The South African close corporation under the Companies Act of 2008

by J J Henning

INTRODUCTION

The purpose of the South African Close Corporations Act 69 of 1984 (the "Act") is the provision of a simple, deregulated, decriminalized, inexpensive and flexible free-standing limited liability vehicle for the single entrepreneur or small number of participants, to meet their reasonable needs and expectations without the burden of legal requirements that would not be meaningful in the circumstances.

The total number of registrations, that is incorporations of new close corporations and conversions from companies to corporations, during the period 1985 to 2006 amounted to 1,494,488 close corporations compared to 387,757 companies of all kinds and types. During 2007 and 2008 a further 519,634 close corporations and 65,504 companies were incorporated. This puts the total for the period 1985 to 2008 at 2,014,122 close corporations and 453,361 companies.

In this contribution attention will be given to the far-reaching if not drastic changes to be wrought by the provisions of the Companies Act 71 of 2008 (the "new Companies Act") when it comes into operation.

SOUTH AFRICAN CLOSE CORPORATION

Under the Act the South African close corporation is a juristic person that confers on its members all the usual advantages associated with legal personality and 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, to act as an agent for the corporation, and 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.

It is ideally suited to small businesses. The managerial and administrative requirements for close corporations are less formal than those for companies. The typical small entrepreneur will be able to complete the constituting documentation and register the corporation personally without expensive professional advice. Although a close corporation is required to have an accounting officer, a formal audit of financial statements is not required. There are no requirements for compulsory meetings, such as annual general meetings. Meetings are usually held between members on an ad hoc basis. The members do not all have to take an active role in the running of the business but are in principle entitled to do so.

The concept and development of the close corporation elicited international interest and even enthusiastic admiration. A recent in-depth comparative 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 SADEC and the African Union. It does not only serve as a highly significant indication of the importance of the preservation and development of such legal entities but also sounds as very timely note of warning to South African law reformers to proceed with greater caution, circumspection and more deliberation in this regard.

THE CORPORATE LAW REFORM PROCESS

The Department of Trade and Industry (the "Department") released its policy document on corporate law reform entitled *South African Company Law for the 21st Century – Guidelines for Corporate Law Reform* for public comment on June 24, 2004. It suggested that only one formal business vehicle should be recognised, which should be distinguished on the basis of size of turnover, and which would in turn determine the reporting requirements. The policy document asserted that the current distinction between close corporations, private companies and public companies is artificial and does not allow an easy transition from one type to another.

Towards the end of 2004 newspaper reports suggested that close corporations would have to convert to private companies to avoid losing their corporate status. Starting with relatively low key and tentative statements, these reports eventually explicitly consigned the close

corporation to the dustbin of corporate law reform. They proclaimed: "End of the road for close corporations", "Close corporations to be axed", "The demise of the close corporation", "Death knell for close corporations", "The end of the close corporation." The Department deemed it necessary to issue a statement in February 2005 categorically refuting "these rumours" and stating that there was no plan to compel close corporations to convert to private companies or lose their corporate status. The Department was at pains to emphasise that although its policy document of June 2004 on South African Corporate Law Reform stated "it is necessary to move away from the largely artificial separation between the different business forms, [and] to recognise only one formal business vehicle", this should *not* be interpreted to mean that close corporations would have to convert to private or public companies.

Notwithstanding the negative ambiance and pervasive atmosphere of uncertainty, 519,634 close corporations were registered during 2007 and 2008 compared to merely 65,504 companies.

Eventually the Draft Companies Bill 2007 (the "Draft") was circulated for comment. The Draft recognised various types and categories of companies, ranging from "not for profit" to "for profit" companies, and the latter from "closely held" to "widely held" companies, while all were susceptible to the very strict "public interest company" regime. In 2007 the Corporate Laws Amendment Act 24 of 2006 became operative. In addition to maintaining the present distinctions between companies limited by shares and those limited by guarantee as well as between private and public companies, it introduced a further distinction namely between a "widely held company" and a "limited purpose company." Although the Amendment Act also refers to a "public interest company", this term is not defined.

