

**INVESTOR PROTECTION IN EMPOWERMENT SCHEMES OF
ARRANGEMENTS AND JOINT VENTURES.**

BY

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PREFACE

My interest in empowerment, especially in the corporate sector, arose from my curiosity concerning the working of post apartheid South Africa. As a foreigner in South Africa, who did not experience apartheid per se and being a black person, I have always imagined what life was like during that period. This is because South Africans always seem to be doing things differently from other Africans. Economic empowerment while being at the forefront of the transformation program is something that has happened only in South Africa. One would have thought that this sort of program would have existed in other African states after colonialism but that was not the case. Living in this society has always prompted me to question why certain things are not done differently.

My friends Norman Taku and Achiri Nyindem who visited South Africa from Cameroon in 1996, talked to me about exciting new developments in law in this country. Upon my arrival, the one big question which kept popping up in my mind was “how does black South Africa do business with white South Africa?” I applied myself to the study of South African law and with my interest in Business Law I started asking myself what I would do if I were a Business lawyer. How one goes about organising a fair deal between someone who has little or no money and one who has plenty. It is with these questions mind I undertook this research.

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Michael Joko

Durban, January 2001.

I hereby declare that this dissertation is entirely my own work.

Signed
Michael Kiyong Kimbi Joko

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ABSTRACT.

In this paper, I have attempted to highlight the problems that face investors, both black and white, in South Africa, especially in the light of the effects of the new legislation promulgated after apartheid was abolished. The legislation with which I am most concerned, is the legislation which was promulgated to promote the entry of blacks into the South African economy.

In chapter one, I deal with the concept of empowerment from the constitutional view point and the problem of its definition. I also discuss out the relevant new legislation that in my argument I believe impacts on corporate activity and then deal with the distinction between an “arrangement” within its ordinary meaning in corporate law distinct from that as defined in the in the Companies Act 61 of 1973.

In chapter two, I deal with the dangers facing an individual investor, the benefits of incorporation, the problem of the existence of money revolving schemes, and the effects of a lack of education amongst previously disadvantaged investors.

In chapter three, I deal with joint ventures, their benefits, the effect of the Competition Act 81 of 1998 on joint and potential areas of conflict between black and white partners. Certain aspects of fraudulent and negligent conduct of directors are examined.

In Chapter four, I deal with the methods of executing mergers and acquisition in relation to empowerment companies, their advantages and disadvantages, certain procedures

necessary for the protection of investors like due diligence inquiries, the protection offered by the present company legislation and the common law and criticisms of the courts to protect shareholders. I look at a case study and special considerations in mergers and acquisitions.

In chapter five, I look at the problem of capital in empowerment companies, the various methods that have been used to raise capital, and the loopholes in the law that affect some of these arrangements. I have focused specifically on special purpose vehicles and buyouts.

In chapter six, I deal with the impact of government action and government policy on empowerment and I have compared this with what has happened in other countries. I conclude by recommending that the Black Empowerment Commission should be given teeth to take corrective measure towards empowerment

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PART I

HISTORICAL REVIEW AND BACKGROUND ISSUES

Chapter 1

In order to protect an investor from losing his investment it is necessary to limit his liability to risks. This is done by incorporating the entity in which he intends to invest. It is also important to take other factors that exist in the environment where the entity will operate such as the existing government's policies and laws into consideration.

The feature of incorporation first touched South Africa in 1602 when the Dutch East India Company first set up a refreshing post in the Cape.¹ This was a company that was incorporated under Dutch law by royal charter.² Thereafter each company that operated in South Africa incorporated under statute during the period of Dutch rule. The British took over the territory in 1806, however the first companies legislation in this country was only enacted in 1861. This was the Joint Stock Liabilities Act 23 of 1861 which was based on the English Acts³. After several legislative changes we have arrived at the present Companies Act of 1973⁴.

A major influence on company legislation and how corporate business operated in South Africa was the Group Areas Act of 1950.⁵ This Act disallowed property ownership by

¹ Hosten et al Introduction to South African Law and Legal Theory 1997 p879-880

² Op cit. at 880

³ The Joint Stock Companies Act of 1844 and the Limited Liability Act of 1855

⁴ Various Republics enacted their own laws for example Law No 10, 1864(Natal) and Act 5 of 1874(Transvaal). Then the Companies Act 46 of 1926 which provided a Uniform Companies Act for the whole of South Africa.

⁵ Group Areas Act 41 of 1950.

designated Groups.⁶ These designated groups could only own property in the location areas where they lived.⁷

Section 15-17 of the Group Areas Act dealt with share ownership by members of today's previously disadvantaged communities⁸ and their rights in relation to the controlling interests in companies. It also restricted share ownership of shares by so called disqualified companies⁹ in companies that were in principle white owned companies. It is sufficient to say that this tight restriction on share ownership and other spheres of life by apartheid law is the producer of the demographic features with regards to the racial divide in present day South African corporate ownership. There are hardly any long standing black owned companies. The full effects of apartheid on the economic development of black South African is beyond the scope of this paper. It is sufficient to state that it is a fact that there is an uneven distribution of wealth in South African society and there is a need for redress. In order to address this need, the concept of black economic empowerment was born. With the end of apartheid came the birth of the concept of black economic empowerment.

The constitutional basis for the process of empowerment is section 9(2) of the Constitution of the Republic of South Africa Act 108 of 1996. This clause states:

“Equality includes the full and actual enjoyment of all rights and freedom .To promote the achievement of equality, legislative and other measures designed to

⁶ Section 9 op cit.

⁷ These areas were the townships or the homelands like the former Transkei and Ciskei.

⁸ This will mean Africans, Indians and coloured people.

⁹ Black owned companies.

protect and advance persons, or categories of persons disadvantaged may be taken”.

1.1 Meaning of Empowerment.

The Black Economic Empowerment Commission was formed in 1999 under the chairmanship of Mr Cyril Ramaphosa to define what black empowerment is and to make recommendations on how to achieve it. Apartheid placed huge restrictions on the economic development of Africans, Indians and Coloured people. As a result of these restrictions South Africa has become a very unequal society in terms of wealth distribution. With the political changes that took place in the early 1990s and the advent of a new constitutional order, black economic empowerment is seen as crucial for social stability and development.

In terms of Section 9 of the Constitution, and in order to promote equality past disadvantages must be taken into account and preferential treatment of previously disadvantaged is permissible¹⁰. The definition of black economic empowerment has been the subject of some considerable debate. Black Economic Empowerment has been defined as:

“ The transformation of economic structures in favour of previously disadvantaged people in South Africa ¹¹.

¹⁰ *Pretoria City Council v Walker* 1997(4) SA 189(T)

¹¹ P Mthimkulu “Panel tussles with an issue blurred by lack of definition”. Financial Mail March 17 2000 p 60

This process started in South Africa in 1994. Such a wide definition as the one set out above involves an endless range of issues. With regard to the topic of this paper I will confine myself to the process of share ownership or the process of acquiring shares, the control of companies by shareholders and shareholder rights, minority protection and such other issues relating to the mechanism of profit and power control in corporate law taking cognizance of other stake holders¹². The reasoning behind this is that it has been argued that empowerment goes beyond just ownership to decision making and strategies¹³. It has also been suggested that decision making skills can cost the company by way of its performance and that skills cost money to develop¹⁴.

The acquisition of shares in order to obtain a stake in a company cost money. To obtain control of a company, one must possess shares in it. As Blacks do not have the wealth to buy shares in companies, they need to be financed. If they are not financed, they cannot acquire stakes in companies hence they cannot control the companies since share ownership and control are inextricably linked¹⁵. Even if black people are financed to own shares there is a problem regarding skills. In South Africa, black people were deprived of the education and opportunity to acquire the skills necessary for running businesses. In this paper, I shall attempt to highlight the difficulties blacks and black business entities face in the new South Africa. I shall also look at the problems those who do business with them face from a legal stand point and potential problems that might arise.

¹² Other stakeholder are employees and society.

¹³ B Headbrush "Funding Methods must be reconsidered Business Report," Natal Mercury May 10 2000 p10

¹⁴ Anonymous "Empowerment is about taking decisions" Natal Mercury 10 may 2000 p 12.

¹⁵ The finance here is not from the company in which shares are acquired as this is illegal in terms of section 38 of the Companies Act but rather from financial houses.

1.2 Relevant new laws and the possible impact of these laws on corporate activity.

Two legislative innovations of 1998 I suppose will and has stimulated vigorous activity in the corporate sector. These are the Employment Equity Act¹⁶ and the Competition Act¹⁷.

1.2.1 The Employment Equity Act.

The Employment Equity Act was designed to promote equality as prescribed by section 9(2) of the Constitution. With regards to the topic at hand, its influence is seen in the promotion of affirmative action.¹⁸ In terms of this Act, designated employers¹⁹ have to cater for, inter alia, the promotion, protection and training of previously disadvantaged people based on an employment equity plan²⁰. Failure to comply with the requirement of creating an employment equity plan can lead to a fine the minimum of which is R500

¹⁶ Employment Equity Act 55 of 1998

¹⁷ Competition Act 89 of 1998

¹⁸ Chapter 3 of the Employment Equity Act.

¹⁹ Section 1 of the Employment Equity Act 1998 defines a designated employer as one who employs 50 or more employees or one with annual turnover above R2 million for agriculture, R7.5 m for mining and quarrying, R10m for manufacturing ,electricity gas ,water, transport storage and communication, finance and business services, R5million for construction , catering ,accommodation and other trade , community social and personnel services, or a municipality as defined in chapter seven of the 1996 Constitution, or an organ of state as defined by section 239 of the constitution excluding the defence force , the army the intelligence and Secret services or an employer bound by a collective agreement in terms of section 23 or 31 of the labour relations Act 1995 to the extent to which they are bound by the collective agreement

²⁰ Section 20 of the Employment Equity Act.

000.

What is of concern to investors is whether those who should be promoted have the relevant skills to do these jobs so as to ensure a productive enterprise exists and if not whether they can finance the training of such staff. Because the search for skilled staff in previously disadvantaged groups is fierce and difficult, successful black owned enterprises, it is submitted, are potential targets for bigger white owned firms for mergers and acquisition to fulfill their employment equity requirements. This submission is further supported by the fact that apart from encouraging the affirmative action, the Employment Equity Act denies firms that do not comply with its requirements access to potentially lucrative contracts for the provision of services to government.²¹ Section 53 of the Act states clearly:

“Every employer that makes an offer to conclude an agreement with any organ of state for the furnishing of supply of services to that organ of state or for the hiring or letting of any thing
(a) must
(i) if a designated employer comply with chapters 2 and 3 of this Act.”

The ramifications of this clause are enormous. This will for example mean that a construction company that has not complied with the terms of this Act cannot get a road construction contract from a municipality if it is a designated employer by virtue of its turnover.

1.2.2. The Competition Act.

²¹ Section 53 of the Employment Equity Act 1998.

The Competition Act 1998 was designed to discourage the formation of monopolistic structures. However the Act allows for such an activity if it will lead to

“promotion of the ability of small businesses or firms controlled by historically disadvantaged persons to become competitive”²².

It seems this is a window for a white firm prohibited from the monopolistic practices in terms of the Act to bring in affirmative action partners. White controlled companies will be able to argue that the merger should be allowed on the basis that this will promote the interests of its affirmative action partners. In that way such “control” by way of corporate structures can be easily created and used.

If the Competition Commission or tribunal had to undo such a scenario then it will have to lift the corporate veil from time to time which is difficult to do²³.

The competition Act seems to anticipate the fact that there will be a wave of mergers and acquisitions activity as a result of the impact of the Employment Equity Act.

Hence new wave of mergers and acquisition activity is taking place with a lot of black empowerment companies as targets or at least participants. It is submitted that in order to comply with the requirements of the Employment Equity Act, having a black partner is beneficial. If the Act is strictly enforced it will motivate the cause for mergers and acquisitions. The provisions of the Competition Act 1998 are also a stimulant.

13 Meaning of “arrangement”.

²² See section 3(b) (ii) of the Competition Act 1998

²³ *Robinson v Randfontein Estates Goldmining Co Ltd* 1921AD 168 at 194-195

The phrase 'scheme of arrangement' as used in the corporate law context is usually associated with ' compromise'. This is so because a scheme of arrangement is one of the frequently used methods for takeovers when a target company is facing liquidation.²⁴ Such a method of taking over is dealt with under Section 311 of the Companies Act 1973. Although I intend dealing with such a method of takeover subsequently in this paper I do not intend to limit the meaning of the word ' arrangement' within the bounds contemplated by 311 . For the purpose of this topic an arrangement will mean any reorganisation of share capital of a company ie any scenario that touches on the rights and or obligations of a company or its members or its creditors. This definition is the description given by Coetzee DJP in *Ex parte NBSA Centre Ltd*²⁵

²⁴ PM Meskin et al Henochsberg on the companies Act 5th ed 604

²⁵ 1987(2) SA783 at 787.

PART 2
THE BUSINESS OF INVESTING.

Chapter 2

2.0 Introduction to the climate in the empowerment world.

The main purpose of this paper is to consider ways of limiting the risks involved in investing. These companies (the black owned companies) are protected companies that enjoy, protection policies and legislation by virtue of their stakeholders being members of previously disadvantaged groups. If it is not possible to limit the risks then investors should at least be aware of them.

There are various methods available to a person who wishes to invest. These include, depositing money into a savings account to gain interest, putting money in investment trusts and other more sophisticated models such as buying shares in companies, or starting up new businesses as sole proprietors or close corporations.

I will limit the aforementioned by saying that whatever the method an individual chooses to use he/ she should be reasonably satisfied that the entity to which the money goes should be what it purports to be and is not some sort of scam. An example of such a scam in the corporate world are Ponzi schemes²⁶.

A Ponzi scheme is a scam whereby a company allots shares and these shares continuously change hands by promoting to clients the fact that they offer a high return of investment usually attractive while in reality they do not offer any return of investments at all, except for a small number of people, usually the promoters who earn

²⁶ Ponzi schemes are generally known as pyramid schemes.

rip of money from sums put in by the later investors. A perfect example is the empowerment scheme called Miracle 2000²⁷.

It is suspected that a number of such schemes do exist in the country at this moment²⁸. To be able to criticise the Miracle 2000 scheme, it is necessary to look at earlier ponzi schemes.

