

Some aspects of share investment and the law

INTRODUCTION

The basic rules governing market dealings are a mixture of ordinary contractual principles, statutory regulations and the established customs and practices of The Johannesburg Stock Exchange. These rules are mostly simple, well-known and plentiful. It is the intention of this article to highlight a few points of law, relating to share investment, which are less obvious and less well-known.

In the interests of brevity, it will limit discussion to ordinary, quoted, fully-paid shares.

TRANSFER OF SHARES

The transferability of shares is one of the foundations on which the J.S.E. rests. As between transferor (the person divesting himself of the shares) and transferee (person acquiring the shares), ownership of the shares passes independent of registration, but the transferee does not become a member of the company unless and until registered as such. In other words, if X buys 100 shares, he may exercise his right of ownership to sell them later at a profit (hopefully) but if he is not registered as a member of the company, he may not receive a dividend, or vote etc. This is sufficiently well-known, but the difficulty lies, in the word "ownership". Ownership by and large, implies a **real right** — that is a right to vindicate one's property against "all the world", but a share is an incorporeal and as such is a **personal right**, a right of action. A personal right is available against a particular person and not against "all the world" — thus if the particular person no longer has what one seeks to claim from him, one may not claim it from a third party.

The consequence of this is that supposing X entrusts scrip with a blank transfer to his friend Y as a pledge to secure a loan, or even merely for safe-keeping, X will be estopped (prevented) from claiming the shares from T (a third party), if his friend Y has dishonestly sold the shares to T. The only requirement is that T bought the shares in good faith.

Authority for this is to be found in the leading case of *United South African Association Ltd. v Cohn*¹ where U.S.A.A. entrusted scrip endorsed in blank to one of its clerks. The clerk promptly stole some of the certificates and sold them to Cohn who purchased them in good faith. Innes C.J. held:

"... the general rule of law is that a man cannot be held to have parted with the ownership of property taken from him fraudulently and against his will, and that a thief cannot convey a good title to stolen property even to an innocent purchaser for value. But scrip certificates indorsed in blank do not stand in the same position as ordinary property... by the rules of the Stock Exchange and by admitted custom, such certificates pass freely from hand to hand, are considered the property of the person to whom they are delivered..."

The learned judge went on to state the fundamental reasons for the original owner being estopped:

"The original owner was estopped because he did two things — first, by indorsing the scrip in blank, he represented to all who saw it that it was scrip intended to pass from hand to hand... and second by entrusting it to the custody... of a third person, he placed that person in a position to hand the scrip over, ostensibly as its owner, to innocent purchasers..."

Following this line of reasoning, it would seem that where the scrip was actually stolen from a safe, for example, and not placed in the transferor's custody, the above rule would not apply. So if R, a robber, stole scrip from X's home and sold it to T, it is likely that X would be able to claim the shares back from T.

Of course, if there is fraud involved, as in the previous example, X would have a delictual action against Y for damages. But that would not be very helpful were Y to be hopelessly insolvent.

RIGHTS OF REGISTERED SHAREHOLDERS

Although many of the points below apply to directors in their capacity as registered shareholders, for the sake of clarity, it shall be assumed that the passage below does not apply to directors. They will be dealt with at a later stage.

The three basic rights of a member of a company, subject to the articles of association, are

- (1) to share in the profits of the company,
- (2) to attend and vote at the meetings of the company,
- (3) to share in the surplus assets when the company is wound up.²

These rights speak for themselves as one would expect shareholders, who are fundamentally the owners of a company, to have such rights. It is therefore a little incongruous that they do not have the right to know how the company is faring i.e. they do not have the right to inspect the books of the company.³ Naturally, the directors, whether they are members or not, do have such a right.

(a) Dividends

Subject to certain legal rules which determine the profit which may legally be distributed by way of dividend, it is generally left to the judgement of the directors of a company to determine what profit is available for distribution. Nevertheless, the question has arisen whether it is possible for a minority shareholder to bring an action to **compel** a company to pay a dividend.⁴ Suffice it to say that firstly, no South African court has had to deal with this matter, secondly, S 252 of the Companies Act No. 61 of 1973 is expressed in sufficiently wide terms to enable the court to order the payment of a dividend and thirdly the aggrieved shareholder would have to have a **very strong case**.

Apart from the legal rules for the determination of distributable profit, the articles of association of a company may regulate dividend payments. It is accepted law that a shareholder is only entitled to a dividend once it has been declared. In other words, after the declaration of a dividend, a shareholder may compel the company by means of a court order to pay the said dividend. The authority for this is *Boyd v Commissioner for Inland Revenue 1951 3 (S.A.) 525 at 534*.

