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Editorial

Special Edition on Embracing Corporate Governance, Ethics, FinTech and AI to Combat Financial Crime and Promote Reputable Financial Institutions, Organisations, and Financial Markets

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The 4th Annual International Corporate and Financial Markets Law Conference (CFML) was held in a hybrid format (combining physical attendance and virtual participation) from 6–8 November 2024 at the Department of Law, University of Botswana. This conference provides a platform for students, legal practitioners, regulatory authorities, emerging researchers, established researchers, policymakers, and other relevant persons to examine and discuss topical issues of corporate and financial markets law and related fields.

The CFML conference was held under the theme: *Embracing Corporate Governance, Ethics, FinTech, and AI to Combat Financial Crime and Promote Reputable Financial Institutions, Organisations, and Financial Markets*.[1] The conference focused, inter alia, on the effects of unethical conduct, poor corporate governance measures, and financial crime; and on the credibility and viability of economies, financial institutions, financial markets, companies, and other juristic persons in practice.[2] This follows the fact that corporate scandals and financial crimes have adversely affected most global economies because companies and financial

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[1] Alexandre, C. & Eisenhart, L.C. 'Mobile money as an engine of financial inclusion and lynchpin of financial integrity' (2013) *Washington Journal of Law, Technology and Arts* 288–289; Chitimira, H. & Ncube, M. 'Legislative and other selected challenges affecting financial inclusion for the poor and low income earners in South Africa' (2020) 64 *Journal of African Law* 337–338; Ngwenya, B., Pelser, T. & Chivaura, T. 'Perceptions of post-multicurrency regime financial inclusion confidence challenges in Zimbabwe' (2018) *South African Journal of Economic and Management Sciences* 1–15; Chitimira, H. & Torerai, E. 'The nexus between mobile money regulation, innovative technology and the promotion of financial inclusion in Zimbabwe' (2021) *Potchefstroom Electronic Law Journal* 1–4.

[2] Lumsden 'The future is mobile: Financial inclusion and technological innovation in the emerging world' (2018) *Stanford Journal of Law, Business & Finance* 7–8; Kantor Immerman Legal Practitioners 'Corporate Rescue – A Consideration for Companies Affected by COVID-19?' (15 March 2021) available at http://www.kantorimmerman.co.zw/corporate-rescue-a-consideration-for-companies-affected-by-covid-19/ [Accessed 2 July 2023]; Ngwenya, Pelser & Chivaura op cit note 1 at 1–15; Chitimira & Torerai op cit note 1 at 4; Chitimira & Ncube op cit note 1 at 338.

LEGAL CAPITAL IN SOUTH AFRICAN CORPORATE FINANCE LAW: THE INTERSECTION OF LAW AND ACCOUNTING

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Abstract

Dividend distribution laws, which encompass the funds a company is legally required to maintain after shareholder distribution to protect creditors and ensure solvency, play a pivotal role in corporate governance and financial sustainability. With recent corporate failures in South Africa, such as Steinhoff and Tongaat Hulett, the adequacy of dividend distribution laws and integration with financial reporting practices has come under increased scrutiny. This has signalled some limitations in the dividend distribution laws in interpreting and applying some of the financial principles to balance and protect the interests of all claimants in a business. Addressing these limitations could contribute to improved conduct of corporate and governance practices. This article examines the concept of dividend distribution laws within South African corporate law, exploring its connection with the Companies Act of South Africa 71 of 2008 and relevant accounting and finance principles. Dividend distribution laws influence South African companies' financial decision making and risk management. The objective is to evaluate how corporate law requirements and accountancy principles intersect to support entity growth while ensuring sustainable and reputable institutions.

Keywords: dividend distribution laws; solvency and liquidity; distributions; corporate governance; sustainability

Résumé

Les lois sur la distribution des dividendes, qui englobent les fonds qu'une entreprise est légalement tenue de conserver après la distribution aux actionnaires afin de protéger les créanciers et d'assurer la solvabilité, jouent un rôle central dans la gouvernance d'entreprise et la viabilité financière. Les récentes faillites d'entreprises en Afrique du Sud, telles que Steinhoff et Tongaat Hulett, ont conduit à un examen plus approfondi de l'adéquation des lois sur la distribution des dividendes et de leur intégration dans les pratiques d'information financière. Cela a mis en évidence certaines limites des lois sur la distribution des dividendes dans l'interprétation et l'application de certains principes financiers visant à équilibrer et à protéger les intérêts de tous les créanciers d'une entreprise. Remédier à ces limites pourrait contribuer à améliorer la conduite des pratiques d'entreprise et de gouvernance. Cette étude examine le concept des lois sur la distribution des dividendes dans

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le droit des sociétés sud-africain, en explorant son interconnexion avec la loi sur les sociétés de l'Afrique du Sud (2008) et les principes comptables et financiers pertinents. Les lois sur la distribution des dividendes influencent la prise de décision financière et la gestion des risques des entreprises sud-africaines. L'objectif est d'évaluer comment les exigences du droit des sociétés et les principes comptables se recoupent pour soutenir la croissance des entités tout en garantissant la pérennité et la réputation des institutions.

Mots clés: lois sur la distribution des dividendes; solvabilité et liquidité; distributions; gouvernance d'entreprise; durabilité

Introduction

South Africa has had its fair share of corporate failures in recent years. Some of the most prominent include Tongaat Hulett, African Bank and Steinhoff. Tongaat Hulett's inability to pay its creditors pushed the creditors to vote for a business rescue plan for the company.[1] Furthermore, the company also had an R8 billion debt from banks that is due. The most affected were the unsecured creditors and small and medium lenders who, at most, get a fraction of what they are owed through a business rescue plan, or nothing if the company is liquidated. The company has since been delisted from the Johannesburg Stock Exchange (JSE) for accounting fraud amounting to R3.5 billion by making up profits that did not exist for a dysfunctional division.[2]

Recently, the Steinhoff scandal (the biggest instance of fraud in the private sector of South Africa) resulted in investors losing more than R250 billion by various types of investors. Some of the biggest losers were employee pension funds, losing more than R20 billion due to management's misuse of funds.[3] However, just over R80 billion was lost by the majority shareholder, who was supposedly losing more than half of his wealth. The company had acquired assets and subsidiaries for what was meant to be one of the most significant expansions by a South African company, using banks' funding while doing so on the back of what seemed like a solid asset base.[4] At the back of this massive scandal were fraud, bribes, and all sorts of coalitions by executive directors, highlighting

[1] Harper, P. 'Tongaat Hulett business rescue on, but industry concerned over R900m in unpaid levies' *Mail & Guardian* (2024) available at https://mg.co.za/politics/2024-01-15-tongaat-hulett-business-rescue-on-but-sugar-industry-is-concerned-over-r900-in-unpaid-levies/ [Accessed on 31 October 2024].

