

# Thinking Small Further?

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## South Africa's Company Law Reform and its German Counterpart: Perspectives for SMMEs

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## A. Preface

Every economy has its flagships that can be seen from afar. They fly the flags of Standard Bank, MTN, Vodacom, Deutsche Bank, Mercedes and BMW and are often the pride of the nation – or at least the pride of stock analysts. In their wake flow, another powerful armada – the thousands of small- and medium-sized entrepreneurial vessels – often used to sail below political radar level. But in the past few decades a paradigm shift towards a more entrepreneurial-friendly environment took place. In line with the realisation of the developmental assistance community that large-scale poverty reduction could only be achieved from within the economy,<sup>1</sup> many policy makers realised the potential of small entrepreneurship. The slogan “*thinks small first*” quickly gathered momentum. And even though this valuable insight was picked up earlier in developing economies, such as the South Africa of the 1980s,<sup>2</sup> it is now influencing the economic agenda around the world. Even the European Union felt the urge to focus more on the “*think small first*” approach. Günter Verheugen, former Vice-President of the Commission of the European Union responsible for enterprise and industry policy is sure that “[*e*]ntrepreneurs and entrepreneurship are of enormous importance for our societies. Today and even more so tomorrow small and medium sized enterprises will provide for professional education and employment opportunities. Caring about SMEs means therefore caring about present and future jobs [...]”<sup>3</sup> In 2006 micro, very small and small businesses accounted for 27 – 34 % of South Africa's total GDP,<sup>4</sup> an impressive figure. But more importantly, those enterprises employed 56 % of all employees – with small businesses employing an impressive 21 % of all South African employees.<sup>5</sup> The importance of Small, Medium and Micro Enterprises (hereafter SMME) for job creation, economic stability, poverty reduction and economic growth is therefore

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- 1 Department For International Development (DFID), *Making Markets Work for the Poor Notes (I-IV)*, 2008, Note I at 1, accessible at [www.mmw4p.org](http://www.mmw4p.org) [last accessed 03/10/2010]; C. Leys, *Rise and Fall of Development Theory*, in: M. Edelman/A. Haugerud (Ed.) ‘The Anthropology of Development and Globalization’ (2005), 109 at 110.
  - 2 Naudé, SJ, *Die Toekoms van die Beslote Korporasie en die Private Maatskappy*, Transactions of the Luyt Centre for Business Law (1986), Vol. 3, 1 at 4 exclaimed: “*We are a third world economy. It is time everybody, including the professionals, fully realise this.*”
  - 3 Press release IP/08/1003, June the 25<sup>th</sup> 2008, available at <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/08/1003> [last accessed 03/10/10].
  - 4 DTI, Annual Review of Small Businesses in South Africa 2005-2007, August 2008 at i, available at [http://www.dti.gov.za/publications/Annual\\_Review.pdf](http://www.dti.gov.za/publications/Annual_Review.pdf) [last accessed 03/10/10].
  - 5 DTI (ibid) at 43 f.

indisputable.<sup>6</sup>

But what kind of legal environment do SMMEs need to thrive? Especially in South Africa most small businesses start as informal enterprises. For those mostly survivalist businesses the legal framework, all the more corporate law, is of little concern. Most micro and very small businesses in South Africa furthermore have little or no potential to grow and step up to a stage of development,<sup>7</sup> where questions of corporate law actually become important. And even if successful entrepreneurs choose to incorporate a business vehicle the exact legal framework is probably of less interest than administrative and tax burdens.<sup>8</sup> But corporate law does eventually become important. Especially those small businesses that are thriving and expanding need an appropriate business vehicle if they want to continue to grow. So even though even the best corporate law for SMMEs does neither foster economic growth, nor alleviate poverty all on its own it is one piece of a jigsaw that needs to fit. “*Thinking small First*” is all about less red tape and more red carpet for small businesses<sup>9</sup> - the same is true for corporate law.

In this sense South Africa's red carpet for local entrepreneurs used to be the close corporations Act.<sup>10</sup> A quite unique piece of legislation providing for a corporate entity designed for what was thought to be the typical small business. Now, after almost three decades, the dusty close corporations Act is to be replaced by a modernised company law, hopefully without pulling the rug from under the African entrepreneur. This thesis is dealing with the question if the recent company law reform in South Africa has indeed “thought small further”, or if it might cause problems for SMMEs that could have been avoided. This is being dealt with mainly in terms of a theoretical analysis of the relevant legal framework. For this purpose it is going to be briefly displayed what changes for what reasons the South African corporate law underwent (chapter C.I.) and what forms of incorporation were designed with the small business in mind: that is the

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6 See also Henning, JJ, *enduring South African Close Corporation: 21 years of simply “thinking small first” successfully*; 28(8) *Company Lawyer* (2007), 253 and Henning, JJ, *Company Law for the new Millennium: “Think Small First”*, 24(12) *Company Lawyer* (2003), 353.

7 DTI (note 4) at 50 f.

8 See Henning, JJ, *Reforming Business Entity Law to Stimulate Economic Growth Among the Marginalized: The Modern South African Experience*, 91 *Kentucky Law Journal* (2002-2003), 773 at 778 f. and Freedman, J, *Small Businesses and the Corporate Form: Burden or Privilege?*, *The Modern Law Review* (1994), Vol 57, No. 4, 555 at 561.

9 EU Commission President José Manuel Barroso, EU press release (note 3).

10 Act No. 69 of 1984.

close corporation (chapter C.II.) and the reformed private company (chapter C.III.). Afterwards the legal framework is critically analysed against the backdrop of the needs of SMMEs (chapter D.). Since the company is going to be the only corporate structure that is going to be available for small businesses in the near future this analysis is sometimes focussing more on the new company law than on the fading-out close corporation. Finally a different, yet similar, corporate law reform is being discussed: the recent reform of the German Gesellschaft mit beschränkter Haftung (GmbH) that drew the GmbH much closer to the close corporation than most people in Europe would have thought could be possible (chapter E.). The interesting question is how Germany “thought small first” and what both countries might learn for the future from one another.

But before any consideration about whether or not a corporate framework is appropriate for SMMEs can be made it is indispensable to address the question what SMMEs actually are. The following chapter B. therefore sets the stage by exploring distinctive features and possible definitions of SMMEs and if those features are used or can be used in terms of corporate law.

## B. How small is small enough? Attempts to define SMMEs

Given the diversity of economies and businesses around the globe it is not surprising that there exists no universally accepted definition of SMME and definitions even vary within one country.<sup>11</sup> Often SMMEs are limited to formal enterprises, leaving aside the vast number of informal, survivalist businesses.<sup>12</sup> This is probably inaccurate for developmental purposes, but it is necessary for the purposes of this thesis, since only formal sector businesses require corporate structures. Furthermore there are certain key indicators that may provide guidance on how to identify formal small and medium enterprises, such as the number of employees, turnover, assets, invested capital and membership structure. Which indicators are predominantly used to define SMMEs differs from region to region<sup>13</sup> and is influenced by the respective economy and the organisation providing the statistical data.<sup>14</sup> Generally speaking the more complex an economy, the more differentiated the definition of SMMEs<sup>15</sup> and vice versa.

In South Africa the term SMME for Small, Medium and Micro Enterprises, has been adopted,<sup>16</sup> to include the even smaller micro enterprises in the definition and thus probably depict the local business structure more accurately. In line with the South African Small Business Act (SBA)<sup>17</sup> the term SMME is also going to be used to describe the variety of small to medium sized enterprises. To define SMMEs the SBA uses a variety of indicators (employment figures, annual turnover and total gross asset value) and adjusts the respective threshold for each indicator according to the relevant business sector.<sup>18</sup> A business is then classified

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11 Freedman, J, “*One Size Fits All*” - *Small Business and Competitive Legal Forms*, Journal of Corporate Law Studies (2003), Vol. 3, 123 at 124; focussing on Turkey see Napier, G / Serger, SS / Hansson, EW, *Strengthening Innovation and Technology Policies for SME Development in Turkey*, International Organisation for Knowledge Economy and Enterprise Development (IKED) Papers, Malmö 2004 at 58.

12 Similarly Ayyagari et al, *Small and Medium Enterprises Across the Globe*, Small Business Economics (2007), 415 at 417.

13 Napier et al (note 11) at 54, box 9.

14 Ayyagari et al (note 12) at 416.

15 Using more indicators, see for example the EU guidelines on SMME, Recommendation No. 2003/361/EC, Official Journal of the EU No. 124, 36 at 39 f.

16 s. 1 (xv) of the Small Business Act No. 102 of 1996.

17 Small Business Act No. 102 of 1996.

18 Schedule of the SBA-A.

as being either micro-, very small, small or medium.<sup>19</sup> The SBA does not distinguish between formal and informal businesses. This is reasonable given that the aim of the SBA is not to provide guidance for corporate legislation, but to foster growth in the small and medium enterprise sector generally. Therefore the definitions and indicators of the SBA might provide some guidance on what is 'small' in terms of corporate law – but they cannot be used for this purpose unquestioned. In the following chapters the three most common indicators and their appropriateness in terms of corporate law are going to be assessed. That is: number of employees (chapter I), financial criteria (chapter II) and membership structure (chapter III). To broaden the scope the relevant South African indicators are going to be compared to European ones wherever possible.

## ***I. Number of Employees***

Developing countries,<sup>20</sup> most notably on the African continent,<sup>21</sup> largely define SMMEs according to the number of their employees, making it the single most important indicator.<sup>22</sup> The advantage of this simple indicator is obvious: once the threshold of employees is defined, SMMEs can easily be identified both by the relevant authorities<sup>23</sup> and the owner of the business. In South Africa the SBA<sup>24</sup> defines the employee thresholds in comparison to the EU recommendation<sup>25</sup> as follows:

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19 s. 1 (xv) SBA in association with the schedule of the SBA-A.

20 See for Vietnam Rand, J / Tarp, F / Dzung, NH / Ving, DQ, *Documentation of the Small and Medium Scale Enterprise (SME) Survey in Vietnam for the Year 2002*, Documentation accessible at <http://www.econ.ku.dk/rand/images/VNDodumentation02.pdf> [last accessed 07/10/2010] at 4; for Turkey Napier et al (note 11) at 58 note 22.

21 Napier et al (note 11) at 54, box 9.

22 Ayyagari et al (note 12) at 416.

23 Even though it seems as if the official state agencies in South Africa do not follow the four defined categories of the SBA for no obvious reasons, according to Berry A. et al, *The Economics of SMMEs in South Africa*, Trade and Industry Policy Strategies (TIPS) Paper, December 2002; accessible at <http://www.tips.org.za/files/506.pdf> [last accessed 07/10/2010] at 14.

24 s. 1 (xv) SBA in association with the schedule of the SBA-A.

25 Art. 2 of the Annex to 2003/361/EC.

Table 1: SMME defined by number of employees

	SBA	EU Recommendation
Micro:	< 5 <sup>1)</sup>	< 10
Very Small:	<10- 20 <sup>1)2)</sup>	-
Small:	< 50 <sup>1)</sup>	< 50
Medium:	< 100-200 <sup>1)2)</sup>	< 250

<sup>1)</sup> The Schedule of the SBA-A does no longer specify if the relevant criterion requires 'less than' or 'up to' the specific number. In accordance with the old schedule of the SBA it is assumed that the adjunct 'less than' has simply been forgotten.

<sup>2)</sup> Depending on sector.

Many government initiatives in developing countries and even more donor-agencies regard SMMEs as the primary vehicle to provide employment for the vulnerable.<sup>26</sup> They are hoped to be the major agents for sustainable and large-scale poverty reduction, thus leading to a general development of the relevant country similar to the early European industrialisation.<sup>27</sup> From this developmental perspective it is perfectly understandable to focus on employment figures. The more people are being employed, the more are enabled to generate income and thus alleviate their (and their family's) poverty.

There are, however, serious shortcomings of the employment indicator, especially for the purpose of corporate law.

Firstly employment figures are prone to changes over time. This is permissible for the purpose of statistics and development schemes not focussing on a single business. But linking legal requirements (or exemptions thereof) to the varying number of employees might cause serious problems. A stable legal environment is crucial for SMMEs,<sup>28</sup> however defined. Adjusting to the changing legal requirements by the business and monitoring by the state does significantly increase costs for both. Moreover, the objective of fostering employment through

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26 In East- and South-East Asia SMMEs provide a livelihood for three quarter of the regional workforce and especially for women and the young, according to Wattanapruttipaisan, T, *Promoting SME Development: Some Issues and Suggestions for Policy Consideration*, Bulletin on Asia-Pacific Perspectives 2002/03, 57 at 57.

27 TIPS (note 23) at 4.

28 Acevska, *Entrepreneurship under difficult circumstances: factors hindering SME growth in the Republic of Macedonia*, South-East Europe Review for Labour and Social Affairs (SEER), Issue 1/2002, 109 at 114.

the SMME sector could even be jeopardized by corporate regulations linked to the number of employees. The increase of regulations once a certain threshold of employees is reached might incentivise SMMEs to refrain from creating new job opportunities in order to stay below the threshold. This is even more likely to happen since some SMMEs remain at a certain stage of growth e.g. due to personal lifestyle decisions of their owners<sup>29</sup> and are not aimed at infinite growth.<sup>30</sup> Especially those SMMEs might be discouraged from employing as many people as they could at the desired stage, if this would have the consequence of having to comply with more regulation.<sup>31</sup>

Secondly the number of employees is a very rough indicator and does not accurately depict the importance or size of a business. Especially holding companies employ few people,<sup>32</sup> but yet can have a remarkable economic power. The same goes for highly profitable, specialised businesses that are not labour-intensive.

Thirdly, and for the purposes of this thesis most importantly, the number of employees does not necessarily affect the structure of the business. Unless there exists a mandatory worker participation regime<sup>33</sup> the number of employees does neither influence the internal, nor the external structure of a business, its decision-making, representation etc. In fact, given its versatile nature, this would otherwise have serious consequences on the manageability of the business. Since both close corporation and company are juristic persons unaffected by a change of its respective members,<sup>34</sup> this principle is even more important in respect of employees, who do not even stand in any corporate relationship to it.

Unsurprisingly employment figures as indicator for SMMEs is neither taken into account by the close corporations Act, nor the new Companies Act. The new

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29 See Lewis, K, *New Zealand SME owners: In it for 'lifestyle' or 'freestyle'?*, Published by the New Zealand Centre for SME Research, Massey University; accessible at [http://sme-centre.massey.ac.nz/files/10\\_Lewis.pdf](http://sme-centre.massey.ac.nz/files/10_Lewis.pdf) [last accessed 07/10/2010] at 1 f.

30 Freedman (note 11) at 126.

31 Freedman (note 11) at 133; the problem of outgrowing the legal form if SMMEs are defined in terms of employment figures is also mentioned by Naudé, SJ, *The need for a new legal form for small businesses*, Modern Business Law (1982), Vol. 4, 5 at 11.

