A Critical Analysis of the Role and Protection of Shareholders in the Appointment of Directors in the South African Companies Act 71 of 2008

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Abstract: Today’s companies are characterised by dispersed ownership. This coupled with the separation of ownership and control challenge how the shareholders may exercise control over companies. One way through which the shareholders retain control of the companies is through their power to replace the board. This paper looks at the vulnerability of shareholders in the exercise of this power in the light of recent corporate law developments in South Africa. The focus is on the statutory safeguards that ensure the control of companies remains in the hands of shareholders through the power to replace a board. The development of company law appears to bring with it a dilution of shareholder control by disenfranchising the shareholder - or is the opposite in fact the case?

Keywords: Shareholders, directors, corporate governance, shareholder franchise, shareholder control, appointment, protection, role, agency problem, appointment rights.

1. Introduction

The traditional focus of study in company law is on the rules and principles that safeguard the interests of the company’s shareholders and creditors. However, developments in company law have seen other stakeholders gaining recognition. In addition to members and creditors, stakeholders such as customers, suppliers, employees, other companies, and society in general are also recognised. Decisions made by companies affect a wide range of stakeholders directly or indirectly.

This paper recognizes the many different stakeholders, but focuses only on the roles that shareholders play when directors are appointed or removed, and whether the shareholders are protected in these processes. The question to be answered is whether the Companies Act 71 of 2008 protects or advances the shareholders’ interests in this regard.

2. The position under the 1973 Act

A distinction should be drawn between the first directors who are the incorporators of the company, and what Ncube refers to as ‘subsequent directors’. In terms of section 208(2) of the 1973 Act, every subscriber to the Memorandum of Association of a company is deemed for all purposes to be a director of the company. When all incorporators are also directors, the agency problem does not arise as ownership and control vest in the same persons. However, the assertion that shareholders are owners of the company is controversial with some scholars – Stout, for example - arguing that shareholders do not own the company, but that the company owns itself. It is when subsequent directors are appointed that the issue of the protection of shareholders arises as ownership and control diverge, and in so doing usher in the agency problem.

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1 Parkinson Corporate Power and Responsibility 50.
2 The other stakeholders are customers, suppliers, creditors, employees, etc. Naidoo Corporate Governance 130.
3 Parkinson Corporate Power and Responsibility 50.
5 Ex parte Umtentweni Motels (Pty) Ltd 1968 (1) SA 144 (D).
6 Stout 2010 NACD 1 ‘Shareholder as Owners: Legal Reality or Urban Legend’.
7 Armour, Hansman and Kreakman 2009 Oxford University 3.
Section 209 of the 1973 Act provides that the **first directors** may be appointed in writing by a majority of the subscribers to the company’s Memorandum of Association. The 1973 Act places the responsibility of appointing directors on the shoulders of the general meeting of the company. It is submitted that granting powers to appoint directors to the majority of subscribers, is born from the view that they are the owners of the capital in the enterprise, and consequently have a greater interest than any other stakeholder in the company’s welfare. It is further submitted that the requirement that the appointment be in writing is a protective measure which ensures that only the correct persons appoint the directors. The writer submits that as owners of the capital in the company, subscribers have more interests in the choice of who will act on their behalf. Provisions of the 1973 Companies Act, and section 209 in particular, are intended to achieve exactly that.

Mongalo, however, holds a different view. He recognises that while the law provides that shareholders appoint directors, this is not what happens in practice. He asserts that the appointment of directors in general meeting generally takes the form of an endorsement of decisions taken by the board of directors. It is submitted that this is a credible observation. Usually the board provides a shortlist of persons eligible for election as directors. In practice, the board actually nominates prospective directors to the general meeting. The business of the general meeting will then be to vote for the nominees on the list. It is further submitted that if they vote for the nominees that would amount to endorsing or rubberstamping the choices of the board.