Clause 226(1)(b) of the Draft made provision for the repeal of the Close Corporations Act. However, clause 2 of Schedule 6 of the Draft stipulated that the President may not bring clause 226(1)(b) into operation before a date at least 10 years after the general effective date of the new Companies Act; *and* the Minister has reported to Parliament, no earlier than eight years after the general effective date of the new Act, on the utility of continuing the dual system of incorporation under this Act and the Close Corporations Act, and the advisability at that time of the repeal of the Close Corporations Act.

Thus the Draft envisaged that close corporations would continue to co-exist for an interim period with the "closely-held company" after the new Companies Act eventually had come into operation. This is not to say that the Close Corporations Act would inevitably be repealed at that stage. The Draft expressly created the possibility that the Close Corporations Act might continue in existence indefinitely. It did not envisage a prohibition on the formation of new close corporations during the interim period.

However, in the event this interim "in tandem" arrangement did not survive the reform process.

COMPANIES ACT 71 OF 2008

Introduction

In reaction to comments received on the Draft, a much revised Companies Bill was tabled in Parliament in 2008. It eventually reached the end of an arduous parliamentary process as the Companies Bill 61D of 2008 and was enacted in April 2009 as the Companies Act 71 of 2008 (the "new Companies Act"). At the time of writing its operative date has not been determined by the President.

Categories and types of companies

Abandoning the terminology "closely held company", "widely held company", "public interest company" and "limited interest company" used in the Draft or introduced into the present Companies Act by the Corporate Laws Amendment Act 24 of 2006, the new Companies Act reverts to the traditional terms private company and public company.

The new Companies Act provides for two categories of companies, namely non-profit companies, the successor to the current section 21 company, and profit companies. The latter may be one of the following types:

(i) Private companies, which are broadly comparable to companies of the same status under the present Companies Act;

(ii) personal liability companies, which are comparable to section 53(b) companies under the present Companies Act;

(iii) public companies, which are comparable to companies of the same status under the present Companies Act; and

(iv) state-owned companies.

Interestingly, an important sub-species of company, that may be referred to for practical purpose as a "closely-held" or "exempted" company, is not dignified with a specific designation by the new Companies Act, although it is rather obviously intended to compete directly with, or even replace, the close corporation.

For instance, in terms of section 30(2) of the new Companies Act a *private* company in which a single person holds or has all of the beneficial interest in all the securities issued by the company, or in which every person who is a holder of or has a beneficial interest in the securities issued by the company is also a director of the company, is exempted from the independent review of its annual financial statements. The exemption does not apply if the company has only one director, and that director is a disqualified person contemplated in section 69(12).

Then again, under section 57(2) of the new Companies Act, if a *profit company* (other than a state-owned company) has only one shareholder, the shareholder may exercise any or all of the voting rights pertaining to that company on any matter, at any time, without notice or compliance with any other internal formalities, except to the extent that its memorandum of incorporation provides otherwise. In addition its governance is exempted from the detailed requirements of sections 59 to 65 of the new Companies Act.

In terms of section 57(3) of the new Companies Act, if a *profit company* (other than a state-owned company) has only one director that director may exercise any power or perform any function of the board at any time, without notice or compliance with any other internal formalities, except to the extent that the company's memorandum of incorporation provides otherwise. In addition sections 71(3) to (7), 73 and 74 do not apply to the governance of such a profit company.

Section 57(4) of the new Companies Act stipulates that if every shareholder of a *company* (other than a state-owned company) is also a director of that company any matter that is required to be referred by the board to the shareholders for decision may be decided by the shareholders at any time after being referred by the board, without notice or compliance with any other internal formalities, except to the extent that its memorandum of incorporation provides otherwise.