32 Unless one takes into account the employees of the subsidiaries.

33 Such as in Germany, see for example § 1 I MitbestG and § 1 I Nr. 3 DrittelbG.

34 s. 2 (2) close corporationAct; less obviously s. 19 (1) (1) CompAct.

Companies Act acknowledges, however, that the size of the workforce is a factor that has to be taken into account in order to determine a public interest in certain additional regulations. Therefore the minister has to consider the size of the workforce when prescribing the categories of companies that need to have a social and ethics committee<sup>35</sup> and private companies that are required to have their annual financial statements audited.<sup>36</sup> These are clearly not provisions intended to apply to SMMEs. To the contrary they are drafted for large companies whose number of employees amount to certain “*economic or social significance*”.

## II. Financial Criteria

In order to more accurately depict the economic power of an enterprise, several financial indicators such as the annual turnover or balance-sheet, can be used to define SMMEs. Obviously the relevant threshold varies significantly from economy to economy. Table 2 compares the relevant thresholds of the SBA and the EU recommendation:

Table 2: SMME defined by annual turnover

	SBA	EU Recommendation
Micro:	< R 0,2m <sup>1)</sup>	≤ € 2m (ca. R 20m) <sup>3)</sup>
Very Small:	< R 0,5-6m <sup>1)2)</sup>	-
Small:	< R 3-32m <sup>1)</sup>	≤ € 10m (ca. R100m) <sup>3)</sup>
Medium:	< R 5-64 <sup>1)2)</sup>	≤ € 50m (ca. R 500m) <sup>3)</sup>

<sup>1)</sup> The Schedule of the SBA-A does no longer specify if the relevant criterion requires 'less than' or 'up to' the specific number. In accordance with the old schedule of the SBA it is assumed that the adjunct 'less than' has simply been forgotten.

<sup>2)</sup> Depending on sector.

<sup>3)</sup> At a simplified exchange rate of 1:10.

Additionally the SBA also uses the total gross asset value (excluding fixed property) to determine SMMEs. This criterion is not used by the EU recommendation for micro and small enterprises, but defines medium enterprises

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35 s. 72 (4) (b) CompAct

36 s. 30 (7) (a) in association with (2) (b) (i) (bb) CompAct.

as having a balance sheet total of less or equal to € 43m either in combination with *or* substituting the above mentioned annual turnover.

Financial indicators are more adequate than employment figures to determine economic power and thus smaller and bigger businesses in this sense. Furthermore it is unlikely that entrepreneurs deliberately try to avoid an annual turnover exceeding the relevant threshold, even if they are 'lifestyle businesses. Firstly because growing turnover is perceived as positive even if the business itself is not supposed to grow further. And secondly because the turnover cannot be influenced as easily as the employment figures. This points to the major disadvantage of this indicator for purposes of corporate law: all financial indicators are highly prone to changes and even more fluctuating and less influencable than the number of employees. Linking requirements for the corporate structure etc. to financial indicators would mean that the way the business is run might change without any deliberate decision taken by either the management or the owners.

So even though financial criteria are helpful to determine economic power and can help identify businesses for purposes of for example business developmental schemes, taxation, auditing etc., it is not suitable to determine its internal corporate structures.

Like employment figures financial indicators are not mentioned in the close corporations Act and under the new Companies Act only help to determine the public interest for additional regulations concerning private companies.<sup>37</sup>

### ***III. Membership Structure***

A less obvious indicator for SMMEs is its membership structure. It is often held that the 'criterion of independence'<sup>38</sup> is for example part of the SMME definition laid out by the EU Commission recommendation.<sup>39</sup> Even though this is probably misinformed<sup>40</sup> the composition of a business generally is a useful indicator for the

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37 See above; s. s. 30 (2) (b) (i) (aa) and s. 72 (4) (a) CompAct.

38 The SMME needs not to be owned as to 25% or more in terms of voting rights or shares by another enterprise.

39 See Lundström/Stevenson at 90.

40 Art. 3 (2) and (3) of the Annex to the Recommendation 2003/361/EC merely state that the employment figures and annual turnover of partner and linked enterprises have to be taken into account when determining the headcount and

purposes of corporate law.<sup>41</sup>

Unfortunately the empirical data on the ownership structure on SMMEs is surprisingly scarce. This is even more surprising, since recent corporate law reforms in the European Union, Germany, the United States, the United Kingdom and of course South Africa were intended to foster growth in this very sector. However, older research studies in the United States<sup>42</sup> and the United Kingdom<sup>43</sup> have shown that SMMEs are indeed typically closely held. The latter study found that the “*vast bulk of companies are private*”<sup>44</sup> and “*90% have fewer than 5 shareholders*”<sup>45</sup>, indicating that in fact most businesses are closely held – not just (but especially) SMMEs.

This supports the widely held assumption that SMMEs are very closely held, if not family-owned.<sup>46</sup> In accordance with widely used common-law definitions<sup>47</sup> a closely-held corporation has a small number of stockholders, is not publicly trading its shares and all (or a large portion of the) shareholders participate in the management.

Of course the membership structure *per se* has no effect on an enterprise's 'size', e.g. its economical power or significance. But probably size of any kind is not the most important factor for purposes of corporate legislation anyway. As mentioned above most size-indicators are prone to changes and improper for the purposes of corporate legislation. Moreover, the structure of membership is of utmost relevance for the internal structure of any business. If the members stand in no particular relationship to each other and the business, but merely want to invest capital, the structure of public companies seems most appropriate. Corporate law in this case has to deal with problems of separation of ownership and control and

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financial ceiling set out in Art. 2. The same principle was set out in the previous Recommendation 96/280/EC.

41 Freedman (note 8) at 567.

42 Hochstetler, W / Svejda, M, *Statutory Needs of Close Corporations – An Empirical Study: Special Close Corporation Legislation or Flexible General Corporation Law?*, 10 *Journal of Corporation Law* (1985), 849.

43 Freedman (note 11).

44 Freedman (note 11) at 126.

45 Freedman (ibid).

46 USAID, *SME Lending in Africa: Challenges, Current Trends and USAID Initiative*, USAID Briefing paper of September 2008 at 6; Graham, JP, *Convincing SMEs to always have a global perspective*, *The Gateway Newsletter* (1999), Vol. 4, Issue 6.

47 See Gitlin, B, *When is Corporation Close, or Closely–Held, Corporation Under Common or Statutory Law*, 111 *American Law Reports* (2003) 5th, 207 at § 2 [a] with further references to court decisions concerning the definition of closely-held corporations and companies.

minority protection. On the other hand where the few members know and trust each other it becomes more important to focus on the protection of outsiders and to offer simple internal procedures between members and management. This is most obvious for businesses with only one member who is simultaneously managing.

So if empirical data and common sense show that SMMEs are typically closely-held any policy catering for the corporate needs of such membership structures is favourable for small businesses. The more corporate law anticipates the needs of small businesses, the more it helps reduce their transaction costs.<sup>48</sup> It is therefore permissible to assume that, as far as corporate law is concerned, the needs of SMMEs and those of closely-held businesses overlap to a very large degree. This assumption is also shared by policy makers that regularly seek to address the needs of SMMEs by focussing on the corporate needs of closely held businesses.<sup>49</sup>

Besides being the single most important factor for the internal structure of any business entity, the membership structure seems to have another major advantage over the above-mentioned indicators: it is a fixed criterion that is easy to determine. Unless the members themselves deliberately choose otherwise it is not going to change.<sup>50</sup> And even though the need to change the membership structure can be forced upon the business by unforeseen circumstances<sup>51</sup> this is never going to happen unnoticed, as it might be the case with less influencable indicators.

Having said that for the purpose of corporate law small and medium businesses are best classified as closely held structures,<sup>52</sup> there are several ways to provide adequate legislation for them. Ultimately the question is if a single, flexible Act or a separate close-business act is preferable. This is going to be discussed in greater

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48 Lower, M, *What's on offer? A consideration of legal forms available for use by small- and medium-sized enterprises in the United Kingdom*, 24(6) *Company Lawyer* (2003), 166.

49 McCahery, JA / Vermeulen, EMP, *The Evolution of Closely Held Business Forms in Europe*, 26 *Journal of Corporation Law* (2000-2001), 855 at 856 f.; Gower, LCB in: Department of Trade of the United Kingdom, *A New Form of Incorporation for Small Firms – A Consultative Document*, Command Paper 8171 (1981), presented to Parliament in February 1981 at 29.

50 Leaving aside the death of a member.

51 Freedman (note 11) at 134.

52 Naudé (note 31) at 11 also stated that “[n]o restriction can be imposed in regard to turnover, balance sheet value of assets or number of employees.”

detail in chapter D.II.2 below.

## C. Legal Framework for SMMEs in South Africa

That SMMEs can often be conflated with closely-held businesses is not a new insight. In fact many legislations around the world have experimented with either separate or highly flexible corporate law regimes especially for closely-held businesses. The following chapters briefly outline the South African history of small-business legislation, the regime of the close corporation and that of the new Companies Act.

### I. Short History of Corporate Legislation

History does not repeat itself. Or does it? Astonishingly many arguments that have been brought forward in the current debate about South African, British and German corporate law have been used many decades before. Therefore the following chapters do not just offer a retrospection of South African corporate law that might (or might not) be interesting from a historical perspective. It also helps setting the stage for the discussions of today.<sup>53</sup>

#### 1. Prior to the Close Corporation

From the Companies Limited Liabilities Act No 23 of 1861 of the Cape Colony on, the South African company law remained to a large extent in the mould of English law.<sup>54</sup> From these early times on company law did little to cater for the needs of smaller businesses. The only effort in this sense has been the “*distinction between public and private companies, exempting the latter from some of the Act's requirements.*”<sup>55</sup> But the basic system, especially concerning structure and

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53 Vestal, AW, *Business Law Reform in South Africa: The Right Path, the Right Reason*, 91 Kentucky Law Journal (2002-2003), 829 at 830.

54 Department of Trade and Industry (DTI), *South African Company Law for the 21<sup>st</sup> Century: Guidelines for Corporate Law Reform*, Government Gazette (GG) 26493 Vol. 468 (June 2004) at 12; even though the South African Companies Act of 1973 may have significantly weakened this special relationship, see Mongalo, T, *South Africanizing Company Law For a Modern Competitive Global Economy*, South African Law Journal (2004), 93 at 98.

55 Naudé (note 31).

reporting requirements, remained the same.<sup>56</sup> Furthermore, the few exemptions for small (private) businesses were not easy to discover in the complex Companies Act, especially for business owners who could not afford professional advice.<sup>57</sup>

The main problems identified by Naudé<sup>58</sup> were that

- Formation formalities (submission of memorandum and lengthy articles) and audit requirements were the same for small and big companies,
- statutory requirement for a board of directors and the formal distinction between directors and members and division of power between the two were inappropriate for closely-held companies.
- the multitude of formalities (calling of meetings, adoption and registration of various types of resolutions, minutes, proxies and representatives etc.) was too burdensome and complex for unsophisticated entrepreneurs.

But company law in South Africa used to be not only complex because of the legislative basis, but also because of the massive body of case law and common law.

## 2. The Close Corporation

There was growing awareness that the orientation towards incorporation of capital rather than that of persons was a major structural deficit of the inherited company law. As Naudé, strenuous advocate for the yet to be established close corporation, pointed out: the *“problem is the fact that we (like England but in contrast to all continental European systems) still have a single Companies Act to provide for the needs of all companies irrespective of size, membership and economic function – from the professionally managed conglomerate giant with listed shares and a complete separation between ‘ownership and control’, to the small family undertaking or one-man business.”*<sup>59</sup>

Simply extending exemptions for smaller companies would just have added to the complexity of the Act and would have not been appropriate to encourage small

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<sup>56</sup> DTI (note 54) at 15.

<sup>57</sup> Naudé (note 31) at 6.

<sup>58</sup> Naudé (ibid).

<sup>59</sup> Naudé (note 31). The comparison of the continental European System (notably the German GmbH) and the close corporation is being dealt with in chapter E. below.

businesses in the long run.<sup>60</sup> After all the confusing and complex regulatory regime of the Companies Act was one of the main concerns. Therefore catering for the needs of both listed companies and small businesses in one act was deemed to be quite impossible.<sup>61</sup>

To overcome the structural defect of the Companies Act 1973 in regards of small businesses in 1981 the South African Standing Advisory Committee on Company Law recommended the creation of a new business form for small businesses.<sup>62</sup> What was about to become the arguably most significant departure<sup>63</sup> from the United Kingdom judicial system was ironically inspired by a UK draft prepared by Professor Gower<sup>64</sup> that was – even more ironically – never implemented in the United Kingdom itself.<sup>65</sup>

The Committee suggested the introduction of a new business entity with a limited number of “10, if not less”<sup>66</sup> members and, to avoid circumvention and difficult rules for group formation, a membership limited to natural persons.<sup>67</sup> To emphasise its purpose of small, closely held business vehicle names such as “small business corporation”, “close company”, “partnership company” and “corporate partnership” were considered,<sup>68</sup> but due to international fashion it was finally decided on close corporation.<sup>69</sup> Since the introduction of the close corporation on 1<sup>st</sup> January 1985 only few Amendment Acts have been necessary.

Indisputably the story of the South African close corporation is one of great success.<sup>70</sup> In January 2010 there were more than 1,5 million close corporations listed as active entities in South Africa, whereas only just under 200.000 active

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60 Naudé, SJ, *Beslote korporasie: Die voorgestelde ondernemingsvorm vir kleinsake*, Modern Business Law (1983), Vol. 5, 62 at 63.

61 Naudé (note 2) at 5.

62 Du Plessis, JJ, *Reflections and Perspectives on the South African Close Corporation as Business Vehicle for SMEs*, New Zealand Business Law Quarterly (2009), Vol. 15 (Dec.), 250 at 251.

63 DTI (note 54) at 12.

64 Gower (note 49) annex A.

65 DTI (note 54) at 12.

66 Naudé (note 31) at 11; Gower (note 49) at 29 earlier considered whether “a membership of 20 is not too large”.

67 With some negligible exceptions; see Naudé (note 31) at 11 and Naudé (note 60) at 64;

68 Naudé (note 31) at 6, fn. 7.

69 Naudé (note 60).

70 Henning (note 8) at 777 labels the close corporation “one of the most remarkable innovations in South African entrepreneurial law.”

private companies were registered.<sup>71</sup> This indicates that the close corporation today is “*overwhelmingly the business form of choice for small businesses.*”<sup>72</sup>

However, since the close corporation only provides for closely held businesses – not necessarily being small in regards to employment figures or financial indicators,<sup>73</sup> up to 1996 there existed no coherent strategy specifically targeting SMMEs.<sup>74</sup> And even though the SBA provided a legal framework to aid SMMEs<sup>75</sup> from a government perspective, it did not affect the forms of incorporation provided for entrepreneurs.