In 1996 an investigation was carried out by the Business Practices Committee of the Department of Trade and Industry. This investigation was in terms of Section 8(1)(b) of the Harmful Business Practices Act of 1988²⁹ into money revolving schemes (another name for ponzi schemes). This investigation was done on the Newport Business Club which was alleged at the time to be one of such schemes.

The Business Practices Committee³⁰ discovered that this entity had lured individuals to pay money into it with the hope of a high return of investment within a month. Each new member was expected to bring three additional members before collecting the so called return on investment. Each new member also had to pay a joining fee. The return of investment received by the old members was in essence what the new members had paid. In order for such a scheme to survive it has to keep bringing in new members in order for old members to receive any "return" on investment. This is not possible and the scheme must collapse eventually. When the Newport Scheme was stopped, 60% of its members lost their money. The problem with such a scheme is that there is no new

²⁷ S Theobald "Watch out for sinking rafts" Financial Mail July 28 2000 at 36

²⁸ Ibid

²⁹ Report No 76 Government Gazette No 20169 of 9th June 1999.

³⁰ The Business Practices Committee is now known as the Consumer Affairs Committee or CAFCOM.

wealth creation. “Old” members receive their money from “new” members and eventually (sometime depending on the numbers) there are insufficient people to continue joining, for such a scheme to continue working.

Section 1 of the Harmful Business Practices act defines a harmful business practice as one which directly or indirectly has or is likely to have the effect of harming the relationship between business and consumers unreasonably. After the investigation into the Newport scheme was completed, the Business Practices Committee recommended to the Minister of Trade and Industry that these schemes should be declared a harmful business practice and illegal. This is in terms of section 12(1) (b) of the Harmful Business Practices Act 1988.

In Notice Number 1135 of 1999 (section 3(2)) the minister declared money revolving schemes or ponzi schemes illegal and a harmful business practice. It is submitted that the Miracle 2000 Scheme is illegal and a harmful business practice as its characteristics were the same as that of the Newport scheme. The sad fact remains that even though the public has lost money in this scheme, some people still tried to project it as an empowerment entity.

Criticism has come from some quarter that the manner in which some empowerment companies were structured and managed was such that the investors may have earned more investing in unit trusts than starting up companies as such. The view has been that they were no more than investment trusts³¹. Since this is not a treatise on individual

³¹ T kobokoane “Euphoria gives way to reality of the business world” Sunday Times Business Times July 30 2000 at 8

investment forms, I proceed to look at the options open from a collective point of view which will include either starting a new entity, getting into joint ventures, mergers and acquisitions and schemes of arrangements.

2.1 The Unprotected Investor.

Empowerment to many proponents is thought of as the process of passing either ownership and/or control or the one without the other to people of previously disadvantaged groups³². It is fairly common to find empowerment companies in their own words 'driving empowerment' by offering shares to the public in a facilitated manner to those who had never owned shares before or had been denied the right to do so³³. Such an effort is commendable however it does come with its own problems. The majority of the investors themselves are uneducated and yet they become investors in those companies in their own right. The protection of any individual's rights or obligations starts with an understanding by that individual of what those rights or obligations entail. These new brand of investors suffer a disadvantage arising from history. Without understanding the complex issues of the arrangements between companies, shareholders and directors, it must be questioned whether they will be able to protect themselves. It can be argued that some members in these companies that sell them shares are respected community leaders and may act as trustees to safeguard the rights of these people. Should this be so it raises the question of individual or private interest versus

³² Black Empowerment Commission Draft Report page 1

³³ An example is the Grand Parade Investments, see Business Day, Companies July 21 2000 at 9.

public interest. It defeats the whole idea of control as a concept in corporate governance in these situations.

The consequences of having a group of shareholders who do not understand their rights and obligations are enormous. For example the company might change hands without members knowing, directors may do as they please, in a liquidation scenario some members may abandon their claims. It is because Black investors lack education in investment matters that Ponzi Schemes like Miracle 2000 are bound to come into existence to take advantage of this situation. The aforementioned situation can be alleviated by education only. It is hereby submitted that a structure should be set up, some sort of a watchdog for corporate activity with an extended function of education for the time being. It is understood that the Department of Trade and Industry is charged with consumer education . The Consumer Affairs Committee acts in terms of the Harmful Business Practices Act 1988. However whether this Committee focuses on investor education is unclear as there exist quite a distinction in the ways a consumer is protected and how an investor is protected. An investor lays out money with the expectation of profits and it is generally accepted that there are risks involved in losing the money laid out. A consumer on the other hand in buying or procuring goods or services is expected to get his the goods free of risks of losing what he/she gets and on a recognisable supposition that the goods are suitable for their particular purpose.

2.2 Starting a new entity.

In going into business a company or an investor faces two types of risks- the business risk

and the financial risk.³⁴The business risk relates in corporate law terms to the object of the entity. The financial risk relates to how the capital is raised and employed. From a protection standpoint therefore one needs to limit the liability of the investor to the entity formed.

This is done by incorporating the entity in terms of either the Companies Act or the Close Corporations Act³⁵. Once this is done the entity has a separate legal persona from its Owners (the shareholders)³⁶. A major challenge in the world of empowerment business is that of capital and skill shortage³⁷. In view of these difficulties and in consideration of the Law³⁸ these factors have to play an important role in the type of entities formed and how they will be run. For example while a close corporation needs to keep accounting records using a bookkeeper, a company has to comply with the requirements of section 286 of the Companies Act. Apart from the complexities required in skills to implement this section, there is also the cost of hiring professional accountants to perform this task. Furthermore because capital is an issue for empowerment companies they will end up as public companies in order to raise capital from the public. Some will go as far as listing themselves on the Johannesburg Securities Exchange. Apart from listing, there exist other difficult tasks like complying with the regulations of the Securities Regulation Panel and other corporate governance issues. Steering these companies through these

³⁴ K Ward Corporate financial Strategy 20

³⁵ The Companies Act 1973 as amended and the Close Corporation Act 1984.

³⁶ Section 1 of the Companies Act 1973. See *Salomon v Salomon 1897 AC 22*, *Dadoo v Krugersdorp Municipality* 1920 AD 530.

³⁷ T Kobokoane "Access to Capital Still Spanner in works" Sunday Time Business Times July 30 2000 at 9

³⁸ *ibid*

institutions is not easy for people without experience that is why lots of these companies are delisting and unbundling³⁹. Even after incorporation has occurred it does not necessarily mean that the investor is totally protected or his liability has been totally excluded. For example in case the entity is used to perpetuate fraud⁴⁰, illegalities or to avoid certain undesirable consequences, the corporate veil will be pierced⁴¹

In as much as investors seek to protect themselves against outsiders there exist the necessity to protect themselves from the acts of the company itself, in the area of the duties and functions of directors. With particular concern here in newly formed entities is their ability to get directors to account for reckless or negligent conduct. Section 424(1) of the companies Act and section 61 of the close corporation Act are instructive. Section 424(1) states:

“ When it appears whether it be in winding up, judicial management or otherwise that any business of the company was or is being carried out recklessly or with intent to defraud creditors or any other person or for any fraudulent purpose , the court may on the application of the master, the liquidator, the judicial manager and any creditor or member or contributory of the company declare that person who was knowingly a party to the carrying on of the business in the manner aforesaid , shall be personally responsible, without any limitation of liability for all or any of the debts or other liabilities as the court may direct”.

In commenting on section 424(1), McLennan has taken the view that even though it is

³⁹ T Kobokoane “Euphoria gives way to reality in the business world”supra

⁴⁰ *Lategan v Boyes* 1980(4) SA191(T) 200-201

⁴¹ HS Cilliers et al Company Law 4th ed at 14

difficult to succeed on this section the advantage it presents is that it gives plaintiffs (investors) the locus standi to proceed against defendants (directors) and if successful, execute judgement⁴². This issue usually arises in circumstances where the directors have acted intentionally or negligently. However negligence may arise from a lack of skills. Empowerment companies and those companies that in compliance with employment equity requirements have appointed directors from previously disadvantaged groups which directors may not have the relevant expertise are faced with this question: Can a director who has been appointed for or in the aforementioned circumstances on being sued for reckless or negligent conduct successfully rely on a defence that his lack of expertise is judicially noted? Some practitioners are of the view that a director sued under such circumstances may well plead that but a court will have difficulty accepting such a standard⁴³. However he qualified this opinion by saying that should loss arising out of his conduct be suffered by creditors, the shareholders will bear responsibility for appointing such a director. Even though the director may escape liability the standard of negligence required here needs to be considered. The courts have held that recklessness under this section must be given its ordinary meaning. At the very least gross negligence is what will generate liability and not mere negligence⁴⁴. It has been submitted by some authors that negligence need not arise out of foreseeable circumstances but also from culpably unforeseen circumstances.

The internal scene becomes more complex if the negligent act or conduct is ratified by

⁴² JS McLennan "Reckless or Fraudulent Conduct of Corporate Businesses" 1998 SALJ 596

⁴³ Opinion of M Jackson attorney, Cox Yeats, Durban.

⁴⁴ *Philotex (pty) Ltd v Snyman* 1998(2) SA 138 SCA

shareholders in a general meeting. Under the Companies Act, an action against a negligent director will succeed even if such conduct has been ratified⁴⁵. The English authorities on this point diverge in that if the action of the director is tainted with fraud and is ratified a claim for damages against such a director will succeed⁴⁶. A derivative action brought against a director for negligent action not tainted with fraud which was ratified in a general meeting did not succeed in *Pavrides v Jansen and others*⁴⁷. The English decisions have been criticised by some South African authors notably McLennan⁴⁸. The decision not to sue for wrongful acts might actually be coming from the authors of those acts to the prejudice of minorities.

The number of empowerment companies that fail is evidence of mismanagement or negligence by those who run them. At the end of the day this is to the detriment of shareholders. Perhaps it is the fact that some of these people are still learning and might raise an estoppel that the shareholders were aware of their lack of skill and expertise or perhaps it is because the decision not to sue rests with the perpetrators themselves. In as much as litigation is desirable against directors who conduct themselves recklessly or negligently to protect investors, it is submitted that the fact that some empowerment directors have never had a chance to run businesses must be weighed in their favour. Litigation on the other hand can also have the effect of scaring potential good directors away. This may lead to a setback in the empowerment ideals that are being sought

⁴⁵ Section 266 of the Companies Act.

⁴⁶ See Tempelman J in *Daniels and others v Daniels and others* (1978) 2 All ER 89

⁴⁷ (1956) 2 All ER 518

⁴⁸ JS McLennan "The Condonation by companies of Wrongs committed against themselves" 1998 SALJ 136

Chapter 3

JOINT VENTURES

One of the most frequently used and perhaps one of the most frequently abused methods in the empowerment process is through joint ventures. This is because some of the joint venture partners cannot fulfill their obligations in the relationship. For example, a community trust which is a partner in a casino venture, which in reality may not have the capital for such a venture. They do not also have collateral security to raise debt capital. Their role might be that of window dresser.

A joint venture has been defined as

‘an enterprise, corporation or partnership formed by two or more companies, individuals or organisations at least one of which is an operating entity which wishes to broaden its activities for the purpose of conducting a new profit motivated business of permanent duration. In general the ownership is shared by the participants in more or less equal distribution and without absolute dominance by one party⁴⁹.

Again I must point out that as a hypothesis, the absence of skills and capital for black owned businesses and the denial of access to lucrative contracts and operational licences⁵⁰ to White owned businesses should they not comply with the Employment Equity Act⁵¹ is a prime stimulant for joint ventures coupled with the government’s

⁴⁹ E Herzfeld Joint Ventures 1989 2nd ed at 3

⁵⁰ Here I make reference to the tender requirements by most Provincial Gambling Boards for the award of casino licences, and the requirements by the South African Telecommunications Regulatory Authority for the award of the third cellular licence.

⁵¹ See note 14 for the case of designated employers.

Redevelopment and Distribution Program. The fact that the various players are being forced to comply with these requirements also has the tendency to create window dressing.

Joint ventures fall into two broad categories namely incorporated and unincorporated joint ventures. I have already dealt with the advantages of incorporation and need not return to it for incorporated joint ventures. Where the joint venture is unincorporated, the ordinary rules relating to partnership apply and in case of breach of contract or delictual liability, each joint venture partner can be sued in their own name⁵².

While incorporation limits liability, the limitation of liability is not absolute. It is submitted that new developments applying to groups of companies will apply to joint ventures. Statutory inroads in the Companies Act 1973 now bars limitation of liability⁵³. Under section 424(1) of the Act a holding company in an incorporated joint venture will not have its liability limited in cases of fraud, reckless actions or negligent conduct. Here, the holding company will be liable as a partner, but the joint venture vehicle will have its corporate veil pierced.

Dario Milo⁵⁴ has suggested that in piercing the corporate veil for groups of companies, provided the essentialia⁵⁵ exist a partnership will be presumed to exist. The position in the law on groups of companies, I submit, will fit in the situation of joint ventures

⁵² There are usually shareholder agreements that bind the parties as partners to the joint venture. But since the consortia is unincorporated, it is not a legal entity.

⁵³ Section 424(1) of the Companies Act quoted on page 15

⁵⁴ D Milo "Liability of Holding Companies for debts of subsidiaries" SALJ 1998 at 329.

⁵⁵ Essentialia will be contribution to the partnership, profit for the benefit of all partners.

which are incorporated and expose their incorporated partners to external risks.

With regards to empowerment companies, considering the lack of capital and expertise in the wording of section 424(1) of the Companies Act, it is submitted that these black owned companies which are partners in incorporated joint ventures with white companies will still be personally subject to the risks created by any mismanagement of their side of the venture provided the liabilities caused by them are not merely negligent but grossly negligent to fall within the ambit of section 424(1)⁵⁶.

Despite section 424(1) incorporated joint ventures are still the way to go in view of the stringent requirements necessary to pierce the corporate veil under this section. It is submitted that the meaning of the phrase “if it appears” in this section does not mean that establishment of a prima facie case will suffice under this section⁵⁷. The onus on a plaintiff under this section is still onerous. It has been suggested that this section is not limited to financial matters only but also to other forms of liability.⁵⁸

Another advantage in using it is that it places all the ingredients of a successful bidder in the present economic climate in this country in one entity⁵⁹. An unincorporated joint venture may have little success in a bidding exercise for a license or a contract as opposed to an incorporated one. The former in itself creates difficulties from a contractual point of view as to who the contracting parties are and to what extent they will be liable for the performance for the contract. The offeree in tender situations creates

⁵⁶ *Philotex (pty) Ltd v Snyman* 1998(2) SA138 SCA at 144

⁵⁷ P M Meskin supra at 912 See *Philotex (pty) Ltd V Snyman* 1998(2) SA 138 SCA at144. The dicta here suggests that a party to such proceedings must prove their case on a balance of probability.

