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## Optimising closely held entities to enhance commercial participation and development: The Southern African experience in comparative perspective

### Summary

The important contribution of the small business sector to economic growth and regional development is widely and generally acknowledged. In 1984, the South African *Close Corporations Act* introduced a simple, inexpensive and flexible closely-held entity for the business consisting of a single entrepreneur or small number of participants, designed with a view to his or their reasonable needs and expectations and without burdening him or them with legal requirements that would not be meaningful in the circumstances. This example was followed with varying degrees of success in Southern Africa and Australia by legislative developments aimed at the introduction, in various guises, of new legal forms for small business. In more recent law reform initiatives in Australia and especially the United Kingdom, various options were analysed to optimise closely-held entities with a view to enhancing commercial participation and economic development through small businesses. Eventually, the somewhat less imaginative approach of merely simplifying the private company was chosen. Attention will be given to the Southern African experience of closely-held entities and then to a critical comparative analysis of and perspectives on recent developments in Australia and especially the United Kingdom.

### Die optimalisering van beslote entiteite om ekonomiese deelname en groei te bevorder: Die Suider-Afrikaanse ervaring in regsvergelykende perspektief

Die belangrike bydrae van die kleinsakesektor tot ekonomiese groei en ontwikkeling word wyd en algemeen erken. In 1984 het die Suid-Afrikaanse *Wet op Beslote Korporasies* 'n eenvoudige, goedkoop en buigsame beslote entiteit ingevoer vir die onderneming wat bestaan uit 'n enkele entrepreneur of klein groepie deelnemers, ontwerp met die oog op sy of hul redelike behoeftes en verwagtinge en sonder om hom of hulle te belas met regsvereistes wat in die omstandighede nie sinvol sou wees nie. Hierdie voorbeeld is met wisselende grade van sukses nagevolg in Suider-Afrika en Australië deur statutêre ontwikkelings gemik op die invoering van nuwe regsvoorms vir kleinsake. Tydens meer resente hervormingsinisiatiewe in Australië en veral die Verenigde Koninkryk, is verskeie opsies ontleed om beslote entiteite te optimaliseer met die oogmerk om deelname aan die ekonomie en ekonomiese ontwikkeling deur middel van kleinsake te bevorder. Die keuse het uiteindelik op die ietwat verbeeldinglose benadering geval om bloot die private maatskappy te vereenvoudig. Aandag sal geskenk word aan die Suider Afrikaanse ervaring met beslote entiteite en daarna aan 'n kritiese vergelykende ontleding van en perspektiewe op resente ontwikkelings in Australië en veral die Verenigde Koninkryk.

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## 1. Introduction

Particularly in countries where unemployment levels are high, small enterprises play a valuable role in creating new job opportunities, providing stability, eliminating poverty, improving competitiveness, promoting the development of labour skills and ensuring economic growth.<sup>1</sup> It was estimated in 1996 that small to medium enterprises in South Africa employed approximately 20% of economically active South Africans; that more than 90% of South Africa's formal business entities could be classified as small to medium businesses; that small to medium businesses provided jobs to approximately 7 million South Africans; and that small to medium enterprises contributed almost 45% of the South African GDP.<sup>2</sup>

Clearly, small enterprise development should be encouraged in South Africa.<sup>3</sup> In particular, it is imperative<sup>4</sup> that legislation should ensure that the start-up of small enterprises is cheap, fast and easy; that the regulatory framework for small businesses is improved by ensuring that legislation applicable to small enterprises is clear and simple;<sup>5</sup> that top-class small business support is available; that the creation of small enterprises is promoted by removing all legislative stumbling blocks; that the right business environment is created to ensure that those enterprises that do have the capacity to grow and develop have the right conditions for doing so; and that there is a continuing reform program fostering entrepreneurship. It is of paramount importance that an enabling environment should be created where these types of enterprises can thrive, especially by ensuring that small entrepreneurs have a choice of appropriate business forms at their disposal.<sup>6</sup>

In 1984 South Africa became the first country with a British derivative company law system to take a large step forward in providing effectively for the reasonable entrepreneurial legal needs and expectations of the typical small businessman by way of separate legislation. The recognition of the fact that the small business sector forms the very backbone of a market

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1 South African Chamber of Business 1999:3-4; Commission of the European Community 2001:2; Commission of the European Community: 2000:7; Commission of the European Community 2002a:4. See also O'Neill *et al* 1987:43-45; Burns and Dewhurst 1996:1-19.

2 See the debate in National Assembly 1996:5101.

3 Commission of the European Community 2000:2; Commission of the European Community 2002b:4; Commission of the European Community 2002c:3; O'Neil *et al* 1987:34-46.

4 Commission of the European Community 2000b:2; Commission of the European Community 1998a:5; Commission of the European Community 1998b:1; Frew 1992:158; Hadden 1972:89.

5 As the Commission of the European Communities correctly notes: "A difficult or complex regulatory environment can discourage entrepreneurship and the creation of new business". See Commission of the European Community 1997:4.

6 Commission of the European Community 1997:4; Commission of the European Community 1998a:6; Commission of the European Community 1998b:3; Commission of the European Community 2000:7; Sealy 1984:219; Burns and Dewhurst 1996: 45-47.

orientated economy, gave added impetus to the introduction of the *Close Corporations Act* 69 of 1984.<sup>7</sup>

The Act introduced a new form of incorporation for closely-held enterprises with several unique and innovative features combining some of the attributes of partnership with the corporate attributes of legal personality and limited liability.<sup>8</sup> It provides a simple, inexpensive and flexible form of incorporation for the enterprise consisting of a single entrepreneur or small number of participants, designed with a view to his or their needs and without burdening him or them with legal requirements that would not be meaningful in his or their circumstances.<sup>9</sup>

The *Close Corporations Act* has proved to be one of the most remarkable innovations in South African company law.<sup>10</sup> Its example has been followed by legislative developments in several jurisdictions aimed at the introduction, in various guises, of new legal forms for small business.

Attention will be given firstly to initiatives for small businesses and the evolution of the close corporation in the Republic of South Africa, then to developments in Southern Africa and then to events in a few other jurisdictions of relevance.

## 2. South African initiatives

### 2.1 Strategies for empowerment

In 1997 the South African *National Small Business Act*<sup>11</sup> came into force. This Act established two government bodies namely the *National Small Business Council* and the *Ntsika Enterprise Promotion Agency* in order to provide guidelines for organs of state on national, provincial as well as local level in promoting small business in South Africa;<sup>12</sup> provide business advice to small businesses;<sup>13</sup> assess whether legislation and government policies impose legal barriers to small and medium businesses in South Africa;<sup>14</sup> contribute to policy formulation at national level;<sup>15</sup> and analyse the impact of social and economical factors on small and medium businesses.<sup>16</sup>

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7 Venter 1984:110.

8 Naudé 1984:119; Henning 1996:497-500; Henning and Bleimschein 1990:627.

9 Naudé 1984:117-119.

10 Jordan 1997:2-18.

11 South African *National Small Businesses Act* 102/1996. See Henning and Snyman 1996:132; Snyman and Henning 1998:54.

12 South African *National Small Businesses Act* 102/1996: section 3(1).

13 South African *National Small Businesses Act* 102/1996: section 3(1) read with section 10(1)(c).

14 South African *National Small Businesses Act* 102/1996: section 10(2). See also the debate in National Assembly 1996:5098.

15 See the debate in National Assembly 1996:5105.

16 See the debate in National Assembly 1996:5099.

These government bodies provide non-financial services to the small business sector and advocate the needs of small and medium businesses.<sup>17</sup> Therefore, this Act “represents [the South African] Government’s commitment to creating an enabling environment for small business in South Africa as the mechanism for delivering support to small, medium and micro enterprises.”<sup>18</sup>

However, government should do more than introduce legislation dedicated to small enterprises. It must also ensure that a viable business environment exists within which such small enterprises can flourish. There are various strategies that a government can follow in order to benefit small and micro small enterprises, which, in turn, will empower both historically and socially disadvantaged groups.