[2] Ibid.

[3] Meth, O. 'More violations uncovered in Steinhoff scandal' *Organized Crime and Corruption Reporting Project (OCCRP)* (2024) available at https://www.occrp.org/en/news/more-violations-uncovered-in-steinhoff-scandal [Accessed on 31 October 2024].

[4] Rose, R. 'Steinhest: The inside story behind the Steinhoff scandal' *Daily Maverick* (2024) available at https://www.dailymaverick.co.za/article/2024-03-21-steinheist-the-inside-story-behind-the-steinhoff-scandal/ [Accessed on 31 October 2024].

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the poor governance structures and systems of the Steinhoff Group. All these issues were missed or overlooked by the governing body, the board, which allegedly did not know and was unaware of improper conduct and suspicious activity by the executive management. For these activities to have gone unnoticed, it seems nobody was bothered to dig, oversee, and ask questions about management's decisions.[5]

The interest of the several claimants of a company's value will always create a conflict as a fundamental principle of corporate finance. This would be the case whenever the company must declare dividends, make further investments, repurchase shares, or change the funding structure of the business. Furthermore, managers of a business may pursue to maximise shareholders' value in most of their dealings.[6] There is some level of perceived opportunism for shareholders at the cost of the creditors. Unfortunately, the creditor only has their contract negotiation as protection and the solvency and liquidity tests, and they get no fiduciary duty protection like the shareholders if the business goes down. This arrangement, economically, should make sense as long as the company operates effectively. However, the conditions should be affected when the company distributes to shareholders, therefore claiming entity value. In addition, if the company gets liquidated, the creditors may be the biggest losers. The creditors may only rely on the principle of business in good faith, as the management of a business usually makes decisions that may maximise the shareholder value at the expense of creditors, as the unwritten law of "shareholder primacy" prevails over time.[7]

On average, in South Africa, from 1980 to 2022, there have been more than 300 liquidations per annum, and at least 400 insolvencies have been noted. That means approximately 12,600 liquidations have occurred over the 42 years, and approximately 16,800 companies have become insolvent.[8] This trend seems to continue as over 1100 companies have been liquidated in the first nine months of 2024, and just over 1000 were voluntarily liquidated.[9] Statistics South Africa (Stats SA) has confirmed that the hardest hit industries based on their data are real estate, finance, insurance, catering, accommodation, and trade. From these sectors, the finance sector is one of the hardest hit by liquidations.[10] The impact of liquidations can be extensive. As seen in a Chinese study, these liquidation

[5] Ibid.

[6] Rhee, R.J. 'A legal theory of shareholder primacy' (2018) 102(5) *Minnesota Law Review* 1952–2017.

[7] Ibid.

[8] 'Business closures in South Africa' *Codera Analytics* (2022) available at https://codera.co.za/business-closures-in-south-africa/ [Accessed on 31 October 2024].

[9] Staff Writer 'Goodbye to 1,130 businesses in South Africa' *Businesstech* (31 October 2024) available at https://businesstech.co.za/news/business/798048/goodbye-to-1130-businesses-in-south-africa/ [Accessed on 31 October 2024].

[10] Ibid.

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effects go beyond the individual company and affect other companies connected to the entity, the employees, and industries that rely on the particular company.[11] The integrated world today makes this even more impactful, where different regions in a country or continent may have built synergies that would thus affect their economies.[12] Furthermore, the effects of liquidations are felt harder by the unsecured creditors as the law of preference is applied during bankruptcy.[13]

There are three main ways a company may finance its operations. It can be through issuing shares, acquiring debt, or using retained or accumulated profits. The use of retained profits and share capital is called equity funding. Retained profits are equity generated by the business over time, increasing the entity's value, while share issue capital is externally generated equity which gives ownership to the shareowners. The owners of shares invest in equity to maximise their returns through increased retained profits or business value and declaring dividends by the entity to shareowners.[14]

Contrary to equity funding, debt providers invest in a business with the idea of charging fixed or interest-linked payments to the business and, after settlement, have further conditions attached.[15] Borrowers play a vital role in the business ecosystem, as evidenced by the South African Reserve Bank (SARB) report based on the funding structure from 1990 to 2003. The report states that corporate total funding from 1990 to around 1997 was, on average, higher by 5 per cent for accumulated profits than interest-bearing debt.[16] However, in 1998, this structure swooped, and there was more debt funding than accumulated profits. From 2003, the difference in weight between these two options narrowed to the same weight in the funding structure. This is because, during low economic conditions, the use of borrowers or lenders usually increases proportionally to total funding.

However, a business is more likely to use its accumulated reserves during profitable economic conditions. Therefore, we can consider debt financing as an alternative to financing operations until the economic conditions improve.[17] The latest version of the Companies Act of South

[11] Song, H. & Zhao, X. 'The unexpected consequences of company bankruptcy: An investigation into the spillover effect of local economic liquidation' (2024) 61 *Finance Research Letters* 1545–6123.

[12] Ibid.

[13] Ross, T. 'The impact of section 547 of the bankruptcy code upon secured and unsecured creditors' (1984) 69(39) *Minnesota Law Review* 40–74.

[14] Enriques, L. & Macey, J.R. 'Creditors versus capital formation: The case against the European legal capital rules' (2001) 86 *Cornell Law Review* 1166–1202.

[15] South African Reserve Bank (SARB) 'Note on the funding structure of non-financial companies, 1990–2003' (2004).