⁵⁸ *Greenwood scheme v 75/2 Sundown (pty) Ltd.*1999(3) SA 480 (W)

⁵⁹ The empowerment component , capital and skills.

for himself the tiresome duty of pursuing multiple defendants for breach of contract and complications in apportioning damages. In the case where the bid is for a license, the problem that arises is determining who owns the license.

An advantage created in using joint ventures as a medium for investing is that it easily circumvents the undesirable situations mergers bring with them. This, it is submitted, is found in the employment scene. Mergers involve negotiations with unions as will be seen below. Statute dictates that unions should be consulted⁶⁰. There are usually job losses which cause unions to oppose such talks. Further implications in the job scene are that it involves negotiating and paying severance packages to employees. The risks of litigation are enormous especially under the present provisions of section 189 of the Labour Relations Act⁶¹. Contrary to the situation in mergers, joint ventures create employment. Employee job security is maintained. Any necessary experts can be seconded to the joint venture as they are projects and this can be for a short period or specified period of time. Because most joint ventures are temporary projects, standard temporary employment contracts or independent contractor contracts can be used for all necessary workers⁶².

A joint venture can be a good testing ground to establish whether a proposed merger will work in the future. A potential danger for companies that get involved in joint ventures in a horizontal situation is that it exposes the partners' intellectual property to

⁶⁰ Section 197 of the Labour Relations Act 1995.

⁶¹ The Labour Relations Act 66 of 1995.

⁶² The difference between an independent contractor and an employee is that independent contractors are not covered by the Labour Relations Act 1995 whereas employees are.

each other as workers work in close proximity to each other. Confidentiality may easily be breached and trade secrets passed on unknowingly from one company to another which in future can lead to the delict of passing off. Also noteworthy is that during a joint venture, intellectual property may be developed. How that is dealt with at the end of the project must be clearly spelt out in the shareholder agreement together with confidentiality and treatment of each partner's intellectual property.

Staff poaching may happen during joint ventures as partners have the chance to observe each other. Proper restraint of trade clauses have to be fitted into the shareholder agreements to deal with these situations. It is necessary for the empowerment companies that do joint ventures with white firms to guard against this because while these black firms do not have sufficient capital hence remuneration of their developed staff may be a problem, the white firms that are wealthier want to attract skilled African staff to fulfil their employment equity needs. Also the white firms must guard their trade secrets .

In as much as joint ventures can evade some of the undesirable consequences of mergers, they can be anti-competitive and might be prohibited in terms of the Competitions Act 1998. Section 4 (1) and (2) of the Competitions Act 1998 states:

- (1) “ an agreement between, or concerted practice by firms , is prohibited if
 - (a) it is between parties in a horizontal relationship and it has the effect of substantially preventing or lessening competition in a market, unless a party to the agreement, concerted practice ,or decision can prove that any technological efficiency or pro-competitive gain resulting from it outweighs that effect; or

(b) it involves any of the following restrictive horizontal practices:

(i) directly or indirectly fixing the purchase price or selling price or any other trading condition;

(ii) dividing markets by allocating customers, suppliers territories or specific types of goods or services ;or

(iii) collusive tendering .

(2) An agreement to engage in restrictive horizontal practice referred to in (1) (b) is presumed to exist between two or more firms if

(a) any one of those firm owns or a substantial shareholding, interest or similar right in the other , or , they have at least one director or substantial shareholder in common; and

(b) any combination of those firms engage in that restrictive horizontal practice”.

Horizontal joint ventures involve partners on the same level of supply or production or doing the same or similar business. Joint ventures like mergers are out to produce synergies. However though some joint ventures are of a temporary nature, others are for much longer periods .

It is submitted that joint ventures (usually having underlying contracts or shareholder agreements between joint venture partners who may be companies themselves) have the effect of substantially lessening competition between partners who would otherwise have been competitors⁶³. These cartels or monopolies created as such will fall within the

⁶³ V.Korah et al *EC Competition Law and Practice 4th ed 1990*. As early as 1964 the United States Supreme Court in *US v Pen/Olin (1964) 378 US. 158* had recognised the fact that a joint venture could bring about anti trust properties, a lacunae conspicuously absent in the 1998 Competition Act. A similar provision against joint ventures seeking to restrict competition is also found in Article 85(1) of the Treaty of Rome governing competition issues with regards to joint ventures. The only notable exceptions to joint ventures are markedly in the field of research and developments (Article 85(3)) and even so limitatons exist.

prohibited practices of Section 4(1) and (2) of the Competitions Act.

By incorporating into a single unit, partners in a joint venture sell at a single price or provide services at one price reducing the number of suppliers. As such, 4(1) b (I) and (ii) are contravened.

If the controllers of a particular tender do not expressly state in the tender requirements that each player shall participate in one tender alone, it is possible to find bidders in other joint ventures thereby colluding contrary to section 4(1)(b) (iii).

The presumption introduced in section 4 (2) can hardly be a rebuttable presumption in terms of a joint venture. This subsection makes reference to any combination of firms engaged in a restrictive horizontal practice. Most joint ventures will be caught by it.

Usually one finds that the directors in joint ventures are usually the same for the parent company.

The proviso to section 10(3) (b) has serious implications. It states:

“The Competition Commission may grant an exemption ...if-

(c) the agreement, or practices, or category of either agreements, or practices concerned , contributes to any of the following objectives:

(ii) promotion of the ability of small businesses, or firms controlled or owned by historically disadvantaged persons, to become competitive;

It is submitted that though a joint venture with white firms might make black firms more competitive by virtue of the fact that they gain access to capital and skills

development this provision seems to be a route for the creation of future cartels if not carefully watched. Examples here are the Afrisun and the Tsogo Sun Groups which are consortia that bided for casino licenses. It should be noted that there is a limited number

of casino licenses in South Africa.⁶⁴ Both groups have casino licenses in more than 5 provinces each. This means that ten of the total number of casino licenses are in the hands of two entities alone. This must be anti competitive behaviour.

On the other hand, because of the large capital requirements to build large hotels to house these casinos, black partners could not raise the capital by themselves and may not necessarily have the skills to run these businesses.

In view of the number of ex- politicians heading large corporations and the number of bidding processes that face judicial review, it is submitted that the bidding for licenses and contracts in present day South Africa is sometimes a political affair.

3.1 Potential areas of conflict between black and white partners.

It is trite knowledge that the bidding for licenses and contracts in present day south Africa is sometimes a political affair. Support for this proposition can be found in the number of ex-politicians heading large corporations and the number of bidding processes that now face judicial review.

This has the potential to lead to conflict. When empowerment partners are brought in , most demand that even though they do not have the capital, they account for the goodwill of the corporation because the white companies stand no chance of winning the bid without a powerful empowerment component. They argue that apart from just being a face, they add substantial value to the group or joint venture. An example here is the Cell C group that was granted the third cellular license. A problem is how the empowerment

⁶⁴ Section 13(J) of the National Gambling Act 1996 stipulates that only 40 casino licenses should be awarded in the country.

partner gets compensated for being black enabling the joint venture to win its bid⁶⁵. In practice most empowerment partners demand success fees as they believe they are the generators of the companies business especially when the companies depend on licenses and contracts. If so agreed how much should this be or how should such a compensation be calculated or measured? Every major corporation that has put in a bid considers this a major challenge, which still remains unanswered⁶⁶.

The second instance is one of balancing of interests in achieving the goals of the joint venture. Normally when empowerment partners are brought in, they are expected to ensure that whatever the goal of the joint venture is, be it to get a license or a contract, is achieved. There is pressure from the other partners as well as their own desire to make money. It is alleged, for example, that the Akani Group⁶⁷ has a shareholder who is a member of the Gambling Board. If this allegation proves to be true decision of the board to grant this group a casino license will probably face judicial review. Lord Hewart CJ in *R v Sussex Justices ex parte McCarthy*⁶⁸ said:

“ justice should not only be done but should manifestly and undoubtedly be seen to be done”.

In the circumstance surrounding Akani, the decision will be reviewable on a number of grounds namely; that there existed a pecuniary interest in a shareholder being a member of the Gambling Board⁶⁹, that there was a personal interest in the matter⁷⁰ and

⁶⁵ For confidentiality, interviewees cannot be cited

⁶⁶ Every bidding prospectus requires an empowerment component to be part of the bid.

⁶⁷ P Kirk “Casino bosses on gaming board”, Mail and Guardian August 11-17 2000 at page 5. Akani is one of the winners of the casino licenses in Kwa-Zulu Natal.

⁶⁸ (1924) 1KB 256

that there was prejudice in the decision of the board against other bidders⁷¹. It may be necessary for the directors of the bidding company to do a background check on the shareholders of a company that is in a joint venture to ensure that these situations do not occur as this increases the chance of a joint venture entity losing a bid, bidding being an expensive process.

An issue that can easily be overlooked when an entity gets into a joint venture is insider trading. Section 1 of the Insider Trading Act No 135 of 1998 defines inside information to mean information that is known by an insider and if exposed will have substantial effect on the securities of the entity or its financial instrument. If the bidding for a licence or contract by a company is not published to investors it could be insider trading as the success of the bid increases the company's avenues to boost profits.

In terms of rule 9.1 (a) of the Listing Rules of the Johannesburg Securities Exchange, a transaction by the subsidiary of a listed company will be regarded as a transaction by that listed company. Depending on the volume of such transaction in value, a cautionary announcement has to be made⁷². If this is not done when required, insider trading could occur and the entity concerned could face suspension, a reprimand or any of the sanctions the JSE hands out for breach of these rules. There are also the provisions of the Securities Regulation Code to guard against if shares in the joint venture are bought by way of

⁶⁹ *Rose v Johannesburg Local Road Transportation Board* 1947(4) SA 272 (W)

⁷⁰ South African Law Commission Report on the investigation into the court's power of review of administrative acts pages 180 -182

⁷¹ *Liebenberg v Brakpan liquor licencing Board* 1944 WLD 52

⁷² Rules 9.3-9.33

Share swap in the parent company which could lead to a change in control of the parent company.

Chapter 4

MERGERS AND ACQUISITIONS

This is a more complex method of investing. It is the approach that has been used by most black businessmen in the empowerment process. The investment choice often depends on the availability of capital. It will be seen for example that schemes of arrangements though good are usually not used as a method of acquisition due to a lack of capital.

4.1 Methods of implementing mergers and acquisitions.

4.1.1. Schemes of arrangements.

This method of acquiring a company falls within the provisions of section 311 of the Companies Act. There has been a considerable debate as to what constitute an arrangement and what does not⁷³. Various authors and judges agree that what constitutes an arrangement under this section is wide, the only limitations being a scheme authorising something ultra vires a company or something illegal or unacceptable in law.⁷⁴ In the words of Friedman and Wilson JJ in *Ex parte Strydom NO: In Re Central Plumbing Works (Natal) (Pty) Ltd*⁷⁵ a scheme

⁷³ PM Meskin Henochsberg on the companies Act supra at601

⁷⁴ *ibid*

⁷⁵ 1988(1) SA616 at 619H-I

“ reduced to its simplest form , amounts to no more no less than this. The offeror makes the following proposal to the company. ‘I am available to make a sum of money available to you to distribute equally amongst your creditors and validly cede their claims to me. If you arrange this, I will then release you from liquidation and permit you to continue to trade’.

Simply put, in a scheme of arrangement a proposer makes a proposition to a company asking the company to agree with its creditors, or its shareholders or as the case might be to pass over their claims or rights to shares to him, the proposer, for a consideration. In terms section 311(2)(a) three fourths of the shareholders or class of shareholders or creditors or class of creditors must agree with the company before a court can sanction this to make it binding. It must be noted that this proposal must be made to the company. The company makes the necessary arrangements with its creditors or shareholders to free itself from its liabilities and not between the proposer and the creditor.⁷⁶ This view has been endorsed in the Cape⁷⁷ and in Natal⁷⁸. It does not however mean that a scheme of arrangement can only take place when a company is in financial difficulty. It can take place even where a company is in a sound financial footing , provided the offer being made to the shareholders is enticing enough.

⁷⁶ A full bench of the Witwatersrand Local Division rejected such a scheme as not falling within the ambit of section 311 see *Ex parte Kaplan and others NNO: In re Robin Consolidated Industries Ltd* 1987(3)SA413(w)

⁷⁷ *Ex Parte Milman and others NNO" In Re Multi-Bou(pty) Ltd and others* 1987(4)SA 40 (C)

⁷⁸ *Ex parte Strydom supra.*

4.1.1.1 Procedure.

To implement a scheme of arrangement the proposal should be prepared, and it is brought before the High Court as an ex parte application, if the judge is satisfied that the relevant parties whose interests are to be affected by his order have been notified and that sufficient information been made available to the creditors or shareholders he will order a meeting of shareholders. The offer or proposal is then placed before the creditors or shareholders as the case may be together with all the relevant information for them to consider the offer and make a decision whether to accept the offer, reject it, or make a counter offer to the company⁷⁹.

Of particular importance is that the explanatory report accompanying the proposal should be of sufficient detail as to enable the parties concerned to get a clear picture of the alternatives before them. I will deal with the content of the explanatory note subsequently. The number of scheme meetings and the chairman of those meetings must be decided by the court. If the required number of shareholders or members making three quarters of the total number required agree to the scheme, the chairman reports to the court by way of an affidavit. The scheme will be sanctioned by the court and upon being sanctioned the report is filed with the Registrar of Companies and only then does the scheme take effect⁸⁰.

4.1.1.2 Content of the proposal and guidelines for making them.

⁷⁹ See Section 311 of the Companies Act.

⁸⁰ Section 311(2)

There has been some discussions as to what the proposal for a scheme should contain. This issue was discussed at length by Stegman J in *Ex parte Lebowa Development Corporation Ltd.*⁸¹ Because this paper is based on the protection of investors, I submit it is extremely important to deal with the issues that were raised by the learned judge and the various criticisms that have been leveled against some of the points raised. He set out the content to be as follows:

1. The proposal should be clear and comprehensible to the ordinary man.

This point has been criticised by Larkin on the grounds that the court should not set such standards⁸². With respect, I disagree with the learned author. In the present South African business scene we have people from previously disadvantaged background who will not be able to follow a complicated argument and difficult language by lawyers. It does not help an investing group of individuals if they cannot understand a proposal being made to them simply because it is not clear. It might cost an unsophisticated investor money just to get to the bottom of what the proposal is. With respect, I agree with the learned judge on this point.

