ensure compliance with requirements set by the Securitisation Notice.[89]

It was submitted that the capacity provisions do not add to the insolvency-remoteness of a limited capacity company, because ultra vires contracts concluded with outsiders are provisionally valid.[90] Capacity restrictions will not be an absolute bar to the conclusion and enforcement of ultra vires contracts. Furthermore, there are certain provisions in the Act that may have a negative impact on the SPV's insolvency-remoteness, as well as on the investors in the scheme.[91] For instance, s 20(2) of the Act may prejudice the investors in the TSS by allowing the SPV's shareholders to ratify ultra vires contracts. This allows the SPV's shareholders to affect the return of the end beneficiaries of the TSS, which may result in a conflict of interests. However, it was submitted that Parliament was correct in not extending the right to restrain ultra vires contracts to the creditors of limited capacity companies.[92] Contracting parties could construct such a provision if they desired it.

In conclusion, and as an answer to the central research question, it is submitted that the capacity provisions in the Act do not make a positive contribution to the activities of SPVs used in TSSs. The evolved ultra vires doctrine created by the Act may not be as effective at limiting a TSS SPV's activities as normal authority restrictions would be.[93]

6.3 GENERAL REMARKS

The research question of this thesis pertains to the means with which a company's shareholders can control the activities of the company's directors. It must, as a general

[87] Schedule to GN 2 Banks Act (94/1990): Designation of an activity not falling within the meaning of "The Business of a Bank" (Securitisation scheme) *GG* 30628 of 1 January 2008.
[88] See 5.3 above.
[89] See 5.3 above.
[90] See 5.3 above.
[91] See 5.3 above.
[92] See 5.3 above.
[93] See 5.3 above.

observation, be noted that absolute control is impossible. Nevertheless, a legal system should allow for clear, consistent and efficient methods for shareholders to reduce the risk of unauthorised corporate action, because shareholder protection is a worthy goal.

The substantive and procedural provisions in the Act that regulate corporate capacity are somewhat complex. The drafting of these provisions was likely an intricate task that required thoughtful analysis, as several stakeholders can be affected by capacity restrictions, including a company's board of directors, its shareholders, and its creditors.[94] The drafters of the Act would have had to contemplate and make provision for a variety of permutations in respect of both a company's commercial activities and of its organisational structure, in order to maintain a predictable and efficient regulatory framework.

It is difficult to say whether the capacity provisions in the Act maintain an equitable balance of power in limited capacity companies, or indeed whether any corporate law rule is perfect, because there are so many different permutations regarding the structuring and governance of companies. An individual may make use of the capacity provisions to restrict a one-man company's capacity to a single line of business, in which case he would be the sole director and shareholder; discussions of balances of power within such a company would be of little to no value. Alternatively, financial institutions and corporate groups can use restrictive conditions to incorporate limited capacity SPVs for specialised commercial purposes. In such a case, the role of the board may be more administrative and ceremonial than managerial, and there may only be the one shareholder, which may be a trust or another company. The drafters of the Act would have had to consider all these possibilities.

It would seem that Parliament has opted for a "best of both worlds" approach to corporate capacity, in terms of which reformulations of the doctrines of ultra vires and constructive notice will be available for those persons wishing to incorporate and invest in a company over which seemingly greater control can be imposed. The Act seems to provide means for shareholders of limited capacity companies to control the actions of directors.[95] This is evident from the fact that while all directors, shareholder and

[94] Delport P 'Companies Act 71 of 2008 and the "Turquand" Rule' (2011) 74 *THRHR* 132 132.
[95] Cassim FHI 'Corporate Capacity, Agency and the Turquand Rule' in Cassim FHI (ed.) *et al Contemporary Company Law* 2 ed (2012) 171.

prescribed officers, individually or collectively, may approach the High Court to *restrain* an ultra vires contract, only a special resolution of the company's shareholders may validly *ratify* such agreements.[96] Therefore, it seems that the Act values shareholder protection in respect of capacity, which is consistent with the recommendations made by the Department of Trade and Industry.[97]