## 2.2 Relaxing financial reporting requirements

Small and micro small enterprises are notorious for lacking the resources to ensure that their financial statements comply with all the disclosure requirements of, for example, company legislation.<sup>19</sup> The simple fact is that many of the abuses at which such encumbering disclosure requirements are aimed are simply not relevant to the small and micro small enterprise environment. For example, many of these reporting requirements seek to ensure that investors are able to ascertain the full picture of their investments. In the case of small and micro small enterprises the investors are, in most instances, also the managers of the business.<sup>20</sup> This is further illustrated by the fact that the financial statements of small companies are not public documents and consequently only banks and revenue authorities have an interest in these statements.<sup>21</sup>

Small and micro small enterprises provide and create substantial employment opportunities. Their financial resources should not be wasted on unnecessary financial reporting requirements.

## 2.3 Appropriate funding and advice structure

A further required government initiative is funding and loans support. Financial institutions such as banks only lend money to an entity whenever either the entity or its owners can provide security for the funds requested. For this reason, many owners of small and micro small enterprises cannot obtain loans and funding from financial institutions. These entrepreneurs eventually turn to cash loan businesses, which normally charge exorbitant interest rates, in effect inhibiting the potential of these enterprises and, further, diminishing the resources of the aforementioned entrepreneurs.

This type of scenario can be avoided if the government establishes local or provincial financial institutions, dedicated to small and micro small enterprises.

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17 See the debate in National Assembly 1996:5098-5099.

18 See the debate in National Assembly 1996:5099.

19 Coppin 1996:11.

20 Coppin 1996:11.

21 Coppin 1996:11.

## 2.4 Tax benefits

It is submitted that in order to ensure the prosperity of small enterprises, governments should ensure that these enterprises are not over-taxed. In this regard, the Republic of Lithuania's *Law on Small Enterprises* is noteworthy.<sup>22</sup> Section 3, dealing with tax relief, provides that:

For the period of two years from the entry into force of this Law or from the founding of a new enterprise, the rate of tax on profits imposed on small enterprises ... and the rate of income tax ... shall be reduced by 70 percent, and, beginning with the third year, by 50 percent, provided the total number of employees in said enterprises is not in excess of 50, and the income received from productive activity amounts to not less than two-thirds of all income generated from the sale of goods and services.

Section 3 provides further relief by stipulating that “[u]pon computing taxable profit or taxable income, all expenditures and investments related to scientific research, design and construction work, and introduction of new technology shall be deducted from gross income.”

## 2.5 Simplified registration

To ensure the continuing emergence of small enterprises, it is imperative that the registration process of small businesses should be simplistic, expedient and relatively cheap. Slow and expensive registration is an inhibiting factor. The limited resources of small and medium enterprises should not be wasted on unnecessary or time consuming administrative obligations.<sup>23</sup>

## 2.6 Issues of transfer

Legislation dealing with small enterprises must, in particular, deal with the transfer of ownership of businesses. Provisions dealing with this aspect should be clear and simple.<sup>24</sup>

## 2.7 Education

It is imperative that a culture of entrepreneurship should be created by promoting business enterprises in schools and informing pupils of the basic differences between the various available forms of businesses. This will ensure that when they enter the economic market, they will be equipped with the necessary knowledge to choose the correct enterprise form for their business scenario.<sup>25</sup>

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<sup>22</sup> [www.finmin.lt/engl/laws/smallent.htm](http://www.finmin.lt/engl/laws/smallent.htm).

<sup>23</sup> Commission of the European Union 2002a:7.

<sup>24</sup> Commission of the European Union 2002b:13.

<sup>25</sup> Commission of the European Union 2002c:15.

### 3. South African close corporation<sup>26</sup>

#### 3.1 Concept

The South African close corporation may startle traditional company lawyers. It is a fully-fledged corporation, which confers on its members all the usual advantages of the attributes of legal personality, in particular perpetual succession and limited liability. It has the capacity and powers of a natural person of full capacity. There is no room for the application of the doctrines of *ultra vires* or constructive notice. It is a closely-held entity in which all or most members are more or less actively involved. In principle there is no separation between ownership and control. No board of directors nor general meeting is required; every member is entitled to participate in the management of the business and to act as an agent for the corporation, every member owes a fiduciary duty and a duty of care to the corporation; the consent of all the members is required for the admission of a new member. Traditional capital maintenance requirements have been replaced by solvency and liquidity.<sup>27</sup>

In principle, membership is limited to natural persons. It may have a single member, as is presently the case with approximately seventy five percent of all close corporations. Though the maximum number of members is limited to ten, there is no restriction on the size of a close corporation's business or undertaking, or the number of its employees or creditors, or the size of the total contributions by members, or turnover, or value of assets or, generally, the type of business. It also need not be an undertaking for gain. In this way the establishment of a wide range of business enterprises is effectively promoted. The close corporation can cater for the unsophisticated and highly sophisticated businessman alike. It can also provide a viable mechanism for helping to bridge the gap between the formal and informal sectors of the economy.<sup>28</sup>

#### 3.2 Background and objectives

This specific legal development originated when a proposal for the introduction of a new legal form for small business<sup>29</sup> was submitted to and accepted by the Standing Advisory Committee on Company Law ("SAC").<sup>30</sup> The memorandum, entitled *The need for a new legal form for small business*, was circulated for comment in 1981<sup>31</sup> and published in 1982.<sup>32</sup> It identified a definite need for a new legal form of business enterprise that would provide entrepreneurs

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26 Henning 2001:917-950; Henning 1995:113-148; Cilliers *et al* 1998:4-6; Cilliers *et al* 2000:574-576.

27 Henning 1996:497.

28 Naudé 1982a:7.

29 Then referred to as the "small business corporation".

30 Naudé 1984:117.

31 On 1981-12-03.

32 Naudé 1982b:5.

with the advantages of incorporation without subjecting them to the complex company law regime.<sup>4</sup> A draft *Close Corporations Bill* was circulated for comment in 1983.<sup>33</sup> The *Close Corporations Act* 69 of 1984 was assented to on 19 June 1984 and became operative on 1 January 1985.<sup>34</sup>

### 3.3 Need

The following are among the more important reasons advanced for a new legal form providing corporate personality for the single entrepreneur or small number of participants:

On account of considerations such as unlimited liability, lack of continuity, absence of legal personality and want of legal certainty, neither the sole proprietorship nor the various types of partnership or indigenous business forms can meet most of the reasonable needs and expectations of the typical small businessman. Incorporation under the *Companies Act* 61 of 1973 offers the evident advantages of limitation of risk, perpetual succession and a regulated structure. However, as a result of the increasing complexity of the *Companies Act*, which historically largely developed in order to deal with problems posed or needs experienced by large public companies, the incorporated company as form of business enterprise has outgrown the particular needs of small businessmen to a definite extent. The small private company is also subject to most of the complex provisions of the *Companies Act*. This is due partly to the fear of possible misuse of private company subsidiaries by public holding companies in a group context. The alternative of building further exemptions for small companies into the *Companies Act* was considered unacceptable. It would only have increased the overall complexity of the *Companies Act* and would have aggravated the problem.<sup>35</sup>

Incorporation under the *Companies Act* has significant implications for the small entrepreneur. The first is complexity. Despite its more than 443 sections and five schedules, this Act is not a codification of company law. It is simply impossible for the unsophisticated businessman with limited access to professional assistance to master the plethora of legal complexities surrounding him. In practice he survives only because his infractions of statutory and uncodified company law are not visited by the criminal and civil sanctions which ought to follow. Secondly, the one or few entrepreneurs have to comply with a system which in many ways is obviously inappropriate for his or their needs and circumstances. The requirement of having a board of directors, the numerous provisions applying to various aspects of meetings and voting thereat, and the extensive accounting and disclosure provisions are merely the most obvious instances. An attempt to build the required

33 It was accompanied by an explanatory document of which more detailed versions were published during the same year — see Naudé 1982c:62; Naude 1982b:7; Naude 1882a:7; Larkin 1984:317.

34 Proc R194 Government Gazette 1984:9503.

35 Cilliers *et al* 1998:12; Cilliers *et al* 2000:575-577; Beuthin 2000:325-327; Williams 1997:319-321.

flexibility into the *Companies Act* could only exacerbate the problem by an inevitable overall increase in complexity. At the root of the development of the close corporation is the conviction that a single Act can no longer present a satisfactory legal form for the large and sophisticated as well as the small and often marginalised entrepreneur. The *Companies Act* developed and is developed mainly in response to the needs of and problems posed by large public companies. It has to provide for the large industrial or financial conglomerate with its listed shares, professional management reflecting a clear separation between ownership and direct or indirect control of an institutional investor, scattered and powerless small shareholders and group problems. Hence it inevitably outgrows the needs and problems of the small entrepreneur with his restricted means and limited access to professional advice.<sup>36</sup>

### 3.4 Objectives

The stated purpose of the Act is to provide a simple, less expensive and more flexible legal form for the enterprise consisting of a single entrepreneur or small number of participants, designed with a view to his or their needs and conferring the advantages of a separate legal personality without burdening him or them with legal requirements that would not be meaningful in his or their circumstances.