2. The proposal or arrangement must embody a compromise or arrangement as envisaged by section 311 of the Companies Act.

I hereby refer to the earlier point made that the proposal should be made to the company not the creditor. If it is made to the creditors of the company or shareholders directly, it might just be a cession which will be incorrect in that it leaves out the company whose

⁸¹ 1989(3)SA 71

⁸² MP Larkin "Compromise" Annual survey of South African Law 1989 at 237.

rights are affected⁸³. As was rightly pointed out in the *Strydom Case* for example the proposer may not be in a position to know all the creditors and may leave some out.⁸⁴ Secondly in the case of shareholders, the articles of the company as a contract binds the company and the shareholders. If the proposer deals with the shareholders directly without the company, whatever rights that exist between the shareholders and the company are not affected.

3. It must be probable that the majority of the agreed conditions of the scheme will be fulfilled.

Goldstone JA ruled in the appellate division (as it then was) that it will be improper for the court to dictate what is in the interest of businessmen⁸⁵. This point has also been criticised Larkin and Friedman and Wilson JJ on the same basis.⁸⁶

4. That Information required by creditors should be put before a court to consider its sufficiency for the intended purpose. This point has received the endorsement of the appellate division (as it then was)⁸⁷. The worrying fact is that it seems what is considered sufficient information may differ from one judge to another or lies in judicial discretion. From the authorities, it seems this information is best provided by way of a comparative analysis between the offer and other alternatives available to the creditors or shareholders

⁸³ See *Ex parte Strydom* supra for criticism of the *Ex Parte Kaplan* Judgement of Coetzee DJP by Friedman and Wilson JJ.

⁸⁴ *Ex Parte Strydom* supra at 622A-C

⁸⁵ *Ex parte De Villiers NNO: In re Carbon Developments(pty)Ltd (in liquidation)* 1993(1)SA 493 (A)

⁸⁶ MP Larkin Supra and *Ex parte Strydom* supra.

⁸⁷ *Ex parte De Villiers* supra

like liquidation.⁸⁸ It has also been held that it is necessary to show the fees payable in both the scheme scenario and the liquidation scenario. The interests of the directors must be reflected in the explanatory note if possible.

A useful check list for the explanatory note will include the following⁸⁹ guidelines:

- (a) A reasonable background to the company or its brief history.
- (b) Financial position of the company stating its assets and liabilities.
- (C) Comparison between arrangement and liquidation or other alternative in existence.

This should include-the administration costs

- what the secured creditors will receive;
- what the preferred creditors will receive like revenue and employees;
- what concurrent creditors will receive.

(d) Explain the salient features of the arrangement for example

- who the receiver will be;
- what the vested assets of the company will be;
- what the excluded assets will be;
- what the proposer will pay as consideration;
- who bears the cost of the arrangement if it fails;
- the order in which funds becoming available to the receiver will be paid;
- fact of the cession;

⁸⁸ *Ex Parte Strydom supra at 624 E-G*

⁸⁹ Per Campbell Alexander

- Proof of claims;
- deadline for acceptance.

(f) The effect of the arrangement on the directors, and others

(g) Sanction by the court.

Any necessary information required by the members or shareholders can always be demanded by them.

5 The Scheme Should have practical Merit.

One of the most criticised suggestions is the requirement for the scheme to be such that it should have practical business merit. It was suggested in the *Strydom Case* that it is not the duty of the court to take decisions for business people.

6 It should not be such that the court cannot approve it.

This relates to any illegal, irregular or ultra vires provisions in the proposal.

When a court has summonsed a meeting of shareholders after such a meeting, the appointed chairman of the meeting of shareholders or creditors has to report back to the court on the meeting. Margo J made a point in *Bowman NO v Leicester Diamonds(pty) Ltd*⁹⁰ that the sanctioning by the court of a scheme is not a mere formality. His lordship's view is that other factors like better offers, terms of payment, financial standing of the proposer and objections to particular provisions of the proposer may cause a scheme to be rejected. This brings to the forefront the importance of the chairman's report to the court. In the above matter the court prescribed the following guideline for the contents of a chairman's report:

⁹⁰ 1983(2) SA 81 at 82F

1. Details of number of creditors present in person
 - number represented by proxy
 - values of each of their claims
 - proxies which have been disallowed
2. Report of the proceedings in each meeting on views of those favour of compromise and those against with the justifications for various views.
3. Resolutions passed with particulars of votes for and against the resolutions and abstentions.
4. Questions asked during the meetings with regards to merits and demerits of compromise and answers given.
5. Details of all rulings made or directions given by chairman of the meetings.
6. Copies of portions of documents presented to the meetings which bear on merits or demerits of the compromise.
7. Main points of any offers of compromise should be given.

4.1.1.3 Advantages of using schemes of arrangements as an acquisition method.

The first source of difficulty in negotiating a merger is employee problems arising out of possible litigation for unfair dismissals. When a company goes into liquidation and as a result of that liquidation it is forced to retrench its employees this is not a dismissal as contemplated by section 189 of the Labour Relations Act of 1995 and as such the employees are not entitled to severance pay.⁹¹ It therefore means that liquidation disposes

of the labour disputes for the acquiring company before the acquirer comes in.

The second advantage in using this method is that the proposer is in a stronger bargaining position to take over the company than he would have ordinarily gotten the company if it were not in liquidation. Furthermore some of the liability the target company has can be fixed on its directors personally if they had been trading negligently as a master's report is bound to come forward in terms of section 400(2) read with 311(4) of the Companies Act 1973⁹². In a situation where this method of acquisition is used, it is less expensive to acquire the company in terms of price as the proposer is also able to say to the buyer that there is much restructuring and effort is needed to turn the business around as it is a failed venture.

The confidentiality questions raised by target companies in mergers are not over emphasised here. However, it must be pointed out that for empowerment groups who are just starting out and are looking at a competitive market, this is an inexpensive way of getting a brand foot hold in a market, as usually the face of a company is the managers and products not the owners. This easily happens when a company that had been trading on a popular brand is acquired by this method. The fact that claims are proven and dealt with during compromise kills all potential litigation arising out of the past of the company a fact that is almost impossible to cure with mergers and other types of acquisition.

⁹¹ SA Agricultural Plantation and Allied Workers Union v HL Hall and Sons (Group Services) Ltd and Others (1999) 201 LJ 401 (LC). Section 38 of the Insolvency Act 24 of 1936 provides that insolvency of the employer automatically terminates the contract of employment of his/her employees.

⁹² See *Ex parte Lebowa Development supra*.

4.1.1.4 Disadvantages

The main disadvantage for empowerment companies for using this method is the unavailability of capital to pay as proposers.

Secondly apart from acquiring the company good managerial skills are needed to turn the company around from the doldrums because here one is acquiring a failed venture. This point is only relevant where the target company is being acquired from a liquidation. The absence of skills for empowerment companies is a factor to be considered.

The third issue here that may be a hindrance is the fact that one places one's acquisition in the hands of a judge. The procedure for making the various explanatory statements and reports to the courts are fairly strict and the court will not sanction any move by a proposer if it looks unclear. Clever negotiation tactics may win the support of the members of the company or shareholders but it is for the court to decide whether the deal goes forward. Apart from the court there lies the difficulty of successfully persuading three quarters of creditors to come to the decision to accept the offer. Lots of lobbying in practice to this end, together with a convincing display to making your offer palatable are necessary. The effect of a sanctioned scheme is that it is a contract between the shareholders and or members and the company.⁹³ As the effect of this scheme of arrangement is also a take over technique that changes control in a company into the hands of people who were not previously in control, if this transaction falls within the threshold to form an affected transaction within the meaning of 440A(1) of the companies Act 1973, the matter has to be reported to the Securities Regulation Panel.⁹⁴

⁹³ Cilliers et al Corporate Law 2nd ed 1992 at 456.

From a Competition Law point of view, it appears that a scheme of arrangement involving a company in provisional liquidation or liquidation will not be prohibited as it will be seen to be increasing the efficiency of the business in that industry by resurrecting a dying business.⁹⁵

4.1.2. Conversion of Shares.

The repealed Section 84 of the Companies Act which provided for a reduction of share capital was recognised as a method of acquisition of a company.⁹⁶ The reason this section was recognised as a method of acquiring a company is because control changed hands to a person (incorporated or natural) who previously did not have control of the company. A study of section 440 of the Companies Act indicates that the Companies Act still recognises this route to acquire a company. Section 440A states:

“ ‘acquisition’ in relation to securities of any company, means the acquisition of securities of such company by any means whatsoever, including purchase or subscription;”

Conversion of shares can take place by way of a scheme of arrangement or by way of subscription. In looking at empowerment companies this method of takeover generates an interesting area of dispute as shall be seen.

4.1.2.1 Procedure

⁹⁴ 440G of the Companies Act 1973

⁹⁵ Section 10 of Competition Act of 1997

⁹⁶ Firer et al Fundamentals of Corporate finance 2nd ed at 456

The key feature to note is that class rights are to be dealt with which may naturally involve rights to dividend and rights to be preferentially treated should the company go into liquidation. The norm here will be that if the shares of the acquirer are preference shares, those preference shares will be cancelled and ordinary shares for a consideration equal to the value of those preference shares will be issued to the previous preference shareholders⁹⁷. This may be fact subscription if the value of the preference shares is higher such that a share swap leads to the allotment of new shares.

4.1.2.2 New Trends

In the advent of the period when empowerment deals were made, most empowerment companies were financed by way of special purpose vehicles. This meant that because they were out to create black controlled companies, these institutional shareholders took preference shares in these empowerment companies called N shares⁹⁸ that were non voting shares. Effectively, because the shares in these companies that were issued to the institutional shareholders were N shares and non voting in nature control vested in the black directors. However the financial arrangements between the empowerment companies and the institutional investors have proved unworkable in a bearish market.⁹⁹ The consequence of this on these companies is that the institutional shareholders no longer enjoy the position they used to enjoy as preference shareholders and have now decided to take control of these companies by converting those shares to ordinary shares.

⁹⁷ Ciliers et al Corporate Law 2nd ed 1992 at 463

⁹⁸ N shares are redeemable preference shares.

⁹⁹ Business Map Empowerment 2000 New Directions at 35. A bearish market exist when stock prices continue falling.

A further motivation why more companies are likely to be seen using this method of acquisition is that the new listing requirements of the Johannesburg Securities Exchange will no longer list N shares.

It would be incorrect to say that the woes of empowerment companies have come from the markets alone. The other causes are as follows:

1. There was a notable absence of due diligence in the manner in which these companies structured their businesses. I submit that their financial advisers are guilty of professional negligence. From a finance point of view, they should have told the stakeholders that these companies were not going to fare well in a bearish market. A bullish market existed in 1998, for how long was it going to continue knowing that these deals were structured to last for up to five years? From the political side there was a lack of due diligence on the lawyers who patched the deals together. They were aware that a change of government was coming at the presidential level. Certainly a change in policy was coming on the political front. It is indeed surprising that up to election time Special Purpose Vehicles (spv) were still being structured. A look at the present government's policy should have indicated that a policy change that was going to affect the livelihoods of SPVs was on the way since these SPVs relied on government contracts for survival.¹⁰⁰

2. Bad corporate governance created a poor perception of SPVs. The much publicised issue of the New Africa Investment Limited directors abusing control is just an example.¹⁰¹ The agency problem is clearly indicated in empowerment companies. The

¹⁰⁰ Analysis of change in government affecting SPVs from Yolisa Pikie of Business Map.

agency problem is the influence which the remuneration of directors have on their performance. Further to this most of the benefits the empowerment partners were going to get lay years in the future. With regards to the manner in which the relationship between the directors of the companies were dealt with there seem to have been some condonation of malpractices. It is believed that these directors have acted wrongly with impunity because most of them are political heavy weights with lots of influence to affect future deals to come.¹⁰² Others have argued that some of the malpractices is brought about by the fact that some of them are over committed and cannot focus seriously on one issue¹⁰³.

This argument is true for managing director and not non executive directors because non executive directors are not responsible for running companies. On the other hand while appearing to be a problem, it has been noted that most white owned businesses went for political heavy weights who would not be there to attend board meetings. There has been some suggestion on the field that even though black directors were appointed, they were not the ones running the show¹⁰⁴.

4.1.2.2 (a) Controversy

During the initial tendering for contracts and licences and as is still the case a strong empowerment component is required for a bidder to succeed in his bid. In the SPV

¹⁰¹ Business Map op cit.

¹⁰² Discussions with L Gadd, Corporate Affairs manager, Thebe Investments Ltd

¹⁰³ Argument by Lindiwe Gadd of Thebe Investments Ltd

¹⁰⁴ Per Nomthle Canca of Wiphold.

arrangement this component is clear. The control vested in that component that was the empowerment partner. The controversy that arises is that, when the institutional shareholders who had N shares convert them to ordinary shares and regain control of the company the company may not be regarded again as an empowerment company as control in it has shifted to those who were not in control during the bidding process.

It is critical to deal with this issue because these companies received contracts and licenses because of their empowerment components and this was the social responsibility factor of redressing the inequality created by the past.

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-Apart from the faults experienced by empowerment companies by way the way they structured and financed themselves, there exists the problem created by the market itself by way of the Johannesburg Securities Exchange. At the time when these empowerment deals were struck there existed the culture of nondisclosure that still exist in part. Lots of the arrangements within these companies were kept secret. Had there been proper disclosure rules in place the situation could have been different.

4.1.3. Acquisition of Shares and or assets.

4.1.3.1. Background

One accusation which has been leveled against empowerment businesses is that they left the route of growing a business organically to growing it by acquisition¹⁰⁵. Whatever the aims of the businessmen were, they all wanted to progress. I hereby submit that one of the strongest reasons for their failure lay in their misunderstanding of the fundamentals of

¹⁰⁵ ibid

buying shares as a method acquisition and when to buy assets. Had they understood this many companies would not have used scarce capital to purchase stakes in companies that were not required. In order to make an informed decision about the method to follow prior to an acquisition, it is necessary to look at the reason for that particular acquisition first and then thereafter the result of the due diligence inquiry. The analysis that follows deal with the considerations empowerment entities must follow and guide lines to carrying a decent due diligence investigations in any entities they wish to acquire.