[16] Ibid.

[17] Ibid.

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Africa 71 of 2008 (the Act)[18] was enacted in 2008 and took effect on 1 May 2011, more than 13 years ago. The business context and other variables have changed. Globalisation and trade have increased significantly. The investors or claimants in a company profile are different and more diverse. Technological advancements have also changed and impacted business significantly; some technological advancements may take out "old" businesses and introduce new ones, such as those online.

Furthermore, an emphasis on Environmental, Social, and Governance (ESG) considerations is now more prominent than it was 13 years ago. Therefore, governance principles must also address the complexities of balancing the complicated mix of stakeholders' or claimants' interests. In addition, the financial accounting standards have changed almost every year since the 2008 enactment of the Act. The Act relies on these reporting standards for applying specific requirements like the solvency and liquidity tests. This has signalled some limitations of the dividend distribution laws in interpreting and applying some of the financial principles to balance and protect the interests of all claimants in a business.

Addressing this limitation could contribute to improved conduct of corporate and governance practices. Therefore, this paper examines the concept of dividend distribution laws within South African corporate law, exploring its connection with the Act[19] and relevant accounting and finance principles. Dividend distribution laws influence South African companies' financial decision making and risk management. The objective is to evaluate how corporate law requirements and accountancy principles intersect with management or board decisions while ensuring sustainable business growth for all stakeholders. This article applied the case study research strategy with a document review method to achieve its objective.[20] This is a process of reviewing printed or electronic documents to gather information or facts on a phenomenon, in this case, s 46 under the Act. This qualitative analytical method allows the author to gain insights into the meaning of the research subject, resulting in scientific comprehension.[21] The article explores how the dividend distribution law under s 46(1)*(a)*(ii)–46(1)*(c)* of the Act aligns with accounting and finance principles and its impact on corporate decision making and sustainable business growth for all stakeholders. It examines the extent to which these laws are consistent with established financial principles, identifies limitations in their ability to protect the interests of various claimants,

[18] Section 46(1)*(a)*(ii)–46(1)*(c)* of the Companies Act 71 of 2008.

[19] Ibid.

[20] Kohlbacher, F. 'The use of qualitative content analysis in case study research' (2006) 7(1) *Forum Qualitative* available at http://www.qualitative-research.net/fqs- texte/1-06/06-1-21-e.htm [Accessed on 31 October 2024].

[21] Bowen, G. 'Document analysis as a qualitative research method' (2009) 9(2) *Qualitative Research Journal* 27–40.

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and evaluates their influence on management and board decision-making processes. Additionally, the study considers the role of these laws in fostering sustainable business growth that benefits all stakeholders, offering a comprehensive analysis of their implications for corporate governance and financial stability.

Theoretical framework

The theoretical framework for analysing this discussion is based on the stakeholder theory. Stakeholder theory posits that corporations are where stakeholders hold intrinsic value, not merely as instruments for advancing shareholder interests alone.[22] The theory has three dimensions: descriptive, instrumental, and normative. The description dimension explains how entities operate and emphasises their relationship with the various stakeholders, not only with the shareholders. The instrumental dimension examines the links between stakeholder management practices and traditional corporate goals, such as profitability and growth. Then, the normative dimension asserts that the stakeholders have legitimate moral and ethical claims about the corporation, emphasising value and fairness in stakeholder relationships.[23] The stakeholder theory principles contradict the input-output model, which prioritises shareholder interests. The stakeholder model depicts an entity as accountable to all stakeholders, with no prima facie priority of one group over the other.[24] This theory also provides a framework for ethical decision making, encouraging firms to balance the interests of diverse stakeholders.[25]

Furthermore, it integrates moral and ethical principles, offering a robust framework for addressing modern challenges like sustainability and corporate social responsibility.[26] The theory addresses criticisms of the shareholder primacy model by proposing an inclusive approach that accommodates multiple stakeholder groups without undermining corporate accountability.[27] It also does not mandate changes to legal structures; however, it advocates flexibility to include other stakeholder interests within existing frameworks.[28] Considering this introduction and background, the article discusses accountancy, finance-related, and other relevant considerations.

[22] Donaldson, T. & Preston, L. 'The Stakeholder Theory of the Corporation: concepts, Evidence, and Implications' (1995) 20(1) *Academy of Management Review* 66–91.

[23] Ibid at 71–73*;* Parmer, B.L, Freeman, R.E., Harrison, J.S. et al 'Stakeholder theory: The state of the art' (2010) *Management Faculty publications* at 2–56.

[24] Donaldson & Preston op cit note 22 at 65–91; Phillips, R., Freeman, R.E. & Wicks, A.C. 'What stakeholder theory is not' (2003) 13(4) *Business Ethics Quarterly* 480–502.

[25] Donaldson & Preston op cit note 22 at 65–91; Phillips, Freeman & Wicks op cit note 23 at 479–502.

[26] Ibid.

[27] Phillips, Freeman & Wicks op cit note 23 at 479–502.

[28] Ibid at 490.

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Accountancy and finance-related matters for consideration

The primary purpose of accounting reporting standards is to accurately reflect a company's value by accounting for all transactions and balances appropriately.[29] Accountancy principles are essential for transparency and the accurate accounting of liabilities to ensure financial stability. Entities need to comply with the relevant reporting standards to enhance the reliability of the published financial information.[30] Financial reporting standards also change regularly, and entities need to comply with and adapt to those changes as they become effective in their reporting.[31] To further unpack the relationship between law and accountancy, the relevant section to be critically discussed is part of the South African dividends distribution law, specifically s 46 (1)*(a)*(ii)–46(1)*(c)* of the Act:

> 46. (1) A company must not make any proposed distribution unless
> *(a)* the distribution
> (i) is according to an existing legal obligation of the company, or a court order; or
> (ii) the board of the company, by resolution, has authorised the distribution;
> *(b)* it reasonably appears that the company will satisfy the solvency and liquidity test immediately after completing the proposed distribution; and
> *(c)* the board of the company, by resolution, has acknowledged that it has applied the solvency and liquidity test, as set out in section 4, and reasonably concluded that the company will satisfy the solvency and liquidity test immediately after completing the proposed distribution.