### 3. Close Corporation Reaching a Crossroad

Resulting from the impression that the South African company law with its roots stuck in Victorian English law<sup>76</sup> was no longer appropriate for a modern South African economy<sup>77</sup> the Department of Trade and Industry (DTI) in 2004 embarked on a comprehensive review of company law.<sup>78</sup> Given the drastic changes within<sup>79</sup> and outside<sup>80</sup> South Africa since the only major reform of company law in 1963 the time seemed ripe for such an extensive overhaul. The DTI expresses, amongst others, the goal of “*encouraging entrepreneurship and enterprise diversity by simplifying the formation of companies and reducing costs associated with the formalities of forming a company and maintaining its existence, thereby contributing to the creation of employment opportunities.*”<sup>81</sup>

In the spirit of a truly comprehensive review<sup>82</sup> the DTI did not only focus on the

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71 CIPRO Web Statistic of January 2010, accessible at [http://www.cipro.co.za/about\\_us/Web\\_Statistics\\_Version5.pdf](http://www.cipro.co.za/about_us/Web_Statistics_Version5.pdf) (last accessed 24/2/2010)

72 Du Plessis (note 52) at 254.

73 See chapters B.I and II above.

74 See Snyman, E / Henning, JJ, *The National Small Business Act, 1996 from White Paper to Statute: creating and enabling statutory environment for small, medium and micro enterprises in South Africa*, 23 *Journal for Juridical Science* (1998), 54.

75 Especially through the creation of the National Small Business Council, s. 2 SBA and the Ntsika Enterprise Promotion Agency, s. 9 SBA.

76 DTI (note 54) at 12.

77 DTI (note 54) at 7.

78 An excellent overview of the reform process is provided by Mongalo, T, *An overview of company law reform in South Africa: From the Guidelines to the Companies Act 2008*, *South African Law Journal* (2010), xiii.

79 Most notably of course the transition to a constitutional democracy and open economy, DTI (note 54) at 7.

80 The DTI (note 54) at 7 mentions the company law reviews in other countries, for example the United Kingdom, and the series of spectacular failures due to a lack of corporate governance.

81 DTI (note 54) at 9.

82 A “far-reaching fundamental revamp of the corporate legislation for South Africa”, as Mongalo (note 78) at xv puts

Companies Act of 1973, but included the close corporations Act of 1984 and the respective Common Law for both entities.<sup>83</sup> The outcome of the review – especially concerning the future of the close corporation – has been “surprising”<sup>84</sup> for many scholars. Many believed that the close corporation would be retained “*in view of its track record and the undoubted success of the concept of the close corporation as an ideal form of corporate enterprise for small businesses.*”<sup>85</sup> But the DTI decided otherwise. It “*believes that the regime in the new Companies Act for forming and maintaining small companies, which has drawn on the characteristics of the close corporations Act, is sufficiently streamlined and simplified as to render it unnecessary to retain the application of that [close corporations] Act for the formation of new corporations.*”<sup>86</sup> Hence schedule 3 CompAct amending s. 1 (1) close corporationAct provides that no new close corporation can be incorporated as soon as the new CompAct enters into force.<sup>87</sup>

With the decision to abandon the system of the close corporation and provide a single, flexible corporation vehicle – the company – for all businesses, South Africa follows the example of the United Kingdom.<sup>88</sup> Like South Africa the United Kingdom felt the need to review its existing company law which led to the final report of the company Law Reform Steering Group (CLRSG) in 2001.<sup>89</sup> Certainly this review has been of assistance for the South African reform<sup>90</sup> and in fact the DTI explicitly refers to the CLRSG's strategic framework.<sup>91</sup>

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it. But Cassim, R / Cassim, F, *The Reform of Corporate Law in South Africa*, International Company and Commercial Law Review, ICCLR 2005, 16 (10), 411 at 411 rightly point out that “partnership law is sadly not included” in the review.

83 DTI (note 54) at 9.

84 Du Plessis (note 52) at 268.

85 Correspondence from Dean Johan Henning to Cally Jordan dated August 29, 1998, cited through Jordan, C on behalf of the Department of Trade and Industry of the United Kingdom, *Modern Company Law for a Competitive Economy. An International Survey of Companies Law in the Commonwealth, North America, Asia and Europe*, Published August 1998, accessible at <http://webarchive.nationalarchives.gov.uk/tna/+http://www.dti.gov.uk/cld/jordan.pdf/> [last accessed 07/10/2010] at 53.

86 Memorandum on the Objects of the Companies Bill, 2008 chapter 2 at 188.

87 According to unverified reports this is supposed to happen in the third quarter of 2010. Ironically due to a technical error on the website of the Companies and Intellectual Property Registration Office (CIPRO) it is already impossible to conveniently register a close corporation online since April 2010.

88 The Company Law Reform Steering Group (CLRSG) of the United Kingdom, *Modern Company Law – For a Competitive Economy (Final Report Vol. 1)*, DTI, Company Law Review: Final Report, URN 01/942 of July 2001 at 2.7.

89 CLRSG (ibid.)

90 Mongalo (note 54) at 98.

91 DTI (note 54) at 24 ff.

This leaves an odd impression. It seems at first glance that only thirty years after Naudé tackled the British influenced one-size-fits-all company, the DTI by modernizing company law takes South Africa back to square one.

In the following chapter D. it is going to be assessed whether the new Companies Act is a favourable one for small businesses in South Africa. But to begin with it is necessary to take an inventory of the law that had been and is going to be provided for SMMEs in South Africa.

## ***II. Structure of the Close Corporation***

This chapter briefly outlines the structure of a close corporation according to the close corporations Act 69 of 1984 that is planned to be faded out over the next few years.

### **1. Legal Personality**

On its registration the close corporation becomes a juristic person<sup>92</sup> and acquires the capacity and powers of natural persons, as far as they are applicable.<sup>93</sup> In contrast to partnerships the close corporation has thus a legal personality separate from those of its members.<sup>94</sup>

This has far reaching consequences for the structure of the close corporation: First and foremost the members are not liable for the liabilities of the close corporation merely because of their membership.<sup>95</sup> This is the logical and – as far as the members are concerned – most desirable consequence of a separate personality. All rights and duties ultimately have to be attached to a legally capable person in order to exist. In the case of a partnership only the members (partners) can acquire rights and be liable for duties. Therefore it is necessary to attribute any 'conduct' of the partnership to its members, because the partnership itself has no personality and is nothing but a contractual relation between the partners. But as soon as there exists a separate legal personality, as it is the case for the close corporation,

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92 s. 2 (2) CCAct.

93 s. 2 (4) CCAct.

94 Cilliers, H et al, *Close Corporations Law*, 3<sup>rd</sup> ed., Butterworths (Durban) 1998 at 15.

95 s. 2 (3) CCAct.

nobody is *per se* liable for actions by this separate person.<sup>96</sup>

Having said that the close corporation is liable for 'its' conduct it is evident that the personal responsibility of the members for their own actions is unaffected.

## 2. Formation

Granting legal capacity to an artificial business construct and thus creating a juristic person is not a power vested in private persons. This quite extraordinary act can only be performed by the State. Therefore a close corporation has to be registered at the close corporation registration office in Pretoria<sup>97</sup> in order to be vested with legal personality.<sup>98</sup> To be registered the completed founding statement<sup>99</sup> and written consent of the first accounting officer<sup>100</sup> in triplicate and the application for reservation of name in duplicate<sup>101</sup> has to be lodged with the registrar and the prescribed fee (currently ZAR 100)<sup>102</sup> needs to be paid.<sup>103</sup>

Following the anglo-american tradition and in contrast to many continental-European jurisdictions the incorporation of a legal person (and with it the limited liability) is not dependent on a certain minimum capital.<sup>104</sup>

Given that the formation (and continuation) of a close corporation is an act of State the requirements for its formation are not subject to modification by the founding members. If any subsequent alteration or addition of matters important to the founding statement occur, the amended founding statement needs to be lodged with the registrar.<sup>105</sup>

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96 In absence of a special relationship.

97 s. 3 (1) CCAct.

98 s. 2 (2) CCAct provides that a close corporation is a juristic person only '*on registration*' (emphasis added).

99 s. 12, Form CK1.

100 s. 12 (g) (i) CCAct.

101 Form CK7.

102 Schedule 1 of the close corporations Administrative Regulations.

103 s. 13 CCAct.

104 In contrast to the GmbH; see chapter E. below.

105 s. 15 (1) and (2) CCAct.

### 3. Membership / Internal Relations

The internal structure of a close corporation is quite flexible as a result of the perceived close personal and fiduciary relationship between the members that resembles that of a partnership.<sup>106</sup> The largely flexible internal structure serves the purpose of creating a simple business vehicle and thus most provisions dealing with internal relations are not compulsory and can be altered by a written association agreement.<sup>107</sup> It is this flexibility and personalisation of a partnership combined with the limited liability of a company that makes the close corporation very attractive for small entrepreneurs.

The members can for example determine the quantum of a member's interests<sup>108</sup> as well as the nature and value of their respective contributions.<sup>109</sup> It is neither compulsory to link the interest to the contribution made by each member,<sup>110</sup> nor to link the voting rights to the percentage of interest.<sup>111</sup> The default structure in absence of an association agreement is outlined in s. 46 and provides for equal rights to participate in the carrying out of the business, as well as a democratic process of decision-making in which the number of votes correlates with the respective interest of each member. Like in a partnership there neither exist different organs, nor a distinction between directors and members, thus preventing a separation of ownership and control.

The agreement is a purely internal matter between the members<sup>112</sup> not affecting the external relationships. There are, however, certain peremptory provisions distinctive for a close corporation, especially concerning membership and member's duties.

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106 Cilliers et al (note 94) at 15.

107 s. 44 CCAAct, see also Cilliers et al (note 94) at 24.

108 As long as all interests expressed as a percentage combined equals 100%, s. 38.

109 s. 24 (1) and (2) CCAAct; as a direct result from the renunciation of a minimum capital even services qualify as contribution.

110 Cilliers et al (note 94) at 35.

111 s. 46 (a) CCAAct.

112 See s. 45 CCAAct stating that no third party is entitled to inspect the association agreement and is conversely not deemed to have known any of the provisions of the agreement.

### ***a. Limited Number of Members***

As its name implies a close corporation is a closely held corporation with a close relationship between the members. Thus the number of members is limited to a maximum of ten.<sup>113</sup> As yet another consequence of the close corporation's separate legal personality it can be formed with just one member,<sup>114</sup> because in contrast to a partnership no contractual basis is needed, which necessarily requires at least two parties.<sup>115</sup>

### ***b. Only Natural Persons***

To avoid circumvention of company law and to avoid difficult rules for group formation for the sake of simplicity,<sup>116</sup> the membership is furthermore limited to natural persons<sup>117</sup> with some negligible exceptions.<sup>118</sup>

### ***c. Fiduciary Duties / Duty of Care and Skill***

Even though there is no separation of ownership and control *per se*,<sup>119</sup> members of the close corporation have fiduciary duties<sup>120</sup> and the duty of care and skill.<sup>121</sup> Flowing again from the separate legal personality of the close corporation, the members stand in a fiduciary relationship to the corporation itself<sup>122</sup> – not to the other members, because they act as agents for the Corporation.<sup>123</sup> Even though the exact scope of fiduciary duties of members remains unclear, the fiduciary duties of directors enunciated by the courts provide certain guidance.<sup>124</sup>

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113 s. 28 CCAct.

114 s. 28 CCAct.

115 See for example Cilliers et al (note 94) at 15.

116 Naudé (note 31) at 11 and Naudé (note 60) at 64.

117 s. 29 (1) CCAct., see further Naudé (note 31) at 11; Naudé (note 60) at 64.

118 s. 29 (2) (b) and (c) CCAct.

119 s. 46 (a) CCAct; Cilliers et al (note 94) at 52.

120 s. 42 CCAct.

121 s. 43 CCAct.

122 s. 42 (1) CCAct.

123 Members are generally vested with the power to bind the close corporation according to s. 54 CCAct; on external relations see below at 4.

124 Cilliers et al (note 94) at 52.

## 4. External Relations

As any juristic person the close corporation can only act through agents. The urge to create a simple business entity is most apparent when it comes to the question who can act as such an agent: any member can principally bind the corporation towards a *bona fide* non-member dealing with the corporation.<sup>125</sup> This simple rule is unaffected by questions of internal relations (if for example the member is precluded from carrying out the business by an association agreement) and even by the scope of the corporation's business,<sup>126</sup> as long as the external person was in good faith.<sup>127</sup>

This clear-cut rule even renders the application of the fairly complicated *ultra vires* doctrine unnecessary and helps to further simplify external relations of close corporations.<sup>128</sup>

## 5. Liability

Members are generally not liable for the debts of the close corporation – hence the limited liability. However, members (and other persons) can become jointly and severally personally liable with the corporation<sup>129</sup> if certain provisions of the close corporations Act are breached, such as correct use of the corporation's name (esp. the affix),<sup>130</sup> requirements for membership<sup>131</sup> and management,<sup>132</sup> as well as the provisions concerning solvency and liquidity,<sup>133</sup> as long as the person knew about this incident. Furthermore any responsible person is liable for reckless or fraudulent carrying-out of the business,<sup>134</sup> as well as abusing corporate juristic personality.<sup>135</sup>

Given that the main sanction for irregular behaviour is the resurgence of the

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125 s. 54 (1) CCAct.

126 s. 54 (2) CCAct introduced by s. 13 of Act 26 of 1997, which replaced the previous dispensation that accepted such a limitation: see Cilliers et al (note 94) at 66.

127 s. 54 (2) CCAct; see further Cilliers et al (note 94) at 62 f.

128 Cilliers et al (note 94) at 62.

129 s. 63 CCAct.

130 s. 63 (a) CCAct.

131 s. 63 (d) CCAct.

132 s. 63 (g) CCAct.

133 s. 63 (e), (f) and (h) CCAct.

134 s. 64 CCAct.

135 s. 65 CCAct.

personal liability, the Act largely eschews criminal sanctions.<sup>136</sup>

### ***III. Structure of the Company***

This chapter briefly outlines the structure of a company according to the Companies Act No. 71 of 2008 (hereafter “the Act”). In this Act there are few specific rules and much less a comprehensive legal framework for small<sup>137</sup> or closely held<sup>138</sup> companies. For the purpose of this thesis the following description is limited to a profit company<sup>139</sup> that is privately held<sup>140</sup> and has a limited liability<sup>141</sup> (hereafter “company”).