Section 210(1) of the 1973 Act prohibits the appointments of two or more persons as directors of the company by a single resolution, unless the resolution proposing this has faced no dissent. Any resolution moved in contravention of section 210(1) of the 1973 Act, is void, but is subject to section 214 of the 1973 Act. This is a safeguard provision which is necessary for the protection of shareholders in that one will not be obliged to cast his vote in favour or against a would-be director merely because he or she will be voted for together with another. It is submitted that if it were not for this provision, it would be easy to frustrate shareholders in the exercise of their right to vote for the persons of their choice. The provision is not peremptory, however, as leeway is allowed for the group appointment of directors by a single resolution - but only if it is unanimously so agreed by the meeting. It is submitted that legislators intended to plug any loopholes that could be used to weaken shareholders’ voting power. The requirement that there be no dissenting vote requires unanimity and makes the provision difficult to circumvent, thereby protecting shareholders.

The Articles of Association of companies can be used to empower certain people or organs of the company to appoint directors. Articles can contain provisions or agreements permitting third parties - such as associated or affiliated companies, creditors, and trustees of debenture holders - to appoint one or more directors to the board. It is noteworthy that the Articles of a company are drafted by the company (subscribers/shareholders). Consequently, if the Articles grant the power to appoint directors to some other person or organ, it is submitted that this remains an exercise by shareholders of their rights since it is they who determine the contents of the Articles.

The situation where appointment rights are vested in persons other than shareholders, is an exception

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9 Own emphasis.
10 Section 210(1).
11 Mongalo 2004 Tzar 96.
12 Id 102.
13 Naidoo Corporate Governance 93

Although shareholders are ultimately responsible for determining the composition of the board, and it is in their interests to ensure that the board is properly constituted with appropriate skills and representivity, the fact that shareholders of South African public companies are often a largely disparate group, makes it difficult for shareholders to exercise these rights in a practically meaningful sense. In most companies the potential directors are chosen and put forward for election at the AGM by management, which ultimately controls the candidates who are proposed to be considered by the nomination committee.

14 Olson 2010 Acta Juridica 237-9; Schachat v Trans-African Credit & Savings Bank Ltd 1963 (4) SA 523 (C)
15 The acts of a director shall be valid notwithstanding any defect that may afterwards be discovered in his or her appointment or qualification. This section protects both the company and third parties as the director will not escape liability by merely showing his appointment was defective.
17 Section 210(1).
18 Benade Entrepreneurship Law 119.
20 Gohlike & Schneider v Westies Minerale (Edms) Bpk 1970 (2) SA 685 (A).
to the general rule that shareholders in general meeting wield such power. The power of shareholders to appoint is a default provision where Articles are silent on who is to appoint directors.21 Where the Articles empower the shareholders to appoint directors, or where the Articles are silent on how to appoint directors, a resolution providing for the appointment of directors adopted otherwise than in general meeting by all the shareholders entitled to vote thereon at such a meeting, is effective by virtue of the application of the principle of unanimous assent.22

The Articles can also provide for the tenure of directors. Board tenure is viewed as a defining characteristic of director independence.23 Table A, Articles 66-69, for example, provides for the retirement of all directors at the first Annual General Meeting so that a new board can be elected. Thereafter, one-third of the directors retire at each succeeding Annual General Meeting with an option for re-election. It was also accepted in Grundt v Great Boulder Proprietary Cold Mines Ltd24 that the Articles could provide for the rotation of directors. It is submitted that rotation and retirement of directors can be a useful mechanism in maintaining director independence.

Under the 1973 Act,25 upon being appointed the director is required to consent to his or her appointment, and/or subscribe for qualification shares where this is required.26 The issue of qualification shares not obligatory unless the company imposes it in its Articles.27 Failure to comply with section 211(1) and 211(3) does not affect the validity of the director’s appointment.28 The director’s acts remain valid, notwithstanding any defects subsequently discovered in his or her appointment or qualification.29 However this section applies only to acts performed by a director whose appointment or qualification is later found to be defective. It does not apply to acts which are ultra vires the company, or to acts by a director which are ultra vires his powers because they are ultra vires the company.30

Section 212 provides for the filling of casual vacancies in the office of director. How and by whom this is done, is determined in the company’s Articles of Association. It is submitted that providing for the filling of casual vacancies in the Articles of Association, effectively means that power vested in the shareholders - albeit indirectly as contributors to the Articles of Association. It is further submitted that shareholders can amend the Articles as and when they wish. Where the Articles of Association are silent, it is presumed that shareholders will appoint replacements at the general meeting.31 While they may delegate other persons to appoint replacements in the Articles of Association, they are protected in that where it is not specified, that power reverts to the shareholders. They are, therefore not disadvantaged in the event of omissions so safeguarding their right to appoint directors.