The Act only judges the board to consider what a "reasonable" solvency and liquidity test is in the context of bias. Will this be an objective view?[32]

The insolvency theory

Solvency refers to an organisation's or individual's ability to meet long-term financial obligations. It measures financial health, indicating whether the entity's assets exceed its liabilities. However, insolvency occurs when an entity cannot pay its debts as they become due, leading

[29] Onyema, E.M. 'Accounting issues in the digital economy' (2020) 4(6) *Central Asian Journal of Mathematical Theory and Computer Sciences* at 81–84.

[30] Nematovich, K.I. & Farxodjon, O. 'Accounting of provisions and its prospects for application in Uzbekistan' (2023) 3(5) *European Journal of Business Startups and Open Society* 52–57; Ashbaugh, H. & Pincus, M. 'Domestic Accounting standards, international accounting standards, and the predictability of earnings' (2001) 39(3) *Journal of Accounting Research* 418–434.

[31] Nematovich & Farxodjon op cit note 30 at 51–57.

[32] Ibid.

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to potential bankruptcy or liquidation.[33] The concept of solvency theory encompasses various approaches and principles aimed at understanding and managing the financial stability of entities. It includes the analysis of financial distress, the distribution of assets among creditors, and the legal frameworks governing bankruptcy and insolvency. The theory distinguishes between economic distress (inability to generate sufficient revenue) and financial distress (inability to service debt despite positive earnings).[34] The primary purpose of solvency theory is to ensure the equitable distribution of an insolvent entity's assets among creditors and to provide mechanisms for resolving financial distress. It aims to maximise social welfare by determining whether a financially distressed firm should continue operations or be liquidated. Solvency theory also seeks to prevent inefficient liquidation and to coordinate creditors' efforts to maximise the total value recovered from the debtor's assets.[35]

Criticisms of insolvency and liquidity test

Various studies have criticised the application of the solvency and liquidity test.[36] This includes the fact that financial characteristics vary significantly between industries, making applying a "one size fits all" approach to solvency and liquidity tests difficult. This article highlights the need for industry-specific models to improve classification accuracy.[37] Many financial ratios are generally not distributed, which can affect the reliability of discriminant analysis. Adjustments such as deleting extreme values or using logarithmic transformations may not fully address these issues. The high correlation between specific ratios can lead to ambiguity in discriminant weights, complicating the interpretation of results. However, this study found that using ratios with lower correlation coefficients did not significantly reduce classification accuracy.[38] The accuracy of solvency and liquidity tests can vary over time. Ratios derived from data closer to the failure time tend to predict insolvency more accurately than those derived from earlier periods.[39] The efficiency of models based on solvency and liquidity tests can vary.

While some models may perform well in predicting failure, they may not be as effective in providing actionable insights for management to

[33] Onakoya, A.B. & Olotu, A.E. 'Bankruptcy and insolvency: An exploration of relevant theories' (2017) 7(3) *International Journal of Economics and Financial Issues* 707–712.

[34] Ibid.

[35] Ibid.

[36] Lincoln, M. 'An empirical study of the usefulness of accounting ratios to describe levels of insolvency risk' (1984) 8(1) *Journal of Banking and Finance* 22–340. See Heaton, J. 'Solvency tests' (2007) 62(3) *The Business Lawyer* 984–1006.

[37] Lincoln op cit note 36 at 322–340.

[38] Ibid at 328.

[39] Ibid at 330.

reduce insolvency risk.[40] As one of the solvency and liquidity tests, the balance sheet test is criticised for its rigidity and reliance on historical cost accounting. It does not account for the current market value of assets or future business prospects, potentially leading to an inaccurate assessment of a company's financial health.[41] The prudence principle influences traditional balance sheet tests, leading to an asymmetric view of risks and opportunities.[42] Profits are only recognised when realised, while losses are accounted for when probable. This conservative approach may not provide an accurate and fair view of the company's financial situation.[43] Solvency tests often have a limited time horizon, focusing on short-term liquidity rather than long-term obligations. This can be problematic for companies with significant long-term liabilities, such as pension obligations or decommissioning costs.[44] Solvency tests give directors significant discretion in assessing the company's financial health, which can lead to optimistic projections and potential manipulation. This discretion can undermine the reliability of the test, especially in critical situations.[45] Implementing balance sheets and solvency tests can create a significant compliance burden for companies, and preparing multiple sets of accounts to meet different regulatory requirements can be costly and time consuming.[46]

The practical challenges of calculating the solvency and liquidity tests

It may be harder to apply the solvency and liquidity test practically. Various courts have struggled in the past to provide a consistent application for determining solvency.[47] Furthermore, there may be confusion on which test to rely on to comply with the requirements, as s 46(1)*(a)*(ii) –46(1)*(c)* of the Act is not explicit.[48]

There are three types of tests. The so-called "non-current asset test" tests the entity's ability to pay its debts in the long term if the assets exceed the liabilities in the short term; the current assets test, or "quick ratio"; and the "capital test" to determine if the entity has sufficient capital to sustain its operations and absorb any losses. In accountancy, disagreements exist regarding what should be included and excluded when calculating ratios. The other concern is whether all these types of ratios should be met. Or the majority? As a result, this calculation also requires professional

[40] Ibid at 334.

[41] Schön, W. 'Balance sheet tests or solvency tests or both?' (2006) 7(1) *European Business Organization Law Review* 182–198.

[42] Ibid.

[43] Ibid.

[44] Ibid at 189.

[45] Ibid at 193.

[46] Ibid at 197.

[47] Heaton op cit note 36 at 984–1006.

[48] Ibid.

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judgement; ideally, some objective judgement. Even with judgement, it is unclear what a reasonable estimation is; for example, will 51 per cent be reasonable or only 80 per cent? However, this judgement may be biased in the context of the "shareholder primacy" concept. Adding to the solvency test challenge, to comply with the requirements of the Act, some estimation of the possible balances after distributions needs to be made. Estimations are also not factual; some may use different methods or assumptions to satisfy this requirement. However, this would also require professional judgement that is not biased. For example, the solvency test is a health checkup that lenders use to see if a company is financially healthy enough to pay its debts now and in the future. Suppose a company is insolvent; it is like having a financial cancer that makes it hard to repay lenders.

