"DUPED" SHAREHOLDERS MAY APPLY FOR WINDING-UP ORDER – SECTION 81(1)(e) OF THE COMPANIES ACT 71 OF 2008

Pinfold v Edge to Edge Global Investments Ltd 2014 (1) SA 206 KZD

1 Introduction

In what is the first case of its kind that to have come before the South African courts the shareholders in *Pinfold v Edge to Edge Global Investments Ltd* (2014 (1) SA 206 KZD) were granted permission by the KwaZulu Natal High Court (Durban) to wind up Edge to Edge Global Investments, a public company on allegations of fraud committed by the directors of the company. The application was brought before the court in terms of section 81(1)(e) of the Companies Act 71 of 2008 (hereinafter "the Act"). The decision is significant as it provides insight as to what the courts would consider to be fraudulent, illegal and a misuse or waste of the company's assets by the directors of a company, and what the shareholders of a company need to prove in order to be successful in an application based on section 81(1)(e) of the Act.

2 Facts

The applicants, Anthony Richard Pinfold and Others, are a group of South African and British shareholders in the Durban-based company Edge to Edge Global Investments who claimed that, based on the strength of the representations made by the directors John and Kathy Ellis and Jan Louw, they invested R60 to R70 million in the company (par 12). The applicants contended that as result of their investigations they proved that the directors had misappropriated the monies that belonged to the company or alternatively that the directors had wasted the monies that were invested in the company (par 12). The shareholders claimed that they invested in the company on assurances by the directors that their money would be used to develop a "life-changing" Aids nutrition pack (Imuniti Nutritional Supplement Combo Pack or ISCP) which would be sold across Africa (par 13.1). The shareholders submitted that they were told by the directors that Blue Gold Water and Chemicals (Pty) Ltd was owned by the respondent and was the owner of a patent in respect of the water-purifying drops in the pack – which they had discovered was not true – and that the pack was to be clinically tested in Abidjan by Nobel prizewinner Professor Luc Montagnier, who was credited with the discovery of HIV (par 13.1). These trials never happened. The shareholders argued that with the business office shut down and staff unpaid, they believed that the company was insolvent and their money was

used to prop up the directors' luxury lifestyles. Pinfold stated that at the time that he purchased the shares in the company he was not aware that Ellis had three previous convictions, then expunged, and that Louw had a 2001 judgment against him for R200 million. It was argued by the applicants that the failure to disclose these facts constituted a fraudulent disclosure and that the applicants would never have invested in the respondent had this been disclosed (par 15). The applicants contended that the respondent failed to issue financial statements in respect of the financial year ending February 2012 and February 2013. This was not disputed by the respondent. The respondents further admitted that R31 million were received by the company and that there were ongoing attempts to market the company. The applicants alleged that the directors had abandoned and lost site of their role in managing the public company. They further alleged that the directors had failed to act as agents of the shareholders in that they did not act in the interest of the shareholders and shareholders investments and that they also had failed to conduct activities in the interests of the company. In essence the applicant argued that the directors had acted fraudulently, illegally misapplied assets of the company and had failed to account to the shareholders (par 2). On 13 September 2013 the applicants brought an action based on section 81(1)(e) of the Act asking the court to grant an order to wind up the company on the grounds that the directors in control of the company had acted in an illegal, fraudulent manner and that they had misapplied and wasted the company's assets (par 1). The directors of the respondent sought to challenge the applicants' *locus standi* rather than attempting to answer the serious allegations that were leveled against them (par 12).

3 Legal issue

The issue the court had to decide was whether the conduct of the directors was such that it could be considered that they had "acted in a manner that was fraudulent or otherwise illegal" and that their actions were "misapplying or wasting" the company's assets. The application before the court therefore focused on the conduct of the directors of the respondent and whether such conduct would warrant the court granting an order to wind up the company (par 2).

4 Judgment

The judge held that the directors had lost sight of their role in managing a public company and their duty they to act in the best interests of shareholders. The judge held further that those duties included compiling annual audited statements "which are vitally important to everyone with an interest in the company". Judge Esther Steyn found that a careful analysis of the answers given by Ellis and Louw showed that they had not directly responded to allegations or proffered any reasonable explanation to the allegations against them. The learned judge held that the directors had "most certainly made misrepresentations" regarding their claims of ownership of patents and "such conduct was misleading and potentially prejudicial to investors". Accordingly Judge Esther Steyn granted the order

giving the shareholders permission to initiate liquidation proceedings against the public company based on allegations of fraud (prayers 2 and 3 of the notice of motion).