4.1.3.2 Acquisition by the purchase of shares:

The following factors influence acquisitions by the use of shares as opposed to the acquiring of assets.

1. Who to pay.

In a situation where the seller wants to be paid directly as opposed to the buyer paying the company this is the route to use¹⁰⁶. Normally this arises for companies where directors have an influence granted by the articles of association with regards to the payment of dividends. The reasoning here comes from the fact that in the sale of assets, the seller is the company as opposed to the shareholders. As such payment is made to the company as opposed to the shareholders in a sale of assets and the cash arising from the sale is only available to shareholders when dividends are declared. The declaration of dividends in the above mentioned instance may be a discretionary issue which is dealt with by directors, and the shareholders may wish to avoid this.

¹⁰⁶ PFC Begg Corporate Acquisitions at 4.7

2. Continuity in business.

If the business has to be sold as a going concern, that will entitle the transaction to be zero rated for VAT. Sale of shares will simply mean change in ownership. A possible advantage here to be noted is that there is a clean break between the vendor and the purchaser. The second issue here is the consideration of employment. The Labour Relations Act of 1995 entitles the parties to transfer the contracts of employees from one employer to the other provided they are done the same or similar terms and conditions as there were with the old employer¹⁰⁷. Any new condition will have to be agreed to with the employee.¹⁰⁸ An employees' contract of employment are with the company and not with the shareholders, hence a sale of shares usually does not affect employees' contracts with the company.

3. An advantage in using this method is the possibility of transferring things that cannot otherwise be transferred from one company to the other like recognition awards or goodwill and licenses¹⁰⁹. I must point out here that it works both ways here for empowerment and white owned businesses. Some established white business and its client base may be passed on in this way while some white company may use this as a method of getting a license that it may not be able to obtain easily nowadays.

4. In a multi asset company, the acquisition of the company by way of shares is better than the acquisition of assets because it minimises the risk of omitting assets in the process.

¹⁰⁷ section 197

¹⁰⁸ J Grogan Workplace Law 5th ed 1999 at 196-197

¹⁰⁹ PFC Begg op cit and MA Weinberg et al Take Overs and Mergers 4th ed at 401 to 407

5. The trade losses of the company can be used for tax relief if the target company has been trading at a loss¹¹⁰.

It is important to note that in acquiring the target company through its shares, the target company can transfer its liabilities to the acquiring company. Therefore the importance of carrying out the due diligence properly must be emphasised¹¹¹. If the acquiring company is unsure of or suspects problems, this can be cured by providing warranties in the sale of shares agreement. The due diligence exercise for acquisition by way of acquiring shares is more intensive than that for the acquisition of assets. This is because, in the acquisition of assets, the due diligence is centered around the assets to be acquired whereas the due diligence in acquisition of shares involves other stake holders in the company for example employees, the communities where the company is found by way of the environment, operational aspects and the legal rights that may exist between the company and other parties which may give rise to litigation.

4.1.3.2 Acquisition by purchase of assets.

The following factors affect the acquisition of assets.

1. In a situation where actual of contingent liabilities cannot be covered by warranties, the way forward is by acquiring the assets¹¹². Some of such contingent liabilities may include environmental damage and bad labour relations with worker's unions.

¹¹⁰ PFC Begg at 4.8

¹¹¹ For a full discussion on Due diligence exercises, see page 47 below.

¹¹² PFC Begg supra at 4.8.

2. Cherry Picking.

Where the target company has several assets and some may not be profitable, it is not necessary to purchase the shares as this will mean acquiring those non-profitable assets too. This factor I submit is very relevant to note when dealing with empowerment companies where capital is a problem. Capital should not be spent on unnecessary assets. The new trend is for empowerment companies to be seen to be involved at the operational level hence the necessity to adopt a constructive approach.

3. Generally an employee's contract is between that employee and the employer which in all cases is personified by the company. With the acquisition of shares, the employment contract remains in force. On the other hand if the assets are sold, the employment contract remains in force as well as liability for environmental damage or litigation with the company while these assets pass to the acquiring entity. The acquisition of assets can be a useful way of dodging these problems.¹¹³ In the case of employees, those who are necessary for the running of the business can be reselected without liability for labour relations claims towards the acquiring company.

4. Onerous provision in articles.

In circumstances where there exist provisions in the target company's articles of association, that restrict the transfer of shares, especially for private companies these sort of problems can be avoided by the acquisition of assets¹¹⁴.

5. Where the target company wants to use the proceeds of the sale to plough back at its

¹¹³ *ibid*

¹¹⁴ MA Weinberg et al Takeovers and Mergers *supra* at 402

businesses, acquisition of assets is the way to go.

4.1.3.4 The Process of Acquisition

Generally whether it be for shares or assets an acquisition may start with a letter of intent, followed by a due diligence inquiry, and pricing of what is to be acquired.

4.1.3.4(a) Due Diligence exercises

If investing is like a battle due diligence investigations are like a reconnaissance exercise. Simply put due diligence processes are investigations into the firms that investors or other entities wish to become involved with. The absence of a proper due diligence exercise has been acknowledged as one of the strongest reasons mergers and acquisitions fail to meet their expected objectives.¹¹⁵ The general view in practice especially here in Kwa-Zulu Natal is that these inquiries have been done mostly by foreign investors or companies. This practice is only just beginning here.¹¹⁶ Due Diligence inquiries are also important in other areas out of the mergers and acquisitions scene. These areas are:

1. Restructuring.

Where a company is restructuring its business, if it is to be done properly, a due diligence inquiry is necessary.¹¹⁷ In restructuring a company, jobs are lost or made redundant, but those occupying redundant positions may not be retrenched. Contracts may be repudiated. To get a fair assessment of the situation and the legal and commercial

¹¹⁵ "Why Mergers go wrong" Sunday Times Business Times July 23 2000.

¹¹⁶ Per S Davidson, attorney at Shepstone and Wylie Durban.

¹¹⁷ H Sher "Due Diligence Investigations" Juta Business Law Vol 6 Part 1 at 16.

consequences, a due diligence exercise aimed at achieving a successful restructuring is necessary.

2. Financing.

Some practitioners have taken the view that when third party financiers wish to syndicate Loans, due diligence exercises are necessary. This exercise must focus not only on the company's assets and affairs but also on the business activity that is being financed.¹¹⁸

Any financier is approached for a loan of a large amount of money must carry out a due diligence exercise. This is particularly important where the loan is to an empowerment companies where skills shortage is a critical issue and collateral security to back up loans is almost always absent. Conversely, empowerment entities themselves should examine the history of some of these financial houses. A study has revealed that some of the financial houses withdraw their support for empowerment entities in times of crisis even where the problem was out of the control of these empowerment entities. This causes further problems to the struggling companies¹¹⁹.

3. It is said that due diligence inquiries are done prior to listing on the London and New York Stock exchanges but hardly ever for those intending to list on the Johannesburg Securities Exchange.¹²⁰ This is so because of the amount of detail required in these exchanges in the prospectuses of the companies. The new General accepted Accounting Practices (GAAP) accounting standards now demand fair valuations of companies in

¹¹⁸ B Baillie Mergers and Acquisitions Law Society of South Africa, Continuing Legal Education at 1

¹¹⁹ Business Map Empowerment 1999 report. The Bear markets led to higher interest rates that affected empowerment companies. Some financiers were supportive, others pulled out.

¹²⁰ B. Baillie Op cit 82

greater detail.¹²¹ Also the new listing requirements of the JSE now require slightly more detail from entities seeking to list than it did before as the JSE strives towards the international best practice standards to improve disclosure.¹²² I hereby submit that the trend by both the accounting profession and the stock exchange is to move towards more disclosure of information to the investing public and in future due diligence inquiries may be necessary to produce prospectuses for listing on the JSE.

Having dealt with the circumstances in which due diligence inquiries are necessary it is important to look at who does the inquiries. Traditionally, due diligence inquiries tended to be an issue handled by accountants because it was seen as a financial issue to be dealt with by auditors only.¹²³ This is really incorrect as some of the issues are outside the financial field and need the expertise of other experts, such as specialist lawyers, management consultants and environmentalists.¹²⁴ The International Bar Association in its 8th Conference identified three main problematic areas namely employment law, environmental law and confidentiality¹²⁵. It was suggested by practitioners at the IBA conference that when taking instructions for a due diligence inquiry, the instruction must be specific as it is a broad field. Other practitioners in South Africa have suggested that one should not assume responsibility for areas that one does not have expertise in..¹²⁶

¹²¹ J Gordon "Companies Face Costly Evaluations" Business Day 27 July 2000.

¹²² S Enslin "New Listing Rules Released" Business Day 31 August 2000

¹²³ H Sher op cit 81

¹²⁴ Due Diligences , Disclosures and Warranties in the Corporate Acquisitions Practice .International Bar Association Section on Business law , 8th Conference 1988.

¹²⁵ Ibid

¹²⁶ B. Baillie op cit.82

4.1.3.5 Timing of the exercise.

Sher and Baillie agree that it must be done prior to the process which it seeks to give effect to¹²⁷. The reasoning by these practitioners is that if this is not done, it creates difficulty in the negotiation process as to what consideration is appropriate depending on whether it be a merger, an acquisition or a financing operation. This is particularly so with acquisitions in circumstances where a source of liability is discovered after the price of the target to be acquired has been made, or to gain any other concessions in mergers. Secondly on the part of the seller of the object in an acquisition, it gives the buyer more of an advantage if he knows more of the liabilities involved in the acquisition over a seller who does not as he will use those liabilities to reduce the selling price.

4.1.3.6 Object of the exercise.

Different due diligence inquiries seek to achieve different things. The focus therefore in each inquiry should be related to the object of the inquiry. For those due diligence exercise that precede acquisitions the object is to find out whether the company being bought contains the target asset the acquiring company seeks to acquire and whether the company is in good form.¹²⁸ For example if the target asset in a company to be acquired is a license, then the person conducting the inquiry has a duty to find out that the license

¹²⁷ H Sher, "Due Diligence Investigations" supra at page 16. B Baillie Mergers and Acquisition Supra at page 1

¹²⁸ H Sher supra at page 1

is there, that it is transferable and if it were for a particular period of time, that the time scale has not expired. If the target asset in a construction company is a contract, he must establish that the contract is transferable.

Other liabilities that come with the company should be dealt with by estimating the cost of such liabilities and used to reduce the purchase price accordingly. In addition warranties if necessary must be included in the contract of sale.

In the case where the due diligence exercise is being done to merge companies, then the focus also extends to the operational compatibility of the companies. The of corporate culture and information technology systems for both companies must be examined¹²⁹.

In a situation where the focus is a restructuring exercise the object will also focus on the operational side of the business, potential job losses or duplication of functions, contracts with third parties and the possibility of breaches thereof.

Where the object of the due diligence investigation is to finance an operation then the focus of the exercise will be on investigating the collateral security or for debt and the viability of the deal that is being financed¹³⁰.

4.1.3.7 Confidentiality.

Most targets for mergers and acquisition are potential competitors in industry. It becomes an unfair situation where a company after having exposed itself to an acquirer, the acquisition or merger fails to take place.¹³¹ Information obtained may then be used against

¹²⁹ B Bailee op cit at page 3

¹³⁰ ibid at page2

¹³¹ See 88 supra.

the target if the deal fails.

Notwithstanding the above, the following checklist is essential as a minimum to be investigated during due diligence inquiries¹³².

- The constitution of the company that is the articles and memorandum of association.
- All agreements within that is shareholders agreements and without, that is contracts with third parties.
- Minutes of general meetings and the board of directors.
- Litigation and performance history of the company.
- Balance sheets.
- Environmental impact assessment reports of the companies.
- Title deeds and a deeds registry search.
- Licenses to see whether they are current.
- Tax situation with the receiver.
- Recognition agreements and collective agreements with trade unions and employers' organisations.

This list is not exhaustive and can be amended depending on the circumstances.

4.1.3.7(a) Case Study¹³³

The Privest Group/Natal Training Centre (NTC)– Employment Law.

This case study is an illustration of how a company can easily loose money in a badly handled takeover bid. It goes to stress the fact that a due diligence exercise is of such a

¹³² B. Baillie op cit 82. Some of these points come from her writing, others are personal representations.

¹³³ Information obtained from Conflict Resolution Alliance, the Union which represented the employees.

fundamental importance that prior to any commitments with the target company, it should be done.

The Privest Group is a company involved in the business of staff outsourcing, recruitment, training and placements, amongst other things. In 1999 it decided to acquire NTC a training company with the aim of boosting its training division.

As the acquiring company operated a labour intensive business, the NTC staff were an extremely valuable asset in the target company. Prior to the conclusion of the sale of business agreement and during the due diligence process, one of the Privest Group's managers, seconded to be the head of the NTC division when the acquisition was completed, issued letters of employment to certain NTC staff stating that these employees were now Privest staff members and that they will be employed on the same terms and conditions as they were employed by NTC. The acquiring company also provided overdraft facilities in for the payment of staff salaries prior to the acquisition.

After carrying out a due diligence exercise it was discovered that the target was in huge financial difficulties in terms of its liabilities to banks. The Privest group withdrew from the negotiations.

During all this process, NTC went into liquidation. A dispute now arose as to who was the employer of the 128 employees who were formerly in the employ of NTC. It became important to settle this question because in terms of section 41(2) of the Basic Conditions of Employment Act 1997 these employees had to be paid severance packages and this had not been done. In addition NTC itself was in liquidation. Finally there was the issue of the letters issued to some employees by the acquiring company and these employees contended that they were Privest employees and Privest had to pay severance packages.

The problems in this failed acquisition lay in the conduct of its due diligence enquiry. The liabilities of the target company were not clearly established before agreements were being made for example the decision to grant letters of employment was not supposed to be done without establishing the terms of service of these employees under NTC. Severance packages in terms of section 41 of the Basic Conditions of Employment Act are calculated at the rate of 1 week's pay per completed year of service and therefore an employee who has spent 10 years at NTC will get 2 and ½ months salary. The overall cost is huge when the years of service, salaries and the total number of employees are taken into consideration . The exclusion of their years of service logically should have been excluded in any offer of employment. Secondly the granting of overdraft facilities to NTC without a proper investigation of its financial situation was negligent as it later went into liquidation forcing the Privest Group into the position of a concurrent creditor. The dispute with the employees alone was settled out of court for approximately half a million Rands. Just for attempting to acquire and not succeeding, this exercise cost the Privest Group well over 3/4 of a million Rands. This case study shows how important and how cautiously any acquirer must approach a due diligence exercise.