Therefore, lenders would want this financial cancer to be avoided or removed so as to not expose themselves to further risk, for example through a dividends payout that could undermine the company's ability to meet their future obligations. Like many diseases, there are different solvency tests for diagnosis, but some are similar to quick, basic screenings, which may miss signs of financial trouble. Sometimes, a deeper or more detailed test may be required to cover what the quick tests may have mistakenly missed in terms of signs of "financial cancer". However, like in medicine, detailed testing for financial errors may be exhaustive and is only pursued if there are resources, time, and significant indicators that the "quick tests" have missed something. Therefore, in applying these solvency tests, the board and management may fall under the same trap, and even make the situation worse because of other biased (explicit or implied) intentions to make the shareholders happy.[49] This test also has further limits. A perceived solvent business has no restrictions on distributing dividends as it meets the requirements. However, the same business may be entering into hazardous projects or deals to maximise shareholder value, severely impacting creditors in the long term. This is like an undetected severe cancer, which the tests put in place are not designed to detect.[50]

Another challenge is dealing with contingent provisions or liabilities, which are usually not presented in the face of financial statements and are instead disclosed in terms of the International Accounting Standard (IAS) 37. There could be a valid reason to include or exclude them in calculating the liquidity and solvency tests, and it might not be relevant for a case expected to run over years and not necessarily within the next 12 months.

[49] Ibid.
[50] Ibid.

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Other relevant considerations

Leverage

There are instances where a business using increased debt could maximise profitability and shareholder returns. An entity's ability to maximise profitability can be increased by acquiring more debt to purchase productive assets. In this instance, it is referred to as leveraging, which describes using lenders' funds to create value for shareholders or business owners. This process may result in higher shareholder returns as productive assets are used effectively and efficiently with limited equity funding. The advantages of leveraging include favourable tax benefits or deductions, which debt owners' equity funding does not have. Hence, shareholders create more value while getting tax deductions for using borrowed funds and maximising their return on equity. However, lenders only benefit from fixed, or interest rate-linked payments, not the total value created with their funding.[51]

Environmental, Social, and Governance (ESG) principles

ESG criteria establish standards for a company's operations that socially conscious investors use to evaluate potential investments. Environmental criteria consider how a company performs as a steward of nature. Social criteria examine how it manages relationships with employees, suppliers, customers, and the communities in which it operates. Governance involves a company's leadership, executive pay, audits, internal controls, and shareholder rights.[52] ESG integration is crucial for promoting sustainable development. It encourages companies to operate in ways that enhance environmental protection, social equity, and good governance, which are essential for long-term sustainable growth. Incorporating ESG criteria helps identify and manage risks that could impact a company's financial performance. This includes risks related to climate change, regulatory changes, and social issues.[53]

Companies that integrate ESG criteria tend to perform better in the long run. ESG integration can lead to better financial performance, enhanced reputation, and increased investor trust, ultimately contributing to value creation.[54] ESG integration fosters better engagement with stakeholders,

[51] SARB op cit note 15.

[52] Sciarelli, M. et al 'Socially responsible investment strategies for the transition towards sustainable development: The importance of integrating and communicating ESG' (2021) 33(7) *The TQM Journal* 40–56; Kim, S. & Yoon, A. 'Analyzing active fund managers commitment to ESG: Evidence from the United Nations Principles for Responsible Investment' (2023) 69(2) *Management Science* 742–758; Schanzenbach, M.M. & Sitkoff, R.H. 'ESG investing: Theory, evidence, and fiduciary principles' (2020) *Journal of Financial Planning* 43–50.

[53] Sciarelli et al op cit note 52 at 39–56; Kim & Yoon op cit note 52 at 741–758; Schanzenbach & Sitkoff op cit note 52 at 42–50.

[54] Ibid.

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including employees, customers, suppliers, and the community.[55] Despite s 76 of the Act mentioning the social and ethics committee, it is not required for all companies. This leaves the decision to have such a committee at the discretion of those in charge of governance.[56] The King IV Report™ also notes that Regulation 43 of the Act does not provide the role of this committee. The King IV Report™ recommends that this committee deal with reporting on similar ESG objectives.[57] However, because this is not mandatory and this reporting is not implied and explicitly applied to the rest of the Act, its importance might be taken for granted.

Creditor perspective and their role in the economy

The accounting and economic laws provide that any value paid to senior claimants is paid in full before any junior claimants.[58] If the business were to be liquidated, the order of priority would start with creditors before any distribution to shareholders. Creditors expect to receive the business's future value, limited to the face value of their borrowing.[59]

Lenders typically protect themselves from any risk that a business may default or cannot repay the loan by charging higher interest rates. They do this by agreeing to limited control over company operations or applying lower rates with some control over business operations.[60] However, this view is challenged by the fact that not all creditors can enter into these types of agreements to secure their lending. These are usually sophisticated and established creditors with market or industry dominance based on resources. Other typical smaller lenders, who may not be in leading positions, might negotiate at a compromised position, and even in a worse position, are creditors like trade payables, employees, and tax collectors who may not even be able to enter into agreements of their own. Therefore, they would be compromised if the company goes down.[61]

Shareholder perspective and their role in the economy

The shareholder primacy principle seems fundamental to corporate law and governance. This considers shareholders the primary interest in the corporation's economics and governance.[62] The business is considered

[55] Sciarelli et al op cit note 52 at 39–56; Schanzenbach & Sitkoff op cit note 52 at 42–50.

[56] Section 76 of the Companies Act 71 of 2008.

[57] Institute of Directors Southern Africa 'King IV Report on Corporate Governance for South Africa 2016™' (2016).

[58] Casey, A. 'The creditors' bargain and option-preservation priority in Chapter 11' (2011) 78 *The University of Chicago Law Review* 759 at 760–807.

[59] Ibid.

[60] Ibid. Enriques & Macey op cit note 14 at 1165–1202.

[61] Ibid.