#### **1. Legal Personality**

Like the close corporation a company is a juristic person distinct from its members (shareholders).<sup>142</sup> Consequently the company has the legal power and capacity to acquire rights and bear duties.<sup>143</sup> Persons affiliated with it (incorporators, shareholders or directors) are not solely because of their position liable for liabilities or obligations of the company.<sup>144</sup>

#### **2. Formation**

A company can be incorporated by one or more natural and/or juristic persons.<sup>145</sup> Given the primary function of effectively mobilising capital from the public,<sup>146</sup> the number of incorporators and shareholders is not limited any more.<sup>147</sup>

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136 Cilliers et al (note 94) at 76.

137 Most notably provisions in s. 30 (2) (b) (i) and (7), s. 72 (4) (a) and s. 118 (1) (c) (i) CompAct.

138 s. 45 (5) and 57 (4) CompAct.

139 s. 8 (2) CompAct.

140 s. 8 (2) (b) in contrast to a public company according to s. 8 (2) (d) CompAct.

141 s. 8 (2) (c) CompAct.

142 s. 19 (1) (a) CompAct. see also Knight, P, *Keep it simple and set it free: The new ethos of corporate formation*, Acta Juridica 2010: Modern Company Law for a Competitive South African Economy, 3 at 19 f.

143 s. 19 (1) (b) CompAct.

144 s. 19 (2) CompAct.

145 s. 13 (1) CompAct.

146 Cilliers, H et al, *Corporate Law*, 2<sup>nd</sup> edition, Butterworths (Durban) 1992 at 2.

147 s. 20 (1) (b) of the Act No. 61 of 1973 limited the number of members for any private company to fifty; see also Knight (note 142) at 10 f.

To incorporate a company the memorandum of incorporation<sup>148</sup> and the notice of incorporation<sup>149</sup> have to be lodged with the Companies and Intellectual Properties Commission established by s. 185 (1) and the fee has to be paid.<sup>150</sup> Internal structures previously set out in the now abolished articles of association<sup>151</sup> can be incorporated in the memorandum.<sup>152</sup> Although the regulations and forms have not yet been promulgated it is fair to assume that the formation of a company which required the completion and filing of 15 separate documents has been streamlined.<sup>153</sup>

### 3. Membership / Internal Relations

Both natural and juristic persons can become shareholders of a company. It consists of at least two organs, the general meeting of members<sup>154</sup> and at least one director.<sup>155</sup> This distinction has to be made even in companies where every shareholder is also director.<sup>156</sup>

The most prominent internal feature of the company is its division of corporate functions between organs. The exact allocation of powers to each organ is determined by the company's memorandum of incorporation<sup>157</sup> and incidental rules,<sup>158</sup> as long as they are not contrary to compulsory rules of the Act.<sup>159</sup>

Since the shareholder are not the company itself,<sup>160</sup> once certain powers have been referred to the director by the memorandum of incorporation they can be

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148 s. 13 (1) (a) CompAct.

149 s. 13 (1) (b) CompAct.

150 s. 13 (2) (a) CompAct.

151 s. 59 ff. Act No. 61 of 1973.

152 See below.

153 See Knight (note 142) at 13.

154 Which might very well consist of one single shareholder, s. 13 (1).

155 According to s. 66 (2) a private company only needs to have one director. In this case s. 57 (3) (a) provides that the single director can perform "any function of the board". By way of legal fiction the single director – even though he is not a board of directors – is vested with the powers of such a board and the company thus can act as if it had a multi-directorial board (with notable exceptions from formalities). Because of this legal fiction it would probably be incorrect to assess that the board of directors is a compulsory organ of any company.

156 s. 57 (4) (a) CompAct only exempts from certain formalities, but does not depart from the strict distinction between the organs.

157 s. 15 (2) CompAct.

158 s. 15 (3) CompAct.

159 s. 15 (1) CompAct.

160 Contrary the aged authority of *Isle of Wight Railway Co v. Tahourdin* (1883) 25 ChD 320, but this distinction is nowadays undisputed, see Cilliers et al (note 146) at 79 f.

exercised only by them.<sup>161</sup> Although the shareholder can alter the allocation of powers after the company has been incorporated this requires time and money consuming amendment of the memorandum of incorporation according to s. 16 and does not affect the rights retrospectively.

The division of corporate powers has consequences for shareholders that are at the same time directors, as it may often be the case in smaller companies. Depending on their actions they are either acting in their role as shareholder (e.g. amending the memorandum of incorporation), or as director (e.g. management decisions) with varying rights and duties.<sup>162</sup>

#### ***a. Shareholder***

First and foremost the shareholder hold the power to structure the company, its organs and their respective capacities through the memorandum of incorporation.<sup>163</sup> After the company has been incorporated they mainly have four distinctive rights whose exact scope is set out in the memorandum: the right to capital remaining after the winding up, the right to income (esp. in form of dividends), the right to vote and the right to be informed.<sup>164</sup>

#### ***b. Director(s)***

Although the Act does not assign particular tasks to the board of directors the “*business and affairs of a company must be managed by or under the direction of its board.*”<sup>165</sup> This emphasises that management is the primary responsibility of the board. Strengthening its position s. 66 (1) now provides explicitly that, unless the memorandum of incorporation specifically allots powers to other persons or organs, the board has the “*authority to exercise all of the powers and perform any of the functions of the company*”.

Being the prime organ to act for the company puts the board and its members in a

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161 *Scott v. Scott* (1943) 1 All ER 582, an authority most probably also relevant for South Africa, Cilliers et al (note 146) at 82.

162 See chapter D.II.1.b.aa below.

163 s. 16 (1) (c.) CompAct.

164 See DTI (note 54) at 37 f.

165 s. 66 (1) CompAct.

fiduciary relationship to the company.<sup>166</sup> Even though some of the duties of directors under common law have now (partly) been codified in the Act,<sup>167</sup> the principles of common law largely remain applicable.<sup>168</sup> Additionally directors must exercise their powers with skill and care.<sup>169</sup>

#### 4. External Relations

The legal powers and capacity of a company can be limited by the memorandum of incorporation,<sup>170</sup> usually restricted by an objects clause to the type of business carried out by the company.

Additionally to the provisions of the Act and the memorandum some rules of common law important for external relations still remain applicable although they have partially been modified. For example according to the common law rule of the *ultra vires* doctrine<sup>171</sup> any action beyond the scope of the objects clause used to be null and void. This harsh consequence is eased by s. 20 (1) (a)<sup>172</sup> providing that “*no action of the company is void by reason only that [...] the action was prohibited by that limitation, restriction or qualification (in the memorandum) [...].*” This section only applies to limitations of capacity laid out in an objects clause according to s. 19 (1) (b) (ii) CompAct and does not affect other rules relating to agent's authority.<sup>173</sup> Of course the directors remain internally bound not to act outside the scope of the objects clause in order to avoid liability towards the company.<sup>174</sup>

Like any juristic person the company acts through agents who need to have the relevant authority in order to bind the company. The authority is set out in the memorandum and can be granted to directors, members, employees and even third

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166 Cilliers et al (note 146) at 135 f., not towards a specific individual or group of shareholders.

167 e.g. s. 76 (2) CompAct.

168 s. 77 (2) (a) CompAct.

169 s. 76 (3) (c) CompAct.

170 s. 19 (b) (ii) CompAct 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*”.

171 See Cilliers et al (note 146) at 174 f.

172 In accordance with its predecessor norm s. 36 Companies Act No. 61 of 1973.

173 Under the Companies Act No 61 of 1973 a distinction could be made as to whether the limitation was set out in the memorandum (objects clause) or in the articles of association (agent's authority), see Cilliers et al (note 146) at 179f. With the conflation of memorandum and articles this distinction can no longer be made. However, it is still helpful to decide whether a limitation concerns the object of the company, or its structure and agency.

174 Blackman, MS, *Directors' Duty to Exercise their Powers for an Authorised Business Purpose*, 1990 SA Mercantile Law Journal, 1 at 9 f.

parties. The limitations, restrictions and qualifications of authority<sup>175</sup> are unaffected by s. 20 (1) (a) and in their regard the common law doctrine of constructive notice and its limitation, the *Turquand* rule, are still applicable.

## 5. Liability

Certain wrongdoing, such as reckless or fraudulent conduct, constitutes an offence under the Act.<sup>176</sup> The consequence of being convicted of such an offence is liability to a fine and/or imprisonment,<sup>177</sup> but not to the debts of the company as a whole. In order not to leave the enforcement to the shareholders and the liquidator<sup>178</sup> the Act abandons the mechanism of waiving limited liability<sup>179</sup> as sufficient penalty for misconduct. Claims for loss and damages against certain individuals are of course unaffected by these provisions.

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175 Such as the requirement to have a contract jointly signed by two directors.

176 ss. 213 (1), 214 (1) CompAct.

177 s. 216; although the Act has been significantly de-criminalised, as Henning, JJ, *The new South African Companies Act – an Overview of some of its salient Features: Part 2*, Company Lawyer (2009), 336 at 338 f. notes.

178 DTI (note 54) at 46.

179 s. 424 (1) of the Companies Act No. 61 of 1973; further van der Linde, K, *The Personal Liability of Directors for Corporate Fault – An Exploration*, SA Mercantile Law Journal (2008), 439 at 443 f.

## D. Thinking Small Further?

### *I. Accessible and Comprehensible Legislation*

Like with any major legal reform the drafters of the new Companies Act claimed that the “*new company law should be simple, comprehensible and accessible to business people and their advisors.*”<sup>180</sup> The urge for simplicity also encouraged the drafting of the close corporations Act some thirty years earlier.<sup>181</sup> And in fact simple and comprehensible legislation is not only the noble goal of any reasonable legislator, but also especially important for small business owners, because it helps to significantly reduce their costs of legal advice.<sup>182</sup>

But simplifying legislation is rendered quite useless if few people are going to read the law. It has been argued that since most “*company owners do not read their own memorandum and articles, they will not read the legislation*”<sup>183</sup> either. It is true that legal and administrative papers are closed books to large parts of the population. The specialised legal vocabulary, the myriad of sub-sections and references indeed look intimidating to non-professionals (and often to professionals alike). But inferring from this fact that law needs not to be clear and accessible confuses cause and effect. Precisely because many laws and regulations are drafted in an inaccessible way they are only consulted by specialists who are paid to do so. Comprehensible legislation furthermore is required by the rule of law. Therefore the fact that few people read the law should be seen as an incentive to simplify law. And even if most people do not consult the legislative text or the memorandum until problems arise – as soon as they do it is helpful to find clear rules without having to dig deep into muddy sections. This holds truth for all sectors of law, but is even more urgent for small businesses, because they lack in-house expertise<sup>184</sup> and often cannot afford to consult expensive specialists.<sup>185</sup>

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180 DTI (note 54) at 27.

181 See above chapter C.I.

182 Freedman (note 11) at 132.

183 Freedman (note 8) at 565.

184 Freedman (note 11) at 132.

185 Naudé (note 31) at 6.

Simple legislation does not necessarily mean short legislation.<sup>186</sup> But although 'physical brevity' should not be seen as the main objective<sup>187</sup> it certainly helps to overcome one's inhibition to consult the Act in the first place. However, simple and accessible legislation is more about "*the language used, the manner in which the provisions are drafted and [...] the grouping of subject matter [...]*".<sup>188</sup> So even if the new Companies Act consists of 225 sections compared to 83 sections of the close corporations Act, these figures tell little about the actual simplicity, comprehensibility and clear language. It should not be necessary to "*plough through all the legislation*"<sup>189</sup> in order to ascertain the relevant provisions. The following chapters briefly examine the Companies Act 71 of 2008 (chapter 1) and the close corporations Act (chapter 2) in this regard. Finally a topic related to simple legislation of high importance for SMMEs is being dealt with: the standard form for incorporation (chapter 3).

## 1. The new Company

Since it has already been decided to phase out the close corporations Act more emphasis is being put on the new – and soon the only – legislative piece for small businesses: the new Companies Act 71 of 2008. This brand-new Act unfortunately fails the requirement of simple and accessible legislation to a large degree. Reading the Act one gets the impression that the default company is the widely-held public company. The provisions tailored for small and/or closely held businesses are buried in sub-sections<sup>190</sup> that are hard to trace. The criticism Gower expressed as early as 1981 on the UK Companies Act, namely that it is "*necessary to plough through all the legislation in order to ascertain which sections do not relate to private companies*"<sup>191</sup>, unfortunately holds some truth for the modern South African Companies Act of 2008 as well.<sup>192</sup>

It would have probably been better to follow the recommendations of the Steering Committee in the United Kingdom and structure the act "*in such a way that the*

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186 Freedman (note 11) at 132.

187 Freedman (note 8) at 566.

188 DTI (note 54) at 27.

189 Gower (note 49) at 25.

190 See chapter D.I.1 below.

191 see Gower, Cmnd 1981 at 25.

192 Du Plessis (note 52) at 270.

*provisions which apply to small companies are very much easier to find.*"<sup>193</sup> This could have been achieved by adding a separate section for private companies, by clearly stating in the title of each section if its provisions apply to private and/or public companies,<sup>194</sup> or by simply placing the private company, the most common type of companies in South Africa anyway,<sup>195</sup> in the centre of the Act and on top of each section. Additional requirements for public companies could have easily been added to those of the simpler private companies. Furthermore, starting with the most simple form and adding complexity is a more coherent system than starting with the most complex form and formulating exemptions every now then.

Simplicity and comprehensibility in the Companies Act is further aggrieved by the fact that Common Law still remains applicable.<sup>196</sup> Despite codifying some aspects of director's duties<sup>197</sup> to provide clear guidance to business people that do not have legal expertise,<sup>198</sup> other important rules remain in the realm of Common Law.<sup>199</sup> Why in these cases the unadvised business people need less guidance remains unclear.

But despite its problems, in the whole the new Companies Act is a huge leap forward towards a clear company law. The tendency to codify some of the most important rules of Common Law certainly is helpful for unsophisticated directors and shareholder alike. Moreover, the Act did not try to be as short as possible, but includes certain provisions that are strictly speaking not necessary from a legal point of view, but help to further clarify company law. For example s. 66 (1) CompAct now defines the role of directors and even provides a default provision concerning the authority to act for the company.

Yet the remaining complexity is particularly affecting the smaller private

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193 Department of Trade and Industry (DTI) of the United Kingdom, *Company Law Reform – White Paper*, Presented to Parliament in March 2005 at 4.1.

194 Apparently the method of choice for the DTI of the United Kingdom, see the draft clauses in the UK White Paper 2005 (ibid) and subsequently the UK Companies Act 2006.

195 See the statistics provided by the Companies and Intellectual Property Registration Office (CIPRO) at [http://www.cipro.co.za/about\\_us/Web\\_Statistics\\_Version11.pdf](http://www.cipro.co.za/about_us/Web_Statistics_Version11.pdf) [last accessed 02/10/10], although the number of registered close corporations is in sharp decline as a result of the new Companies Act.