3. Observations

It is submitted that under the 1973 Act the sole appointers of directors were shareholders in general meeting, save for a few exceptions where their power to do so was ousted by provisions in the Articles or by agreements. Shareholders enjoyed extensive rights to appoint directors. They could even appoint directors through a resolution by unanimous assent adopted otherwise than in general meeting, by all members entitled to vote thereon, even where the Articles were silent as to the manner of appointing directors.32

4. The position under the 2008 Act

The 2008 Act, like its predecessor (the 1973 Act), recognises the first directors of the company as those who incorporate it.33 Section 67(2) of the 2008 Act further recognises that the incorporators - who should be the first directors - may be fewer than the minimum number of directors required for that company in terms of the 2008 Act or the company’s Memorandum of Incorporation. It provides that in such a situation, the board must

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21 Benade Entrepreneurial Law 119.
22 Meskin Henochsberg on the Companies Act 61 of 1973; Gohlike & Schneider v Westies Minerale (Edms) Bpk 1970 (2) SA 685 (AD) 693-694.
23 Naidoo Corporate Governance 118.
24 Grundt v Great Boulder Proprietary Gold Mines Ltd (1948) ch[1948]1 All ER 25 Section 211 (1) and (2).
26 Section 211(2)(1).
27 Esser 2007:143
28 Section 211(4).
29 Section 21; Marrok Plase (Pty) Ltd v Advance Seed C. (Pty) Ltd 1975 (3) SA 403 (A).
31 Naidoo Corporate Governance 75.
32 Meskin Henochsberg on the Companies Act 61 of 1973 section 210; Gohlike & Schneider v Westies Minerale (Edms) Bpk 1970 (2) SA 685 (AD) 693-694
33 Section 67(1).
call a shareholders’ meeting within 40 business days after incorporation of the company, to elect sufficient directors to fill all vacancies on the board at the time of election.

The 1973 Act, in contrast, provides only that:

Until directors are appointed, every subscriber to the Memorandum of a company shall be deemed for all purposes to be a director of the company.34

Comparing the two Acts, one may argue that, in comparison to the 1973 Act, the 2008 Act allows shareholders to exercise their right to appoint directors at an earlier stage in the company’s establishment. This could be seen as recognition of the need for shareholder involvement arising from the fact that the shareholders have more interests in the company worthy of protection than any other stakeholder.

As for subsequent directors, that is, those who were not incorporators, the 2008 Act provides for three modes of appointment.35 These are discussed hereunder:

Appointment by a person named in or determined by the Memorandum of Incorporation

Section 66 (4) (a) (i) provides that:

A company’s Memorandum of Incorporation may provide for the direct appointment and removal of one or more directors by any person who is named in/or determined in terms of the Memorandum of Incorporation.

The Memorandum of Incorporation can grant exclusive appointing rights to certain people or organs within the company. These persons eligible who may be granted appointing rights under the Memorandum of Incorporation, may be creditors, trustees of debenture holders, or the board of directors. It is submitted that the granting of power to appoint directors to other persons or organs in the Memorandum of Incorporation, is an indirect exercise of shareholder power in that the Memorandum of Incorporation is a product of their input. It is further submitted that this provision in fact dilutes the shareholders’ power to appoint directors as they now share what should be their exclusive right with other persons.

Where this is the case, and in the absence of any fraud or bad faith, such persons have no duty to take reasonable care to ensure that directors so appointed are competent to discharge their duties.36 This may not be in the interests of the company or the shareholders, as incompetent people may be appointed as directors.

It would appear on the face of it, that the Memorandum of Incorporation disenfranchises the shareholders by granting appointment rights to other people or organs, but that is not so if the preceding argument holds true. They can prevent that by amending the Memorandum of Incorporation if they so wish, but subject to the rigorous requirements set for special resolutions.