The interests worth protecting in respect of corporate action include those of a company's shareholders and those of its creditors. It is submitted that neither are completely protected by the capacity provisions in the Act. A shareholder of a limited capacity company cannot be absolutely certain about the extent of the company's ability to conclude juristic acts, because s 20(1) deems ultra vires contracts to be valid and the scope of the shareholders' right to restrain is unclear, and due to the fact that the company's directors and prescribed officers would also be able to take steps to restrain the company from acting ultra vires, regardless of the wishes of the shareholders. The current capacity provisions also pose a risk to potential creditors of limited capacity companies. Schaeftler sums up the risk as follows: 'As long as any shareholder or creditor may enjoin an executory ultra vires transaction, a third party will lack the kind of security and certainty which he feels when dealing with natural persons'.[98] Existing creditors of limited capacity companies are not protected by the Act in any meaningful way either, as ultra vires contracts are valid and creditors have no right to restrain.[99] The rather flimsy argument that creditors have an interest in the company's capital and activities being devoted to the purposes agreed to in the corporate contract (to which creditors are generally not a party) is not served by the current manifestation of the ultra vires doctrine. To paraphrase Blackman's sentiments, allowing restrictions to a company's capacity in a general framework of unrestricted capacity could prove to be more dangerous than simply abolishing the ultra vires doctrine completely.[100] Under the current framework, third parties dealing

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[96] See 4.10 above.

[97] Department of Trade and Industry *South African Company Law for the 21st Century; Guidelines for Corporate Law Reform* GN 1183 of 2004 GN 1183 of 2004.

[98] Schaeftler MA 'Clearing away the Debris of the Ultra Vires Doctrine — A Comparative Examination of U.S., European, and Israeli Law' (1984) 16 *Law & Policy in International Business* 71 160-1.

[99] See 5.3 above.

[100] Blackman MS 'The capacity, powers and purposes of companies: the Commission and the new Companies Act' (1975) 8 *CILSA* 1 1. See also Carpenter CE 'Should the Doctrine of Ultra Vires be Discarded?' (1923) 33 *Yale Law Journal* 49 69.

with limited capacity companies, and the shareholders of such companies, can have no certainty regarding the validity of ultra vires contracts. This uncertainty is likely to hinder growth and eventually prejudice shareholders.

It is true that there may often be a need or desire to restrict the activities of a company's directors and other officers. However, there are several methods of achieving this. McLennan rejects the idea of making use of capacity provisions to control the conduct of directors: he argues that if a company wishes to limit the power of its directors, it can easily achieve this by way of contractual provisions to that effect.[101]

The best way to control the actions of directors still seems to be to limit their authority. A company's MOI could even restrict the authority of the board to a particular line of business, effectively "restricting" the company's capacity.[102] There does not seem to be a reason why s 20(1) of the Act cannot be avoided in this way.[103] In such a case, a director that concludes an unauthorised contract will have exceeded his powers and possibly misrepresented his authority to the third party, but, more importantly, the contract will be void for the lack of authority, and remain capable of ratification. The validity of the contract will be within the control of the company, which may not have been the case if reliance had been placed on a restrictive condition only. It is true that agency by estoppel may still be proven if the company does *not* wish to adopt the contract, but the company would be able to pre-emptively protect itself by not holding its directors out as having more authority than they do. Therefore, a great deal of control can be created over the actions of a company by way of appropriate authority restrictions in the company's MOI, without reliance on restrictive conditions. For this reason, it is questionable whether the capacity provisions truly serve their intended purpose, and indeed whether they are necessary at all.

6.4 RECOMMENDATIONS

The capacity provisions in the Act do not provide a commercially desirable legal framework to regulate corporate capacity and facilitate the activities of incorporate SPVs used in traditional securitisation schemes.[104]

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[101] McLennan JS 'Contract and Agency Law and the 2008 Companies Bill' (2009) *Obiter* 144 151.
[102] Locke N (2016) 163 and 185.
[103] See 3.5.3.1 above.
[104] This statement is the answer to the central research question posed at 1.4 above.