There is no restriction on the size of a close corporation's business or undertaking, or the number of its employees or creditors, or the size of the total contributions by members, or turnover, or value of assets or, generally, the type of business and it need not be an undertaking for gain.<sup>37</sup>

### 3.5 Moral imperative

The introduction of the close corporation formed part of a larger process of economic, social, political and legal reform in South Africa, together with other components such as democratisation, deregulation, the advancement of effective competition and the advancement of small business.<sup>38</sup>

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36 See Naudé 1984:117-119; Naudé 1982:8. At a later occasion these considerations were phrased as follows: "It is clear that a highly complex situation exists. The fact is that a point has been reached where a single Act can no longer in this country cater for the needs of the big listed company, which may be the ultimate holding company of a vast group having several listed companies, and the small business. Trying to cater for the needs of both in one Act has become quite impossible. In practice when the idea of the new legal form was bandied about, the reaction was: "Why bother with the *Companies Act*? It works so well". The experienced attorney would say to you: "I have registered private companies all my life and they work beautifully". The only reason why it seemed to work beautifully was that it did not work at all. The *Companies Act* was never effectively applied to the small businessman." See Naudé 1986:1-2.

37 Henning 1984:163; Henning 1987:104; Henning 1995:116; Henning 2001:923.

38 Naudé 1986:3; Henning 1986:98; Henning 1987:94.

According to a discerning commentator, the introduction of the close corporation is evidently aimed at a potentially more informal sector of the economy; at giving more power to a disadvantaged class so that they may become more of a capitalist middle class. The previous relatively simple enterprises of yesteryear have turned into conglomerates and multinationals of frightening size and complexity. The lower classes cannot exercise real power because there are too many of them and they are not adequately trained to run an industrial society, let alone operate under the *Companies Act*. In this respect the *Close Corporations Act* may be a moral achievement of a couple of mercantile law experts of South Africa comparable to the work of the Wiehahn Commission on labour law reform, which was acknowledged by the United Nations. People in society who have the intellectual and organisational equipment and wealth to deal with complex problems, are a class of people who benefit from problems which are perceived as being complex. None more so the case than in company law. The wide-spread sham compliance with company law can be interpreted as the result of accepting the norms of the elite for the whole society. In a very definite sense that is founding prosperity on the oppression of other people. The apparatus with which the rest of society was run was more elaborate than the rest of society needed. The *Close Corporations Act* dismantles this apparatus in a sense, and thus mitigates its oppressive character. "Thus the legal system looks beyond the class interests of the business elite, doing justice to all classes, applying the moral imperative."<sup>39</sup>

Perceptions such as these should evidently not be taken as providing some measure of justification for a conclusion that the South African experience of the close corporation can be conveniently discredited as a development exclusively attributable to the vicissitude of political expediency. Professor Larkin aptly emphasises that the *Close Corporations Act* should in the first instance be regarded as "a first rate piece of 'black letter' law."<sup>40</sup>

### 3.6 Private companies<sup>41</sup>

In the memorandum *The need for a new legal form for small business*, the idea was expressed that the introduction of the close corporation should result in the private company being phased out of the *Companies Act*.<sup>42</sup>

In a major policy statement on the future development of company law issued by the SAC in 1985,<sup>43</sup> the second most important issue placed in the most urgent category was the abolition of the distinction between public and private companies. In a further statement on future development issued by the SAC in 1989, the abolition of the distinction between private and public companies again appeared very high on a fairly long list of priorities.<sup>44</sup>

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39 Du Toit 1984:108.

40 Larkin 1984:322.

41 Cilliers *et al* 1992:23-24; Henning and Wandrag 1993:14-16.

42 Naudé 1984:119; Naudé 1986:1.

43 On 8 February 1985.

44 See Cilliers *et al* 1992:23-24.

Consequently the SAC published proposals<sup>45</sup> involving the removal of distinctions between private and public companies concerning the filing and disclosure of annual financial statements;<sup>46</sup> maximum and minimum membership;<sup>47</sup> minimum number of directors; divergent quorum requirements for general meetings; special conditions in the memorandum providing for the personal liability of directors for the debts and liabilities of the section 53(b) company; number of proxies who can be appointed by members at general meetings; and the performance by an auditor of the duties of a secretary or accountant of his company.

A private company would have been allowed to load voting rights. It would not have been required to restrict the right to transfer its shares, although it would have retained an option to do so. In contrast, a public company would have been prohibited from limiting the transferability of its shares. A public company would have had to state expressly in its memorandum that it is a public company. The proposals would thus have retained certain limited privileges and exemptions for private companies. On the other hand, the traditional most important privilege of a private company not to disclose its financial statements would have been abolished, while the obligation of public companies in this respect would have been relaxed to a certain extent. The two forms of company would have been treated with a greater degree of equality, and a substantial simplification of the *Companies Act* would have been effected.

Nevertheless, as a result “of submissions received and its own research into proposed amendments to company legislation”, the SAC decided not to recommend the abolition of the distinction between public and private companies. The wider issue of the place of private companies in company legislation would have been considered by the SAC and a recommendation as to private companies would have been made “at a later stage and after appropriate consultation”.<sup>48</sup>

According to a press release<sup>49</sup> by the SAC the “corporative law in South Africa” is to be developed within a framework of five principal statutes, inclusive of a new *Companies Act*, a new *Securities Act*, and a new consolidated *Bankruptcy Act*. In view of the statement that the *Close Corporations Act* is to be retained in its present form, it may well be expected that the issue of the removal of the distinctions between private and public companies is to receive further serious consideration in the drafting of the proposed new leaner and simplified *Companies Act*.

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45 On 25 September 1991.

46 A private company would have been required to disclose its annual financial statements, which would have had to be available for public inspection at its registered office from the date on which copies of these statements were distributed to its members. A public company would no longer have been required to file its annual financial statements and interim reports with the Registrar but would have had to keep them available for public inspection at its registered office.

47 Which also involved the removal of the provisions relating to the different number of persons required for incorporation and for signing the memorandum.

48 Media release by the SAC on 25 May 1992.

49 Released in 1977. No date is provided.

It is clear that the issue has become part of a far longer and time-consuming process of comprehensive corporate law reform. In view of the undoubted success of the close corporation as well as all the academic research and official attention lavished on the removal of the distinctions between public and private companies, it is paradoxical that in the meantime the latter is simply allowed to soldier on in South Africa in a form almost indistinguishable from that in which it was originally introduced in the United Kingdom in 1907.

### 3.6 Salient features<sup>50</sup>

The term 'close corporation' is derived from the expression 'closely-held corporation'. This refers *inter alia* to the limited number of members of the corporation and the closeness of their relationship.<sup>51</sup> The term was used by company lawyers at least as far back as the previous century and internationally it is a widely accepted concept.<sup>52</sup>

It is clear that in adopting the approach that separate provision be made for the incorporation of the typically bigger and the typically smaller business, cognisance was to some extent taken of similar approaches (particularly in Western Europe), but in essence the Act is original and innovative in design and in content. The Act contains important departures from traditional company law concepts. The maintenance of capital concept is abandoned, and its place taken by a more realistic and flexible approach based on solvency and liquidity. This approach is used as a basis for regulating payments to members,<sup>53</sup> the purchase by the close corporation of its members' interests<sup>54</sup> and financial assistance by the close corporation in respect of the acquisition of its members' interests.<sup>55</sup> There is also a complete breakaway from traditional company law regarding *inter alia* capacity and powers and hence *ultra vires*, shares and share capital, the distinction between a board of directors and a general meeting of members, constructive notice, agency, accounting and disclosure, and sanctions for non-compliance with the Act. Exclusion of corporate membership in a close corporation<sup>56</sup> avoids a situation where large public companies can by a simple conversion of subsidiaries into close corporations do business in a form not intended for them.