4.1. Ex-officio directors

Some persons do not become directors through appointment or election. They become directors by virtue of some other office, title, designation, or status they hold.37 This office, title, designation, or status does not have to be in the particular company to which they are appointed.38 It could be some office in society or in the public service. What offices, titles, designations, or status qualify a person to be an ex officio director, should be set out in the Memorandum of Incorporation.39 In view of this fact, ex-officio directors may also be said to be directors appointed in terms of the Memorandum of Incorporation - albeit under special circumstances.

Again, one is tempted to conclude that by allowing directorship by virtue of holding some office, title, designation, or status, shareholders are deprived of their direct appointment rights. The Memorandum provides for offices, titles, designation, or statuses that qualify as ex officio directors. Shareholders have a say in what the Memorandum of Incorporation provides. It is therefore submitted that shareholders retain an indirect a say as to who can serve as an ex officio director. This means that they have the power to bar individuals holding certain offices, titles, designations or status from becoming directors. However, amendment of the Memorandum of Incorporation is not easily achieved since, as indicated above, it can only be done by the adoption of a special resolution subject to strict requirements.40

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34 Section 208(2).
35 Ncube 2011 SALJ 37.
37 Section 66(4)(a)(ii); In Re The Bodega Co. Ltd [1964] 1 ch 276.
38 Delport Henochsberg on the Companies Act section 66.
39 Section 66(4)(ii).
40 Section 65(9).
(c) Appointment by shareholders

The methods by which a director may be appointed discussed above, are exceptions to the general approach in company law in terms of which appointment rights vest directly in the shareholders. Section 68 of the 2008 Act provides for director election by those entitled to exercise voting rights. This power is critical in exerting influence within the company. Shareholders can change the course of events in the company by changing those at the helm. However, this safeguard is diluted if, as noted by Mongalo, in practice the appointment of directors at a general meeting becomes a mere endorsement of decisions by the board of directors. That such appointments are likely to be endorsements of the recommendations of the board of directors, is more likely to be the prevailing situation in practice in view of the dispersed shareholdings both geographically and numerically, coupled with shareholder apathy. Not many shareholders have a keen day-to-day interest in the operations of the company. When they are dissatisfied with the performance of their investments, many shareholders move their investments elsewhere rather than trying to effect changes in the way the company is being run. Very often, due to lack of time and commitment, they are strongly inclined to rubberstamp the board’s decision. This leaves the shareholders vulnerable and at the mercy of the board, thereby detracting from the spirit of the 2008 Act to protect the shareholders.

Section 68(2) requires that each director be appointed by a separate resolution, unless the Memorandum of Incorporation provides otherwise. A provision may, however, be put in place allowing two or more candidates to be elected as directors by way of a single resolution. This provision serves the same purpose as section 210 of 1973 Act. It is noteworthy that while the Act prohibits the appointment of two or more directors by a single resolution, this can be altered in that the Memorandum of Incorporation may provide to the contrary. This is welcomed, and does not militate against the spirit of the Act which is to protect shareholder interests. A provision in the Memorandum of Incorporation will stand as the view of the shareholders.

It is also a general rule that in exercising their rights to vote for a director, shareholders have no duty to the company. They exercise this right in their own interests even where this is in conflict with those of the company. This is recognition of shareholder independence. A shareholder should vote for a director as he pleases and not be influenced by anyone. This is a protection mechanism as it frees shareholders from being unduly influenced by others, particularly the board. If it were not for this, shareholders could be coerced into voting for certain persons on the pretext that it would be in the interests of the company, or some such reason.

In terms of section 68(1), a director may serve for an indefinite term or for a term set in the Memorandum of Incorporation. The company may provide for a director’s period of tenure in its Memorandum of Incorporation. It is possible, in terms of section 68(1), for that term to be either fixed or indefinite. On the face of it, the possibility of an indefinite term for directors creates room for the entrenchment of their position. However, this may not be so since the Memorandum of Incorporation is subject to amendment by the shareholders. It is submitted that shareholders may amend a provision in the Memorandum of Incorporation whenever they wish – subject always to onerous requirements of a special resolution.