196 See s. 77 (2) (a) CompAct.

197 e.g. s. 76 (2) CompAct.

198 DTI (note 54) at 29; similar CLRSG (note 88) para 3.7.

199 For example the ultra-vires doctrine, the doctrine of constructive notice and the *Turquand*-rule; for details see Henning, company Lawyer 2009 II at 337.

companies. Whereas the just mentioned clarifications are favourable for all companies the exemptions for small and/or closely held companies are the ones that are hard to find. Again it seems that the new Companies Act was not drafted from the perspective of a small private company. Ironically the clarification and simplification that has undoubtedly been achieved fails those that most urgently need a simple and clear legislation. This failure is echoed by findings of a survey in the UK that found many small business owners are calling for separate provisions for different types of companies for these very reasons.<sup>200</sup>

## 2. Close Corporation

The most radical method of providing separate provisions for small businesses – and thereby more clarity – is the creation of a separate legal entity in a separate Act. Probably a reason why the South African close corporation is perceived as being a major success is that its regulations are fairly clear-cut. Focussing only on a closely-held, private corporations by natural persons, many rules relating to division of ownership and control, public offering of member's interests and group formation were dispensable, making the close corporations Act shorter and easier to read. As the inglorious Australian experience has shown the concept of a close corporation loses its popularity if burdened with much traditional company law and thus becoming too complex.<sup>201</sup> At the same time the close corporations Act provides default provisions resulting in a set of rules that does not need to be completed or altered in order to run the corporation.

However, even the South African close corporations Act is far from being ideal. The DTI for instance perceives it as still being “*highly formalistic in nature, making it difficult for unsophisticated entrepreneurs to commence business and ensure its effective management.*”<sup>202</sup> Moreover the scope and breadth of personal liability as a sanction for breaches of the close corporations Act might expose unsophisticated investors, that do not want to engage with the day-to-day running of the Corporation, to liability.<sup>203</sup> But on the whole the success of the close corporation proves it fairly accessible.

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200 Freedman (note 11) at 132.

201 Freedman (note 8) at 579.

202 DTI (note 54) at 16.

203 DTI (note 54) at 16.

### 3. Standard Form

Besides clear and simple legislation a standard form is of high importance for owners of SMMEs.<sup>204</sup> They tend to rather buy the desired form of incorporation “*off the shelf*”<sup>205</sup> than to have it tailored to their specific needs. Any company law catering for the needs of smaller businesses needs to provide a reasonable framework to begin with.<sup>206</sup>

The more knowledge and resources it takes to exploit the provided legislative regime, because it is either very flexible and / or inaccessible, the greater the need for a simple standard form. Such a standard form can significantly help reduce transaction costs caused by the Act. It is virtually the antidote to a toxically complex law. Furthermore it can potentially consolidate the urge for flexible legislation (for sophisticated experts) and simple regimes for small businesses. But since the standard form is going to serve as a quasi-Act for many entrepreneurs, it needs as much attention and consultation as the actual Act. It was initially intended to include a standard form for both profit and non-profit companies in the Companies Act. Due to reasonable concerns that being part of an Act would make future amendments much harder it was finally decided to promulgate the standard form by regulation.<sup>207</sup> The DTI issued a simple standard form for private companies as part of the draft companies regulations on the 21<sup>th</sup> of December 2009.<sup>208</sup> Even though this short memorandum of incorporation has not been specifically designed for closely-held companies it is certainly of great value for small entrepreneurs. On the downside the standard form uses many references to the provisions of the Companies Act, adding complexity where it would probably not have been necessary. Generally the standard form could have spelled out some of the provisions of the Act (probably using a more simple language) and thus helping identify the rights and duties of shareholders and directors to some degree. Article 3.5 (1) for example states that: “*The company is not required to hold any shareholders meetings other than those specifically*

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204 Freedman (note 11) at 132.

205 Freedman (note 11) at 132 f.

206 Freedman (note 11) at 133.

207 Knight (note 142) at 16.

208 Companies Regulations and Rectification of the Companies Act, Government Gazette Vol. 534, 22. December 2009 No. 32832, form CoR 16.1(A) at pages 185 f.

*required by the Companies Act 2008.*” without clarifying when the Act might require a meeting – or where one could find out. Hopefully language and referencing of the draft are going to be even more simplified in the process and probably even a closely-held standard form is going to be provided. Be it as it may – a simple standard form (such as proposed by the DTI) can certainly help to overcome some of the Act's shortcomings in terms of clarity and accessibility.

## ***II. No Artificial Regulations***

But even the most accessible legislation does more harm than good if the rules provided are not appropriate. The following chapters are going to examine what kind of legislative framework SMMs most likely need (chapter 1) and if a flexible one-company-fits-all approach or a separate corporate entity is preferable (chapter 2).

### **1. Which Legal Structure is Appropriate for SMMs?**

#### ***a. Limited Liability and Closely-Held Structures – a Contradiction?***

The company was designed as a vehicle for raising substantial amounts of capital. Therefore classical company law had to deal with the problems arising in public companies, esp. agency costs. Granting limited liability to the members of a company greatly decreases their risk in the event of business failure and thus reduces the cost of investing and monitoring.<sup>209</sup> It is therefore a prerequisite for any public company. But if limited liability is not an end in itself, but merely a *conditio sine qua non* for attracting capital through public companies the question seems legitimate if limited liability is needed, desirable and advantageous for private and closely-held businesses.<sup>210</sup>

This question was raised during the discussion on whether or not to introduce a separate small-business corporation in the United Kingdom and might have influenced the South African reform process as well. On the face of it the

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209 Lower (note 48) at 166.

210 Freedman (note 8) at 566 w.f.r.; Lower (note 48) at 167.

reasoning is compelling: if limited liability is linked to separation of ownership and control and if such a separation is not desired and thus the rules of company law are not appropriate for closely-held businesses, then the corporate form and limited liability is not the best choice anyway.<sup>211</sup>

This is, however, circular reasoning. Defining companies as entities with distinct separation of ownership and control and then stating that if this separation is not desired other forms of businesses should be chosen does not prove the first assumption right: that corporations and limited liability are only justified in companies with separation of ownership and control. This assumption is proven wrong not only by the courts of common law that were quick to allow private companies and even one-man-companies,<sup>212</sup> but also by other legislators. The German *Gesellschaft mit beschränkter Haftung* (GmbH) for example was explicitly designed for private, fairly closely-held businesses and is – as the name implies – vested with limited liability.<sup>213</sup> This concept of limited liability is not just a tool for simplifying public investment, but a privilege handed out by the state to foster entrepreneurship and economic growth.<sup>214</sup> And this privilege can equally be accessed by every entrepreneur, given that the safeguards against misuse are observed.

It is, of course, debatable if incorporation and limited liability are in the well understood interest of every small business.<sup>215</sup> In reality many owners of small businesses are required to supply collateral and thus the limitation of their liability through incorporation is often illusory.<sup>216</sup> This paper cannot discuss the merits and problems of incorporation and limited liability for SMMEs in details. At the end of the day it is up to the entrepreneur to decide what is best for his or her business. And apparently there exists a desire – if not need – to limit liability through incorporation for small closely-held and even one-man businesses.<sup>217</sup> This urge for incorporated business vehicles by small business owners seems to have

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211 Freedman (note 11) at 138 f.

212 *Salomon v. Salomon* [1897] A.C. 22.

213 See chapter E below.

214 Freedman (note 8) at 567 w.f.r.

215 Gower, (note 49) at 26 f.

216 Gower, (ibid) at 26 f.; Naudé (note 31) at 10.

217 Gower (ibid) at 27.

been accepted by the South African legislation<sup>218</sup> and in fact by legislations throughout the world. So even if in the beginning limited liability was in fact linked to a separation of ownership and control this is not true any more.

### ***b. Important Characteristics of SMMEs and their Manifestation in Law***

There exist certain characteristics that most closely-held SMMEs share and that have significant implications for the ideal legislative company law framework. This chapter is going to focus on the two most relevant characteristics for the purpose of company law,<sup>219</sup> that is synonymy of management and ownership and the informal character of internal procedures. Additionally it is going to be examined if and to what extent the new Companies Act acknowledges these special needs of SMMEs.

#### **i. Synonymy**

In the classic public company the separation of ownership (shareholders) and control (directors) might encourage the latter ones to abuse their powers and the corporate form to their benefits. And since most 'outside' stakeholders such as employees, customers and other creditors, society and the environment are protected by special legislation, the regulations of company law almost exclusively need to protect the shareholders from any potential abuse of power by the management.<sup>220</sup> Therefore company law<sup>221</sup>

(1) imposes general duties on directors,<sup>222</sup>

(2) restricts certain potentially harmful actions by directors,<sup>223</sup>

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218 In the United Kingdom on the other hand the CLRS (note 88) at para 2.7 found that the existence of the unincorporated LLP “further weakens the case for creating a new corporate vehicle designed for small businesses.” This reasoning does not seem to apply in the South African context and is even questioned in the United Kingdom itself, see Freedman (note 11) at 139 and Lower (note 48) at 168 f.

219 See Farrington, M, *A closely-Held Companies Act for New Zealand*, Victoria University of Wellington Law Review, November 2007, Vol. 38, 543 at 546 f.

220 Farrington (ibid) at 548.

221 Enumeration inspired by Farrington (ibid) at 548.

222 e.g. s. 76 (2); 76 (3) (c) CompAct and according to s. 77 (2) (a) CompAct also the rules of common law.

Extensively on the duty of skill, care and diligence Du Plessis, JJ, *A comparative analysis of director's duty of care, skill and diligence in South Africa and in Australia*, Acta Juridica 2010: Modern Company Law for a Competitive South African Economy, 263.

- (3) divides power and installs checks and balances within the company,<sup>224</sup>  
 (4) requires certain procedural standards.<sup>225</sup>

Clearly the entire internal structure of the company has been designed to find the right balance between shareholder protection and effective management. But what if the interests of the shareholders and directors conflate? Where there is a synonymy of shareholder and management there is no (potential) clash of interests. In closely-held companies shareholders do not need protection from power-hungry directors<sup>226</sup> and directors do not need further incentive to act in the best interest of the company,<sup>227</sup> because its success is their very own interest anyway.

In fact the livelihoods of the shareholder-director(s) and of the company are likely to be largely synonymous, making a failure of the company a failure of the livelihood-strategy of mostly all its owners and managers.<sup>228</sup> It is obvious that in this case there is a stark alignment of interests of the director-shareholder and the 'company', commonly defined as long-term shareholder value interest.<sup>229</sup> The synonymy becomes even clearer if one realises that most shareholder-directors of closely-held companies are personally liable for debts of their company through guarantees.<sup>230</sup> The interests and actions of shareholders, directors and "the company" therefore are highly interwoven in closely-held companies. Under these circumstances many rules and regulations of traditional company law seem questionable or even obsolete.

Of course the South African company law is not ignorant of the fact that many rules that are necessary and useful for public companies cannot be applied to small, private companies with a close link between management and shareholders

223 Especially insider-trading.

224 Certain actions can only be performed by the proper organ. Whereas the shareholders have the right to amend the memorandum of incorporation [s. 16 (1) (c) CompAct] the board of directors have the last word on distributions [s. 46 CompAct]. These are both vital decisions and company Law needs to take into account the potential clash of interests. The directors might want to limit the powers of the shareholders, but are barred. On the other hand the shareholders might want every last penny to be distributed - even if this is not in the long-term interest of the company.

225 Especially to ensure transparency; see s. 45 (5) and 75 CAct.

226 Probably they need some sort of minority-protection, but this is a separate issue.

227 Farrington (note 219) at 549.

228 Farrington (note 219) at 546.

229 Hutton v. West Cork Railway Co. [1883] Ch. D 654.

230 Farrington (note 219) at 546; Gower (note 49) at 26 f.; Naudé (note 31) at 10; Freedman (note 8) at 561.

meaningfully. Therefore there exist some exemptions for small and closely-held companies. Three main structural peculiarities of smaller companies can be identified that trigger different exemptions and relaxations: the personal union of shareholders and directors (chapter aa.), that there is only one shareholder (chapter bb.) and that there is only one director (chapter cc.).

#### **(aa.) Personal Union of Shareholders and Directors**

How inappropriate some of the provisions made for public companies are if they are applied par for par to closely-held companies is most obvious for reporting and transparency procedures. A lot of these rules are only necessary (and workable) if the powers of ownership and control are indeed separated. Gladly, as far as internal procedures are concerned, the new Companies Act takes a huge leap towards a more practicable *modus operandi* for closely-held companies. Where there exists a total personal union between shareholders and management certain provisions resulting from a separation of power are dispensable. It is for example unnecessary to provide the shareholder with a written notice of a resolution to provide financial assistance to a director, if all shareholders due to their simultaneous position as members of the board already know about (and participated in) this decision.<sup>231</sup>

More generally any internal formality concerning the reference of decisions to the shareholders can be disregarded<sup>232</sup> if there is personal union of shareholders and directors.<sup>233</sup> Especially the need to issue a formal notice of meetings according to s. 62 CompAct is dispensable. This is particularly helpful to allow quick decision-making in closely-held companies, because it enables the directors to immediately 'switch' to their position as shareholders and adopt a shareholder-decision within the same meeting.

Finally there is no need to independently review the financial statements if all shareholder are directors,<sup>234</sup> because as part of the board they are responsible for

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<sup>231</sup> s. 45 (5) CompAct.

<sup>232</sup> Most importantly there is no need to give a formal notice of meetings at least 10 days before the meeting, s. 62 (1) (b) CompAct.

<sup>233</sup> s. 57 (4) (a) CompAct. Of course the requirements of s. 57 (4) (a) (i) – (iii) CompAct have to be fulfilled as well.

<sup>234</sup> s. 30 (2) (b) (ii) (bb) CompAct, with the neglectable exception that the only shareholder-director is a person contemplated in s. 69 (12), that is a person who would normally be disqualified as director.

the annual financial reports themselves.<sup>235</sup> In this case there is no 'board outsider' who has to be protected from false or fraudulent statements that might result from a separation of ownership and control.

But even if some requirements are relaxed a lot of problems remain, because the Act never abandons the formal distinction between shareholders and directors entirely. The above-mentioned s. 57 (4) (a) CompAct notes that even though there exists a total personal-union, the board of directors still has to refer a matter explicitly to the shareholders for decision. Furthermore subsection (4) (b) clarifies that the sections relating to duties, obligations, liabilities and indemnifications of directors are not applicable, if shareholder-directors act in their capacity as shareholder. It is not only irritating for untrained persons to clearly differentiate between their legal roles – it might also have severe consequences. For example the question arises if the rule of acting in good faith when changing the company's constitution<sup>236</sup> also applies to other resolutions of shareholder-managers regardless of their current role.<sup>237</sup> If this is to be answered negatively the shareholder-managers need to be very careful as to if they are acting in their role as manager or shareholder, because this could affect their duties and liabilities. However, research clearly shows that owners and managers of SMMEs do not sufficiently distinguish between their roles as shareholder and directors.<sup>238</sup>

This example clarifies that many rules that are necessary in companies with separated ownership and control cause more harm than good if applied to closely-held companies. Even the most flexible company law regime cannot help the fact that the entire structure was designed for a different purpose: to meet the needs of public companies.