There is no restriction on the size or scope of a close corporation's business or undertaking, or the number of its employees or creditors, or the size of the total contributions by members, or turnover, or value of assets or type of business. Indeed, the business of a close corporation may be large

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50 See in general Naudé 1984:124-129; Cilliers *et al* 2000:13-14; Lessing 1990:57-58; Trichard *et al* 1989:14-18; *Morsner v Len* 1992 (3) SA 626 (A) 631.

51 Henning 1995a:100; Henning 1995b:163; Henning 1996:497; Venter 1984:113.

52 Henning 1995a:100.

53 *Close Corporations Act* 69/1984: section 51.

54 *Close Corporations Act* 69/1984: section 39.

55 *Close Corporations Act* 69/1984: section 40.

56 *Close Corporations Act* 69/1984: section 29(1).

and complex.<sup>57</sup> Hence the successful close corporation cannot outgrow its legal form and conversion to a company, although possible, is not required. The close corporation is also suitable for the sophisticated entrepreneur.<sup>58</sup>

In accordance with the awareness of the socio-economic and political importance of small businesses, simplification was a primary aim in the design and drafting of the Act. In comparison to the *Companies Act* with its 443 sections, five Schedules and comprehensive administrative regulations, a very considerable simplification has been attained.

Incorporation of a close corporation merely involves the registration of a single document, the founding statement, in which concise and simple factual information is stated.<sup>59</sup> The abbreviation of "CC" or its equivalent in any one of the ten other official languages must be subjoined to the name of the corporation.

A lucid statement of members' fiduciary duties and duty of care and skill is contained in the Act. The common law principles relating to the fiduciary duties and duties of care and skill in managing the affairs of the corporation are to a large extent codified in the Act, with the result that even the unsophisticated member knows exactly what is expected of him and his fellow members.<sup>60</sup>

A close corporation is a legal persona distinct from its members.<sup>61</sup> It has the capacity and powers of a natural person of full capacity.<sup>62</sup> It may have a single member,<sup>63</sup> in which event there is little or no resemblance to an incorporated partnership and by and large the applicable law is even more elementary. Where a close corporation does have more than one member, some principles having a clear partnership heritage do become applicable.<sup>64</sup>

The regulation of internal relations is basic and flexible. As in the case of the *naturalia* of partnership, many of the rules regulating the internal relations are variable, in the sense that they apply unless an association agreement or other agreement between the members provides otherwise.<sup>65</sup> In this way members can vary the rules to suit their personal circumstances.

Where members therefore want a particular division of powers between them, this can be effected by an appropriate clause in an association agreement.<sup>66</sup> An association agreement is not compulsory. If there is one, it

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57 There may be other restrictions, for example in terms of the *Unit Trusts Control Act* a close corporation may not act as the trustee of a unit trust scheme.

58 Naudé 1984:119. The most sophisticated internal arrangements can be effected by an appropriate association agreement.

59 *Close Corporations Act* 69/1984: section 12.

60 *Close Corporations Act* 69/1984: sections 42-43.

61 *Close Corporations Act* 69/1984: section 2(2) and (3).

62 *Close Corporations Act* 69/1984: section 2(4).

63 Roughly 75%.

64 See Henning 1984:166.

65 *Close Corporations Act* 69/1984: section 43.

66 *Close Corporations Act* 69/1984: section 46.

must be in writing and must be kept at the close corporation's registered office. It is not filed with the Registrar and not available for public inspection. It can be entered into and amended at any time. Members, but not outsiders, have access to it.<sup>67</sup>

The vast majority of close corporations are single member corporations. In this case the option of an association agreement is not available and the legal position provided for in the Act is very simple indeed. As far as multiple-member close corporations are concerned, detailed precedents for "tailored" association agreements, if needed, are available in a publication of the Association of Law Societies of South Africa.<sup>68</sup>

The substitution of solvency and liquidity for the traditional capital maintenance rules of company law was probably the most significant innovation in the Act. Section 51 provides in essence that a payment by a close corporation to a member by reason only of his membership may be made only if, after such payment is made, the corporation's assets, fairly valued, exceed all its liabilities; if the corporation is able to pay its debts as they become due in the ordinary course of its business; and if such payment will in the particular circumstances not in fact render the corporation unable to pay its debts as they become due in the ordinary course of its business. Subject to these three requirements, as well as the previously obtained written consent of every member for a specific transaction, sections 39 and 40 respectively permit a corporation to acquire and pay for the interest of one of its members, or to render financial assistance in connection with any acquisition of a member's interest in the corporation.

Criminal law is a blunt and largely ineffective instrument for ensuring that technical or administrative duties are complied with. For this reason the Act creates only eleven offences. As sanction for non-compliance with the new system, reliance is placed firstly on self-enforcement. Members failing to observe the relatively few basic rules of the system with its obvious benefits, forfeit their protection by incurring a personal and concurrent liability with the close corporation for the debts of the corporation. Section 63 provides for such liability in regard to restrictions or duties imposed in eight different sections in the Act. Secondly, the Registrar is empowered in a few instances to impose a penalty and this is given the force of a civil judgement.<sup>69</sup>

In order to promote the formation of close corporations, provision is made for the conversion of companies into close corporations and *vice versa*. If a close corporation wishes to convert into a company, or *vice versa*, there is no need for a "deregistration" or "reincorporating" *strictu sensu*. Provision is made for the conversion by way of a simple procedure and in such a way that the existence of the juristic person continues in existence, but in another form. All assets, liabilities, rights and obligations remain vested in the juristic person. A registrar or any other officer maintaining a register under any law is obliged to make in his register all the alterations as

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67 *Close Corporations Act* 69/1984: sections 44 and 45.

68 Hyman 1986:1.

69 *Close Corporations Act* 69/1984: section 15(3).

are necessary by reason of the conversion. No transfer duty or stamp duty is payable in respect of such alterations. Hence cost is kept as low as possible.

Persons who are to become members of a close corporation upon its registration have to make an initial contribution of money or property, or of services rendered in connection with and for the purpose of the formation and incorporation of the corporation. Particulars of the contributions are stated in the registered founding statement. Contributions can be increased or reduced.<sup>70</sup>

A person wishing to become a member of an existing corporation can acquire a member's interest from one or more of the existing members or his or their deceased or insolvent estates, in which case he makes no contribution to the corporation. He may, however, also acquire the interest pursuant to a contribution to the corporation, in which case the percentage of his interest is determined by agreement between him and the existing members, and the percentages of the existing members' interest are reduced proportionally or as they may otherwise agree.<sup>71</sup>

A close corporation has the capacity and powers of a natural person of full capacity (in so far as a juristic person is capable of having such capacity or exercising such powers).<sup>72</sup> For this reason the *ultra vires* doctrine has no application in respect of close corporations. The statement of the principal business of the corporation<sup>73</sup> in the founding statement does not affect the corporation's capacity and powers. There is no constructive notice of any particulars stated in a founding statement.<sup>74</sup> For most practical purposes the legal capacity of a close corporation is unlimited and does not form any hindrance to its participation in business. Those having dealings with a close corporation do not run any risk of finding the validity of transactions being affected by internal limitations to the corporation's legal capacity. This depends on the authority of the person who has acted for the corporation in the particular transaction.

In principle members have equal rights in regard to the power to represent the corporation,<sup>75</sup> like "mutual mandate" in partnership law. As in the law of partnership this is a variable rule, and it may be varied by appropriate provisions in an association agreement.<sup>76</sup>

The power of a member to bind the corporation is set out in section 54. As far as *bona fide* third parties dealing with the corporation are concerned, each and every member is an agent of the corporation. The act of a member binds the corporation to third parties dealing with the corporation whether or not the member performed the act for the carrying on of the business of the

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70 *Close Corporations Act* 69/1984: section 24.

71 *Close Corporations Act* 69/1984: sections 24, 33 and 38(b).

72 *Close Corporations Act* 69/1984: section 2(4).

73 *Close Corporations Act* 69/1984: section 12(b).

74 *Close Corporations Act* 69/1984: section 17.

75 *Close Corporations Act* 69/1984: section 46(b).

76 *Close Corporations Act* 69/1984: section 44.

corporation. If a member's power to represent the corporation is restricted or excluded, he will still bind the corporation in respect of an outsider, unless the outsider has, or ought reasonably to have, knowledge of the fact that the member has no power to act for the corporation in the particular matter. Since there is no constructive notice of the provisions of an association agreement, knowledge of such internal restrictions on members' powers is not imputed to outsiders. They are entitled to assume that each member has the necessary authority to act on behalf of the corporation in a transaction, whether or not the particular transaction was entered into by the member for the carrying on of the business of the corporation.