[62] Millon, D. 'Radical shareholder primacy' (2013) 10(4) *University of St. Thomas Law Journal* 1013 at 1014–1044.

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to operate on their behalf. However, there is an argument about the shareholders' responsibility in a business's governance. This is due to shareholders' influence and giving the board instructions to run a company to maximise the shareholders' wealth.[63] Various corporate law scholars have also normalised this board instruction on wealth maximisation in corporate law. It is also supported by the view that the key mandate of any business manager is to maximise the value for the shareholders as long as it is within the limits of the law.[64] The companies with debt borrowings have enough motivation for the shareholders to take advantage of the current creditors in several ways. They could spread the assets into various classes to maximise their returns and distribute cash to themselves through excessive dividend payout share buybacks at higher values. As a result, the accumulated profits that lenders rely on as backup when they offer favourable loan terms are diminished.[65]

Furthermore, shareholders' influence can lead to the diluting of the claim order of lenders. They do this by issuing more debt with the same or higher priority, which would remove the benefit of the current creditor's claims on the business's assets if the company went down. Therefore, shareholders could benefit from increased value due to improved leverage.[66] Furthermore, shareholders' influence may lead to rejecting or abandoning projects with guaranteed net positive benefits but offering minimum returns, which works for the lender as their fixed cost will be covered. However, the equity owner's pursuit of maximum value would be in conflict. Instead, they should accept projects that may be riskier than anticipated or stated when agreeing on loan terms with lenders just because the potential returns for the equity owners could be maximised at the expense of lenders.[67]

The South African dividend context in comparison to the USA and Europe

Internationally, the United States of America (USA) and Europe have placed their economic success on the validity of their dividend distribution laws. However, there is a significant difference between the USA and European principles regarding how lenders and shareholders are treated. Lenders are treated as essential to European corporate governance, and their dividend distribution laws protect them from shareholders' opportunistic activities.[68] Therefore, the laws protect the European creditors, not their contracts. The fundamental argument in favour of capital laws in

[63] Rhee op cit note 6 at 1951–2017.
[64] Ibid.
[65] Enriques & Macey op cit note 14 1165–1202.
[66] Ibid.
[67] Ibid.
[68] Schön, W. 'The future of legal capital' (2004) 5(3) *European Business Organization Law Review* 429 at 430–448.Enriques & Macey op cit note 14 at 1165–1202.

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Europe is that businesses must pay a cost or "penalty" to be eligible for the advantages of limited liability. According to this view, limited liability is a sort of privilege that affects the lenders but not the shareholders. Therefore, shareholders are expected to pay a minimum amount of capital to the company to receive this advantage, and the business must not repay the shareholders for this capital during the company's existence. This view is still prevalent in Europe.

Contrarily, in the USA, the laws protect shareholders at the expense of lenders. Lenders participate in governance by choice as a way to protect their interests. The USA laws provide maximum flexibility to the shareholders to maximise shareholder value. Therefore, lenders protect themselves against opportunistic shareholder activities through agreement contracts.[69] The latter principles are similar to the South African corporate laws, which give the shareholders more flexibility, as shareholders vote for crucial business decisions and appoint governing body structures which appoint the executive management while allowing shareholders to be board members.[70] When declaring dividends, European laws generally require the maintenance of legal capital and meeting the solvency and liquidity test requirements, however, this is not the case for the USA.[71]

The following studies on South African listed companies provide a diverse context on the motivation for dividend payout, market expectations and reactions, and the correlations between entity performance and governance structure. The first study highlights a strong correlation between dividend payments, agency theory, and investor expectations, even when such payments may not necessarily be in the best interests of all stakeholders. Interestingly, the imposition of high tax rates on dividends did not significantly deter companies from distributing dividends, mainly due to entrenched investor expectations.[72] The objective of the study was to explore the influence of modifications in dividend tax structures on corporate dividend distribution policies and, subsequently, the effect of these payments on stock prices. In particular, the transition from the Secondary Tax on Companies (STC) to the Dividend Tax in 2012 aligned South Africa with the taxation practices of numerous other economies, where dividends are taxed at the investor level rather than at the corporate level. From an individual investor's standpoint, the 15 per cent Dividend Tax rate was anticipated to create a preference for capital gains over dividend receipts, thus discouraging firms from issuing dividends.[73] The increase from the former 10 per cent STC to the 15 per cent Dividend

[69] Ibid.

[70] Ibid.

[71] Schön op cit note 68 at 429–448.Enriques & Macey op cit note 14 at 1165–1202.

[72] Coetzee, M.S. & De Wet, J. 'Dividend tax, dividend payments and share values: A South African perspective' (2014) 11(3) *Corporate Ownership and Control* at 242–252.

[73] Ibid.

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Tax was perceived as a mechanism that incentivised reinvestment over dividend distribution. Investors viewed reduced dividend distributions, coupled with reinvested earnings in projects with promising net present values (NPVs), as a factor potentially driving stock prices upward. However, this approach conflicted with signalling theory and agency theory, which posit that dividends convey valuable information regarding a firm's prospects and that dividend distributions enhance shareholder value, potentially leading to stock price appreciation. The justification for the study was to draw from a hypothesis suggesting that firm value is inversely related to dividend payments and positively correlated with debt levels. However, the findings of this study contradicted the hypothesis, revealing a direct positive relationship between dividend distributions and firm value. It was established that dividends convey information about a company's profitability that is not fully reflected in reported earnings or conventional financial metrics.