#### **(bb.) Only one Shareholder**

If the company has only one shareholder all rules that are somehow connected to the protection of minority shareholders are, of course, dispensable. Therefore s. 57 (2) CompAct provides that if the company has only one shareholder he or she can

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<sup>235</sup> s. 30 (3) (b), reinforced by s. 77 (3) (d) (i) constituting the directorial duty not to sign or publish false or misleading financial statements.

<sup>236</sup> *Allen v Gold Reefs of West Africa Ltd* [1900] 1 Ch. 656.

<sup>237</sup> Lower (note 48) at 167.

<sup>238</sup> CLRS (note 88) para 2.2; Lower (note 48) at 167.

exercise any or all of the voting rights without “*notice or compliance with any other internal formalities*”<sup>239</sup> and that “*sections 59 to 65 do not apply to the governance of that company*”<sup>240</sup> at all.

Also the financial statements need not to be reviewed if one person holds all beneficial interests in and all the securities of a company, but is not also a director.<sup>241</sup> Even though there exists a separation of ownership and control it seems as if the Act is confident that a sole shareholder is vested with so much power and control over the company and its board of directors that an independent review is not always necessary. And in fact the sole shareholder can at any time by altering the memorandum of incorporation require a financial review or even auditing of the statements, if he or she deems this necessary.

**(cc.) Only one Director**

It is needless to say that some internal procedures aiming at a board consisting of several directors are inapplicable to companies with a sole director.<sup>242</sup>

But the agency risks flowing from a separation of ownership and control are particularly high if the board consists of only one director not being the sole shareholder. Therefore s. 57 (3) CompAct provides certain stricter rules concerning possible conflicts of interests of the sole director.

**(dd.) Conclusion**

Although the South African company Law acknowledges that certain constellations common among SMMEs require special rules and exemptions it does not depart from the strict separation of the board of directors and the shareholders. Rules and regulations that flow from this separation are to a large degree unnecessary and inappropriate for closely-held SMMEs.<sup>243</sup>

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239 s. 57 (2) (a) CompAct.

240 s. 57 (2) (b) CompAct.

241 s. 30 (2) (b) (ii) (bb) (AA) CompAct; this provision does not concern a one-person company in which the sole shareholder is also the sole director – as it might often be the case for smaller companies. This constellation is dealt with in subsection (BB).

242 See s. 57 (3) and s. 100 (7) CompAct.

243 Cassim/Cassim (note 82) at 413.

Yet another problem stems from the method used in the Act: rather than providing a separate set of rules for small, closely-held companies the applicable provisions are often hard to find.<sup>244</sup> To make things worse most SMMEs not only qualify for one of the above-mentioned exemptions, but for several. The prevalent one-person-start-up-company for example has only one shareholder and one director in a complete personal union.

This complicated patchwork legislation is probably unavoidable in a highly flexible system that does not provide a certain ideal-type of a business.<sup>245</sup> But it is not to the advantage of small, closely-held businesses.

## ii. Informality

Because they lack the resources and knowledge to legally circumvent the complicated and burdensome regulations (like major corporations might be able to) small companies often simply do not completely adhere to these rules. Mandatory provisions might be neglected by accident, due to incapacity to identify the applicable rules in the first place<sup>246</sup> or simply because of wilful disregard.<sup>247</sup> And where the rules are applied they are often dealt with in a once-in-a-year “wash-up”<sup>248</sup> and not on an ongoing basis. Because they cannot cope with (all of the) the burdens of company law many small businesses seek refuge in informality.

This widespread phenomenon of non- and sham-compliance with unsuitable legislative provisions is undisputed. Even Freedman, one of the major proponents of a one-company-fits-all approach in the United Kingdom acknowledges that “many [small] companies do not clearly differentiate between directors’ and shareholders’ decisions, even though they should, and they may not hold formal meetings or pass formal resolutions at all.”<sup>249</sup> South African company law suffered from the same phenomenon of sham compliance with internal provisions

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244 See also chapter D.I.1 above.

245 Unlike the continental European approach; see chapter E. below.

246 Here the accessibility of company law is a major factor: see chapter D.I above.

247 Farrington (note 219) at 547.

248 Farrington (ibid) at 547 with further reference to the New Zealand experience.

249 Freedman (note 11) at 131; the problem of sham compliance with requirements of company law by SMMEs is also mentioned by Gower (note 49) at 25.

flowing from a separation of ownership and control prior to the introduction of the close corporations Act.<sup>250</sup> It could be argued that in this case the actual burdens are less heavy, because they do not affect the small businesses as negatively as they could – rather: as they *should*. The argument that those inappropriate rules are in reality not causing too much trouble for small businesses, because they are circumvented or blatantly breached, is indefensible from a legal perspective. As Naudé pointed out “... *the fact that sham compliance has not given rise to serious prejudice does not prove that the 'system works'. It rather shows that the formalities concerned are meaningless*”<sup>251</sup> and that those formalities were made for the benefit of the elite that has the resources to utilise them, rather than for the whole society.<sup>252</sup> Probably most disturbingly – especially from the perspective of the legal profession – sham compliance ultimately causes disrespect for the law generally.<sup>253</sup> This is a serious and not at all theoretical concern.

Rather than assessing that the rules are being ignored anyway and do not cause much trouble one should acknowledge that the rules *de lege lata* are not suiting the needs of SMMEs and should either be reformed, or an alternative should be offered.

## 2. One Company – No Choice?

So why force an overly complex legal structure<sup>254</sup> upon small businesses that used to have a successful alternative to the company? The reason why the close corporation was abolished was certainly not because of its own shortcomings. As Knight, advisor to the DTI and principal drafter of the new Companies Act,<sup>255</sup> puts it: “[...] *the issue was not ‘What’s wrong with the close corporations Act as an instrument for incorporation?’, but rather ‘What’s wrong with providing two different, alternative and concurrent instruments for incorporation?’ When framed that way, the issues come into sharper focus, and the answer is ‘a great deal’.*”<sup>256</sup>

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250 See the criticism of Naudé (note 31) at 6.

251 Naudé (ibid.)

252 Henning (note 6, first essay) at 253.

253 Gower (note 49) at 25; Naudé (note 31) at 6.

254 See chapter D.II.1.b above.

255 Knight (note 142) at 3, footnote \* on the author.

256 Knight (note 142) at 7.

This 'great deal' basically consists of three main arguments. The first is a rather technical one, namely that having just one piece of legislation for all corporate entities helps to curb legislative arbitrage. The validity and cogency of this argument is examined in sub-chapter (a). A possible second argument would be the reduction of costs for the administration and legal professionals. This argument is not being brought forward in the South African context – for reasons explored in sub-chapter (b). The most compelling argument is being dealt with in sub-chapter (c), that is that the complex structures of a company are needed at later stages of business evolution. According to this line of argument a one-company approach is therefore necessary in order not to limit opportunities for progression.

#### *a. Curbing Legislative Arbitrage?*

By amending and ultimately abandoning the close corporations Act the DTI sought to harmonise the law in order to reduce potential opportunities for regulatory arbitrage.<sup>257</sup>

An argument that is occasionally being brought forward against a small-business regulation is the difficulty of defining these businesses.<sup>258</sup> The possible methods have been discussed in chapter B. above. And of course limiting the maximum number of members of a close corporation to precisely ten<sup>259</sup> seems arbitrary. And of course it could very well have been a different number.<sup>260</sup> Most legal thresholds cannot precisely be calculated and therefore are to some degree arbitrary. Law-making is not a natural science – its a policy decision. Still, as long as these decisions are not completely arbitrary and are founded on reasonable arguments, they have to be accepted – as long as they are constantly open for revision.

However, the argument of legislative arbitrage in the South African discussion does not seem to target the maximum number of members for a close corporation. It is more fundamental: “*Closing the close corporations Act to new incorporations*

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<sup>257</sup>Knight (note 142) at 7.

<sup>258</sup> See Freedman (note 11) at 127 f.

<sup>259</sup> s. 28 close corporation Act; see also chapter C.II.3 above.

<sup>260</sup> In fact the numbers ranged from “10, if not less”, Naudé (note 31) at 11 up to smaller than 20, Gower (note 49) at 29.

*eliminates the redundancy that would have existed had that Act remained open.*"<sup>261</sup> Asserting that the new Companies Act leaves the close corporation redundant is a strong claim, however.<sup>262</sup> Even more so a real competition between the simplified company Act and the close corporations Act seems to have been deliberately avoided by the authorities. One comes to wonder: if the legislator is confident that the company is in fact better suited for SMMEs – why not let them choose? As the example of Europe has shown<sup>263</sup> a competition between different types of incorporation can be very fruitful and help identify and overcome existing problems in company law.

### ***b. Reducing Costs?***

The argument that having only one company law framework can help to reduce costs both for the proper authorities and legal experts has apparently not been brought forward in South Africa so far. For good reasons. During the transition period already incorporated close corporations still remain in business the separate provisions and consequences for incorporated entities still remain. Therefore there still needs to be legal expertise for both close corporations and Companies and courts, administration etc. still have to deal with questions concerning close corporations.<sup>264</sup>

But only those who can afford expensive expertise can still avail the close corporation, especially by acquiring shell close corporations.<sup>265</sup> This means that the possible advantage of competing legal forms is only open to sophisticated, well-off businessmen and -women, but not to small business owners who are most likely to have benefited from a choice between a simplified company and a close corporation.<sup>266</sup>

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261 Knight (note 142) at 7.

262 Du Plessis (note 52) at 270 asserts the New Companies Act does probably not provide a simpler and better legal framework for small businesses.

263 See below chapter E.

264 Du Plessis (note 52) at 269.

265 According to media reports “ company lawyers predict that until then (entering into force of the new Companies Act) the Companies and Intellectual Property Registration Office might see an increase in the number of registrations of close corporations.”, Business Day on 28<sup>th</sup> 2009. And despite an uncertain future in 2008 more close corporations than ever before in one year's time were registered according to CIPRO statistics available at [http://www.cipro.co.za/about\\_us/Web\\_Statistics\\_Version9.pdf](http://www.cipro.co.za/about_us/Web_Statistics_Version9.pdf).

266 This is aggrieved by the fact that – probably due to a dead link – it is impossible to incorporate a close corporation online at [www.cipro.co.za](http://www.cipro.co.za). The web-page that should provide information, online forms etc. is unavailable since April 2010.

### ***c. Business Evolution***

It is certainly gratifying to imagine the growth of a business from the (probably informal) “*one person firm through the husband and wife company, the family company, the private company which brings in outside finance, the unlisted public company and the quoted company to the multinational group*”.<sup>267</sup> These stages of business growth resemble organic evolution and seem to be the natural way of how a thriving business advances. It seems evident that disturbing or interfering with this process has to be avoided in order not to hamper growth and success.

So “[...] *whilst a corporate regime is designed to facilitate separation of ownership and control and whilst this creates problems where there is in fact no such separation, by choosing this legal form the business owner is creating the option for such separation, if not now then in the future.*”<sup>268</sup> Therefore the conclusion is that those initially inappropriate structures<sup>269</sup> need to be in place from the beginning in order not to set up a potential barrier to the natural growth of businesses<sup>270</sup> which is feared to even result in distrust by financiers of close corporations.<sup>271</sup>

The evolution of businesses seems to be the ultimate argument for abandoning the close corporation in favour of a single – and admittedly flexible – company law in South Africa.<sup>272</sup> But given the severe consequences of this step which, in contrast to the United Kingdom, abolished a well-established and renowned legal entity, this paradigm of business evolution needs to be carefully examined.

#### **i. Evolution Largely a Myth**

Compelling as the idea of business evolution may be it seems as if it has more in common with an idealistic dream than with reality. The conception of an ever-

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267 Freedman (note 8) at 559.

268 Freedman (note 11) at 137 f.

269 See chapter D.II.1.b above.

270 Knig Knight (note 142) ht at 8; CLRSG (note 88) at 2.7; Freedman (note 11) at 137 f.

271 DTI (note 54) at 30.

272 This also seems to be one of the main reasons not to introduce a small-business vehicle in the United Kingdom, see Freedman (note 11) and CLRSG (note 88) at 2.7.

growing business through several stages as described above is very much related to some sort of “American Dream” or rather a western-capitalist dream. In this dream everyone who works hard – if he or she is capable enough – can make it from rags to riches.<sup>273</sup> Or, in the context of this work, make it from the one-person business to a multinational group.

This notion is, however, at odds with available empirical data. Even Freedman, proponent of the one-size-fits-all company law in the United Kingdom, found that the “vast bulk of companies are private”<sup>274</sup> and “90% have fewer than 5 shareholders”<sup>275</sup>. Statistics from New Zealand<sup>276</sup> and especially South Africa paint a similar picture. According to the Companies and Intellectual Property Registration Office (CIPRO) out of a total of 1.888.414 active profit-seeking entities<sup>277</sup> from 1800 up to June 2010 a stunning 85.8 % were close corporations, 12.4 % registered as private companies and only 0.17 % were public companies.<sup>278</sup> Although there is no data available on the number of shareholders in South African private companies, one can draw a parallel to the findings in the United Kingdom cited above and infer that of the 12 % companies a majority is closely-held. These figures strongly suggest that only a minority of active business entities reach the stage of extensive separation of ownership and control that occurs when shares are up for public trading. So the overwhelming majority of businesses do not experience separation of ownership and control thus not needing any extensive regulations on this topic and are even trying to avoid it.<sup>279</sup> In conclusion it seems as if the principles of company law, as described above,<sup>280</sup> cater for the needs of less than 1 % of all corporate entities and disturb the remaining 99 %.

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273 A perception that is also prevalent within the developmental aid community targeting small businesses, see for example the “stages of pro-poor enterprise growth” as outlined by CARE Canada, *Making Markets Work for the Poor – CARE Canada's Strategy for Helping the Poor through Enterprise*, available at <http://www.careinternational.org.uk/4075/business-partnerships/making-markets-work-for-the-poor-care-canadas-strategy-for-helping-the-poor-through-enterprise.html> [last accessed 07/10/2010] at 13 f.

274 Freedman (note 11) at 126.

275 Freedman (ibid)..

276 Farrington (note 219) at 544 f. suggests that a large proportion of New Zealand's companies are in fact closely-held and provides statistics supporting this assumption.