As in the law of partnership, a *bona fide* outsider who does not know of internal restrictions of power is in principle not affected by it. However, in contradistinction to the position in partnership law, a corporation may even be bound to contracts by members not falling within its scope of business whether or not they were authorised or ratified by the corporation.

A close corporation is obliged to keep accounting records in order to enable it to report to its members.<sup>77</sup> Financial statements have to be made out in respect of each financial year. The annual financial statements must, in conformity with generally accepted accounting practice appropriate to the business of the corporation, fairly present the state of affairs of the corporation as at the end of the financial year concerned, and the results of its operations for that year.<sup>78</sup>

A close corporation is not required to have a chartered accountant as an auditor. It must appoint an accounting officer who must report on the annual financial statements.<sup>79</sup> A formal audit as in the case of companies is, however, not required. Although chartered accountants qualify for appointment as accounting officers, quite a number of other sufficiently qualified professions have also been permitted.

### 3.7 Ongoing development and simplification

The SAC<sup>80</sup> is responsible for making recommendations from time to time regarding the amendment of the *Close Corporations Act* and for assisting the Minister on matters he refers to it.<sup>81</sup> A Standing Sub-Committee on Close Corporations is appointed by the SAC in terms of the Act for advice on all matters referred to it by the SAC.<sup>82</sup> In this way provision is made for the observation of the operation and development of the *Close Corporations Act* and for shaping suggestions for reform.<sup>83</sup>

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<sup>77</sup> *Close Corporations Act* 69/1984: section 56.

<sup>78</sup> *Close Corporations Act* 69/1984: section 58(2)(b).

<sup>79</sup> *Close Corporations Act* 69/1984: section 59.

<sup>80</sup> *Companies Act* 61/1973: section 18.

<sup>81</sup> *Close Corporations Act*: section 11. Cilliers *et al* 1998:20.

<sup>82</sup> Cilliers *et al* 1998:20.

<sup>83</sup> DTI 1995:24.

### 3.8 Response

#### 3.8.1 Domestic

The close corporation has met with wide and enthusiastic approval despite a generally unfavourable economic climate. Until the end of 2002 almost a million close corporations were registered compared to roughly two hundred and fifty thousand companies of all forms and types.<sup>84</sup>

#### 3.8.2 International

Developments within South Africa did not go by unnoticed outside Southern Africa.<sup>85</sup> Professor Uriel Procaccia of the Hebrew University of Jerusalem found the Act to be impressive.<sup>86</sup> Professor Len Sealy of the University of Cambridge described the Act as a model worth very serious consideration and considered it to be a much bigger success than the 'unanimous written resolution' and 'elective regime' amendments introduced for private companies by the United Kingdom *Companies Act* of 1989.<sup>87</sup> A report on alternative structures for small businesses in the United Kingdom pointed out that the South African close corporation has been highly successful *inter alia* because of "its own intrinsic merit",<sup>88</sup> while Professor Dine of the University of Exeter recently expressed a particular fondness for some aspects of the South African close corporation.<sup>89</sup>

In her comprehensive 1996 survey of company law in more than twelve jurisdictions as part of the review of the Hong Kong Companies Ordinance, Professor Cally Jordan stressed that the South African *Close Corporations Act* has proved to be one of the most remarkable innovations in South African company law and one, at that, which appears to have been singularly successful.<sup>90</sup>

#### 3.8.3 The United States in particular

Professor Allan Vestal, Dean of the College of Law of the University of Kentucky, reacted as follows on a paper dealing with the South African close corporation which was presented at his College during 2002:<sup>91</sup>

Dean Johan Henning's Order of the Coif lecture at the University of Kentucky College of Law was an interesting presentation and a

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84 The relevant information was kindly supplied by the Registrar of Companies and Close Corporations, SACRO, Pretoria.

85 Anon 1987:77; Ping-fat 1992:17; Henning and Bleimschein 1990:627.

86 Procaccia 1987:589.

87 Sealy 1993:2.

88 Chartered Association of Certified Accountants 1995:44.

89 Dine 1998:83.

90 Jordan 1996:47-49.

91 Vestal 2002:34-36.

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valuable reminder of the correct reason for business law reform. It could serve as a much-needed cautionary note for those of us in the United States involved in such reforms.

Vestal pointed out that business entity reform in South Africa was a response to the economic and political situation in that country. Informed first by the need for business entity laws to facilitate economic development in South Africa's peculiar economy, and informed somewhat later by the need for business entity laws to facilitate the political development of the post-apartheid society, the South African reforms present a practical and creative response towards fostering generally accepted social goals.

According to Vestal the story of business entity reform during the same period in the United States presents rather differently. The reworking of business entity law in the United States appears to deal much less with the pursuit of generally accepted social goals and much more with the combination of academic ideology and private advantage.

It is a reasonable observation that in its business entity reforms South Africa appears to have been on the right path, for the right reason. We should be rather less sanguine about the American reforms.

## 4. Southern Africa

### 4.1 Zimbabwe

After the introduction and apparent success of the close corporation in South Africa, a privately commissioned and prepared report on a new legal form for small businesses in Zimbabwe was widely circulated for comment. This report, which became known as the Christie/Fairburn Report, recommended the reorganisation and removal of private companies from the *Companies Act*. Thus a two-tier system was envisaged: public companies under the *Companies Act* and private companies under a new separate law.

Subsequently the Law Development Commission appointed a subcommittee in January 1989 to report on proposed changes to the company law. Two interim reports were brought out: The *Interim Report on Proposed New Private Business Corporations Bill* and *Proposed Amendments to the Companies Act*. These were followed in 1991 by the *Final Report: Private Business Corporations Bill* and the *Final Report: Amendments to the Companies Act*.

The *Companies Amendment Bill*, 1993<sup>92</sup> was promulgated as the *Companies Amendment Act 6/1993*.<sup>93</sup> The principal objects of the amending legislation are *inter alia* to enable a company to be formed with one member (two directors are however still required), to modify the *ultra vires* rule and to make fuller and better provision for the judicial management of companies. Save for these amendments, the position of private companies remained unaffected.

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<sup>92</sup> *Companies Amendment Bill*: 1993HB 23/1992.

<sup>93</sup> General Notice 658 published in the Zimbabwean Government Gazette of 1993.

The *Interim Report on Proposed New Private Business Corporations Bill* rejected the two-tier approach of the Christie/Fairburn Report and recommended a three-tier system. Public and private companies would continue to be governed by the *Companies Act* and entirely new legislation should provide for the introduction of a new form of business enterprise called the private business corporation (PBC). This recommendation was formally adopted in the *Final Report: Private Business Corporations Bill*. The full Law Development Commission recommended on 30 June 1991 that its draft *Private Business Corporations Bill*, 1991 be passed into law. Consequently the *Private Business Corporations Bill*<sup>94</sup> was presented to parliament by the Minister of Justice, Legal and Parliamentary Affairs in 1993. The *Private Business Corporations Act* 15/1993 was promulgated on 18 February 1994<sup>95</sup> in the Gazette. The *Private Business Corporations Act* became operative on the 5th of May 1997 by virtue of Statutory Instrument 107/997 published in the Supplement of the Zimbabwean Government Gazette of 2 May 1997.<sup>96</sup> One hundred and two private business corporations have since been incorporated.

The Law Development Commission drew attention to the possibility that not only the very small businessman but also large enterprises may form a private business corporation. The Commission did not regard this as a matter for concern, except from a revenue viewpoint in the case of a conversion of a company.<sup>97</sup>

The salient features of the private business corporation are (very briefly): (a) a minimum membership of one and a maximum of twenty; (b) formation by way of an incorporation statement filed with the Registrar of Companies; (c) complexity and formality is reduced to a minimum as there is no need to specify the objects of the private business corporation in a formal memorandum, no need to appoint directors to hold formal meetings, no shares or share capital but members' interests, no need to publish or submit annual accounts to the Registrar, no need to appoint a chartered accountant as auditor but a suitably qualified person as accounting officer, form of accounts have been simplified, each member is an agent of the private business corporation, in the event of reckless dealing members can be declared personally liable by the court, no complicated provisions dealing with judicial management and winding-up, decriminalisation is the central policy — only six criminal offences are provided for. Non-compliance with the law gives rise to personal liability of members for debts.