5 Analysis and discussion

The grounds for the winding up of a solvent company by the court under the Act are quite different from the grounds under which a court was able to wind up a company under section 344h of the Companies Act 61 of 1973 (hereinafter "the 1973 Act"). Cassim *et al* (Cassim, Cassim, Cassim, Jooste, Shev and Yeats *Contemporary Company Law* 2ed (2012) 916–917) opine that, where there were similarities between the circumstances previously listed in which a company could be wound up by a court and those which currently apply under the Act, or where the same words or phrases are used, the court might be guided or even bound by existing case law in this regard (*Muller v Lilly Valley (Pty) Ltd* [2012] 1 All SA 187 (GSJ) par 1 and 2 of the judgment). The 1973 Act provided that the court might wind up a company if "it appears to the court that it is just and equitable that the company should be wound up" (s 344h of the 1973 Act). Section 81(1)(c) and section 81(1)(d)(iii) also includes "just and equitable" ground.

There is no fixed category of circumstances or set of circumstances which may provide a basis for a winding-up on the just and equitable ground (*Thunder Cats Investments 92 (Pty) Ltd v Nkonjane Economic Prospecting and Investment (Pty) Ltd* (2014) 1 All SA 474 (SCA) par 15 of the judgment). In *Thunder Cats Investments 92 (Pty) Ltd v Nkonjane Economic Prospecting and Investment (Pty) Ltd* (*supra*) the application before the court was based on section 81(1)(d)(iii) in the alternative whether it was just and equitable to wind up the company (par 1 and 2 of the judgment). The winding-up application was motivated by the desire of the second and third respondents to dispose of their shares. The shareholders' agreement provided a mechanism for this but required that all the other shareholders consent thereto in writing. The appellants, it was argued, were unwilling to consent to the respondents' disposing of their shares or to meet in order to discuss a reasonable basis for their leaving the company. The result of the *impasse* and the consequent lack of trust between the parties had rendered the management of the company dysfunctional and the company moribund, justifying its winding-up (par 7 of the judgment).

Despite the company being solvent, Vermeulen AJ in the court *a quo* granted the order liquidating the company on the basis that it was just and equitable to do so as provided for by section 81(1)(d)(iii) of the Companies Act 71 of 2008. The Judge found that the general breakdown of the relationship between the shareholders, and in exercising his discretion whether to liquidate, said that the company was of the kind envisaged in *In re Yenidje Tobacco Company Limited* ([1916] 2 Ch 426 (CA)), that was a partnership in the guise of a company (par 2 of the judgment; see also in *Ebrahimi v Westbourne Galleries Ltd* [1973] AC 360; *Lawrence v Lawrich Motors (Pty) Ltd* 1948 (2) SA 1029 (W) 1032; *Budge v Midnight Storm Investments* 2012 (2) SA 28 (GSJ) par 15–21; *Erasmus v Pentamed Investments (Pty) Ltd* 1982 (1) SA 178 (WLD) and the detailed analysis 181A–185C; and see also the contribution by JJ Henning in LAWSA Vol 19

2ed 272 and 273, wherein the author specifically dealt with "just or lawful cause" pertaining to the dissolution of partnerships). Vermeulen AJ took into account that the company had only four members, each having the right to appoint a director, and that there was accordingly no body of shareholders distinct from the board. Each of the shareholders had the right to participate in the management of the company (par 2 of the judgment). The shareholders' rights to dispose of their shares were restricted so that a shareholder could not, without the consent of the other shareholders, simply sell its shares and go elsewhere. Given the irretrievable breakdown in the relationship between the parties, which went further than the inability to meet or pass resolutions, and irrespective of whether it also resulted in a deadlock at board level, he found that the liquidation of the company was, in the absence of any other remedy, the only route to follow (par 2 of the judgment). Malan JA, in the Supreme Court of Appeal (SCA) had to consider whether the provisions of section 81(1)(d)(i) and (ii) of the Act affect the interpretation of the words "just" and "equitable" in section 81(1)(d)(iii) so as to preclude all other grounds of deadlock (par 5 of the judgment). The court held that "just" and "equitable" in section 81(1)(d)(iii) of the Act should not be interpreted so as to include only matters similar to the grounds stated in section 81(1) (par 14 of the judgment). The Judge held further that the examples of deadlock in section 81(1)(d)(i) and (iii) constitute examples only and are not exhaustive and do not limit section 81(1)(d)(iii) (par 14 of the judgment; and see also *Budge v Midnight Storm Investments 256 (Pty) Ltd* supra par 9–10 of the judgment). The court therefore concluded that it was satisfied that the relationship between the shareholders had irretrievably broken down. The court stated that the shareholders' agreement and the equal holding of shares and voting power on the board required the shareholders to co-operate. Without such co-operation the company could not function (par 33 of the judgment). The court held that the company could not function properly as the relationship of trust and confidence between the parties had been destroyed. The court held that the appeal was dismissed and it was just and equitable that the company be wound up (par 32–33 of the judgment).

