Codes offer greater balance

THE recently issued final codes of good practice on broad-based black economic empowerment make provision for enterprises to retain limited ownership points; "exit points" in situations where black shareholders quit the enterprise by selling, or otherwise losing their shares.

This position was adopted by the trade and industry department subsequent to a long debate concerning the "once empowered always empowered principle". The debate goes to the root of the principles of black empowerment and how best to achieve the goal of transformation in the South African economy.

In the first draft of the codes, and according to the sector charters which pre-dated the codes, an enterprise was not entitled to retain ownership points if a black economic empowerment (BEE) shareholder subsequently sold his or her shares. Consequently, most empowerment deals were structured on the basis that the BEE shareholder would be restrained from selling his or her shares for a certain period of time using contractual "lock in" provisions. These provisions were used not only to tie in the BEE shareholder but resulted from the fact that the shareholder would often pay for the shares through dividends declared by the enterprise, over time.

IT WAS argued that the fact that the BEE shareholder may not freely realise that his or her shares run counter to the principle that black people should be brought into the economy and trade on an equal footing. In addition, most lock in provisions provide that once the BEE shareholder's shares were paid up and the lock in period expired, the shares could only be sold to another "black person".

One could easily envisage that there could be circumstances where the BEE shareholder could be tied into a bad investment with no escape mechanism. For the BEE shareholder, finding a suitable replacement may require the sale of the shares at a substantial discount and, should the enterprise itself seek a BEE shareholder, it will probably need to facilitate or even fund such a transfer, at some cost to the enterprise and its other shareholders.

The counter to this argument is that often BEE shareholders earn in their equity and, particularly if the sale has been vendor-financed, the enterprise seeking to become empowered should have the comfort that its BEE shareholder is in for the "long haul", not only by enabling the enterprise to retain its ownership points but by allowing the shareholder to become more involved and entrenched in the business.

An active BEE shareholder would also be in a position to ensure the proper implementation of the other pillars of empowerment such as employment equity, preferential procurement and enterprise development. The fact that the BEE shareholder was tied in this manner was also regarded as consideration for the fact that it may have received shares at a discount, or even free, and this lock in was an equitable means of ensuring the shareholder was giving the enterprise concomitant value for the shares.

The final codes seek to address this dichotomy with a compromise proposal, seeking to encourage enterprises to put shares in black hands, while allowing the shares to be relatively liquid in the hands of the shareholder.

The codes provide that an enterprise may qualify for "exit points", representing up to a maximum of 40% of its total ownership points, if a BEE shareholder owned shares in the enterprise for a period of at least three years prior to the sale or loss of the shares. The number of points that an enterprise may be awarded will be dependant on the composite strength of the following factors:

- The degree of transformation that has taken place within the entire enterprise, excluding ownership.
- The net value created in the hands of black people. The net value of shares contained in a share instrument (such as a sale of shares agreement) held by the BEE shareholder will be determined against the date on which the equity was sold or lost, as a percentage of the enterprise's entire shareholding. The codes seek to recognise and reward a company if it has empowered black individuals in the course of the transaction.
- Ownership points from a previous BEE share deal may only comprise up to the above stated maximum of 40% of the ownership points available. This means the enterprise cannot simply rest on its laurels and will need to ensure some ongoing BEE investment either through the current shareholder or by actively seeking a new shareholder to ensure the maximum exploitation of the available ownership points. One of the additional rationales for the exit points given by government, is that the enterprise will then be allowed a hiatus period in which to find another suitable BEE shareholder to replace the departed shareholder.

EACH of these broad principles may in themselves give rise to more questions. For example, in the first factor, one may double counting the other "pillars" of empowerment to count towards ownership, in the second, it could well be that the business has failed due to a myriad other reasons and the BEE shareholder's investment has not quite lived up to its expectations — should the enterprise be punished for this lack of financial performance in its empowerment rating, regardless of the cause?

The compromise position presented by government is a courageous one, but it will not always be straightforward or even equitable, to implement these principles.

In addition, the codes draw a distinction between those BEE shareholders who sell their shares and those who "lose" their shares. The loss rather than "sale" of such shares seeks to encompass those instances where, for example, the BEE shareholder has defaulted in its loan payments to pay for such shares.

Usually, in the case of a default of this nature, the enterprise or its other shareholders could exercise a right to buy back the shares, or if external funding has been used, the funding institution could realise its security for such loans by selling the shares. In these circumstances, the enterprise may be afforded "exit points" even though it is clear the BEE transaction has actually failed.

The trade and industry department provided that additional requirements must be provided for such a "loss" of shares — the enterprise would have to disclose a documented loan or security arrangement under which the BEE shareholder lost its shares and the enterprise will only be afforded exit points for as many years as the shareholder actually held the shares. The details relating to this provision, especially the loan and/or security arrangement are vague and could potentially result in allowing enterprises to discard their BEE shareholders and simultaneously retain ownership points, if not carefully monitored and implemented.

Despite the encouraging endeavours in the codes to balance the interests of enterprises in their BEE shareholding, with the freedom of BEE shareholders to deal with their shares, the codes still lack some precision in the implementation of this section. One could easily imagine that if this section of the code is not carefully controlled, an opportunistic market could be created both for BEE shareholders who just want to get rich quickly by neatly timed departures and enterprises that may attempt to avoid true ownership empowerment by the manipulation of this provision.

As with many of the provisions of the codes, the effective utilisation of this section and its contribution towards the equitable transformation of the economy, will be dependant on the integrity of the transaction in question and its participants.

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