The *Private Business Corporations Act* contains 63 sections and one schedule.

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94 *Private Business Corporations Bill*: 1993.

95 *Private Business Corporations Act* 1993: General Notice 101/1994 published in the Zimbabwean Government Gazette of 1994-02-18.

96 This information was kindly supplied by the Zimbabwean Law Development Commission.

97 Final Report 6.

## 4.2 Namibia

Namibian company law is largely based on the South African *Companies Act* of 1973, without the South African amendments introduced after 1978.<sup>98</sup> The Law Reform and Development Commission of Namibia has recently invited proposals on the reform of company law and related matters.

The *Close Corporations Act* 26/1988, in effect the South African Act as amended, was promulgated on 31 December 1988. It came into operation on 1 March 1994<sup>99</sup> in consequence of the transfer of Walvis Bay from South Africa to Namibia on 28 February 1994. The administrative regulations made under section 10 of the Act were published on 30 March 1994.<sup>100</sup>

A proclamation<sup>101</sup> under the South African *Transfer of Walvis Bay to Namibia Act* 203/1993 makes provision for the deregistration in South Africa and conversion into a close corporation incorporated in Namibia of close corporations which were registered in South Africa and which have their registered office or place of business in Walvis Bay. If such an existing close corporation, wishing to be converted into a close corporation incorporated in Namibia under the Namibian *Close Corporations Act*, has a place of business in South Africa, the South African Registrar of Companies and Close Corporations may, upon compliance with certain conditions, register that close corporation as an external company in South Africa.<sup>102</sup> Because such an external company is a body corporate under the Namibian *Close Corporations Act* which is required to subjoin the abbreviation CC to the name under which it is registered,<sup>103</sup> it will in addition have to subjoin the statement "Incorporated in Namibia — external company under section 322" in terms of the South African *Companies Act*.<sup>104</sup>

The *Close Corporations Amendment Act* 8/1994<sup>105</sup> incorporated some of the South African amendments up to 1992 but also, to some extent, went its own way. For example, section 7 has been amended to provide expressly that no magistrate's court shall entertain any matter with respect to the winding-up of a close corporation. In addition, Namibia has pre-empted the South African legislature as far as the amendment of at least one section is concerned. The amendment to section 47(1) of the *Close Corporations Act*

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98 Registration of Companies Proclamation 234/1978 amended by Proclamation 23/1979.

99 Proclamation 9/1994 given on 1994-02-22 and published in Government Gazette 820/1994-03-14.

100 *Close Corporations Act*, 1988 (Government Notice No 43 published in Government Gazette No 829 of 1994-03-30).

101 The Registration and Incorporation of Certain Companies and Close Corporations in Namibia Proclamation, 1994 (Proclamation R 57/1994 published in Government Gazette No 15616 of 1994-03-31).

102 Proclamation R 57/1994 section 4.

103 Namibian *Close Corporations Act* section 22(1) as amended by the *Close Corporations Amendment Act* 8/1994 section 13.

104 *Companies Act* 61/1973, section 49(2) as amended by Proclamation R 57/1994 section 6.

105 *Close Corporations Amendment Act*: 1994.

so as to exclude disqualified persons from the management of the corporation even if they are not members of that corporation (which was recommended by the South African SAC in 1993 and effected only in 1997),<sup>106</sup> was introduced in the Namibian Act in 1994 by section 20 of the *Close Corporations Amendment Act*.

Approximately one hundred close corporations registered in South Africa were initially converted into close corporations incorporated in Namibia. It is indicative of the inherent merits of the concept and its successful application beyond the borders of its country of origin that almost five thousand close corporations were registered in Namibia until December 1997.

### 4.3 A Societas Africaea?

In the same manner in which the European Community recognised the necessity of company law harmonisation through, *inter alia*, the establishment of a *Societas Europaea*, the need for a Southern African form of business enterprise in order to achieve the ideal of greater economic cooperation must be recognised. It is submitted that there is, however, little need for the formulation of an entirely new form of business enterprise.

When the SAC became convinced of the need for a new form of business enterprise, the close corporation was introduced in South African Law as a form of business offering greater freedom of choice in respect of an incorporated business entity; deregulation; the promotion of more effective competition between small businesses; and certain tax advantages.

It proved less cumbersome than the highly complex and inappropriate company law regime and infinitely more accessible. At present, in addition to South Africa, Namibia and Zimbabwe both offer entrepreneurs the option of incorporating a close corporation.

When one takes into consideration the fact that the close corporation developed as a uniquely South African export, the application of the objectives mentioned above to a Southern African context seems fitting.

These objectives are by now familiar to every student of company law, but they echo the needs of the Southern African Development Community for a *Societas Africaea* to complement its African Renaissance. The same objectives guiding the South African legislature can now guide SADEC: simplicity, accessibility and limited liability. The distinctive features of the close corporation mentioned above can serve the whole of SADEC well.

In conclusion, one of the most important aspects of the close corporation is the extent to which the criminal sanction has been avoided. The Close Corporation offers an example of effective and premeditated non-criminalisation of the variety that is necessary in the region. Supple application of personal liability serves as a commendable precedent for other African countries in the regulation of small business enterprises. There is no need to reinvent the wheel.

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<sup>106</sup> Henning 2001:946.

## 5. Comparative overview

### 5.1 Australia

In August 1984 a discussion paper was circulated in Australia by the Companies and Securities Law Review Committee (the "CSLRC") entitled *Forms of Organisation for Small Business Enterprises*.<sup>107</sup> In canvassing the possibility of the introduction of a new category of an "incorporated partnership company" (later the "close corporation") the CSLRC noted that for entrepreneurs the main advantages of the new form may be corporate personality, limited liability, absence of any legal duty to have accounts audited or lodged for public inspection, removal of the distinction between proprietors and directors, flexible regulation of internal relations by rules appropriate to a partnership rather than those traditionally associated with a company, and a minimum of administrative detail.

This discussion paper was followed by the *Report to the Ministerial Council on Forms of Legal Organisation for Small Business Enterprises* of the CSLRC in 1985. The CSLRC set itself the objective of recommending a simpler and cheaper form of corporate structure for entrepreneurs, with due regard to their particular needs and without burdening them with statutory requirements which are not significant under the circumstances. The CSLRC did its level best to place the emphasis throughout the report on simplifying the legal obligations involved in the establishment and operation of a close corporation but not with unqualified success.<sup>108</sup> It further recommended that in the event of the introduction of close corporation legislation, the category of exempt private company be dispensed with for future incorporations.

Based on the recommendations of the report of the CSLRC a *Close Corporations Act*, with more than 170 sections and bearing some resemblance to the South African predecessor, was introduced in Australia in 1989 as part of a comprehensive Commonwealth package for company law reform. Due to constitutional difficulties and the resulting decision in *NSW v Commonwealth*<sup>109</sup> which confirmed its unconstitutionality, the Act was never promulgated.<sup>110</sup>

Professor Sealy<sup>111</sup> aptly summarised these developments in Australia as follows: "The (South African) legislation shows that it is possible to do without shares, capital, directors, meetings, articles of association, annual returns and audit .... Australia endeavoured to go down the same road in the mid 1980s and did, in fact, enact a *Close Corporations Act* in 1989. It was modelled initially on the South African precedent, but they (the Australians) kept wanting to build more and more of the traditional company into it, so it

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<sup>107</sup> August 1984.

<sup>108</sup> See Tomasic *et al* 1992:203; French 1990:384-385; Ford 1990:131.

<sup>109</sup> (1990) 169 CLR 484; 1 ACSR 137; 90 ALR 355.

<sup>110</sup> Henning and Wandrag 1993:40.

<sup>111</sup> 1994:11.

became a fairly lengthy piece of legislation. If that were not enough, it then incorporated by reference, huge chunks of the main *Corporations Act*. So it was not a totally successful venture.”

On 19 June 1992 the Joint Parliamentary Committee on Corporations and Securities announced its intention to investigate the regulation of small businesses in Australia. This might have lead to a rewrite of the *Close Corporations Act* with a view to simplification. This initiative was based on the finding that more than 765 000 of the 800 000 registered companies in effect were small businesses which could benefit materially from the introduction of this new form of incorporation.<sup>112</sup> The terms of reference of the Committee were to inquire into the creation of a new corporate form tailored to meet the needs of small business. It had to examine the unproclaimed *Close Corporations Act* of 1989 which “had as its object the simplification of the corporate rules for small business by reducing financial and other reporting requirements and abandoning the company law distinction between directors and shareholders in favour of simple principles based on partnership laws.” The Committee also had to examine suggested amendments to the *Close Corporations Act* and other corporate structures having the same broad objectives.

