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Close corporations without end. Two remarkable decades of simply "thinking small first"

1. Introduction

Particularly in countries where unemployment levels are high, small enterprises play a valuable role by creating new job opportunities, providing stability, eliminating poverty, improving competitiveness, promoting the development of labour skills and ensuring economic growth. It is estimated that small enterprises in South Africa employ approximately 40% of economically active South Africans; more than 90% of South Africa's formal business entities could be classified as small businesses; and small enterprises contributed almost 45% of the South African gross domestic product.[1]

It is of paramount importance that small entrepreneurs have a choice of appropriate business forms at their disposal. The essence is to put small business first in the attentions of policy makers shaping company law reform. The golden thread underlying government policy dealing with small enterprises should be: "think small first." It follows that government should be committed to identifying the needs, characteristics and problems of small businesses and by putting the needs of these enterprises at the centre of any policy making.

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 orientated economy, gave added impetus to the introduction of the *Close Corporations Act* 69 of 1984 (the "Act").[2]

The sole object of this contribution is to provide a brief overview of the close corporation's highly successful implementation of the *adagium* "think small first" during the past two decades, especially with some of the uncertainties caused by the present corporate law reform initiative in mind.[3]

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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.

2 Venter 1984:110.

3 For more detailed discussion of the various issues, see e.g. *Morsner v Len* 1992 3 SA 626 A: 628; Naude 1984:124-129; Lessing 1990:57-58; Henning 1884:156-171; 2004:773-828; Larkin 1984:15; Cilliers *et al* 1998:12; Cilliers *et al* 2000:288;

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2. Concept

The Act has proved to be one of the most remarkable innovations in South African company law.[4] 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 meeting his or their needs and without burdening him or them with legal requirements that would not be meaningful in his or their circumstances.

Under the Act a close corporation is a fully fledged corporation which confers on its members all the usual advantages associated with legal personality. 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. 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.[5]

In principle membership is limited to natural persons. A close corporation may have a single member. 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, the number of its employees or creditors, the size of the total contributions by members, turnover, value of assets or, generally, the type of business and it need not be an undertaking for gain.[6]

3. Need

At the root of this development is the conviction that a single Act cannot provide a satisfactory legal form for the large and sophisticated as well as the small and often marginalised entrepreneur. Historically, the *Companies Act* 61 of 1973 and its Southern African and British predecessors 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 control or direct and indirect control of say an institutional investor, scattered and powerless small shareholders and group problems. Hence it inevitably outgrows the needs and problems of the small man with his restricted means and limited access to professional advice.[7]

It is clear that the close corporation is aimed at a potentially more informal sector of the economy. The previous relative simple enterprise of yesteryear

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Naudé 1986:1; Bleimschein & Henning 1989:251,1990:567; Henning & Bleimschein 1990:627; Henning 1992:90-105; Henning & Wandrag 1993:14; Beuthin 1992:325; Ping-fat 1992:17; Henning 1998:29; Henning 2001:917-950; Henning *et al* 1996:497. Olbrisch 1997:3; Vestal 2003:829-840; Jaehne 2006:4. This contribution reflects developments until 1 December 2006.

4 See e.g. Olbrisch 1997:33; Jaehne 2006:4-12; Henning 2004:773.

5 See e.g. Jaehne 2006:4-12; Henning 2001:919.

6 See e.g Olbrisch 1997:33; Jaehne 2006:4-12; Henning 2004:783.

7 Naudé 1984:117-119.

has turned into conglomerates and multinationals of frightening size and complexity. People in society who have the intellectual and organizational equipment (and wealth) to deal with complex problems, are a class which benefits from problems being perceived as complex. None more so 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 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."[8]

4. Response

During its two decades of existence, the close corporation has met with wide and enthusiastic approval. Until the end of 2005 more than 1,3 million close corporations were registered compared to less than four hundred thousand companies of all forms and types. On the 12th of June 2006, exactly 1,276,157 close corporations were still active in South Africa.[9]

Developments in South Africa did not pass without remark outside Southern Africa.[10] Thus the Act was judged by Professor Uriel Procaccia of the Hebrew University of Jerusalem as "[A] recent impressive close corporation statute".[11] One of the doyens of modern English company law, 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 *Companies Act* of 1989.[12] He also succinctly contrasted the South African and Australian experience of the close corporation:

> 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 the Australians kept wanting to build more and more of the traditional company into it, so it 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 successful venture.[13]

8 Du Toit 1984:108.
9 See http://www.cipro.co.za/about_us/registration_stats.asp.
10 See Anon 1987:77; Ping-fat 1992:17; e.g. Henning and Bleimschein 1990:627.
11 Procaccia 1987:589.
12 In a paper "Legislating for the small business" read at the Company Law Reform Seminar of the Institute of Directors on 7 December 1993.
13 Sealy 1993.

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",[14] while Professor Janet Dine of the Centre for Commercial Law Studies of the University of London expressed a "particular fondness" for aspects of the close corporation.[15] 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 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.[16]

Dean Allan Vestal's reaction to an Order of the Coif lecture dealing with the South African close corporation and presented at the College of Law of the University of Kentucky during 2002 was that it was an interesting presentation and a valuable reminder of the correct reasons 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 as a practical and creative response to foster 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 much less to do with the pursuit of generally accepted social goals and much more about 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."[17]

It is interesting to note that notwithstanding the United Kingdom's membership of the European Union and the recommendations of the European Union High Level Group of Company Law Experts on the need for a European Private Company (EPC) separate from the European Company (Societas Europaea) (EC) and the European Company Statute (ECS), the Report of the United Kingdom Company Law Reform Steering Group refers to only two prominent examples of free standing limited liability vehicles for use by small firms adopted by "overseas jurisdictions" which the Group considered suitable for consideration in the context of the Review. One of the two was the South African close corporation.[18]

5. Simplification and accessibility

Compared to the *Companies Act* of 1973, the *Close Corporations Act* has proved to be relative free of teething trouble. Up to 1992 four *Close Corporations Amendments Acts* were introduced dealing with a variety of matters as they arose.