In terms of the 2008 Act, shareholders have discretion in certain issues which they can provide for in the Memorandum of Incorporation. There is nothing in the Act making it obligatory for a director to hold any qualification shares, but the Memorandum of Incorporation may provide for this. It is when the Memorandum of Incorporation provides for such qualification, that a director who fails to obtain qualification shares within the prescribed period, must vacate his office or be guilty of an offence. Failure to satisfy a qualification as provided in the Memorandum of Incorporation renders the director ineligible to serve. If in the course of his or her directorship, a director loses a qualification prescribed in the Memorandum of Incorporation, he or she

41 Section 68(1).
42 Mongalo 2004 TSAR 102.
43 Naidoo Corporate Governance 76, 93. Robert Clark of Harvard University is quoted as having said that voting in a public company is a mere ceremony designed to give a veneer of legitimacy to managerial power. Naidoo Corporate Governance 76. In most companies the potential directors are chosen and put forward for election at the AGM by management, which ultimately controls the candidates that are proposed to be considered by the nomination committee. 44 Kuwait Asia Bank EC v National Mutual Life Nominees Ltd (1991) AC 187 (PC) 220-1.
45 Re HR Harmer Ltd [1959] 1 WLR 82.
47 Section 69(7)(c) of the 2008 Act.
immediately ceases to be a director as he or she will have become ineligible or disqualified.\textsuperscript{48}

In addition to fixing a term of office for directors, the Memorandum of Incorporation can also provide for rotation of directors and require directors to have qualification shares. The 2008 Act does not make these provisions mandatory. It is submitted that this flexibility in the Act may leave the shareholders vulnerable in the sense that they may be taken advantage of and manipulated to their detriment by the board. The tenure of a director has a bearing to his independence. It is felt that the independence of a non-executive director is increasingly compromised the longer he or she remains in office because rational perspective is lost with time. The longer the director stays, the more he or she becomes an insider.\textsuperscript{49} Lack of knowledge coupled with apathy; place the shareholders at the mercy of directors. It is submitted that the provision safeguards the position of shareholders which could be diminished if the right were granted to some other persons. This is a welcome safeguard and has been made peremptory for profit companies. It reserves power to the shareholders to exercise their ownership right of controlling the company through the power to determine those who direct it.

With regard to vacancies on the board, section 70 provides that these should be filled by a new appointment at the next annual general meeting, or within six months after the vacancies arise.\textsuperscript{51} This provision is clear. The advent of a vacancy in the office of a director will call for the replacement by the same persons who appointed the outgoing director.\textsuperscript{52} Where circumstances demand, the board may appoint a temporary director to fill the vacancy.\textsuperscript{53} Granting the board the power to appoint temporary directors is expedient as it is not always easy to assemble shareholders for a general meeting. It would not serve the interests of shareholders to wait for vacancies in the offices of directors to be filled at the next annual general meeting. Such a delegation is necessary for the smooth running of the company, and should not be regarded as an erosion of shareholder powers.

Section 60(3) provides:

An election of a director that could be conducted at a shareholders’ meeting may instead be conducted by written polling of all the shareholders entitled to exercise voting rights in relation to the election of that director.

This provision implies that it is not necessary for shareholders to physically convene a general meeting to elect a director. This provision is convenient for shareholders in view of the dispersed shareholding in today’s companies. Shareholders need not be physically present at a meeting. As a result, they save on travelling costs and time. It allows the shareholders the opportunity to exercise their rights in the comfort of their offices or homes, which is wise given the level of shareholder apathy obtaining in the corporate world today.

\textsuperscript{51} (3) If a vacancy arises on the board, other than as a result of an ex-officio director ceasing to hold that office, it must be filled by:-

(a) a new appointment, if the director was appointed as contemplated in Section 66(4) (a)(i);

(b)Subject to subsection (4) by a new election conducted;

i) at the next Annual General meeting or

ii) in any other case within six months after the vacancy arose.(aa)at a shareholders meeting called for the purpose of electing the director, or exercise by the poll of the persons entitled to exercise voting rights in an election of the director, as contemplated in Section 60(3).