In *Sweet v Finbain* (1984 (3) SA 441 (W) O'Donovan J said (444) that:

> "The ground is to be widely construed; it confers a wide judicial discretion, and it is not to be interpreted so as to exclude matters which are not *eiusdem generis* with the other grounds specified in s 344. The fact that the Courts have evolved certain principles as guides in particular cases, or examples of situations where the discretion to grant a winding-up order will be exercised, does not require or entitle the Court to cut down the generality of the words 'just and equitable'" (see also *Sunny South Canners (Pty) Ltd v Mbangxa NO* [2001] 1 All SA 474 (SCA) 481 of the judgment).

In *Apco Africa (Pty) Ltd v Apco Worldwide Inc* (2008 (5) SA 615 (SCA)) the Supreme Court of Appeal (SCA) set down the following points regarding the winding up of a company on "just and equitable" grounds:

- This type of consideration postulates no facts, but only a broad conclusion of law, justice and equity as a ground for winding up (*Moosa NO v Mavjee Bhawan (Pty) Ltd* 1967 (3) SA 131 (T) 136 H);
- it is well settled that the power given to the court to wind up on a just and equitable ground is not confined to cases where there are grounds

analogous to those mentioned in other parts of the section (*Loch v John Blackwood* [1924] AC 783 (PC));

- no general rule can be laid down as to which circumstances have to be borne in mind in considering whether a case comes with in the phrase (*Davis and Co Ltd v Brunswick (Australia) Ltd* [1936] 1 All ER 299 (PC) 309); and
- the cases show that the application of just and equitable provision is not to be limited to cases where the substratum of the company has disappeared or where there has been a complete deadlock (*In re Yenije Tobacco Co Ltd supra* 430; and *Marshall v Marshall (Pty) Ltd* 1954 (3) SA 571 (N).

In *Rand Air (Pty) Ltd v Ray Bester Investments (Pty) Ltd* (1985 (2) SA 345 (W) 350) the court held that certain principles and guidelines had been developed for the exercise of the courts' discretion to wind up the company on just and equitable grounds. These grounds do not represent a closed list. The first is the disappearance of the company's substratum. This occurs where the company was formed for a particular purpose for instance and that purpose can no longer be achieved. Secondly, is the illegality of the objects of the company and fraud committed in connection therewith. Thirdly, it is that of deadlock in the management of the company's affairs which renders the company incapable of carrying on its business because there is no way to resolve the deadlock between the dissenting groups. Fourthly, are grounds that are analogous to those for the dissolution of partnerships (see *Ebrahimi v Westbourne Galleries Ltd supra*; and *BH McPherson* (1964) 27 MLR 282 303) and fifthly, where there is oppression. This may occur where the persons who are in control of the company have been guilty of oppression towards the minority shareholders whether in their capacity as shareholders or in some other capacity (see also Blackman, Jooste and Everingham *Commentary on the Companies Act Vol 1* (2002 loose-leaf) 14-102–14-116).

The case law that has developed around the concepts and grounds which make it just and equitable for courts to wind up the company will not only be helpful and instructive but will also give the court direction as to when the courts may order the winding up of the company based on sections 81(1)(d) and 81(1)(e) respectively (Cassim *et al* Contemporary *Company Law* 917).

The Act now also recognizes a management's or a shareholders' deadlock (s 81(1)(d)) and fraud or illegal actions on the part of the company's controllers (s 81(1)(e)) as potential grounds for winding up of the company by the court.

The circumstances under which the court may wind up a solvent company are enumerated in section 81 of the Act. In *Knipe v Kameelhoek (Pty) Ltd* (2014 (1) SA 52 (FB)), the court held that the winding-up of the company should be considered in accordance with the provisions of section 81(1)(d) of the Act and not in accordance with section 344(h) of the 1973 Act). Daffue J held that the approach in considering whether it was just and equitable to wind up a company in terms of the Act is in essence not any different to what it is (or was) in accordance with the 1973 Act which still applies to the winding-up of companies which are not solvent. The legal basis for winding

up a company according to the Judge remains the same (par 23 of the judgment; and see also *Budge v Midnight Storm Investments 256 (Pty) Ltd supra* par 5–12 of the judgment).

The court has a discretion as to whether or not to grant a winding-up order on not, and is therefore not obliged to grant the order merely because the resolution has been passed when one of the other grounds for winding-up has been established (*LAWSA Vol 4* 3 par 110).