4.1.3.8 Special considerations in the process of mergers and acquisitions.

1.Minority Shareholders.

In the case of affected transactions,¹³⁴ if 90% of the shares of the target company have

¹³⁴ See section 440A(1) of the Companies Act 1973. Transactions shifting control to persons or persons acting in concert in whom control did not vest prior to the transaction are affected transactions. Such

been acquired, the minority shareholders of the acquiring entity may compel the acquirer to purchase the remaining minority shares at the same or similar terms as those of the majority¹³⁵. A court may compel such a sale if it is satisfied that the minority shareholder cannot be traced even in circumstances where less than 90% of the shareholders in the target company are willing to sell their shares to the acquiring company.¹³⁶

The issue of minority shareholders is important, particularly with regards to this paper because most black owned companies have small stakes in large corporations as a result of capital constraints and therefore fall within the minority. In a case where a white owned company does an acquisition by expropriating the shares of a black owned company in the minority, though such a company may well be within its legal rights to do so, such a transaction may be deemed to be politically incorrect as the general tendency is to promote black economic empowerment by ownership.¹³⁷ On the other hand even most white owned companies placed in this situation will not be willing to acquire a minority black stake as that will give that particular target company a black empowerment component. Depending on the relationship between the black component and the old or new shareholders they may be able to force the acquiring company to buy them out as it is within their legal rights to do so while the white owned company cannot prevent the black shareholders from selling their shares.

control does not necessarily have to be de facto. Suffice it that the control be in general meeting with voting shares.

¹³⁵ See section 440K

¹³⁶ J Bellew Mergers and acquisitions 1999 Continuing Legal Education at page 28.

¹³⁷ See definition of Black Economic Empowerment at chapter 1. Also see new laws that promote this ideology. Discussions with Lindiwe Gadd Corporate Affairs manager at Thebe Investments Limited.

2. Directors' Role.

In terms of section 228 of the Companies Act directors cannot dispose of the whole or substantially the majority of assets of a company without the approval of the general meeting. The issue of directors disposing of the assets here therefore rests on the shareholders who appointed them to pass a resolution allowing the sale in a general meeting by a simple majority. This concern is raised because of the method of acquisition by assets. This must be read together with the Securities Regulation Panel rules as these rules also control the sale of assets since the Securities Regulation Code also covers the sale of assets.¹³⁸ Some practitioners have held the view that the SRP's power extends to directing how votes may be cast to avoid inequity to other shareholders by either allowing a shareholder whose vote may cause prejudice to a minority shareholder to vote in part or refrain from voting.¹³⁹

3. The Securities Regulation Panel.

The most significant role played by the securities regulation panel is that of ensuring that all shareholders are treated fairly whether they are in the majority or not.¹⁴⁰ This in essence means that they must be provided with the same information, at the same time, that the same offer is made to them, that they are treated in good faith, and that the information supplied should be accurate.¹⁴¹ When a person becomes holder of 35% of the

¹³⁸ See 440A(1) for definition of affected transaction which includes a disposal as contemplated in section 228 of the Act, namely a disposal consisting the whole or substantially the majority of assets in the company by directors.

¹³⁹ J Bellew op cit95 at page 5

¹⁴⁰ Cilliers et al supra at 458.

¹⁴¹ cilliers et al Corporate law at 460. Section C

voting rights of a company, that person must make those mandatory offers to all the other shareholders in that company.¹⁴² The offer must be kept standing and the offer must be kept open for 21 days after the posting of the offer documents.¹⁴³ The party making the offer must be able to implement the offer. Cautionary announcements and the intention to make an offer must be published. The impact of the rules of the panel, especially with regard to mandatory offers to other shareholders, is difficult one for empowerment companies as the ability to make the offer then becomes dependent on whether the empowerment company has the money to buy the shares of the offeree and those of the other shareholders that are ready to sell. The offeree's minority may try to compel the empowerment company to buy its shares. Because lack of capital is such an issue with empowerment companies that the SRP rules only make them difficult for these companies to participate effectively in acquisitions. Yet it is expected that empowerment should take place by share ownership. I submit that perhaps the rules should be amended giving the panel the power to intervene in circumstances where mandatory offers are made. The reasoning here is based on Section 10 of the Competition Act that allows mergers that may promote the participation in business of people from previously disadvantaged groups.

4. Competition Law.

This has quickly become a thorn in the flesh of industry practitioners and currently one of the fast growing fields of practice in commercial law.¹⁴⁴ The threshold for mergers that

¹⁴² Section B of the Securities Regulation Code.

¹⁴³ *ibid*

are controlled is regulated by the Minister of Trade and Industry in consultation with the Competition Commission . The aim is to remove practices that lessen competition in the market whether horizontally or vertically.¹⁴⁵ The main exemptions lie in the fact that the transaction may promote exports, small businesses and previously disadvantaged businesses, stop decline in an industry, or cause stability in any industry designated by the minister.¹⁴⁶ In recent times the trend has been to run away from the clutches of the Competition Act.¹⁴⁷ To do this, recourse is made to section 3(1)(d) of the Act. This section states that the Act applies to all activities in the Republic except, inter alia, acts subject to unauthorised public regulation.¹⁴⁸ This was the argument provided by Nedcor in their unsuccessful bid against Stanbic. They argued that their bid to merge with Stanbic was governed by the Banks Act and not the Competitions Act and this was upheld by the Supreme Court of Appeal. Most black companies will enjoy the proviso to section 10 (3)(b)iv of the Competitions Act.

5. The Stock Exchange.

The listing requirements of the JSE indicate that it is concerned with insider trading as unavailability of information might lead to the prejudice of shareholders. Once an acquisition is contemplated a cautionary announcement should be made.¹⁴⁹ The degree of

¹⁴⁴ This fact can be seen in the number of mergers that have been struck down in the year 2000 for example the Nedcor Stanbic merger, The Ellerines cases. The Competition Commission is taking a more interventionist approach than its predecessors.

¹⁴⁵ see section 4(1) and (2) and section 5 (1) and (2) of the Competition Act 89 of 1998.

¹⁴⁶ See section 10(2) b of the Act.

¹⁴⁷ Example is *Standard Bank Investment Corporation v The Competition Commission*(unreported)2000

¹⁴⁸ “public regulation” has been described by section 1 as meaning “ any national, provincial or local government legislation , or any license, tariff, directive or similar or similar authorisation issued by a regulatory authority or pursuant to any statutory authority”.

disclosure needed is related to the volume of the transaction which is tied to how the various cautionary announcements are to be made.

6. Unbundlings or Divestitures.

In the world of black owned businesses, there has not been any heavy mergers with white owned companies though there have been acquisition of stakes.¹⁵⁰ But one thing that seems to be a characteristic in black owned businesses is the tendency to unbundle.¹⁵¹ This tendency is supported by the fact that most of these companies grew by acquiring stakes in other companies. There are no real rules in the companies act for the protection of minorities in unbundlings. However these can be used as methods to avoid the Securities Regulation Panel, particularly in situations where the acquiring company does not have sufficient funds to buy out everyone. In this case the majority shareholders can ask the company to unbundle and then sell themselves to the acquirer in a separate arrangement.

¹⁴⁹ Rule 9.3-9.33

¹⁵⁰ The only exception here is the merger between Lexshell 296 Investment Holdings/Molope Group Ltd with certain subsidiaries case No 04 /LM/JAN00 www.comptib.co.za

¹⁵¹ Most popular example being New Africa Investment Limited

CAPITAL IN EMPOWERMENT SCHEMES

5.1 The use of Special Purpose Vehicles (S.P.V s)

5.1.1 Background

As discussed above, it was generally accepted and constitutionally enshrined that blacks should play a role in the mainstream of the economy. One of the areas targeted was corporate life. To do this blacks had to be in control or own a stake in the economy or be seen to be doing so. It is a generally accepted principle in company law that control rest in the hands of the board of directors which board of directors is elected by the shareholders in general meeting. Voting the general meeting to create a board is logically linked to the amount of shares owned in the company as the shareholders with the greatest number of shares elect the majority of Directors in the board. It is also influenced by the type of shares they own in the company. But in order to become investors, shareholders must subscribe for shares in the company. Control of the company also depend on the type of shares subscribed for that is preference or ordinary shares. By virtue of the fact that the black population in the country had been marginalised and discriminated against, the black population was in no financial position to own equity in large corporations, let alone to such an extent as to gain control in them. It is for this reason that various methods of financial engineering were used to place control in the hands of blacks in circumstances where they would not normally have been able to achieve. It must also be remembered that under apartheid law, blacks were not allowed to own property per se and as such could not provide collateral to secure debt capital for business purposes even after the apartheid system was abolished.

5.1.2 Shareholding and Control in the SPV.

These entities, now called special purpose vehicles, were first created as a financial mechanism to bring in capital into the companies formed by black business people in a manner that complied with the law but also safeguarding the interest of financial institutions.¹⁵² They are however not necessarily without risks. A normal SPV involving a Black empowerment company has three types of shares falling into two groups. Ordinary shares and Preference shares. The preference shares are divided into redeemable preference shares and non redeemable preference shares.¹⁵³

Usually the empowerment partner holds the ordinary shares.¹⁵⁴ These shares give that partner the right to vote and all other ordinary rights to dividends in the company that is the SPV. Their risk in the company is limited to their subscribed value of shares in the company. The Financial institutions on the other hand subscribe for the preference shares¹⁵⁵. It is usually a mixture of redeemable preference shares and the normal preference shares. Redeemable preference shares earn interest just like loans while the SPV has to pay back the interest on such shares and try to redeem them by way of dividends. There is a fixed amount to be paid for the redemption of these shares for each period and after the payment of the sum for the redemption and the interest, the ordinary shareholders get a profit if there is any money left after such aforementioned payments. Ordinarily in the traditional SPV these preference shares do not carry voting rights in

¹⁵²Discussions with Dirk Kemp of Marriot Investment Bank.

¹⁵³ Cilliers et al at 221

¹⁵⁴ Lindiwe Gadd of Thebe investments Ltd

¹⁵⁵ Kemp supra

the company¹⁵⁶. Much needed capital for empowerment groups is raised when financial institutions subscribe for these preference shares. Their position is akin to that of creditors to these SPV save for the fact that the SPV does not grant any collateral security, and more importantly they are able to participate in certain instances in the making of strategic decisions of the SPV whereas a normal creditor will not be able to do so. The result of this sort of financial engineering is that control which rests in the hands of the ordinary shareholders is actually in the hands of the shareholder who has in fact put less money into the company. Logically control in a company should lie in the hands of those with more capital at risk but this is not the case here since the preference shareholders have no voting rights in the day to day running of the company. This lies in the hands of the elected board of directors. In the case of black empowerment companies, directors elected by ordinary shareholders who are the black shareholders.¹⁵⁷

5.1.3 Limitation on control.

The control mechanisms in a company will be found in the article of association especially when preference shares are concerned since control by shareholders come by way of voting rights.¹⁵⁸ Any limitations placed on the voting rights of any class of shares will normally be found there.

Generally all shareholders have a right to vote in a company.¹⁵⁹ For preference shares, the

¹⁵⁶ L Gadd supra

¹⁵⁷ Business Map Empowerment 1999 The SPV Variant at 13

¹⁵⁸ Section 193 and 194 of the Companies Act 1973

law provides that this limitation may be placed in the articles except in situations stipulated in section 194. Section 194 states:

“ Voting rights of preference shareholders.- (1) Notwithstanding the provisions of section 193(1), the articles of a company may provide that preference shares shall not confer the right to vote at meetings of the company except-

(a) during any period determined as provided in subsection (2) during which any dividend or any part of any dividend on such shares or any redemption payment thereon remains in arrears and unpaid; or

(b) in regard to any resolution proposed which directly affects any of the rights attached to such shares or the interests of the holders thereof, including a resolution for the winding up of the company or for the reduction of its capital.

(2) The period referred to in subsection (1) (a) shall be a period commencing on a day specified in the articles of the company concerned, not being more than six months after the due date of the dividend or redemption payment in question, or where no due date is specified, after the end of the financial year of the company in respect of which such dividend accrued or such redemption payment became due.

The ramifications of this section are enormous especially for empowerment companies that are using preference shares as a means for raising capital. The contention has been that, transfer of risks leave the financial institutions powerless. However if section 194 is considered this is untrue. An examination of section 194 indicates that so long as the dividends of the preference shareholders are paid this sort of arrangement gives

¹⁵⁹ Section 193

empowerment partners control or so long as the redemption payments for redeemable preference shares are paid, control stays in their hands. But once these payments are not made, control swings to the hands of the financial institutions or the preference shareholders then have a right to vote.¹⁶⁰ In *Du Plessis V Utopia Vakansie –Oorde Bpk*¹⁶¹ the Appellate Division (now the Supreme Court of Appeal) confirmed a decision of the Transvaal Provincial Division of the High Court that so long as there are dividends in arrears (or a portion of the payment for redeemable preference shares) by law the preference shareholder then has a right to vote in general meetings

It is further submitted that control in SPVs can be taken out of the hands of empowerment partners very easily by factors in the Stock market beyond their control. Bullish markets¹⁶² favour financial arrangements such as SPVs.¹⁶³ When the market turns bearish¹⁶⁴ interest rates rise and the repayment of interest and dividends or installments for redeemable preference shares becomes quite difficult. The repayment of redeemable preference shares can only come from profits.¹⁶⁵ Therefore a bear market causing non payment of dividends can transfer voting rights to shareholders of preference shares in SPVs. Section 194(1) (b) has its own repercussions in SPVs. The phrase “ resolution

¹⁶⁰ *Du Plessis v Utopia Vakansie-oorde Bpk* 1974(3) SA 148(A)

¹⁶¹ *ibid*

¹⁶² P. Newman et al. The New Palgrave Dictionary of Money and Finance defines a bullish market to mean a stock market where stock prices are moving sharply upwards and substantially enriches shareholders as a group.

¹⁶³ Business Map Empowerment 1999 Financing Challenges at 11

¹⁶⁴ P. Newman *Supra* .Bear markets are markets where the general trend of stock prices is down wards and impoverishes investors.