This represents a slight departure from English law which states that if a date for the payment of the dividend has been stipulated, the debt only becomes due, and therefore enforceable, at this date.⁵

(b) Voting

In contradistinction to directors who may not enter into agreements to vote in a certain way (because their fiduciary duty demands that they must do what they consider will best serve the interests of shareholders), shareholders may enter into contracts determining the manner in which they must vote.⁶ These contracts can in fact be enforced.⁷

(c) Liquidation

In the interests of both brevity and clarity, the complicated sphere of liquidation will not be dealt with here.

DIRECTORS

The two most widely known aspects of sharetrading for which criminal liability exist are "rigging the market" and "insider" trading. While one might venture that rigging the market is becoming less frequent (or at any rate less obvious, if one is a cynic), the tell-tale build-up of volume on shares that are relatively unknown/unpopular immediately before their profit announcements confirms the continued active existence of insider trading on the Stock Exchange. It is a practice, like prostitution, which the law is determined but unable to prevent.

Firstly, the position with regard to criminal liability is simple enough. Section 233 of the new Companies Act, No. 61 of 1973, provides, in relation to listed shares: "*Every director, past director, officer or person who has knowledge of any information concerning a transaction or proposed transaction of the company or of the affairs of the company which, if it becomes publicly known, may be expected materially to affect the price of the shares or debentures of the company and who deals in any way to his advantage, directly or indirectly, in such shares or debentures while such information has not been publicly announced on a stock exchange or in a newspaper or through the medium of a radio or television, shall be guilty of an offence.*" The "person" referred to above is defined as a "person in accordance with whose directions or instructions any of the directors of a company is accustomed to act," in terms of section 229. Furthermore, in terms of section 224 (1), a director is forbidden absolutely to deal in options in respect of the listed shares or debentures of his company or of his company's controlled or controlling company or of a company controlled by his company's controlling company — in other words, whether he has inside

information or not, a director is not allowed to deal in options.

In an attempt to give teeth to these provisions, section 230 requires that the material interests and chronological changes thereof of directors, past directors, officers and persons in the shares and debentures of a public company with share capital be entered in a register which is available for public inspection. Of course, such people need not be quite so blatant.

If they deal through nominees or friends, the statutory provisions can be rendered quite ineffectual.

As far as civil liability is concerned there are two aspects:

(a) Civil liability to individual shareholders

Although a director owes a fiduciary duty to his company or to the members as a group, it is accepted law that he owes no such duty to individual shareholders nor of course, to outsiders. The rationale behind this is that the interests of a member and the interests of the company may diverge with the result that a director would be in an untenable position if he were to observe fiduciary duties towards both. Furthermore, since the judgement in the leading English case of *Percival v Wright*⁹, it has been accepted in England that a director having "inside" information may buy and sell shares in his company for his personal gain without being required to disclose that information to the other party. The logic behind this as far as Stock Exchange dealings are concerned is well phrased by Millner in his article *Fraudulent non-disclosure 1957 SALJ 177* —

"Stock Exchange transactions . . . have a pronounced speculative character well recognised by both buyer and seller and heightened by the anonymity of the principals and the complete absence of preliminary negotiations. There is a common understanding in such cases that each is content to trust exclusively to his own judgement about the shares dealt in, no matter how unequal the knowledge of the parties may in fact be".

Nevertheless, it should be noted that in South African law a contract in contravention of an express statutory prohibition is void for that very reason,¹⁰ therefore a contract for the purchase or sale of shares in contravention of section 233 above will be declared void and the parties will be restored to their former positions. Again, one is making the improbable assumption that one can catch a director etc. engaging in insider trading in contravention of section 233.

(b) Civil liability to the company

This is disputed. On the one hand, it is claimed that there is no clash between the interests of the director and those of his company when he deals in the company's shares — whether he makes a profit or loss when trading in the market does not affect the company.¹¹ Furthermore, the director does not act in his capacity as director when dealing in the company's shares. Accordingly, he is not in breach of his fiduciary duty and does not have to account to the company for "improper gains".

However, on the other hand, there is a corollary or offspring of the principle that directors must avoid a

conflict between their own interests and those of the company and that is that even if a director makes a profit openly and in good faith and without any prejudice to his company, such profit is deemed to be an improper gain if it was made by virtue of the fact that it was only realisable as a result of information which he acquired in his capacity as director.¹² Accordingly in the absence of approval by the general meeting, the director would be in breach of his fiduciary duty and liable to account for his "improper gains".