Single Act approach

The approach of the drafters of the new Companies Act by preferring a single Act for small and large businesses and by de-emphasising the close corporation, through additional onerous regulation and prohibiting the formation of new ones, contrasts with the basic philosophy underlying the Act that proved so successful. At the root of the development of the Act is the conviction that it is very difficult for a single Act to provide a satisfactory legal form for both the large and sophisticated as well as the small and often marginalised entrepreneur. Historically, South African company legislation developed mainly in response to the needs of and problems posed by large public companies. It had to provide for the large industrial or financial conglomerate with its listed shares and 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 outgrew the needs and problems of the small entrepreneur who, typically, has restricted means and limited access to professional advice.

As far as the new Companies Act is concerned, a case in point is the dispensation concerning capacity and representation, which are applicable to both public and private companies alike, whether closely-held and/or exempted or not.

The ordinary rules of agency provide the foundation for the representation of juristic persons, but have not been able to supply solutions in all cases. A special or characteristic branch of agency has consequently developed with specific common law doctrines such as the doctrine of constructive notice, the *ultra vires* doctrine and the *Turquand* rule.

The legislature considered it unwise to burden close corporations with the accumulated learning on the *ultra vires* doctrine and the doctrine of constructive notice. This Act, instead, in effect provides that these doctrines have no application and are not relevant to the question of whether a close corporation is bound by a particular contract made on its behalf.

A company incorporated under the new Companies Act is a juristic person. Therefore all the common law doctrines applicable to the capacity and representation of juristic person will apply, except to the extent that the new Companies Act provides to the contrary.

From section 19(4) and (5) of the new Companies Act it should be clear that the doctrine of constructive notice, although curtailed, has not been completely abolished. In fact, a person will be regarded as having received notice and knowledge of any provision of a company's memorandum of incorporation contemplated in section 15(2)*(b)* if the company's notice of incorporation or a notice of amendment has drawn attention to the provision as contemplated in section 13(3), or of the effect of section 19(3) on a personal liability company. To this extent the doctrine of constructive notice will be applicable and still remain relevant to the consideration of the legal position of a company within this context.

Section 19(1) of the new Companies Act provides that a company has all of the legal powers and capacity of an individual, *except* to the extent that the company's memorandum of incorporation provides otherwise. Thus the powers and capacity of a company may be limited in the company's memorandum of incorporation and, to this extent, the *ultra vires* doctrine finds application. In contradistinction to close corporations law, the *ultra vires* doctrine is thus not completely abolished, consequently complicating the legal position of the company and third parties dealing with the company with the accumulated learning on this doctrine.

This seems to have been realised by the drafters, because it is sought to address some of the doctrine's consequences, reflecting to some extent the approach followed in section 36 of the present Companies Act. In terms of section 20(1) of the new Act, if a company's memorandum of incorporation limits, restricts or qualifies the purposes, powers or activities of that company, no action of the company is void by reason only that the action was prohibited by that limitation, restriction or qualification or as a consequence of that limitation, restriction or qualification, the directors had no authority

to authorise the action by the company. In any legal proceedings, no person may rely on such limitation, restriction or qualification to assert that such an action is void. Exceptions are proceedings between the company and its shareholders, directors or prescribed officers, or between the shareholders and directors or prescribed officers of the company. The similarity between section 20(1) of the new Companies Act and section 36 of the present Act is striking. Even the criticised expression "the directors" has been retained.

In terms of section 20(7) of the new Act an outsider dealing with a company in good faith is entitled to presume that the company, in making a decision in the exercise of its powers, has complied with all of the formal and procedural requirements in terms of this Act, its memorandum of incorporation and any rules of the company unless, in the circumstances, the person knew or reasonably ought to have known of any failure by the company to comply with any such requirement. A director, prescribed officer or shareholder of the company is not regarded as an outsider. The new Companies Act stipulates that this provision must be construed concurrently with, and not in substitution for, any relevant common law principle relating to the presumed validity of the actions of a company in the exercise of its powers. The primary, if not the only, "common law principle" in this regard is contained in the *Turquand*-rule.

Clearly, the new Companies Act creates a far more complicated legal position in regard to capacity and representation than the Act. This is especially so because of the continued, though limited, application of complex common law doctrines and their accumulated learning to companies, even small one-man or closely-held private companies.