277 Excluding the 24.308 section 21 non-profit entities.

278 Raw data provided by CIPRO at [http://www.cipro.co.za/about\\_us/Web\\_Statistics\\_Version9.pdf](http://www.cipro.co.za/about_us/Web_Statistics_Version9.pdf) [last accessed July 13<sup>th</sup> 2010].

279 This explains the problem of sham compliance mentioned above at D.II.1.b.ii.

280 See chapter D.II.1.b.

## ii. What Businesses Benefit from 'Continuity'?

Even if many businesses will never climb high on the ladder of business evolution they undergo changes and, despite being small in total numbers, some may indeed find the need to include external investors or even go public. So which businesses do benefit from a flexible and continuous company law regime?

The new Companies Act certainly provides a flexible regime that can follow up any change in the business – be it due to evolution or otherwise.<sup>281</sup> The argument of continuity is, however, only true for the superficial legal structure itself and does not hold much truth for the actual internal structure. In fact the concept of the company is and ought to be so flexible that the continuity of the label 'company' does not say much about the actual legal changes this company has to undergo. From the small and private company to the large public company the structural needs are completely different and – given the absence of any peremptory provision of the Act – have to be entirely accommodated by the memorandum of incorporation. Therefore each major evolutionary step of a company requires an amendment of the memorandum of incorporation.<sup>282</sup> The greater the evolutionary step, especially from private to public companies, the more complex, costly and time-consuming the amendment. Just because on the face of it the company remains the same this does neither reduce the need, nor necessarily the expenditure, for corporate changes. The same goes of course for any close corporation that faces the same challenges and consequently has to adapt its founding statement according to any new situation as well.

But in fact very few unplanned changes require a complete change of the closely-held legal form, contrary to what Freedman and others seem to suggest.<sup>283</sup> A close corporation is typically managed by the owners, but this does not have to be so. The day to day running of a close corporation can be managed by any third person the owners entitle to do so. The only situation a close corporation is by its very nature unable to adapt to is the inclusion of a large number of members and especially the going-public. It is true that in this regard the close corporations Act

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281 Knight (note 142) at 8.

282 s. 16 CompAct.

283 Freedman (note 11) at 134; Knight (note 142) at 8.

is less scalable.<sup>284</sup> But this advantage of continuity only kicks in at a very late stage of business development. A stage that actually less than 1% of all businesses ever reach.<sup>285</sup> And if they do reach it they are typically so large in numbers of turnover, resources and employees that they can very well afford to undergo a change of their legal form.

#### ***d. Conclusion***

The new South African company might very well be a very flexible and successful concept. And it is even true that due to this flexibility it might be modified to be fairly appropriate for SMMEs. However the fact remains that the very structure of a company is not ideal for closely-held businesses.<sup>286</sup> Moreover an elegant and fully scalable<sup>287</sup> company law is probably not what small entrepreneurs need or want. Unfortunately there had been no extensive consultation with the SMME sector before the reform started. This is not a particular problem of South Africa, but is prevalent elsewhere as well.<sup>288</sup> And it is not just the administration and the legislator who is to blame: SMMEs are often not organised, do not have a lobby and often do not care much about law-making decisions.<sup>289</sup> However the argument that has been brought forward in the previous chapters seems to be supported by the few empirical studies available. For example a study from the United States in 1985 suggests that special close corporation legislation – either in form of separate acts or provisions within a company act – is preferable over a flexible one-size-fits-all approach: “*The empirical study data supports the adoption of special close corporation provisions—provisions available only to defined close corporations. The data further indicates that the elective close corporation subchapter approach is preferred over the scattered provisions approach.*”<sup>290</sup> And in contrast to the United Kingdom South Africa is in the fortunate position to have (had) one of the world's most precisely drafted special legislation for SMMEs. The problems of eligibility and transition that are being brought forward to argue against a special close

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284 Similar Knight (ibid.).

285 See above. And even the majority of large public companies did not evolve, but were already incorporated as public companies.

286 See chapter D.II.1.b above.

287 Knight (note 142) at 17.

288 See Freedman (note 8) at 560.

289 Their reliance on informality might be one explanation for this; see above chapter D.II.1.b.ii.

290 Hochstetler/Svejda (note 42) at 1028.

corporation legislation in the United Kingdom<sup>291</sup> would not have occurred in South Africa. Furthermore statistics clearly show that in South Africa 70 % of incorporated SMMEs so far choose the close corporation.<sup>292</sup> The Business Unity of South Africa (BUSA) made clear that there is still a need for the close corporation by stating that it was important to retain “*a corporate structure which includes the characteristics of the current close corporation*”.<sup>293</sup> Whether the new Companies Act is indeed favourable for SMMEs in South Africa depends to a large degree on how it is being implemented. But why not let the small entrepreneurs decide for themselves what seems to be appropriate?<sup>294</sup> It would have been no problem to provide the flexible company Law as an alternative to the existing (and probably reformed) close corporations Law. If the new Companies Act is as superior as its proponents argue the close corporation would have slowly faded anyway. But not by a top-down legislative decision, but because the entrepreneurs chose themselves.

And while South Africa is abandoning its close corporation some other countries discover the need for a special small-business corporation anew.<sup>295</sup> The next chapter is going to assess how Germany, a country that came up with a “small” business vehicle very early, is dealing with the challenges of modern company law, the increasing influence of the United Kingdom's concept of a single company and what lessons could be learned from the South African experience.

### 3. Conclusion

It is doubtful if the company as it is can ever become a truly appropriate form of incorporation for SMMEs, because its internal structure based on a separation of ownership and control is simply not ideal for closely-held businesses. Of course there are ways to accommodate the needs of small businesses in a company law regime as much as possible: building in exceptions from some of the most inappropriate rules, simplifying language and structure of the Act and most

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291 SteeringFramework at 13 (p. 4).

292 DTI (note 4) table 3.4 at 58.

293 BUSA Working Paper of August 2004, cited through Henning (note 6, first essay) at 255.

294 See Du Plessis (note 52) at 270.

295 For example the introduction of the *Societas Privata Europaea* (SPE) in the European Union, see the proposal for a European private company, European document COM(2008) 396/3; the German *Unternehmergesellschaft* (UG), extensively on this chapter E. below and reform ideas in New Zealand, see Farrington (note 219).

importantly providing an accessible and appropriate standard form for small, closely-held private companies. But all this is fighting the symptoms rather than the cause.

South Africa used to have one of the world's most specialised forms of incorporation for closely-held businesses that proved to be very successful. Yet it was decided to abolish the Close Corporations Act in favour of a flexible companies act. This decision is regrettable. The competitive pressure from another form of incorporation could have helped to realise weaknesses of both Acts – and to promote further reforms to the advantage of small businesses. Moreover most arguments that are being brought forward to support a one-company-fits-all approach are not compelling – especially from a South African perspective. Therefore the decision to fade out the close corporation should probably be reconsidered.

## E. Is South Africa one Step Ahead? Germany's GmbH Adapting to the Flexible British Company

South Africa has been the first country with a British company law system that departed from the one-company-fits-all approach to a significant degree. Providing different legal structures for different types of businesses is not a new idea, however. Like Naudé rightly observed most continental European countries chose this path as early as in the 19<sup>th</sup> century.<sup>296</sup> One of the first and certainly most influential legal structure in continental Europe used to be (and probably still is) the German *Gesellschaft mit beschränkter Haftung* (GmbH). This different concept of corporate law also stems from a different perspective on what corporate law should provide.<sup>297</sup> Until recently South Africa was amongst the few countries whose corporate law was rooted in both legal traditions and it deliberately chose to let the continental European root die back.

Therefore this chapter is going to briefly display the development and the concept of the GmbH, its influence on other jurisdictions and the recent developments in reaction to the competitive pressure by the British company. Since it was laid out in previous chapters that the one-company-fits-all approach is most probably disadvantageous to SMMEs this chapter should be understood as an encouragement to re-think and re-define the concept of a separate form of incorporation for small businesses – in Africa *and* continental Europe.

### I. The Concept of the GmbH

#### 1. Historical Background

The GmbH was introduced in Germany to overcome the gap between the public and 'capitalistic' *Aktiengesellschaft* (AG)<sup>298</sup> with limited liability and the unincorporated, personalistic business vehicles of *Offene Handelsgesellschaft*

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<sup>296</sup> See Naudé (note 31).

<sup>297</sup> The continental European system has a more ideal-typical approach; see chapter E.2.b below.

<sup>298</sup> A company limited by shares designed to accumulate as many funds as possible by offering its shares to the broad public.

(OHG) and *Kommanditgesellschaft* (KG) that did not offer comprehensive<sup>299</sup> limited liability.<sup>300</sup> Like in South Africa prior to the introduction of the close corporation there was growing awareness that the existing company law was not catering for the needs of small and medium-sized businesses that longed for a simple juristic person with limited liability and a flexible regime.<sup>301</sup> Unlike Great Britain Germany decided not to just relax the strict provisions of the AG law but introduced an entirely new form of incorporation: the GmbH.

## 2. Reasons for the International Success of the GmbH

Today the GmbH is by far the most attractive and successful business vehicle in Germany, surpassing not only the complex AG, but also unincorporated 'partnerships' like the OHG and the KG which were long time seen as the most important business vehicles for small and medium-sized enterprises.<sup>302</sup> Moreover the concept of the GmbH has been coined one of Germany's most successful export articles.<sup>303</sup> Portugal and its colonies in Angola, Guinea-Bissau and Mozambique, as well as Austria and Brazil were quick to adopt the idea of a GmbH-style corporation for SMMEs.<sup>304</sup> And the more the European Community harmonised and regulated the law of public and listed companies/corporations,<sup>305</sup> the more countries readily adopted the idea of a separate corporation in order not to burden their medium-sized enterprises with an increasingly complex legislation. Most of them followed the concept of the GmbH.<sup>306</sup> Today many countries throughout the world have adopted the GmbH concept – or, more precisely – the concept of a distinct corporation for SMMEs similar to the GmbH.

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299 Whereas in an OHG every member is liable jointly and severally for the liabilities of the association (§ 128 HGB), a KG is composed of at least one ordinary partner (*Komplementär*) with unlimited liability and one limited partner (*Kommanditist*) according to § 161 I HGB.

300 See Westermann, HP, *Einleitung zum GmbHG* in: Grezelius, G / Emmerich, G et al (ed.), 'Scholz GmbHG', 10. Ed., 2007 Cologne, at margin number 59 with further references.

301 Lutter, M, *Die Entwicklung der GmbH in Europa und der Welt*, in: Lutter, M / Ulmer, P / Zöllner, W (Ed.), 'Festschrift 100 Jahre GmbH-Gesetz', 1992 Cologne, 51.

302 Lutter, M / Hommelhoff, P, *GmbH-Gesetz Kommentar*, 16. Ed., 2004 Cologne, Einleitung at margin number 1.

303 Lutter (note 301) at 49.

304 Extensively on this topic Lutter (note 301) at 50 f.

305 Especially the 2<sup>nd</sup> Council directive of 1976 played an important role.

306 Lutter (note 301) at 53 f.; Naudé (note 31) at 8.

### ***a. Strict Public Company Law Regime***

Two main reflections may have influenced each and every country's decision whether or not to opt for a separate form of incorporation for small private enterprises. The first is a rather technical one: is the existing law for (public) companies flexible enough to be appropriate even for small private companies? The more flexible the existing regime, the less likely a country is going to introduce a new type of incorporation. This is the reason why many European countries introduced a GmbH-style corporation fairly recently, when the regulations prescribed by the European Union began to complicate the law of public companies.

In the beginning Germany, too, considered just to reform the existing law of the AG,<sup>307</sup> but this way was quickly deemed inappropriate and unrewarding. In retrospective many of the arguments resemble the ones of Naudé arguing in favour of a separate corporation for South Africa in 1982 who stated that

*“[a]t first glance the solution seems to be to build more exemptions for small companies into the Companies Act [...]. However, this in fact adds to the complexity of the small company's position and exacerbates the problem.”*<sup>308</sup>

Both in Germany and South Africa the existing legal regime was perceived as unfit to accommodate small businesses – even after a possible reform. This is the first obvious similarity between the German and the South African company law up until the Companies Act 71 of 2008.

### ***b. Different Philosophies***

Secondly the legal and economical philosophy of a country is important for whether or not a separate business vehicle for SMMEs is introduced. As Lutter points out countries with a one-size-fits-all approach have a significantly different philosophy – especially on segmentation – than those countries who introduced a separate corporate form like the GmbH.<sup>309</sup> Most civil law countries, like Germany,

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307 See Westermann (note 300) at margin no. 59 with further references.

308 Naudé (note 60) at 63; see also chapter C.I.2 above.

309 Lutter (301) at 57 f.

share an ideal-typical approach to company law.<sup>310</sup> The laws and regulations for public companies are drafted in a way that envisages the listing of the company on a stock exchange – regardless if this is the case for each and every company. On the other hand the laws and regulations concerning the GmbH picture a mid-sized corporation that is not – and never will be – trading its 'shares' publicly. German corporate law depicts an ideal-typical AG or GmbH, not one that is constantly changing, evolving and probably decaying.<sup>311</sup> As mentioned earlier in chapter D.II.2.c the anglo-american philosophy is radically different. Progress is key and every company is seen as a vehicle to make it from rags to riches. Obviously the argument of business-evolution and continuity<sup>312</sup> has completely different weight in those two frameworks.

Even though South Africa, due to its exceptional history, has been influenced by both philosophical currents, during the recent company reform the anglo-american perspective clearly had the upper hand. Hardly surprising many foreign experts during the reform process came from an anglo-american legal background.<sup>313</sup> This is probably the reason why the new Companies Act and its fairly strict one-size-fits-all approach has caused some irritation in South Africa.

This is not to say that either one of these perspectives on company law is more appropriate. In fact both have their advantages and disadvantages. As already mentioned above statistics show that the argument of business-evolution is largely built on a myth.<sup>314</sup> On the other hand the ideal-typical approach has also come under scrutiny. Guyon and Vidal have shown that most legal differences in France do not occur between the Société Anonyme (counterpart of the German AG) and the Société à Responsabilité Limitée (counterpart of the German GmbH), but between listed and unlisted companies.<sup>315</sup> Some German scholars therefore suggest law reforms that would lead into the same direction and would in fact

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310 Lutter (301) at 58.

311 This is not to say that a GmbH cannot evolve – but for it to go public it needs to be transformed into an AG (*Formwechsel*) in accordance with the fifth book of the UmwG.