In December 1992 the Committee released its report entitled *Close Corporations Act 1989*. The Committee noted that though the term “close corporation” is widely used *inter alia* in South Africa and the United States, the terminology has been criticised in Australia because its meaning is not readily understood. It pointed out that criticism of the “proposed” close corporation included that the restrictions on its powers would render it unsuitable for small business, that limited liability could be lost relatively easily, that the structure and reporting requirements of the close corporation remain complex, and that there is no simple process for converting a close corporation into a proprietary company. The Committee favoured the introduction of a new corporate form of business enterprise within the existing Corporations Law instead of the proclamation of the *Close Corporations Act*. It would adopt the best features of the Australian close corporation and eliminate those that were subject to criticism. This new corporate form, the private company with a minimum membership of two and a maximum of ten, would be a category of exempt private company and would enjoy the privileges of the exempt proprietary company. In view of the scope of these changes, the Committee recommended that the *Close Corporations Act* be repealed. Professor Sealy remarked that this report builds on the earlier Close Corporations legislation by adding on even more of the traditional features associated with companies, such as bringing back directors. He concludes that the Committee has “gone the full circle and reinvented the private company under another name”.<sup>113</sup>

In July 1994 the *Corporate Law Simplification Bill* was released for public comment. As far as proprietary companies are concerned, it proposes radical reforms to the structure and operation of such companies. It foresees,

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112 Frew 1992:58.

113 1994:14-15.

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*inter alia*, the allowance of single director and single member companies, the scrapping of required annual general meetings, the reduction of accounting and financial reporting, and the provision of a comprehensive guide to the day-to-day rules that matter for small business.<sup>114</sup>

In 1995, the *Close Corporations Act* of 1989 was repealed by the *First Corporate Law Simplifications Act*.<sup>115</sup>

In 1997 the Australian government commenced the “*Corporate Law Economic Reform Program*” (“*CLERP*”) in an attempt to improve company legislation. CLERP consists of various projects, each dealing with a specific subject.<sup>116</sup>

In 2001 a new *Corporations Act* was promulgated, repealing both the *Corporations Law* as well as the *Company Law Review Act* of 1998.<sup>117</sup> The Act consists of 1409 sections and four schedules.

The Act takes account of technology. For example, a general meeting can be held “at 2 or more venues using any technology that gives the members as a whole a reasonable opportunity to participate”.<sup>118</sup> It provides that a company may reduce its share capital provided that is fair and reasonable to the company’s shareholders as a whole; it does not materially prejudice the company’s ability to pay its creditors; and is approved by shareholders.<sup>119</sup> Similarly, a company may purchase its own shares provided that the company’s ability to pay its creditors is not thereby affected and the shareholders’ approval is obtained.<sup>120</sup> In addition, a company may financially assist a person to acquire its shares or the shares in its holding company provided that giving the assistance does not materially prejudice either the interests of the company or its shareholders or the company’s ability to pay its creditors, and the assistance is approved by the shareholders.<sup>121</sup> The Act makes provision for civil liability by providing that where X suffers loss or damage as a result of B’s contravention of the Act, the former may recover the amount of the loss or damage.<sup>122</sup> Small private companies are exempted from preparing financial reports and a directors’ report, unless the shareholders so direct or the ASIC

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114 <http://strategis.ic.gc.ca/SSG/cl00104e.html>. See Henning 1995b:100-109 for a detailed discussion.

115 Act 115/1995.

116 CLERP 1 accounting standards; CLERP 2 fundraising; CLERP 3 directors’ duties and corporate governance; CLERP 4 corporate control; CLERP 5 electronic commerce; CLERP 6 financial markets and competition; CLERP 7 simplifying lodgement of company documentation; CLERP 8 cross-border insolvency review; CLERP 9 corporate reporting and disclosure laws. See [www.treasury.gov.au/content/business\\_law.asp](http://www.treasury.gov.au/content/business_law.asp).

117 [www.austlii.edu.au/au/legis/cth/consol\\_act/ca2001172/](http://www.austlii.edu.au/au/legis/cth/consol_act/ca2001172/)

118 Section 249S.

119 Section 256B.

120 Section 257A.

121 Section 260A.

122 Section 283F.

so directs.<sup>123</sup> Private companies are not obliged to appoint an auditor.<sup>124</sup> Generally speaking, the Act only penalises the making of misleading statements and fraudulent conduct by company officers.<sup>125</sup> The Act retains the (traditional) distinction between private and public companies.<sup>126</sup> It contains a statutory business guide for small businesses which explains the incorporation and management of small private companies.<sup>127</sup>

## 5.2 The United Kingdom

### 5.2.1 Paradigm shift

The White Paper presented by the Secretary for Trade and Industry in 2002, entitled *Modernising Company Law*,<sup>128</sup> makes it abundantly clear that it primarily seeks to address the specific needs of small companies by means of a new *Companies Act*.<sup>129</sup> This Act will also include provisions specifically dealing with larger companies.<sup>130</sup> The White Paper further stresses that the purpose of the proposed new *Companies Act* is to simplify, modernise and streamline company law in order to support the creation, growth and competitiveness of UK companies.<sup>131</sup>

This “think small first” paradigm shift corresponds with the EU legislature’s proposals of creating a flourishing business environment for small enterprises in the EU.

### 5.2.2 Specific recommendations regarding private companies

Private companies will no longer be required to hold annual general meetings unless the members so request.<sup>132</sup> The rules on written resolutions are simplified in order to make it easier for private companies to take decisions.<sup>133</sup>

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123 Section 292 read with sections 293 & 294.

124 Section 325, entitled “Appointment of auditor by proprietary company” provides that “The directors of a proprietary company may appoint an auditor for the company if an auditor has not been appointed by the company in general meeting.”

125 Section 590 read with sections 591 & 596; see also part 8.7, section 1308, section 1309.

126 In fact, the Act provides for 5 different types of companies: (1) unlimited private companies, (2) limited private companies, (3) unlimited public companies, (4) limited public companies and (5) companies dedicated to mining operations. See section 112.

127 See Part 1.5, sections 1-12.

128 See [www.dti.gov.uk/companiesbill/whitepaper.htm](http://www.dti.gov.uk/companiesbill/whitepaper.htm). See also Davies 2003:51-52; Morse 2001:vii-x.

129 Secretary for Trade and Industry 2002:3, 8, 15 and 111.

130 Secretary for Trade and Industry 2002:8 and 15 of the White Paper 2002.

131 Secretary for Trade and Industry 2002:50 (paragraph 6.1) and 111 of the White Paper 2002.

132 Secretary for Trade and Industry 2002:8 and 18.

133 Secretary for Trade and Industry 2002:8.

For example, a private company can pass any written ordinary resolution with a simple majority of the eligible votes and any written special resolution with 75 per cent of the eligible votes.<sup>134</sup> Directors of small private companies will no longer be required to issue a directors' report. Instead, they will issue a short and simple solvency statement.<sup>135</sup> Private companies will no longer be required to appoint secretaries.<sup>136</sup> The rules concerning capital maintenance of private companies are simplified.<sup>137</sup> Private companies will be allowed to repurchase their shares and to provide financial assistance for the acquisition of their shares, provided that the company remains solvent.<sup>138</sup> Furthermore, a private company will be allowed to reduce its share capital by means of a special resolution after the directors have issued a solvency statement.<sup>139</sup> Small companies are no longer under a statutory duty to appoint an auditor.<sup>140</sup>

It should be mentioned that all new incorporated companies will have a single document constituting their constitution.<sup>141</sup> New companies will no longer be required to state an object clause. Even if the constitution contains such a clause it will have no effect on the company's capacity. Thus, newly formed companies will have unlimited capacity.<sup>142</sup>

### 5.2.3 No separate Act

One of the advantages of the South African *Close Corporations Act* is that as a separate Act it is tailored more closely to the needs of enterprises consisting of one or a small group of entrepreneurs.<sup>143</sup>

The Steering Group, responsible for research on the reform of United Kingdom company law, rejected the idea of a separate limited liability enterprise Act. They argued that such legislation would not cater for the scenario where the enterprise ceased to comply with the criteria posed by the separate enterprise Act, such as where the current entrepreneurs wish to expand and include more entrepreneurs than allowed for by the statutory limit for that particular enterprise.<sup>144</sup> Furthermore, they noted that one of the reasons why the members of a "closely held company" would require more members arises whenever there is a need for injection of external funds from a venture capitalist.<sup>145</sup> Stated differently, the Steering Group was not in favour of converting from one type of enterprise to another type of enterprise when the business eventually expanded: "The overall effect would be to

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134 Secretary for Trade and Industry 2002:21.