Signalling theory suggests that despite the tax burden associated with dividends, their payment provides critical insights into a firm's future performance, thereby reducing information asymmetry between management and shareholders. Furthermore, the positive association between dividends and share prices indicated that investors place intrinsic value on dividends.[74]

Within the agency theory framework, dividends are critical in reducing agency costs by limiting managerial discretion over excess cash flows. By paying dividends, management relinquishes free cash flow, which might otherwise be used for inefficient or self-serving expenditures. Additionally, when firms require external financing for investments, they become subject to increased oversight from financial institutions and capital markets, leading to improved governance. The study employed an event study methodology, specifically utilising the constant mean return model. This approach was instrumental in examining abnormal daily stock returns surrounding final dividend declaration dates.[75] The study covered the period from 2008 to 2012 and analysed firms listed on the Johannesburg Stock Exchange, with an initial sample comprising the top 100 firms by ordinary share market capitalisation. Only companies that issued cash dividends between 1 January 2008 and 31 December 2012 were included in the final sample. Data variables included dividend payments, earnings after tax, market capitalisation, dividend declaration dates, and daily stock prices. McGregor BFA served as the primary data source, with a final sample size of 68 firms. The findings were that companies that increased their dividend payout ratios experienced positive stock price reactions on and shortly after the dividend declaration date. These findings reinforced

74 Ibid.
75 Ibid.

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the paradoxical nature of dividends and provided a deeper understanding of dividend policies among South African firms.[76]

The second study critiques the underlying motivations behind dividend payments by corporate boards, asserting that some dividend policies are driven by managerial interests rather than the creation of genuine shareholder value. It suggests that firms with independent and highly competent boards tend to make more rational dividend decisions and hold shares for more meaningful long-term value creation. Over time, financial research has extensively examined the determinants behind firms' decisions to either distribute or withhold dividends.[77] However, dividend policy remains a complex subject, influenced by multiple factors, including corporate governance. Corporate governance is a crucial mechanism designed to safeguard external investors from potential expropriation by corporate insiders. A fundamental component of corporate governance is the board of directors, which is pivotal in overseeing senior management and ensuring that corporate decisions align with shareholder value maximisation rather than managerial self-interest. This study contributes to the knowledge of dividend policy determinants by focusing on corporate governance as a key influencer of dividend distributions.[78] Empirical evidence suggests that companies with robust governance frameworks exhibit higher dividend payouts. In contrast, those with weaker governance structures may use dividends to mask governance deficiencies and compensate for a lack of value-generating investment projects. South African firms with inadequate corporate governance mechanisms were found to substitute investment in high-return projects with high dividend payouts. Additionally, the study underscores the importance of board diversity, particularly in gender representation, mitigating agency problems, and enhancing dividend distribution policies.[79] The study utilised a panel regression analysis to examine the relationship between corporate governance, board characteristics, and dividend payout ratios that covered the period 2013 to 2018, with a sample comprised of 29 firms from the top 40 companies listed on the JSE. The results revealed a significant correlation between board diversity, board independence, and dividend payout ratios. Firms with diverse boards were observed to maintain high dividend payments as a strategy to sustain relationships with shareholders. However, as board independence increased, reliance on dividends as a corporate governance mechanism decreased. Consequently, the study advises shareholders that

[76] Ibid.

[77] Nharo, T., Moloi, T. & Hlobo, M. 'The relationship between board characteristics and dividend payment policies in the JSE top 40 listed companies' (2021) 12(1) *Journal of Academic Finance* 30–52.

[78] Ibid.

[79] Ibid.

firms with highly independent boards are better positioned to retain earnings for reinvestment in high-value projects.[80]

The third study examined the impact of dividend payout policies, revealing that larger firms exhibit a preference for utilising internal funds for dividend payments, leading them to distribute lower dividends. In contrast, firms that rely on debt financing must resort to borrowing to sustain their dividend payouts. Moreover, firms with slower growth rates tend to distribute higher dividends, a practice that may not be sustainable in the long run. The study emphasises that companies should not issue dividends merely to satisfy perceived value and shareholder expectations at the expense of a long-term growth-oriented strategy.[81] It explored the correlation between dividend payout ratios and overall financial performance. The study is grounded in the bird-in-the-hand theory, which posits that dividends serve as a direct means of wealth creation for shareholders, thereby driving up share prices. Investors are inclined to favour higher dividend payouts over capital gains, given that dividend payments exert a more substantial influence on share prices and anticipated future cash flows. This perspective is based on the premise that large dividend distributions lower the capital cost while enhancing firm value. However, a key implication of this dynamic is that allocating a substantial portion of earnings to dividends reduces the capital retained for reinvestment, thereby compelling firms to seek alternative funding sources, such as issuing new equity or securing debt financing for viable investment projects.[82] The study highlights that a firm's profitability is a primary determinant of its capacity to maintain dividend payments both in the present and in the future. A strong and positive correlation between dividend payout ratios and financial performance is identified, suggesting that firms that prioritise dividend distributions without adequately considering investment requirements may ultimately experience declining future earnings and diminished firm value. The method employed investigated the relationship between dividend payout ratios (dependent variable) and financial performance indicators (independent variables), which include net profit margins (NPM), liquidity (LIQ), leverage (LEV), growth (GRO), and firm size (SIZE).[83] The research employs panel data analysis and focuses on the top 40 companies listed on the JSE from 2010 to 2015. These companies were purposively selected for analysis based on their market capitalisation. They collectively represent over 80 per cent of the JSE's total market capitalisation, making them a representative sample for assessing dividend payout trends. The fixed effects

80 Ibid.

81 Mamaro, L.P. & Tjano, R.T. 'The relationship between dividend payout and financial performance' (2019) 9(2) *Journal of Accounting and Management* 5–20.

82 Ibid.

83 Ibid.

model was utilised following recommendations from the Hausman test to ensure robust econometric analysis. Furthermore, the study mitigates potential econometric issues, such as collinearity, autocorrelation, and heteroskedasticity, through the application of the generalised least squares (GLS) method.[84]

The findings reveal a positive and statistically significant relationship between net profit margins and dividend payout ratios. Conversely, a negative but statistically insignificant relationship is observed between firm growth, size, and dividend payout. Liquidity negatively correlates with dividend payouts, indicating that firms with higher liquidity tend to pay lower dividends. Meanwhile, leverage positively correlates with dividend payouts, suggesting that highly leveraged firms continue to distribute dividends despite debt obligations.[85] Overall, the results indicate that larger corporations distribute lower dividends within the FTSE/JSE Top 40 firms, while more profitable firms tend to offer higher dividends. Additionally, firms with high leverage continue paying dividends, while companies with significant current assets distribute lower dividends. Notably, firms experiencing slower growth tend to pay higher dividends, highlighting potential sustainability concerns over time.[86]