Finally, it must be determined whether the Act can and should be amended so as to improve South African law. These recommendations will respond to the final research sub-question.[105]

There are several possible options to address the problems and challenges raised by this thesis:

1) Amend s 20(1) of the Act to state that ultra vires contracts are void;
2) Extend the right to ratify ultra vires contracts to the holders of the debt instruments issued by a TSS SPV;
3) Extend the right to restrain ultra vires contracts to the holders of debt instruments issued by a TSS SPV;
4) Abolish both the ultra vires doctrine and the constructive notice doctrine in their entirety and regard all restrictive conditions as authority restrictions.

An approach that treats ultra vires contracts of limited capacity companies as void ab initio would be similar to the traditional ultra vires doctrine. It is submitted that a return to the traditional doctrine should be avoided, for the same reasons that the rule was modified in the first place.[106] Third parties still require protection and certainty when dealing with corporate representatives, and it still does not seem wise to completely prevent a company from taking on new or different business if required. Therefore, it is submitted that s 20(1) should not be amended to state that ultra vires contracts are void.

A statutory right that would allow creditors to intervene in the contracts of a debtor company is not a good idea. Parties are free to conclude contractual provisions to that effect. Therefore, Options 2 and 3 are not recommended.

McLennan argues that the capacity provisions are largely unnecessary, and suggests that the Act should have adopted the approach of the Close Corporations Act, in terms of which both the ultra vires doctrine and the doctrine of constructive notice are abolished in their entirety.[107] It is submitted that this view is correct. Authority restrictions and contractual provisions can and should be the only means to police the

[105] See 1.4 above.
[106] See 1.1 above.
[107] McLennan JS (2009) 153. See ss 2(4) and 17 of the Close Corporations Act.

conduct of directors. The retention of the internal remedies in respect of the ultra vires doctrine has caused too much uncertainty in an area of law that, with the greatest of respect, should have become black letter law by now.

England's solution is simple and commendable. In the birthplace of the ultra vires doctrine, objects clauses are now optional and function merely as authority restrictions, and the ultra vires defence and a company's lack of capacity cannot be raised by anybody to avoid liability on an ultra vires contract.[108] The Companies Act 2006 places a positive duty on a company's board of directors to observe constitutional limitations to their authority, and declares that third parties are not to be deemed to have knowledge of authority restrictions contained in a company's constitution. No right of restraint is made available.[109] Therefore, both the ultra vires doctrine and the constructive notice doctrine have been completely abolished in English law. It is submitted that England's approach provides an adequate balance between shareholder control and third party protection.

Therefore, it is submitted that the ideal approach to corporate capacity in South Africa should be the following:

1) Companies should have, as far as practically possible, the same capacity as natural persons of full capacity;
2) Capacity restrictions should be prohibited, and any existing capacity restrictions in a company's MOI should be regarded as authority restrictions;
3) Companies should be allowed to restrict the authority of its board of directors and other representatives, in the MOI or in any other appropriate way; but
4) The doctrine of constructive notice should not exist;[110] and
5) The law of agency and law of contract should regulate the validity of transactions purportedly entered into on a company's behalf.

To give effect to these recommendations, most of the capacity provisions in the Act would have to be deleted or substantially amended, including ss 20(1), 20(2), 20(5),19(5)(*a*), 11(3) and 13(3). This may seem like a bold and risky move, but in

[108] See 2.4.1 above.
[109] See 2.4.1 above.
[110] I agree with Oosthuizen's view that a complete abolition of the doctrine of constructive notice would protect third parties. See Oosthuizen MJ (1979) 14.

practice, nothing much will probably change. In the context of TSS SPVs, the other methods of achieving insolvency-remoteness will still be used, but any capacity restrictions would simply be regarded as authority restrictions. It is submitted that ratings agencies should not be disturbed by such a development, as the present capacity provisions in the Act do not meaningfully contribute towards insolvency-remoteness anyway.

Without an ultra vires doctrine, a company could still take all necessary steps to control the activities of its directors and reduce its insolvency risk, including appropriate authority restrictions and contractual provisions. It is submitted that the ability to control a company will not be diminished in such a dispensation, and that nothing more than outmoded terminology and thinking will be lost. Instead, a great deal of certainty and simplicity may be gained.

WORD COUNT: 82097

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