It amply illustrates the difficulty to cater for the reasonable needs and expectations of all types and sizes of companies, their stakeholders and persons dealing with them, with a "one size fits all" approach.

Continuation of existing close corporations

The new Companies Act provides for its co-existence with the Act. It amendments the latter extensively "to avoid regulatory arbitrage". The new Companies Act repeals the present Companies Act and amends the Close Corporations Act as provided for in Schedule 3. The result is the indefinite continued existence of the Act and thus of existing close corporations. Close corporations will continue to exist until deregistered or dissolved in terms of the Act or converted to companies under the New Companies Act.

New close corporations proscribed

From the effective date of the coming into operation of section 13 of the new Companies Act, the incorporation of new close corporations will be proscribed. Thus new close corporations can still be registered until the coming into operation of section 13 of the Act. In terms of section 225, the new Companies Act comes into operation on a date fixed by the President by proclamation in the *Gazette*. That date may not be earlier than one year following the date on which the President assented to the Act, namely April 8, 2009. Obviously that date may be later than one year after the date of assent.

Conversion of companies into close corporations proscribed and conversion of close corporations into companies facilitated

From the date on which Schedule 2 of the new Companies Act comes into operation the conversion of companies into close corporations will be proscribed. Until that date companies can still be converted into close corporations under section 27 of the Act.

Schedule 2 provides for the conversion of existing close corporations into companies under the new Companies Act. A close corporation may file a notice of conversion in the prescribed manner and form, with a filing fee, at any time. The notice must be accompanied by a certified copy of a "special resolution" approving the conversion of the close corporation, and either a new memorandum of incorporation, or an amendment to the existing memorandum of incorporation complying with the new Companies Act.

It is clear that a member of a close corporation will in future no longer be faced with an obligation to become a member of the company upon conversion, but will have the freedom of choice to decide whether or not to become a shareholder of that company.

Section 14 of the new Companies Act, read with the changes required in context, applies with respect to the filing of a notice of conversion, as if it were a notice of incorporation in terms of the new Act. Every member of a converted close corporation is entitled to become a shareholder of the company, but the shares need not be in held in proportion to the members' interests.

Upon conversion of a close corporation in terms of Schedule 2, the Companies and Intellectual Property Commission must cancel the registration of the close corporation in terms of the Close Corporations Act, give notice in the *Gazette* of the conversion of the close corporation into a company and enable the Registrar of Deeds to effect the necessary changes resulting from conversions and name changes.

On the registration of a company converted from a close corporation, the juristic person that existed as a close corporation before the conversion continues to exist as a company. All the assets, liabilities, rights and obligations of the close corporation vest in the company. Existing legal proceedings are deemed to have been done by or in respect of the company, and the liability of any member for the

close corporation's debts in terms of the Close Corporations Act which arose before its registration as a company remains the liability of that person as if the conversion had not occurred.

For the conversion of a close corporation into a company section 29C(4)(b) of the present Companies Act requires a statement by the close corporation's accounting officer, based on the performance of his duties under the Act, that he is not aware of any contravention of the Act by the close corporation or its members or of any circumstances which may render the members of the close corporation together with the close corporation jointly and severally liable for the corporation's debts. Interestingly enough, Schedule 2 of the new Companies Act does not contain a similar requirement.

Loans and the provision of security by or to a close corporation

Section 55(1) of the Act provides for the *mutatis mutandis* application of the provisions of section 37 of the present Companies Act to the employment of funds of a subsidiary company in a loan to its holding corporation or fellow subsidiary company, or the provision of security by a subsidiary company to another person in connection with an obligation of its holding corporation or fellow subsidiary. Where a subsidiary company makes such an "upward" or "sideward" loan, or provides "upward" or "sideward" security, the subsidiary company must furnish detailed particulars of the loan or security in its annual financial statements for every year during which the loan or security is in operation. The directors and officers of the subsidiary company and the members and officers of the holding corporation who authorise or permit or are party to the transaction, are personally liable to the subsidiary for damages, should the terms of the loan or security be unfair to the subsidiary or not provide reasonable protection for its business interests and as a result the subsidiary suffers loss.