¹⁶⁵ Section 98(a)

proposed which directly affects any of the rights attached to such shares or the interests of the holders thereof was discussed in the *Du Plessis case*. Botha concludes that where interests of shareholders are materially affected they are entitled to vote.¹⁶⁶ It must be noted that the *Du Plessis Case* was decided based on the 1926 Companies Act.¹⁶⁷ From the learned authors's interpretation therefore, a resolution to appoint directors in a company will entitle the shareholders of preference shares to vote as it materially affects their interest. Likewise the decision apply for a loan by the directors of a company. The argument that was raised in the Appellate Division is that a loan that is not repaid immediately puts the assets of the company under threat if they have to be sold to pay a debt. When the assets are sold , it affects the interest of the preference shareholders.¹⁶⁸In the case of empowerment companies with financial institutions as preference shareholders the ability to take loans for instance will automatically trigger a right to vote if this interpretation is followed. This is especially so where their main source of capital has been raised by the issuing of preference shares. It is submitted here that it appears from the above argument that, contrary to popular belief, substantial amount of control in terms of strategic decisions still rest in the hands of institutional investors in terms of the law.

From a rights point of view, section 194 is the properly in built protector of investors.

The mechanism of preference shares has created a situation where financial institutions apart from providing the much needed finance by way of loans can influence the way the

¹⁶⁶ DH Botha Section 194 of the Companies Act and *Utopia Vakansie_oorde Bpk v Du Plessis*. De Jure 1978 page 63 at 77.

¹⁶⁷ Section 64 quat (4) of the 1926 Companies Act corresponds to section 194 of the 1973 Companies Act.

¹⁶⁸ DH Botha Op cit 114

borrower of funds should use their funds so as to safeguard their money by being able to hold equity in these companies.

Empowerment companies on the other hand have benefited in gaining access to capital from a source they otherwise would not have as a result of them not having collateral security in addition to the control they gain as a right so long as the preference shareholders are paid dividends.

The control of these companies is a difficult task. The aim of financial institutions and empowerment companies need to be spelt out properly. With the SPV mechanism, by the placing of capital in the hands of a shareholder who bears little risk, this situation can lead to an loss of investor's money where carelessness or poor management exist since those in control have little or no risk at stake.

On the other hand, where market forces at the stock exchange force control as seen above out of the hands of empowerment group, an interventionist approach from the institutional shareholder can lead to a loss in focus of management since they have lost their power. Once Section 194 kicks in and the empowerment goals of the financial institutions can be easily forgotten.¹⁶⁹

The second issue is that even though the empowerment groups hold control without having put in capital it is by agreement that they control. It is very easy for control to pass where it is not intended to be which creates a situation where there is a change of contractual terms¹⁷⁰ by external forces.

¹⁶⁹ Factual discussions with Nomthle Canca of Women's Investment Potfolio Holdings and Lindi Gadd of Thebe Investments.

¹⁷⁰ Contract here refers to the articles of association which is a tripartite contract between the shareholders, the company and the board of directors.

5.2 Leverage and Management Buyouts.

Black owned businesses have a problem raising capital. Most of these businesses do not have the necessary collateral security to apply for loans from banks to fund acquisitions or other operations. These businesses resorted to the SPV model as a financial engineering method, which has been less than satisfactory because of what has happened to some companies. An example is Dynamo Investment Ltd which has delisted from the stock exchange and has gone into liquidation. The failure in the performance of black companies using the SPV model has led to a rethinking of that method of financing black businesses. A new method on the horizon that is being tested is “Leverage buyouts (LBO) and Management buyouts (MBO)”¹⁷¹

A leverage buyout (LBO) is an acquisition made using little or none of the acquirer’s funds but relying on the assets of the target company to support the financing of the acquisition¹⁷². With this method, the target company’s assets are used as security to obtain a loan. This loan is the money used to pay the shareholders for their shares in the company or for the purchase of assets of the company if the acquisition proceeds by way of assets. The new owner of the target company now takes over the company and repays the debt on terms stipulated in the loan agreement¹⁷³.

A management buyout (MBO) on its part is the same as a leverage buyout save for the fact that part of the acquiring shareholders are made up of top managers in the target

¹⁷¹ Business Map Empowerment 2000 , New Directions.

¹⁷² DA Brown et al, Financing the Acquisition; Corporate structure, finance and operation 1986 at page 27

¹⁷³ Ibid

company or almost exclusively of these managers.¹⁷⁴ The fact that managers of the target company try to acquire the company they work for generates a conflict of interest and raises issues of fiduciary duties to the target company.¹⁷⁵ These will be discussed below.

The financing of an acquisition by this method must take into consideration all the issues discussed in the preceding chapter on mergers and acquisitions. The acquirer still has to deal with the decision whether to proceed by way of a purchase of shares or purchase of assets¹⁷⁶. Due diligence enquiries need to be done and minority shareholders taken care of. When an acquisition is financed using this method, it is easier for the acquiring company or shareholders as the case may be, to purchase assets instead of shares. This is so because the transaction to use the target company's assets as security for the acquisition of loan is simpler than to purchase shares.

Secondly other unseen liabilities of the target company do not pass over. These liabilities will be in the payment of severance packages and unsecured debts. The contracts that generate these liabilities remain with the company since it has a direct relationship with the parties concerned. This relationship can easily be transferred by the purchase of shares.

A potential danger that exist with the purchase of assets is that if the sale is not published in terms of section 34 of the Insolvency Act 24 of 1936, the sale of assets could be voidable.¹⁷⁷ Section 34 is to the effect that any sale of a part of a business must be

¹⁷⁴ Top managers here means both directors and senior managers of the company.

¹⁷⁵ Fiduciary duties and loyalty to the company versus a desire to purchase the company creates conflict of interest.

¹⁷⁶ See page...Supra

published in two newspapers circulating in the area where the business is carried out.

Failure to comply with this section gives creditors the right to render the sale void up to six months from the date of the sale.

5.2.1 Special considerations when financing by MBOs

The presence of managers of the target company as members in the acquiring company raises technical problems. There is the duty of confidentiality and there may be a conflict of interest. The relationship between the various classes of managers and the company are different and impact differently with regards to the transaction. Managers who are not directors are in fact employees of the company. The general term managers when not referring to a person who is of the status of a director is a business term.¹⁷⁸ For these sorts of managers who are also employees, an MBO generates a problem of conflict of interest. Bidding to buyout one's employer places a person in direct competition with the employer which is against the common law rule that an employee should not compete with his employer for the same business¹⁷⁹. Here the trust relationship is broken down and in case the takeover bid fails, the employment relationship becomes untenable.

For those managers who are directors, they owe a fiduciary duty to the company at common law.¹⁸⁰ They owe this fiduciary duty because they hold the assets of the company in their keep and have the power to act on behalf of the company. If this were

¹⁷⁷ Creditors of the target company have the right to enforce their claims against the company making the sale voidable.

¹⁷⁸ Cilliers et al Corporate law at 165

¹⁷⁹ J. Grogan Workplace Law at page 46-47. See also *Premier Medical and Industrial v Winkler and Another* 1971(3) SA 866 (W)

¹⁸⁰ Cilliers et al op cit120 at 135

not so, they will be in a position to do as they please with the assets of the company thereby affecting the value of the shares of the company. Because of this fiduciary duty, I submit that they cannot act for the company any more once their intention to buyout the company has been made as their actions, no matter how justifiable, will be deemed to be unfair. They will be breaking a fundamental rule in natural justice of being a judge and a party to a case and cannot be seen as impartial¹⁸¹.

The position of managers and directors as insiders of the target company raise issues of fairness with regards to other bidders. An outsider who is also bidding for the same company is not in the same position as an internal manager to know what the company is like internal as the managers who are part of the acquiring team. Infact these managers' unique situation can lead to insider trading. Section 1 of the Insider Trading Act 135 of 1998 defines an insider as

“ an individual who has inside information

(a)through-

(i)being a director , employee or shareholder of an issuer of securities or financial instruments to which the inside information relates ;

In terms of the above section , all the persons who will naturally be concerned with an MBO are insiders since they include directors and employees. The Insider Trading Act

1998 Section (2) states:

”Subject to section 4 (1), any individual who knows that he or she has information and who-

¹⁸¹ An example of an MBO involving empowerment partner is Nampak selling a stake to some managers.

(a) deals directly or indirectly , for his or her own personal account or for any person , in the securities or financial instruments to which such information relates or which are likely to be affected by it :

(b) encourages or causes another person to deal or discourages or stops another person from dealing in the securities or financial instruments to which such information relates or which are likely to be affected by it; shall be guilty of an offence.

(2) Subject to 4(2) any individual who knows that he or she has inside information and who discloses that information to another person , shall be guilty of an offence.

From the above, I submit that not only listed companies can cause insider trading but also unlisted entities.¹⁸² The Insider trading Act 1998 extends the meaning of security to those that are not traded in a regulated market but to any security that has similar characteristics to those traded on the regulated market.¹⁸³ It will mean that whether a company is listed or not, in a management buyout situation its managers can cause insider trading.

The fact that managers of a company are involved in the entity bidding for it is sufficient to discourage other bidders. The other bidders immediately sense their disadvantage in terms of the information the managers know which they do not. This can cause those bidders not to bid and the price lessens as competition for bidding drops. With the reduced competition, the bidder composed of the managers of the target, trying to buyout then has the bargaining power to undervalue the company so as to pay the lowest possible price for it. The solution to this sort of scenario will be to insert a clause in the sale of

¹⁸² The insider trading Act of 1998 defines securities as instruments or rights bearing substantially or similar characteristics to such securities dealt with in a regulated market.

¹⁸³ *ibid*

business agreement to recover money from the purchaser if he makes an over profit above a certain percentage on the transaction¹⁸⁴.

Leverage and management buyouts as methods of financing acquisitions has just began amongst empowerment companies. Nozala the investment group bought Fedics (the catering group) by a leverage buyout. Some managers in Nampak bought a stake in the packaging company by a management buyout¹⁸⁵.

5.2.2 Advantages of LBOs and MBOs for Empowerment Companies.

It is likely that the problem of raising capital and finding security by black businesses will not be solved in the short term. The use of a target company's assets as security for loans to buy a stake in acquisitions makes for a good sense. I submit that rather than floating shares of state parastatals like Telkom on the stock exchange to privatise it, a stake in the company could be sold using this method of finance. This will put ownership in black hands as reasonable terms of payment can be negotiated with the government for the assets bought than with privately owned companies. This will also avoid the situation where after the privatisation of a parastatal, only a small fraction ends up with the previously disadvantaged people as was the case with Airports Company South Africa where a huge part was sold to the Italians.

It is further submitted in conclusion to this point that if government has to empower through privatisation this is the route to take. Few or no black companies can raise the necessary capital to buy stakes in the parastatals that are going to be privatised.¹⁸⁶

¹⁸⁴ S Kaplan. "Management Buyouts" New Palgrave Dictionary of Money and Finance at page 638.

¹⁸⁵ Interview with the MD of Nozala and Business map Empowerment 2000 report.

As concerns management buyouts managers who buyout their companies end up as owner managers. This provides a is good incentive to manage companies properly as any careless losses are losses that would have ended up as dividends for them. It could therefore be argued that, a management buyout should bring in better standards of management.

5.2.3 Disadvantages.

Companies that are acquired by buyouts depend on debt for capital. This is a serious issue as it causes a strain in terms of repaying and servicing the debt such that the company could fail.

Because the capital is debt capital and there is need to continue servicing the debt, the calibre of managers necessary to run these companies are supposed to be extremely efficient and experienced. There is a shortage of this type of managers amongst black companies owing to historical factors.

¹⁸⁶ Should fair valuation of these parastatals go on and from the experience in the market potraying a lack of capital for black business.

THE IMPACT OF GOVERNMENT ON BLACK ECONOMIC EMPOWERMENT

The role of the government on Black Economic Empowerment is still a much debated Issue.¹⁸⁷ This debate has largely been centered around coordination, implementation, and monitoring of the process.¹⁸⁸

In order to understand the government's point of view it is necessary to go beyond the laws that have been promulgated to the political agenda of the present African National Congress (ANC) government.

This agenda spun out of the Reconstruction and Development Program (RDP). This agenda sought to implement through a "people centered approach" which centered around human needs and a "people driven approach" which sought sustainability of empowerment¹⁸⁹. This government seeks in its empowerment policies to empower previously disadvantaged people through skills transfer, job creation and provision of finance to conduct business, irrespective of technical competence. It seeks to seek by all means to force the previously disadvantaged people through this into the economy.

6.1 Implementation

The aforementioned political ideology translated into law is seen in the number of new laws that have been promulgated and what the government wishes to promote. This process is called juridification. Professor Rycroft defines juridification as

¹⁸⁷ J.Sikhakhane "A rumbling from behind the scenes" Financial Mail 29 September 2000

¹⁸⁸ Black Economic Empowerment "Hat trick needed" Financial Mail 29 September 2000

¹⁸⁹ Black Economic Empowerment Committee Draft Report at page 44.

“the use of law by the state to ‘steer’ social and economic life in a particular direction by limiting the autonomy of individuals or groups to determine their own affairs.”¹⁹⁰ Chiefly in this context is the Employment Equity Act of 1998, the Skills Development Act, the Preferential Procurement Act and the Competition Act of 1998. These laws have had the effect of forcing the use of previously disadvantaged individuals into the economy by way of employment and ownership of stake holds in enterprises. The extent to which this succeeds is linked to the extent to which these laws are enforced. A typical area to look at is employment equity. Fines proposed in terms of the Employment Equity Act¹⁹¹ which were due in terms of a deadline scheduled for June 1999 were not issued. This fine was to be imposed on all designated employers¹⁹² who did not submit an Equity Plan by that date. This has prejudiced all the other employers who submitted the Employment Equity plan by the deadline. This is so because those who drew employment equity plans and adopted affirmative action policies have had to employ lesser skilled people, incurred costs of training them, spent time and resources negotiating with trade unions while their colleagues or competitors who did not follow these practices remain unfined, gained by using their skilled employees and were generally more competitive in business. Lack of action by the government has also slowed employment equity as a process since defaulters have gone with impunity.

On the other hand though, one finds that there are a number of joint ventures and partnerships between previously disadvantaged individuals and white owned businesses in fields where the main businesses depend on licenses or tenders.¹⁹³ Without these joint

¹⁹⁰ A Rycroft “Obstacles to employment equity?: The role of judges and arbitrators in the interpretation and implementation of affirmative action policies”. Vol 20 ILJ 2000 at 1411.

¹⁹¹ Section 20

¹⁹² See section 1 of the Employment Equity Act, footnote 18

ventures these consortia will be unable to show commitment to transformation and black economic empowerment and will not get these contracts or tenders. This situation occurs because those who award licenses and tenders are part of the government or can be influenced to implement government policy. It can be said that had the government implemented the employment equity laws more strictly, more would have been achieved.