\textsuperscript{52} Delport Henochsberg on the Companies Act section 71.

\textsuperscript{53} Section 68(3).
As explained above, the agency problem arises where there is a separation of ownership and control. As a safeguard, it is submitted that the share qualification requirement should have been made mandatory by the 2008 Act rather than leaving companies to provide for this in their Memorandum of Incorporation if they so wish. If directors were obliged to acquire qualification shares on their appointment, this would protect shareholders in that directors would share the risks resulting from their decisions. As they would also benefit or lose in the process, directors would avoid reckless decisions that would expose the company to risks. It is submitted that this would compel them to transact as if they were transacting their own business, thereby making them more responsible and diligent and resulting in greater shareholder protection. Section 213 of the 1973 Act leaves it to the company to provide for this in its Articles. The 2008 Act also leaves it to the company to provide for share qualification in the Memorandum of Incorporation. As already mentioned, it would have been far better had share qualification been made mandatory by the 2008 Act and not been left to the whim of the company in its Memorandum of Incorporation. It is submitted that not all shareholders are enlightened in the way companies operate. Shareholders may not be informed as to the benefits of directors holding qualification shares. Where directors hold qualification shares, it is expected that they will be more prudent and diligent in the way they perform their duties because they will have a direct interest in the operation of the company. By making share qualification mandatory in the 2008 Act shareholders would have been better protected.

Section 68(1) of the 2008 Act expressly allows space for directors to serve for an indefinite term. It is submitted that this provision is not in the interests of shareholders because the longer directors serve, the more their independence is compromised. The provision, as already alluded to, creates the opportunity for the entrenchment of the positions of directors. Serving for indefinite periods does not accord well with current corporate governance principles. It is submitted that in this regard both the 1973 and 2008 Act are lacking when it comes to shareholder protection.

5. Observations

The 2008 Act accords shareholders powers to appoint directors. However, it goes further by permitting the Memorandum of Incorporation to provide for appointment of directors by persons who are not shareholders. Leaving such important matters to the decision of non-shareholders in the Memorandum of Incorporation, could expose shareholders to manipulation by directors. While it is true that shareholders may contribute to what the Memorandum of Incorporation provides, their influence and control become remote. This means if they have a change of heart on what the Memorandum of Incorporation provides, they will need to take the arduous route of making amendments, which can only be done by special resolution. This is not an immediate process.

The argument is that the right of appointment should be held by the owners. The 2008 Act should not allow room for persons such as creditors, trustees of debenture holders, or the board of directors to appoint directors, as this amounts to usurpation of shareholder powers. Creditors should remain as creditors, and should have means other than the exercise of ownership rights by which to safeguard their interests in the company. Appointment rights are ownership rights. It is submitted that there is no justifiable reason to transfer these powers to non-owners.

6. Summary and Conclusion

The exclusive direct right of shareholders to appoint directors has been seriously eroded by the 2008 Act. Shareholders no longer wield this power exclusively. The 2008 Act allows other persons to appoint directors under the Memorandum of Incorporation. Granting other persons rights to appoint directors implies that shareholders also lose the right to remove directors. Removal is often done by persons who appointed the directors. However, the fact that the Memorandum of Incorporation may permit the appointment of directors by other persons means the role of shareholders become indirect through dictating what the Memorandum of Incorporation may provide. This means shareholders can still achieve their wishes by alternative means. So one wouldn’t say they are worse off in the current dispensation than in the previous.

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Abreviations
ABLR -Australia Business Law Reports
AD-Appellant Division
All ER -All England Law Reports
Australia Corp-Australia Corporate Law Reports
D&C-Durban and Coast Local Division
ILJ-International Law Journal
JRP - Journal of Research Practice
O -Orange Free State
SA Merc LJ - South African Mercantile Law Journal
SALJ-South Africa Law Journal
SC - Supreme Court
SCA- Supreme Court of Appeal
T –Transvaal
Tk-Transkei
VI LR-Virginia Law Review