14 Chartered Association of Certified Accountants 1995:44.

15 Dine 1998:83.

16 Jordan 1997:47-49.

17 Vestal 2003:829-840.

18 See Henning 2005:188.

The comprehensive *Close Corporations Amendment Act* 26 of 1997 *inter alia* dramatically improved the position of the *bona fide* third party dealing with a member of a close corporation. As previously discussed and explained in some detail, the original provisions of section 54 were in effect derived from the United Kingdom *Partnership Act* of 1890.[19] This made any interpretation of section 54 an unnecessarily complicated exercise.[20] The amended section 54 provides, in essence, that a contract by a member with a third party is binding on the close corporation without any more ado, provided the third party contracted in good faith. Only in the event where the third party was aware of the lack of authority of the member to enter into a particular transaction, or where he should reasonably have been aware of the same, will the corporation not be bound. This amendment greatly simplified the legal position relating to the power of a member to bind a corporation in contract and enhanced the protection of innocent third parties in their dealings with close corporations to a very significant extent.[21]

The object of the *Close Corporations Amendment Act* 25 of 2005[22] is *inter alia* to enable a trustee of a trust inter vivos to be a member of a close corporation under certain conditions. As this was not possible since 1988,[23] the accessibility of the close corporation has been considerably improved, especially with the perennial popularity of contractual business trust in mind.

6. Future

In December 2001 the Committee on Corporate Laws of the Section of Business Law of the American Bar Association released its Report on South African *Companies Act* No 61 of 1973 and Related Legislation containing numerous recommendations for amending the *Companies Act* as well as, to a lesser extent, the *Close Corporations Act*. A few years later it was revealed that the Department of Trade and Industry (DTI) "has decided to revamp the company law in this country" to bring it into line with international trends, although the intention is that the revised product should "resonate with the South African situation".[24] The DTI published its policy document on corporate law reform for public comment on the 24th of June 2004.[25] The policy document was also tabled at the National Economic Development and Labour Council (NEDLAC) on the same date.[26]

The policy document suggests that only one formal business vehicle should be recognised, which should be distinguished on the basis of size of turnover, which will in turn determine their reporting requirement. According to the South African Institute of Chartered Accountants (SAICA) the policy document asserts that the current distinction between close corporations, private companies and public companies, which is based on shareholding, is artificial and "does

19 Henning 1984:156-171.
20 Henning 1984:156-171.
21 For detailed discussion see Henning 2001:917-950.
22 Promulgated on 11 January 2006.
23 See *Close Corporations Amendment Act* 64 of 1988 s 3(1).
24 Mongalo 2004: 93.
25 See http://www.pmg.org.za/bills/040715companydraftpolicy.pdf.
26 See https://www.saica.co.za/DisplayContent.asp?ContentpageID=456.

not allow an easy transition from one type of company form to another." Hence the policy document envisages one model with a series of thresholds:

> the smaller you are the less the mandatory requirements … . (T)he policy makes it clear that the overriding principles of corporate law reform should be simplicity of formation and flexibility for businesses.[27]

However, it has been pointed out that the proposals in the policy document appear to lean too heavily on recommendations of international case practice, and that a cursory glance of recommendations by the American Bar Association seems to have influenced the guidelines disproportionately.[28] Confidence was expressed that other perspectives and recommendations will receive due consideration by the DTI.[29]

In its Working Paper of August 2004 Business Unity of South Africa (BUSA) disagreed with the DTI proposals concerning close corporations and recommended that the *Close Corporations Act* be retained in its present form. It is important to note that, according to the final NEDLAC *Report*, it was agreed by NEDLAC's constituencies (business, labour and government) towards the end of 2004 that a corporate structure which includes the characteristics of the current close corporation will be one of the available structures.

A recent in-depth study emphasises the importance of the continued availability of the close corporation and its potential as a role model for an eventual *Societas Africaea* furthering socio-economic integration within the context of the African Union. It does not only serve as a highly significant indication of the importance of the preservation and development of such a legal entity but also sounds as very timeous note of warning to South African law reformers especially, to proceed more cautiously and with greater deliberation in this regard.[30]

It seems that consensus was reached eventually to recommend that the close corporation be kept in place at least for the next decade. It will only be replaced if it is clearly outperformed during this period by an alternative corporate structure specifically designed for small businesses.[31]

In any event, not only did the *Close Corporations Amendment Act* of 2005 enhance the accessibility of the close corporation for small entrepreneurs, but the Soccer World Cup 2010 is expected to boost the establishment of close corporations dramatically as well, as small entrepreneurs increasingly identify business opportunities linked to this very significant sporting event in South Africa.

Viewed against this background, it would seem a reasonable observation that the close corporation is particularly well set to fulfill its primary object least for the next decade, that is of meeting the reasonable needs and expectations of the typical small entrepreneur without burdening him or her with legal requirements that would not be meaningful in his circumstances, in other words of simply "thinking small first".

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27 SAICA policy document.
28 COSATU 2004:4.
29 COSATU 2004:4.
30 Jaehne 2006: 220-236.
31 Mongalo 2006:2-4.

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