The other area where the government seems to be falling short is that of coherency in the implementation of Black Economic Empowerment.¹⁹⁴ The first noticeable downside in the implementation is that there is no monitoring body for black economic empowerment and the Black Economic Empowerment Committee that was formed has no power at all except to make recommendations¹⁹⁵. It becomes difficult to deal with problems that arise in the process of BEE without a body in charge of co-ordinating and monitoring its progress. An example of the fallout of incoherency can be seen in the gambling industry. The Gambling Act 1996 stipulates that only 40 casino licenses can be issued in the Republic.¹⁹⁶ Prior to the issuing of the new casino licenses there were numerous independent casino operators. Most of these operators cannot compete with the bigger consortia. In the whole of South Africa the various provincial gambling boards have granted licenses to various combinations of consortia under different company names but with essentially the same partner.¹⁹⁷ The partners in these casino ventures are all big

¹⁹³ Joint ventures like Afrisun in the Casino industry, Vulindlela in the construction industry depended on a state contract to develop the point area in Durban, Cell C and others.

¹⁹⁴ Black Economic Empowerment commission Report at page 202.

¹⁹⁵ See terms of reference of the Black Economic Empowerment Commission at page 1 supra.

¹⁹⁶ Section 13 (J) of the Gambling Act 1996

groups. Meanwhile the smaller operators have been forced by law to close down their businesses as they do have licenses to operate. Clearly this is a monopoly that is being created by the government through in-coherency in the implementation of its policies. No provision was given in the National Gambling Act 1996 for the smaller operators nor was any consideration given to their activity. Their businesses were made redundant and their capital in the form of gambling machinery is lost as there is nothing to do with it.

From a constitutional point of view the rights of this people to economic activity¹⁹⁸ seems to be violated in the sense that they cannot carry out their chosen businesses. It can be argued in the light of the case of *S v Lawrence*¹⁹⁹ that gambling is a dangerous activity that necessitates special regulation and that licenses are a necessary requirement to regulate not only the activity, but where and how it should be conducted.

In distinguishing the situation of the small “illegal” casino operators to that of the respondents in the *Lawrence Case*, it is important to note that liquor licenses which were part of the issue in the *Lawrence Case*, are not limited in number. In the *Lawrence Case* it is pointed out that²⁰⁰ measures which restrict a market as contemplated in Section 26(2) will be justifiable. Examples of such protected markets pointed out there will be the transport industry (rail and air), telecommunications and broadcasting.

Section 26(2) of the constitution reads:

“Subsection (1) shall not preclude measures designed to promote the protection or the

¹⁹⁷ An example here is the Sun International group that is present in almost every province in the country as a partner in a casino venture.

¹⁹⁸ Section 26 of the Constitution of the Republic of South Africa Act 108 of 1996.

¹⁹⁹ 1997(4) SA 1176

²⁰⁰ at 1180B-D

improvement of the quality of life, economic growth, human development, social justice, basic conditions of employment , fair labour practice or equal opportunity for all, provided such measures are justifiable in an open democratic society based on freedom and equality.”

Chaskalson P, went on to say that the appellants in the *Lawrence Case*

“will have to establish that that they have been denied the right to engage ‘freely’ in the selling of liquor .”²⁰¹

In one ruling the Constitutional Court has found that the limitations placed on the number of casino licences issued is reasonable.²⁰² However the fate of the small operators in that field is uncertain as they stand at a risk of being excluded out of the market.

The second area where a lack of coherency is affecting the impact of Government on empowerment is in privatisation activities. This could be one of the methods of redressing the imbalances of the past in terms of how state assets are going to be privatised. The absence of a body in charge of empowerment to coordinate , has led to the absence of a privatisation empowerment plan . The absence of this sort of plan will probably mean that blacks may not benefit from empowerment as they should.

An important debate in the role the government should be playing in BEE is how to finance black owned business.²⁰³ The National Empowerment Fund Act was passed to help the process of finance with the National Empowerment Fund as a body to provide much needed capital for small businesses. The National Empowerment Fund was to hold

²⁰¹ S v Lawrence 1997(4) SA 1176 at 1194E

²⁰² *Grand Slam Entertainment centre v Minister Veiligheid en Sekuriteit en Andere* 1996(2) BCLR 213 (0)

²⁰³ J.Sikhakane supra

shares in privatized entities which later would be transferred to private hands. The National Empowerment fund was also to provide startup capital for small businesses. The problem is financing the fund itself and managing it as both these processes are quite complicated.²⁰⁴

The perception that previously disadvantaged borrowers are big credit risks still persists and nothing has been done to counteract this perception.²⁰⁵ This has led to discrimination of previously disadvantaged creditors in their search for capital.²⁰⁶ There has not been any action by the government to entice financiers to fund black businesses. The approach used to lure white owned businesses to employ blacks in the employment equity Act cannot work in financing as financing involves creating a contract between the borrower and the lender.

In the present circumstances therefore tax incentives would seem to be appropriate.

In dealing with financing empowerment it should always be borne in mind that the funding should go to areas where the majority of people can participate in small businesses. Investors should for example enjoy a tax incentives for investing in black owned small businesses and there should also be tax incentives for certain areas of the country which are very poor. In that way the financial community will be persuaded to get involved in such deals as they themselves will benefit.²⁰⁷

There has been considerable debate about the necessity for new legislation on the subject of empowerment.²⁰⁸ However I submit that there should be more focus on

²⁰⁴ Black Economic Empowerment Draft Report at 65.

²⁰⁵ Black Economic Empowerment Commission Draft Report at page 69 to 70

²⁰⁶ Op Cit at 70.

²⁰⁷ Op cit at 66

implementation of the existing laws rather than a rush to introduce new legislation. New legislation, no matter how good cannot be of any use unless it can be effectively implemented. If there is any thing that needs to be done, some of the existing legislation can be amended and a body created with some teeth to give effect to what the new laws stipulate and to monitor progress.

6.2 Political Stability

One issue that cannot be left out of a discussion concerning investor protection is political stability and consideration of government policy.

Firstly, with political stability, South Africa is now a stable country politically.

What should be of concern to any investor here is whether the possibility exists that it can degenerate into the situation of its neighbours. It is clear that if the issue of black economic empowerment is not dealt with properly not only by the government but also by the private sector, the danger of instability lurks. Perhaps the government should consider reparations for victims of apartheid to deal with this aspect. This is because the perception will always persist in the minds of the victims of apartheid that they may take what they believe is rightfully theirs legally or illegally. A proper reparation plan could do away with this perception.

Secondly the predictability of government policies and how they might affect business is necessary for the conduct of business activity by investors. The inability of most companies to predict that a change in government was going to affect their contract

²⁰⁸ Black Economic Empowerment Commission Conference 29th and 30th September 2000.

supply lines led to some of these companies being placed in debt.²⁰⁹ A timely release of policy changes that can affect businesses will boost investor confidence in the system. Even at the scale of municipal elections, the minor changes in the power rungs of a city council have the effect of distorting business relationships between the municipality and a business entity.

²⁰⁹ Business Map Empowerment 1999 at 14

COMPARING BLACK ECONOMIC EMPOWERMENT IN THE CORPORATE SECTOR WITH OTHER JURISDICTIONS.

Although there has been concepts like economic empowerment and affirmative action in other jurisdictions like the United States and Malasia, it is submitted that it would be a mistake to import wholesale concepts from one jurisdiction into South Africa to cope with the post apartheid situation. I will make an effort to compare situations that are similar in nature to South Africa's situation not necessarily from countries that have used concepts like affirmative action and economic empowerment but also from other transitional economies like the Eastern block countries.

7.1 Comparison with the United States.

The concept of affirmative action seems to have emanated from the US, to improve the lives of African Americans. Within a year of its implementation, the number of businesses owned by African Americans tripled. Affirmative action in the corporate sector was boosted by the reservation of a quarter system for African American businesses similar to the effect being generated by the Employment Equity Act of 1998 and the Preferential Procurement Acts. These are all commendable efforts.²¹⁰

However unlike in South Africa, the situation of African Americans was different to that of South Africans in several respects.

They were a minority as opposed to being a majority, the US government has more economic resources than its South African counterpart, the historically black educational

²¹⁰ In *Fullilove v Klutznick* 448US 448(1980) The United states Supreme court ruled that it was not unconstitutional that 10 % of federal funds granted for local and public work must be used by the state or local grantees to procure services from businesses owned and controlled by minority group members.

institutions in the US had far greater standards in comparison with historically white institutions in South Africa compared to the difference in educational standards between historically black educational institutions in South Africa and the historically white institutions here in South Africa.

Further more the focus of the US government was never in trying to put assets in the hands of the historically disadvantaged. Its focus was on skills and educational development.

Dealing with a small minority of people is easier than dealing with the majority. In south Africa, the government is under more pressure to deliver empowerment. Coupled with the fact that the resources available to it are very limited. The training facilities available to the US government in that it has more money and a majority of its population being skilled to help in the transformation process makes their task very different and simpler compared to that of the government of South Africa. Even with these advantages, the US government has had to fight claims that it is discriminatory in its practices towards the majority.²¹¹ It is very necessary to note that prolonged affirmative action and empowerment policies for the benefit of the majority in the long term will be seen as harsh discrimination and exclusion of the minority.

7.2 Comparison With Malaysia.

A frequently cited example of empowerment policies in the international scene is Malaysia. There was colonisation and not apartheid in that country. The empowerment policies that were implemented were in favour of the Bumiputra or local Malay people who were the majority in that country but had been left at the outskirts of the economy.

This was done in terms of a program called the New Economic Plan.

Unlike the US and South Africa, Malaysia had a significant foreign intervention by the World Bank and other foreign investors to kick start a boom in their economy.

The areas of focus were education and a significant reform in the banking sector²¹². The focus in education there led to an easier technology transfer to the local population. The policies of affirmative action there were in favour of the local Bumiputra people. Part of the fortune of the Bumiputra people is that this era was accompanied by the oil boom. Comparatively speaking, the situation of the Bumiputra people is far from that of South Africans. It should be noted that the empowerment process in Malaysia was driven by the government. Its government was courageous to take reforms in sectors where the South African government has not ventured in all these years of transformation namely the Banking and Finance sector of the economy. Apart from Laws that necessitate white businesses in this country to enter into joint ventures with black owned businesses, there has been no measure enticing the Banking and Finance industry to finance empowerment transactions at the SMME level. Unlike the Malaysian situation where this led to a rapid growth in the number of small businesses, the absence of intervention in this sector, is slowing down empowerment in South Africa.

A centrally driven approach to education is absent in not in effort but in the funding of education and training initiatives. The negative side of the situation in Malaysia is that if the preferential treatment of the previously disadvantaged is kept on for too long, it breeds window dressing schemes²¹³.

²¹² Business Map, "An International Perspective on Empowerment" Empowerment 2000 at 40

²¹³ KA Johnston "Affirmative Action: A necessary clause in the Bill of Rights or mere reverse Discrimination, 1996

7.3 Comparison With The Eastern Block Countries

Although there was no apartheid in the former Eastern block countries and there was no racial or class discrimination there are striking elements there to the situation in South Africa. These similarities come from a skills point of view and a capital point of view. In the communist system that existed in these states there was no question of ownership as everything belonged to the state. The absence of such ownership rights is very similar to that of apartheid South Africa where blacks were denied these rights. The lack of ownership rights in a system definitely creates problems if that system with no property rights is transformed to a capitalist system. When individuals in such a society decide to invest in companies, access to funds become extremely difficult as they do not have funds and cannot raise funds by debt since they do not own property to use as collateral security for shares. The second problem here is in their management skills. Under both the communist and apartheid system (in the black sectors) there was no real commercial activities going on, such that those who developed under these systems cannot be expected to perform well under the capitalist system as skilled managers will.

It is worthwhile looking at how businesses are run in the former communist states as guided to what can happen in south Africa.

The first aspect that comes to mind is privatization. In the former Eastern block countries with the end of communism, there has been a lot of privatization going on. However the process has to be regulated to avoid collusive bidding as competition for bids in the industries being sold are very low.²¹⁴ This has been the case in some sectors for the

issuing of licenses²¹⁵.

In commenting on the transition economies and specifically on what direction corporate governance in these companies should take, Miwa and Ramseyer compared the companies in transition economies to those in the pre war Japanese cotton and textile Industry.²¹⁶ According to these commentators, the experience in Pre –War Japan was that the firms that had used less debt capital, corporate structures that constrained shareholder power, and attracted only shareholders who were top professionals adding value to the firm and who will monitor the firm were allowed to join. These successful firms avoided large institutional investors who used the company only for their own gain.²¹⁷ With respect I submit that while some of these policies are necessary for good corporate governance, because of the inability of the government of South Africa to provide funding for empowerment businesses, it will be necessary to include large institutional investors on their own terms as there is very limited source of financing empowerment deals. One may also argue that shareholders who add value to their respective enterprises come at a price be they top professionals or not. Here I refer to my earlier argument that the field of empowerment businesses is full of ex politicians who are being brought in because of their political connections for the purpose of lobbying for contracts or licenses. These type of shareholders will want a stake in the company less than the average shareholder pays for theirs.

²¹⁴ M Wright et al “ Privatization and Buyouts in Central and Eastern Europe” New Palgrave dictionary of Money and Finance.

²¹⁵ See Competition Law aspects of Joint Ventures.

²¹⁶ Y Miwa et al Corporate Governance in Transitional Economies : Lessons from the pre –war Japanese Coton Textile Industry. Jolin Center For Law Economics and Finance, Havard University.

²¹⁷ Ibid at page 21

CONCLUSION

There has been a tremendous effort by government evidenced by the new laws promulgated to get black empowerment on track, which is quite commendable.

The new laws are necessary to achieve their empowerment objectives. However the implementation of these laws is going to be more meaningful than just the existence of these laws.²¹⁸

In order to properly implement the new laws in a meaningful way in the process of empowerment, I submit there must be constant evaluation of various benchmarks for empowerment. The Black Empowerment Commission is in a good position to do this, but it must have some teeth to intervene and not only recommend . Its first report came out in the year 2000 which is appalling for a process that has been going on for at least seven years. It is an indication that the empowerment process has been going unmonitored for all these years.

Apart from evaluating the empowerment process, any commission in charge must take corrective action in areas where monitoring shows the existence of drawbacks.