Subject to certain exceptions, section 226(1) of the present Companies Act, as applied by section 55(3) of the Close Corporations Act, prohibits loans or the provision of security by a subsidiary company to:

(a) *a member* or officer of its holding corporation; or

(b) a director or officer of its fellow subsidiary company; or

(c) a close corporation, company or other body corporate controlled by one or more of the members or officers of its holding corporation; or

(d) a close corporation, company or other body corporate controlled by one or more of the directors or managers of its fellow subsidiary company.

A loan or provision of security contrary to the prohibition is fatal to the validity of the transaction.

Unless the express prior consent in writing of all members to the particular transaction is obtained, loans and the provision of security by a close corporation to another corporation in which one or more of its members hold more than a 50 per cent interest, or to a company or other juristic persons controlled by one or more members of the corporation, is prohibited by section 52 of the Close Corporations Act. This provision is in effect a simplified version of the prohibition in section 226 of the present Companies Act.

The new Companies Act provides for the repeal of section 55 of the Act *in toto*. The definitions of "holding company" and "subsidiary" in the Act are amended to reflect the corresponding definitions in the new Companies Act.

Section 45 of the new Companies Act regulates loans or other financial assistance by a *company* to directors or prescribed officers of the company or of a related or inter-related company, or to a related or inter-related company or corporation, or to a member of a related or inter-related corporation, or to a person related to any such company, corporation, director, prescribed officer or member.

In contrast, section 52 of the Close Corporations Act (dealing with loans and the provision of security *by a close corporation*) will not be repealed by, or even amended to refer to, section 45 of the new Companies Act. Section 52 will therefore not only continue to reflect the arrangement contained in (the then repealed) section 226 of the present Companies Act, but will continue to refer pertinently to (the then repealed) section 226(1A)(b) for the definition of control.

This does not augur well for the attainment a "seamless match" between the various statutory arrangements regulating the provision of loans and security *by and to companies and close corporations*.

Accounting and disclosure

Annual financial statements

Within six months after the end of every financial year, annual financial statements in one of the eleven official languages will have to be prepared by the close corporation's members. Presently the period is nine months.

Compulsory audit of financial statements

Presently a close corporation must appoint an accounting officer who has to report on the annual financial statements. A formal audit of annual financial statements is, however, presently not required. Although chartered accountants qualify for an appointment as accounting officers, quite a number of other sufficiently qualified professions have also been permitted. It should be emphasised that it is quite possible to have audited annual financial statements for instance where the members need it for their own purposes or because a potential creditor requires it. Hence audits are carried out where they serve a meaningful purpose.

The new Companies Act introduces a compulsory audit of the financial statements of certain close corporations. A close corporation may be required by the regulations made in terms the new Act to have its annual financial statements audited. The Minister may make regulations prescribing the categories of close corporations that are required to have their respective annual financial statements audited, taking into account whether it is desirable in the public interest, having regard to the economic or social significance of the company, as indicated by its annual turnover; the size of its workforce; or the nature and extent of its activities.

A qualifying close corporation's financial statements must comply with section 30(3) to (6) of the new Companies Act and not section 58(2) of the Close Corporations Act.

The annual financial statements may also be audited voluntarily at the option of a close corporation.

Accountability

A close corporation may voluntarily make the enhanced accountability and transparency provisions of Chapter 3 of the new Companies Act applicable. In such an event the provisions of Chapter 3 of the Act, read with the changes required by the context, applies to such a corporation and prevails over any conflicting provision of the Close Corporations Act.

Financial reporting standards

The Minister, after consulting the Financial Reporting Standards Council, may make regulations prescribing financial reporting standards or the form and content requirements for summaries of financial statements of close corporations, as if those regulations have been made in terms of the Act. These regulations must promote sound and consistent accounting practices. In the case of financial reporting standards, they must be consistent with the International Financial Reporting Standards of the International Accounting Standards Board or its successor body.