135 Secretary for Trade and Industry 2002:9 and 34.

136 Secretary for Trade and Industry 2002:10 and 51.

137 Secretary for Trade and Industry 2002:10.

138 Secretary for Trade and Industry 2002:51.

139 Draft Companies Bill section 51.

140 Draft Companies Bill section 96.

141 Secretary for Trade and Industry 2002:50.

142 Secretary for Trade and Industry 2002:50 (paragraph 6.2).

143 DTI 1999:1.

144 DTI 1999:63.

145 See DTI 1999:64.

make the transition from close to more broadly held status — a critical process to facilitate, in order to promote competitiveness — a complex, difficult or risky and uncertain process.”<sup>146</sup>

The above-mentioned was echoed in the White Paper: “The Review considered whether there should be a special and distinct corporate structure for small businesses. The problem with this approach is that it requires a definition of small, for example a maximum number of shareholders, number of employees, turnover or assets. Once a company passed the threshold, it would no longer qualify for the special regime. Such a threshold would therefore be likely to act as a barrier to growth, and could create problems were it to be crossed inadvertently, or re-crossed several times by a company.”<sup>147</sup>

Another consideration was that entrepreneurs and existing businesses would not use and exploit a new form of business: “The novelty of the free standing approach, taken with the fact that the existing corporate form used by many thousands of small companies would need to continue (compulsory re-registration of such companies under the new regime would be very hard to justify) suggest that the new regime might be unlikely to be used on formation, and even more unlikely to be exploited by existing companies. Professional advisers are likely, even for new companies, to adhere to the tried and tested system they know, and for which they have invested in standard procedures.”<sup>148</sup> It is thus, a problem of “novelty”.<sup>149</sup>

Normally in a “closely-held company” all the members may participate in the management. According to the Steering Group this posed various problems in that when one of the members died, his shareholding would be dispersed amongst his heirs, who might not qualify for participation in the management.<sup>150</sup> The Steering Group was of the opinion that “[t]o deal with such problems either detailed rules are required (probably impossible to devise in the abstract), member involvement in adaptation will be needed (probably re-registration with a new constitution under the main Act), or a sweeping discretionary power of court intervention will be necessary.”<sup>151</sup>

The Steering Group’s analysis of the South African Close Corporation is not above criticism. *Inter alia*, the following perceptions may be questioned:

It noted that all members participate in the management of the CC.<sup>152</sup> As indicated above, the *Close Corporations Act* provides that all members may participate in management of the close corporation, provided the association agreement does not stipulate the contrary.

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146 See DTI 1999:64.

147 See DTI 1999:15.

148 DTI 1999:64.

149 DTI 1999:65.

150 DTI 1999:64.

151 DTI 1999:64.

152 DTI 1999:185.

It noted that there are no limitations to membership.<sup>153</sup> As explained above, only individuals may become members of a close corporation. Juristic persons, such as companies and other close corporations, are excluded from membership.

With regard to the question whether “[t]ransition into full, limited company without loss of legal entity [is] possible”, the Steering Group answered in the negative.<sup>154</sup> As noted above, a close corporation may convert into a company, private or public, with limited liability. The members of the close corporation do not lose their limited liability privilege.

It is submitted that the contentions as to why a dedicated separate Act for small companies is not preferable, are questionable. A separate Act can ensure a corporate structure that is simplistic and pliable and which focusses on the reasonable needs and expectations of the single entrepreneur or small group of entrepreneurs. This will ensure that such a business enterprise form is attractive to new entrepreneurs as well as existing businesses. The fact that a separate and dedicated small enterprise Act will not cater for transition is no reason for not adopting such a form of business enterprise. The dedicated Act can always include provisions dealing with the conversion from the small enterprise form to a company tailored to the needs of large business enterprises. It should be borne in mind that a business cannot “outgrow” a close corporation in that no limitation is imposed on the maximum turnover of a close corporation. Should the members wish to acquire additional funds, such as investments by a venture capitalist, the close corporation can always enter into suitable contractual arrangements with investors. There is no reason why the latter should become members of the close corporation. Furthermore, should the members of the close corporation seek public funds, i.e. “go public”, they will have to convert to a public company, adhering to the requirements pertaining to prospectuses and listing of public companies and filing of financial statements for public inspection. Private companies face identical problems should they require public funds.

The argument that legal advisors will normally opt for the more established and well-known business structures, such as a company, is not well founded. If the dedicated small enterprise Act offers distinct advantages over and above other business enterprise legislation, such as maximum flexibility and minimum statutory intervention, both advisors and entrepreneurs will favour such an enterprise.

The Steering Group’s concern regarding the inheritance of a member’s interest is unfounded. The provisions of the *Close Corporations Act* are noteworthy in this regard. Section 35 provides that where a member of a close corporation dies, the executor of the aforementioned member’s estate shall, subject to any other arrangement in an association agreement, transfer the member’s interest to a legatee, provided that the remaining member or members of the corporation (if any) consent to the transfer of the

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<sup>153</sup> DTI 1999:185.

<sup>154</sup> DTI 1999:185.

member's interest to such person.<sup>155</sup> Where the aforementioned consent is not given within 28 days after it was requested by the executor, the latter must sell the deceased member's interest<sup>156</sup> to the corporation (or if there is a member or members other than the deceased member) to any other remaining member or members of the corporation in proportion to the interests of those members in the corporation or as they may otherwise agree upon; or to any other person.

Lastly, it should be kept in mind that when the *Close Corporations Act* was drafted, the committee responsible for such drafting was limited by their mandate to proposing a new business form without amending the provisions of the South African *Companies Act*.<sup>157</sup> In contrast, the Steering Group was given a mandate to propose whatever changes to the United Kingdom company law which were necessary to bring it into line with 21st century demands.

## 6. In conclusion

In the three Southern African jurisdictions special provision is made for the small business either by way of close corporation or private business corporation. Thus, the notion that differentiation between the small incorporated business concern and the large company is needed in order for each to participate in the commercial activity of the country in the most efficient manner and in furtherance of the best interests, individual and collective, of all concerned, is accepted.

In all three of the jurisdictions the traditional English private company, almost indistinguishable from the form in which it was introduced in 1907, soldiers on, notwithstanding serious efforts in two jurisdictions to have it phased out of the *Companies Act*.

In all three jurisdictions a three tier system presently exists or is provided for: Public and private companies formed under the *Companies Act*, and a specialised new legal form of business enterprise, close corporation or private business corporation, formed under a separate enabling Act. This seems to be the shape of things for the foreseeable future, unless priority is given to a comprehensive reform of company law in Southern Africa. It may very well be that the private company will not survive such a reform in its present guise and with all the distinctions between private and public companies intact. The necessity for the continued rigid adherence to traditional statutory distinctions between private and public companies, such as presently still exist in South African, Namibian and Zimbabwean company law, can be seriously questioned. For instance, especially as far as the requirements for financial disclosure are concerned, the approach adopted by the United Kingdom that rather distinguishes between small, medium and large companies is to be preferred.<sup>158</sup>

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<sup>155</sup> *Close Corporations Act* 69/1984 section 35(1)(a).

<sup>156</sup> *Close Corporations Act* 69/1984 section 35(1)(b).

<sup>157</sup> *Companies Act* 61/1973.

<sup>158</sup> See further Henning and Wandrag 1993:21.

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The South African experience of the close corporation during the past sixteen years has been a positive one. The very favourable and enthusiastic reaction of entrepreneurs has far exceeded expectations. The introduction of the close corporation has given a considerable and very necessary impetus to the small business sector in particular, while many large undertakings prefer to conduct business in the form of a close corporation. It is also used as the vehicle for association by a variety of professions.

However, for a variety of reasons, this novel and meritorious approach unfortunately has not found favour in all jurisdictions, especially those where company law reform initiatives were constrained to follow less imaginative approaches.

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