Section 81(1)(e) of the Act states that:

> "A court may order a solvent Company to be wound up if – ... a shareholder has applied, with leave of the Court, for an order to wind up the company on the grounds that –
>
> (i) The directors, prescribed officers or other persons in control of the company are acting in a manner that is fraudulent or otherwise illegal; or
>
> (ii) The company's assets are being misapplied or wasted."

A shareholder would not be able to apply to court under section 81(1)(d) or (e) of the Act unless he or she:

(a) has been a shareholder continuously for at least six months immediately before the date of the application; or

(b) became a shareholder as a result of –

(i) acquiring another shareholder; or

(ii) the distribution of the estate of a former shareholder, and the present shareholder, and other or former shareholder, in aggregate satisfied the requirements of paragraph (a) (s 81(2)(a) of the Act)."

It is important to note that the court may not make an order applied for in terms of section 81(1)(e) or (f) if, before the conclusion of the court proceedings, any of the directors has resigned or has been removed in terms of section 71, and the court concludes that the remaining directors were not materially implicated in the conduct on which the application was based; or one or more shareholders have applied to the court for a declaration in terms of section 162 to declare delinquent the directors, if any, responsible for the alleged misconduct, and the court is satisfied that the removal of those directors would bring such conduct to an end (s 81 (3) of the Act).

Mr Parker who appeared on behalf of the respondents submitted that since the matter was before the court as an application, that the ordinary principles and rules relating to applications should apply. He contended that the mere allegations of misconduct were insufficient for the purposes of section 81, and that the court was to dismiss the application based on the defences raised by the respondents or refer the matter for oral evidence (par 4). Mr Harper SC, appeared on behalf of the applicants and argued that the court did not need to make a definite finding regarding the grounds that were required in terms of section 81(1)(e). He argued that all that the court was required to do in light of section 81 (1) (e) was to be satisfied that there was *prima facie* evidence that supported the allegations submitted by the applicants (par 4).

Owing to the fact that section 81(1)(e) does make reference to fraudulent conduct it is therefore necessary to consider what actually constitutes fraudulent conduct (*R v Grantham* [1984] QB 675 (CCA) as cited by Zulman JA in *Heneways Freight Services (Pty) Ltd v Grogar* 2007 (2) SA 561 (SCA), and *In Re: South African Co-Operative Livestock Company, Ltd (in Liquidation) Beachy-Head and Others v The Master* 1911 TPD 1013; and *cf Estate Nochomovitz v The Victory Shirt Co Ltd* 1923 CPD 467 468). Fraud is defined in our common law as: "unlawfully making, with the intent to defraud a misrepresentation which causes actual prejudice or which is potentially prejudicial to another" (Burchell *Principles of Criminal Law* 3ed (2005) 833). Although this concept finds application more so in the context of criminal law, it remains relevant in the corporate context.

The court stated that section 81 of the Act served as a safeguard to prevent solvent companies from being faced with frivolous applications to be liquidated on either or both of the grounds listed in section 81(1)(e) of the Act (par 6; and see also *Boschpoort Ondernemings (Pty) Ltd v Absa Bank Ltd* 2014 (2) SA 518 (SCA)). In this respect the Act grants protection to solvent companies by requiring that a court should first grant leave. This being the case, applications that are brought *mala fide* or without substance should not be granted by the court. The court went on to state that the section essentially fulfilled a filtering function by affording a solvent company an opportunity to make submissions to show why such an application was without substance (par 6).

Judge Steyn was of the view that the discretion to be exercised in terms of section 81 was very broad and the onus of satisfying the court that the directors acted fraudulently or illegally was an evidential onus that required an applicant to place sufficient evidence before a court that such grounds existed. The judge went on to state that the reading of the section appeared to indicate that *prima facie* proof would suffice in showing the existence of the grounds listed. The test according to the judge was no higher in showing a *bona fide* triable ground. If that was established a court should grant permission to wind up the company (par 7).

In interpreting section 81(1)(e) the court had to be mindful of obligations resting upon it when interpreting legislation. Section 39 of the Constitution of the Republic of South Africa, 1996, provides as follows:

> "(2) When interpreting any legislation, and when developing the common law or customary law, every court, tribunal or forum must promote the spirit, purport and objects of the Bill of Rights."

In *Investigating Directorate: Serious Economic Offences v Hyundai Motor Distributors (Pty) Ltd: In Re Hyundai Motors Distributors (Pty) Ltd v Smit NO* (2001 (1) SA 545 (CC)), Justice Langa, as he then was, stated:

> "[Accordingly judicial officers must prefer interpretations of legislation that fall within constitutional bounds over those that do not, provided that such an interpretation can be reasonably ascribed to the section" (par 23 of the judgment).