The fourth and last study for the South African context underscores the importance of aligning dividend payments with a firm's life cycle stage to ensure sustainable growth. It asserts that dividends should not be paid indiscriminately at any stage of the business life cycle but rather at an appropriate stage for financial stability. Additionally, firm size plays a crucial role in determining dividend policy.[87] Notably, even at the maturity stage, firms may opt to withhold dividend payments and instead reinvest excess funds to maintain control over resources, a decision that aligns with managerial discretion and long-term sustainability. The research aimed to empirically test the dividend life-cycle hypothesis within the South African corporate context. The life-cycle hypothesis postulates that firms progress through different stages in their operational journey, each influencing their strategic and financial decisions. For instance, newly established or young firms often characterised by smaller size and lower profitability face survival challenges, primarily due to financial constraints.[88] These firms typically have lower internal liquidity and encounter higher costs when accessing external financing, driven by market inefficiencies and agency costs. At this stage, the firm's priority is

[84] Ibid.
[85] Ibid.
[86] Ibid.
[87] Munzhelele, N.F., Wolmarans, H. & Hall, J. 'Erratum: Corporate life cycle and dividend payout: A panel data analysis of companies in an emerging market' (2021) 14(1) *Journal of Economic and Financial Sciences* 1–9.
[88] Ibid.

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to develop its product or service offerings, establish its market presence, and position itself strategically. As firms transition into the growth stage, they focus on maximising investment opportunities, expanding their customer base, and improving production, marketing, and overall strategic positioning. At this point, earnings remain volatile and relatively low, making dividend payments a secondary concern. Subsequently, firms reach the maturity stage, achieving market stability, slowing down aggressive growth pursuits, and securing better access to internal and external financing at reduced costs. At this point, profitability is high, and firms have a greater capacity to distribute dividends.[89] The study confirms a direct relationship between dividend payout policies and the life-cycle hypothesis. It reveals that dividend payouts tend to increase as firms advance through their life cycle, peaking at the maturity stage. Moreover, larger and more profitable firms exhibit a higher likelihood of paying dividends, whereas firms with extensive investment opportunities are less inclined to distribute dividends. However, maturity-stage firms face a heightened risk of overinvestment as they accumulate substantial free cash flow. In such cases, managers may allocate excess funds toward investments that may not necessarily be beneficial to retain control over company resources, thereby exacerbating agency problems. The motivation for the study was that the dividend policy remains a crucial component of corporate financial strategy, as it enables shareholders to derive tangible returns on their investments.[90] Amidst increasing corporate failures and financial scandals, stakeholders have become more vigilant in monitoring their investments. These corporate governance lapses, often resulting from mismanagement and inadequate risk controls, highlight the significance of sound dividend policies. The South African market presents an ideal setting for this research, as the country is a key emerging market and a member of the BRICS (Brazil, Russia, India, China, and South Africa) economic bloc. The findings from this study offer valuable insights into dividend policy trends within emerging markets, providing a broader understanding of financial decision making in similar economic environments.

The study employed a combination of basic and dynamic panel data estimation techniques to analyse the data by utilising panel data comprising financial information from 119 companies listed on the JSE from 2006 to 2015.[91] The data is sourced from published financial statements stored in the Identification Requirements for Enterprise Social Software (IRESS) database, a widely used financial information system in South Africa. The study confirmed the presence of the dividend life-cycle hypothesis among

[89] Ibid.
[90] Ibid.
[91] Ibid.

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South African firms. Specifically, companies in the growth phase tend to prioritise reinvestment over dividend distribution, thereby paying lower dividends. Growth firms demonstrate a strong commitment to expansion and, in doing so, create greater shareholder value than firms classified as value companies. These findings have significant implications for financial managers and investors alike. From a managerial perspective, the study highlights the necessity of sacrificing short-term dividend payments to fund investment initiatives that drive long-term value.[92] Notably, the study's unique contribution to the South African context lies in its confirmation that growth firms can generate higher shareholder value than traditional value firms. For investors, these findings underscore the importance of recognising the value-creation potential of growth firms rather than focusing solely on immediate dividend returns.[93]

Conclusion

Section 46(1)*(a)*(ii)–46(1)*(c)* of the Act establishes dividend distribution laws, aligning them with solvency and liquidity tests to ensure financial stability. However, the Act has notable limitations in its application, which hinder alignment with accounting and finance principles and affect corporate decision making and sustainable growth. The solvency and liquidity tests lack precise guidance on methodologies, allowing boards significant discretion to determine what is "reasonable". This opens the door to subjective judgements, often influenced by shareholder primacy, prioritising short-term returns over long-term sustainability. Ambiguities, including contingent liabilities and conflicting methods for calculating financial ratios, further complicate consistent application. Boards may overestimate solvency or liquidity, risking biased dividend payouts that could harm creditors or other stakeholders in the long run. Therefore, more detailed and defined guidance for reasonability assessment should be considered in revising the provisions of s 46.

Furthermore, leveraging a practice where companies use debt to maximise returns exemplifies another gap. While it benefits shareholders through tax efficiencies and increased equity returns, it exposes companies to significant risks. Excessive leveraging can diminish creditor claims and compromise financial stability, highlighting the current framework's lack of robust safeguards against such practices. The sustainability concerns are further amplified by the Act's insufficient focus on ESG factors. Without mandatory ESG reporting or enforced stakeholder protections, companies may neglect sustainable practices, creating long-term risks for communities, employees, and the environment. The King IV Report™ report's discretionary social and ethics committees exacerbate governance

92 Ibid.
93 Ibid.

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gaps, leaving significant decisions to board discretion with minimal accountability.

The dividend distribution laws under s 46(1)*(a)*(ii)–46(1)*(c)* of the Act only partially align with accounting and finance principles, as their application lacks clarity and consistency. While they influence corporate decision making by providing a baseline for solvency, the emphasis on shareholder primacy undermines broader stakeholder protection and sustainable growth. Therefore, reforms incorporating objective guidelines, mandatory ESG considerations, and balanced stakeholder frameworks are essential to address these issues.

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