Disqualification from participation in management

Disqualification of a person to act as director of a company will in general also exclude that person from managing a close corporation. Section 47(1)(c) of the Act will be amended to incorporate all the grounds of disqualification of a director of a company specified in section 69(8), as well as the provisions of section 69(9) to (11) of the new Companies Act.

Despite being disqualified on one of the grounds detailed in section 69(8)*(b)* of the new Companies Act, a person may participate in the management of a close corporation if 100 per cent of the members' interest in the corporation is held by that disqualified person or the disqualified person and other persons who are all related to that disqualified person, and each person has consented in writing to the disqualified person participating in the management of the corporation.

The provisions of the new Companies Act relating to an application to declare a director delinquent or under probation apply to a member of a close corporation. A reference in section 162 of the new Companies Act to a company must be regarded as referring to a company or a corporation, while a reference to a director must be regarded as referring to a director of a company, or a member participating in the management of a close corporation.

A person who has been placed under probation by a court in terms of section 162 of the new Companies Act or section 47(1C) of the Act may not participate in the management of the business of a corporation, except to the extent permitted in the probation order.

Winding-up and liquidation

The Department of Justice and Constitutional Development has been developing uniform insolvency legislation for quite some time which may conflict with the regime set out in the present Companies Act for dealing with and winding-up insolvent companies. In order to avoid any future conflict, the new Companies Act provides for transitional arrangements that retain the current disposition set out in Chapter 14 of the present Companies Act for the winding-up and liquidation of companies until such time as the new uniform insolvency legislation is enacted. However, if there is any conflict between the provisions of Chapter 14 of the present Companies Act and Part G of Chapter 2 of the new Companies Act, concerning the winding-up of *solvent* companies and deregistration of companies, the provisions of the latter prevail. The Minister may by notice in the *Gazette* determine a date on which this arrangement ceases to have effect. This may not be effected until the Minister is satisfied that alternative legislation has been brought into force adequately providing for the winding-up and liquidation of insolvent companies. The Minister may prescribe ancillary rules as may be necessary to provide for the efficient transition from the present provisions to the provisions of the alternative legislation.

This transitional arrangement, with the changes required by the context, also applies to the liquidation of a close corporation in respect of any matter not specifically provided for in the Act or in the business rescue and compromise provisions of the new Companies Act.

Business rescue

Neither judicial management under Chapter XV nor a so-called "judicial management scheme" in terms of section 311 of the present Companies Act is available currently to a close corporation. In terms of the amendment to the Act by the new Companies Act, the

business rescue provisions in Chapter 6 of the new Companies Act apply also to close corporations. Any reference in Chapter 6 to a company must be regarded as a reference to a close corporation. Any reference to a shareholder of a company, or the holder of securities issued by a company, must be read as a reference to a member of a close corporation.

Other arrangements incorporated by reference

The provisions of the new Companies Act are applied also to regulate the names, dissolution and deregistration of close corporations as well as the administration and enforcement of the Act.

CONCLUSION

The main impact of the new Companies Act on the South African close corporation may be summarized as two-fold.

First, the proscription of new close corporations: this not only translates into the phasing out of close corporations, however gradual, but leaves small entrepreneurs with only one avenue for new incorporations and that is under the new Companies Act. If the new "exempt" private company is really so much more deregulated and simplified than the present close corporation it only serves to beg the question why the present choice of incorporation has perforce to be limited and why it is necessary to overburden the close corporation with additional regulation. The philosophy is apparent: "out with the old in with the new."

Second, there is the clearly discernible tendency to subject the close corporation to more and more onerous administrative duties and arrangements. A prime example is the introduction of annual returns, with their attendant duties and liabilities. This impact is significantly added to by the approach to supplant numerous arrangements in the Act by that of the new Companies Act, by repealing some provisions of the first and by incorporating large tracts of the latter by reference.

It is unfortunate that the new Companies Act will proscribe new close corporations and encumber existing close corporations by duties and obligations contrary to their very nature and fundamental design philosophy.

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