Section 61 of the Act regulates shareholders' meetings and places a duty on a company to convene a meeting of its shareholders. Section 61(7) provides as follows:

> "(7) A public company must convene an annual general meeting of its shareholders –
>
> (a) initially, no more than 18 months after the company's date of incorporation; and
>
> (b) thereafter, once in every calendar year, but no more than 15 months after the date of the previous annual general meeting, or within an extended time allowed by the Companies Tribunal, on good cause shown."

The procedure that should be followed at such meeting is prescribed in terms of section 61(8) which reads:

> "(8) A meeting convened in terms of subsection (7) must, at a minimum, provide for the following business to be transacted –
>
> (a) Presentation of –
>
> (i) The directors' report;
>
> (ii) Audited financial statements for the immediately preceding financial year; and
>
> (iii) An audit report;
>
> (b) Election of directors, to the extent required by this Act or the company's Memorandum of Incorporation;
>
> (c) Appointment of –
>
> (i) An auditor for the ensuing financial year; and
>
> (ii) An audit committee; and
>
> (d) Any matters raised by shareholders, with or without advance notice to the company"

The financial statement of a company is vitally important to everyone with an interest in that company. Section 30 of the Act compels companies to prepare annual financial statements within six months of each financial year. The directors contravened section 28 (Accounting Records); Section 29 (Financial Statements) and section 30 (Annual Financial Statements) of the Act in not submitting statements. Section 30 should, however, be read together with section 26 and 28 of the Regulations. The court was of the view that the financial statements would have served as cogent proof of the assets of the respondent, its debts and its expenditure (par 11).

The directors had not compiled financial statements for the year ending 2012 and 2013 and that the company had received R31 million. The directors had not given any reasonable explanations to allegations made against them; instead they chose to blame the delay of issuing the financial statements on Ms Jennifer Etchells (former employee and chartered accountant). Ms Etchells left the service of the company in March 2013 and the company had sufficient time to obtain the services of an independent auditor and to satisfy the shareholders that everything was in order regarding the finances of the company. The court was of the view that the directors attributing the delay of the issuing of the financial statements on Ms Etchells constituted a dereliction of their duties as directors (par 13).

The court stated that for the directors to hold out that the respondent company was the patent holder of ISCP when they were clearly not, was misleading and potentially prejudicial to investors who relied on such representation. The court noted that there was a vast difference between lodging a registration for a patent and owning a patent. The true status of the patent was that the respondent had applied for the registration in June 2013 but that objections were lodged and a decision on the objections were still pending (par 13.2). The court stated that the aversions made by the directors in the respondent company's memorandum regarding the registration of the trademarks, and the success of the products marketed by the company were untrue and misleading (par 14).

The court was satisfied that there were a number of instances were misrepresentations were made by the directors and that the shareholders relied on these misrepresentations when they invested in the respondent and that these misrepresentations could have had the effect of causing prejudice to those who either relied or acted upon. The court also pointed out that there was no genuine dispute of fact and that the version provided by the respondents was untenable when compared with the version of the applicants (*Buffalo Freight Systems (Pty) Ltd v Crestleigh Trading (Pty) Ltd* 2011 (1) SA 8 (SCA)). The court therefore concluded that the applicants were entitled to an order in terms of section 81(1)(e) of the Act (par 16).

6 Conclusion

Section 81(1)(e) of the Act is designed to act as a safeguard to prevent solvent companies from being faced with frivolous applications to be liquidated and also to prevent instances where applications are brought *male fide* or without substance. However, in instances where the directors of a company lose sight of their responsibilities to act in the best interest of the company by failing to keep keeping proper financial records and where there is evidence of defrauding and misleading shareholders as well as a misapplication and wastage of company resources, then the courts in light of the judgment in *Pinfold v Edge to Edge Global Investments Ltd* (*supra*) will be prepared to grant an order to the applicant shareholder for an order to wind up the company. The court, in granting such an order, not only provides an opportunity for an aggrieved shareholder to finally have a liquidator probe and make full and proper disclosure of what happened to the assets of the company, but also protects innocent members of the public who remain at risk of being misled into investing in a company where the directors have conducted the affairs of the company in a fraudulent manner and misused or wasted the assets of the company (par 4). It is always important to keep in mind that the conduct and management of the company's affairs are based on the conduct of the directors, not in regard to their private lives but in regard to the company's business.

Darren Subramanien
University of KwaZulu-Natal, Pietermaritzburg