In America, in certain circumstances, a director may be ordered to pay over such improper gains to his company,¹³ and it is not unlikely that a South African court would make such an order in certain circumstances.

TOPICAL

Recently, the JSE Committee declared void all dealings which took place in nil paid letters for the right to subscribe to a rights issue. The Committee resolved that the decision "would be binding on the clients involved as well as the brokers". The details are unimportant — it was basically a case of miscomprehension of the terms of the rights issue with the result that certain nil paid letters were exchanged at a price far below their real worth.

Assume that the Committee had made no ruling. What is the position in law?

An offeree is not entitled to "snatch at a bargain" that he knows or ought to know as a reasonable man, was made by a mistake in expression. Although it might be disputed that there was a mistake in expression, the case would probably have been dealt with under this head if, as is alleged, either of the contracting brokers was aware of the other's mistaken belief i.e. that the true price was a great deal higher.

Authority for this is found in *Diedericks v Minister of Lands*¹⁴ where it was held that if one party to the contract had been aware of the other party's mistaken belief and attempted to take advantage of it, the contract would have been ruled void for "snatching at a bargain". Further authority lies in the enunciation of Smith J. when dealing with a case of bargain snatching.¹⁵

"He knew all along that a mistake had been made and he now endeavours to take advantage of it."

It seems, therefore, that the exchange of the nil paid letters was correctly ruled void.

As far as the broker-client relationship is concerned, this is governed by the law of agency.¹⁶ One of the duties of an agent towards his principal is to perform the mandate. A requirement to fulfil this duty is that the

agent should exercise **reasonable** care in carrying out the mandate. If the act that he undertook required special skill or knowledge, he must show a reasonable degree of it.

However, a broker is a special type of agent, and his ordinary function is simply to negotiate. Unlike other brokers he has no plenary powers to bind the parties. "A broker, according to our law, is a middleman or intermediary whose office to negotiate between two parties until they are ad idem as regards the terms upon which they are prepared to buy and sell. He is, as it were, agent for both one and the other to negotiate the commerce and affair in which he concerns himself".¹⁷

Therefore, as a negotiator, a broker has **no** implied authority to complete the contract. Nevertheless, his mandate is to negotiate and it is inconceivable that because he does not have the plenary powers of a normal agent, that a broker does not have to exercise reasonable care in his negotiations. On this basis, it would be up to the court to decide, whether, on the facts of the above case, the brokers' miscomprehension of the terms of the rights issue was a failure to exercise reasonable care.

Notes and references

- 1 1904 TS 733.
- 2 Hahlo, H. R., "Company Law through the Cases", 1969 Juta and Company p 188-207.
- 3 This stems from the principle that in law, the shareholders may *not* usurp the powers and function of the directors — *John Shaw & Sons Ltd v Shaw* 1935 2KB 113.
- 4 See McLennan, J. S. 1976 4 BML 142.
- 5 *Potel v Inland Revenue Commissioners* 1971 2 all ER 504.
- 6 *Coronation Syndicate Ltd v Lilienfeld and The New Fortuna Co Ltd* 1903 TS 489 at 496.
- 7 *Diner v Dublin* 1962 (4) SA 36 (N) and *Adams v North* 1933 CPD 100.
- 8 Cilliers, H. S. & Benade, M. L., *Company Law*, 1973 Butterworth & Company p 237-247.
- 9 1902 (2) ch 421.
- 10 Cilliers & Benade: *ibid* — p 244 and see *Trans-Afrika Bank v Union Guarantee & Insurance* 1963 (2) SA 92 (c) 103 and *Eland Boerdery (Edms) Bpk v Anderson* 1966 (3) SA 400 (T) 405.
- 11 McLennan, J. S., "Insider Trading" 1973 (3) BML 67.
- 12 See *Regal (Hastings) Ltd v Gulliver* 1942 1 All ER 379, followed in South Africa by *Peacock v Peacock* 1956 (1) SA 413 (T). Also, see *Industrial Development Consultants Ltd v Cooley* 1972 All ER 162.
- 13 McLennan, J. S.: *ibid* p 67.
- 14 1964 (1) SA 49 (N).
- 15 *Betz v Worcester Exploration & Gold Mining Company* 1888 65c 79.
- 16 See Gibson, J. T. R., "South African Company and Mercantile Law", 3rd Edition, Juta & Company p 228-229.
- 17 *Benoni Produce & Coal Co. Ltd v Gundelfinger* 1918 TPD at 458.