312 See chapter D.II.2.c above.

313 See Mongalo (note 78)

314 See chapter D.II.2.c.i above.

315 Vidal, D, *Der Dualismus von GmbH und AG in Frankreich: Benötigen wir zwei Rechtsformen für Kapitalgesellschaften?* in: Roth, G (Ed.) 'Das System der Kapitalgesellschaften im Umbruch – ein internationaler Vergleich' (1990) Cologne, p. 84 with further reference to Guyon.

bring the non-listed AG closer to the GmbH than to its listed brothers.<sup>316</sup>

So even before turning to the exact structures of the GmbH in comparison to the close corporation it is fair to say that both share the same philosophical framework concerning company law. They are both rather ideal-typical than flexible and favour appropriate rules for the ideal over utmost flexibility. Furthermore they were designed with the same ideal in mind: to provide a legal form for small and medium sized businesses that do not want or need to obtain capital from the capital market.<sup>317</sup>

## ***II. The Structure of the GmbH***

### **1. Overview**

Like the close corporation, the GmbH comes into being as a juristic person distinct from its members upon registration<sup>318</sup> and provides limited liability to its members and directors.<sup>319</sup> Its internal structure is defined by the *Satzung*<sup>320</sup> (the statute of the GmbH) and to a large degree the members are free to adapt the internal organisation to their needs.<sup>321</sup> In contrast to the fairly strict law of the AG the internal rules and regulations provided by the GmbHG are to a large degree optional. Together with the lower minimum capital this flexibility is the most important advantage over the AG. The most obvious disadvantage in this regard is that any transfer of interest in the GmbH (*Geschäftsanteil*) has to be notarised,<sup>322</sup> which prohibits speculative trading and listing at the stock exchange.<sup>323</sup>

This thesis can neither provide a comprehensive summary of all the salient features of the GmbH, nor an exhaustive comparison between close corporation

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316 Claussen, CP, *Die Mittelstands-Aktiengesellschaft*, Die Betriebswirtschaft (1991), 183; Hommelhoff, P, *Die deutsche GmbH im System der Kapitalgesellschaften* in: Roth, G (ed.) 'Das System der Kapitalgesellschaften im Umbruch – ein internationaler Vergleich' (1990) Cologne, 26 at 55.

317 Olbrisch, N / Du Plessis, JJ, *Some structural differences between the South African Close Corporation and the German GmbH*, Journal of South African Law (1997), 315 at 315.

318 § 13 I and § 11 I GmbHG.

319 § 13 II GmbHG.

320 For the minimum requirements of the *Satzung* see § 3 GmbHG.

321 Hueck, G / Windbichler, C, *Gesellschaftsrecht*, 20. Ed. 2003, Munich at § 34 II 1.

322 § 15 III GmbHG.

323 Grunewald, B, *Gesellschaftsrecht*, 4. Ed. 2000, Cologne, 2.E. at margin no. 5.

and GmbH.<sup>324</sup> The following two chapters therefore concentrate on the most important aspects of the GmbH for the purpose of this paper: the recently and thoroughly reformed system of minimum capital and the internal structure, especially concerning any separation of ownership and control.

## 2. Minimum Paid-in Capital

### a. General Concept

The incorporation of a GmbH requires a certain minimum paid-in capital (*Stammkapital*), currently € 25.000 (ca. ZAR 250.000).<sup>325</sup> This *Stammkapital* was designed as a safeguard against misuse of the corporate form and as a 'last resort' for creditors of the GmbH.<sup>326</sup> This concept falls into two imperatives: *Kapitalaufbringung* and *Kapitalerhaltung*. *Kapitalaufbringung* means that the minimum capital has to be raised once the GmbH is being registered,<sup>327</sup> whereas *Kapitalerhaltung* describes the duty to maintain this minimum capital while the GmbH is doing business.<sup>328</sup>

The *Stammkapital* does not need to be contributed (and maintained) in money, but can also be contributed in kind.<sup>329</sup> On the other hand manpower (and the value thereof) cannot be contributed to the *Stammkapital*, because this immaterial value is not an adequate security for creditors. Contrary to popular misunderstandings the *Stammkapital* does not need to be deposited into a special bank account and remain there untouched. This would deprive the GmbH of much needed capital to open and run its business. Therefore the GmbH can use the *Stammkapital* to acquire assets that are needed for the business as long as the assets remain with the GmbH and are not distributed to the members, e.g. in form of dividends.<sup>330</sup>

The concept of minimum capital, which is prevalent in all other European

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324 Olbrisch/Plessis (note 317) provide an excellent comparison between close corporation and the GmbH before the MoMiG entered into force in November 2008.

325 § 5 I GmbHG. Of course the members are also free to agree upon a higher sum.

326 Hueck/Windbichler (note 321) § 36 II at margin no. 11.

327 Grunewald (note 323) 2.E. at margin no. 112 f.

328 Grunewald (note 323) E.2. at margin no. 115 f.

329 To make sure that the initial assets are valued correctly some stricter rules apply if the GmbH is being incorporated on the basis of contributions in kind (*Sachgründung*); see § 5 IV GmbHG.

330 § 30 I GmbHG.

countries except Ireland and the United Kingdom,<sup>331</sup> has been described as the “most essential structural difference between the GmbH and the close corporation”<sup>332</sup>. It is not only an essential difference, but one of the very reasons why the close corporation was 'invented' in the first place.<sup>333</sup> As Prof. Gower rightly observed “[i]t is obviously impracticable to insist upon this [a minimum capital] so long as private limited companies are not required to have a minimum capital.”<sup>334</sup> Since the concept of a private company did not exist in continental Europe this concern did not apply to the GmbH – until recently.

### ***b. The Concept of Minimum Capital Under Threat***

The concept of minimum capital came under severe competitive pressure in continental Europe after the European Court of Justice (ECJ) allowed corporations that were incorporated in one member-state of the European Union to operate in a different member-state and remain their foreign legal personality.<sup>335</sup> Prior to these ground-breaking judgements<sup>336</sup> most jurisdictions shielded their local forms of incorporation by invoking the principle of the *Real Seat Theory*. According to this theory any business vehicle is subject to the jurisdiction in which it has its real seat,<sup>337</sup> that is where it is carrying out most of its business activities and where its administrative head quarter is actually situated. This meant that any company incorporated under British company law that effectively moved its activities to Germany had to be re-classified under German company law for the purposes of German jurisdiction. And since all foreign companies/corporations lacked the formal requirement of being registered in Germany they inevitably lost their status of incorporation and limited liability through this process of re-classification.<sup>338</sup> But according to the ECJ this procedure infringed the freedom of establishment

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331 Freedman (note 8) at 573 f.

332 Olbrisch/Plessis (note 317) at 316. However, the peremptory division between director(s) and member(s) seems to be a likewise essential structural difference; see chapter E.II.4 below.

333 See Freedman (note 8) at 575.

334 Gower (note 49) at 32.

335 ECJ C-212/97 (*Centros*); C-208/00 (*Ueberseering*) and C-167/01 (*Inspire Art*); for a detailed discussion on the Ueberseering-Decision and its implications for German corporate law see Baelz, K / Baldwin, T, *The End of the Real Seat Theory (Sitztheorie): the European Court of Justice Decision in Ueberseering of 5 November 2002 and its Impact on German and European Company Law*, German Law Journal (2002), Vol. 3 No. 12 and on the probably most important Inspire-Art-Decision see Kersting, C / Schindler, CP, *The ECJ's Inspire Art Decision of 30 September 2003 and its Effects on Practice*, German Law Journal (2003), Vol. 4 No. 12.

336 See McCahery/Vermeulen (note 49) at 860 f.

337 See Lutter/Hommelhoff (note 302) Einleitung at margin number 31.

338 They were either treated as being OHGs or GBRs, depending on nature and size of their businesses.

within the European Union.<sup>339</sup>

Now the long-established GmbH had to face a competitor that offered limited liability without requiring any minimum capital. And even though the *Stammkapital* can be raised and used quite flexible,<sup>340</sup> the amount of € 25.000 constitutes a significant obstacle – especially for small entrepreneurs. The British company therefore offers a compelling alternative to the GmbH. Despite some uncertainties<sup>341</sup> many entrepreneurs opted for the limited company<sup>342</sup> and it seemed that Gower's apprehension more than thirty years ago was correct: the concept minimum capital cannot compete with the cheaper company. So in response to the competitive pressure<sup>343</sup> Germany embarked on the most substantial reform of the GmbHG ever<sup>344</sup> and created a cheap and simple sub-type of the GmbH: the *Unternehmergesellschaft (UG)*.<sup>345</sup> The UG, which literally translates as *Entrepreneurial Corporation*, is not a separate legal form distinct from the GmbH, but a modification thereof<sup>346</sup> to meet the needs of small entrepreneurs who would normally be deterred by the minimum capital of € 25.000. In theory a UG can be incorporated with just € 1.<sup>347</sup> This is a huge step away from the traditional concept of limited liability in Germany that used to be inevitably linked to a minimum capital of some sort. However, the system of minimum capital has not entirely been abandoned.<sup>348</sup> During the legislative procedure concerns were raised that without any minimum capital the goodwill of the GmbH – a major advantage over the foreign company – would be lost.<sup>349</sup> So in order to maintain the system of minimum capital and simultaneously lowering the bar for small entrepreneurs it was agreed upon a middle way: the UG can be

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339 Title III, Chapter 2 of the EC-Treaty.

340 See above.

341 Especially concerning taxation and accounting requirements.

342 In 2007 already 40.000 to 50.000 British Limited Companies with branches in Germany had been incorporated, putting the GmbH under enormous pressure; see Weber, JA, *Die Unternehmergesellschaft (haftungsbeschränkt)*, Betriebs-Berater (2010), 842.

343 Bork, R / Schäfer, C (Ed.), *Kommentar zum GmbHG*, Kommentar zum GmbHG, 1. Ed. 2010, Cologne, introduction at margin no. 17.

344 Bork/Schäfer (ibid.) at margin no. 15.

345 Art. 1 sub-chapter 6 MoMiG introducing § 5a to the GmbHG.

346 Bork/Schäfer (note 343) at margin no. 20.

347 § 5a I in association with § 5 II GmbHG. Such an uncapped UG would not be viable, though. Depending on type and size of business several hundred up to several thousand Euro are necessary in order to avoid immediate insolvency. In practice the average capital of a newly incorporated UGs is around 1.200 €, see Wicke, H, *Praktische Verwendung und Kapitalbildung der Unternehmergesellschaft (haftungsbeschränkt)*, Gesellschafts- und Wirtschaftsrecht (GWR) 2010, 259 at 259.

348 RegBegr MoMiG at 31.

349 RegBegr MoMiG at 31.

incorporated with a significantly lower (almost none) minimum capital. On the other hand any UG has to make a provision of  $\frac{1}{4}$  of its profits per year<sup>350</sup> that can only be used to increase the minimum capital,<sup>351</sup> until this minimum capital reaches the amount prescribed by § 5 GmbHG, that is € 25.000. At this point the UG automatically becomes a regular GmbH.

This solution might seem elegant, but it has a downside to it. Firstly the compulsory provision diminishes the profit of the UG quite significantly, reducing the funds available for dividend payouts. Especially start-up entrepreneurs whose only income is generated by their corporation can be severely affected by this regulation. Of course the legislation was aware of this problem and offers a peculiar solution: since most small businesses are closely held most members are also directors (or employees) of the UG. Their salaries, which are not affected by the provision since they do not qualify as dividends, provide financial security and livelihood.<sup>352</sup> This might be true, but it offers a convenient way to circumvent the compulsory provision to a large degree.<sup>353</sup> For example by linking the salaries of the member-directors to the success of the UG it is possible that the UG does not generate any profit at all. So even though this was never intended, the UG could become a permanent competitor of the regular GmbH.<sup>354</sup>

A more fundamental and probably regrettable downside is that the legislation avoided to deal with the question if the current system of minimum capital is adequate for small businesses at all. The South African experience with the close corporation provides an excellent example of an ideal-typical corporation for small and medium-sized businesses without any minimum capital. This is not to say that the close corporation could or should be introduced in Germany par for par. But probably this major reform would have been the best time to reconsider the German company law for smaller businesses as a whole. According to the memorandum on the objectives of the MoMiG, the German legislation did not seriously consider a new type of corporation because of the “disproportionate

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350 § 5a III GmbHG.

351 § 5a III No. 1 in association with V GmbHG.

352 RegBegr MoMiG at 32.

353 Also sceptical: Bork/Schäfer, (note 343) at margin no. 20.

354 Weber at 845.

effort”<sup>355</sup> of such a major undertaking. Maybe because of the unforeseen competitive pressure time was running out. But the most important reform of the GmbH since it came into effect in 1982<sup>356</sup> probably would have deserved a more courageous approach after all. For South Africa, on the other hand, the retention of the close corporation would cause no effort at all. The cautious German reform towards a close corporation style incorporation in continental Europe could indicate that it was probably premature to fade out the close corporation.

### 3. Formation

Being a juristic person the GmbH needs to be registered in order to come into existence.<sup>357</sup> To be registered certain documents have to be lodged with the registrar.<sup>358</sup> Normally the founding statement has to be notarially certified.<sup>359</sup> This requirement has often been criticised as too costly for small entrepreneurs. Therefore the MoMiG-reform introduced a simplified formation procedure<sup>360</sup> which is of particular interest from a South African perspective. Instead of lodging a lot of different documents with the registrar, the simplified formation procedure requires just one document: a model-protocol published in schedule I of the GmbHG. This model-protocol is just two pages long and easy to understand, significantly reducing the need for costly legal expertise. Furthermore the model-protocol only needs to be publicly certified which is much cheaper<sup>361</sup> than a notarisation.

To take advantage of the simplified formation procedure three requirements have to be met:

- (1) there need to be no additional provisions deviating from the act,
- (2) the minimum capital has to be paid-in in cash<sup>362</sup> and

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355 RegBegr MoMiG at 31.

356 Bork/Schäfer (note 343) at margin no. 15.

357 However there exists the peculiar concept of the *Vor-GmbH* (pre-GmbH): as soon as the founding statement has been signed by the members the pre-GmbH comes into existence. It is not yet a GmbH, but not just a partnership either – it is a legal structure *sui generis*. Since the members wanted to create a GmbH and the main purpose of the pre-GmbH is to be registered the German Civil High Court (Bundesgerichtshof) ruled that it is appropriate to apply the law of the GmbH to the pre-GmbH whenever possible. See Grunewald (note 323) 2.E. at margin no. 30 f.

358 For details see § 8 I GmbHG.

359 § 2 GmbHG.

360 § 2 Ia GmbHG.

361 Additionally, if an UG is being founded, some other cost-reducing exemptions apply, such as § 41d KostO.

362 To avoid the fairly complex legal problems of a contribution in kind (*Sachgründung*).

(3) the number of members is limited to three and the number of directors is limited to one.

Especially the last requirement is stunning. It is the first time a provision specifically for closely-held companies has been introduced to the law of the GmbH. Even more surprisingly the reasons for this extraordinary step are not being explained by the memorandum,<sup>363</sup> nor does the fairly arbitrary number of three members seem to be founded on some sort of reasoning. Moreover this special requirements passed the scholarly debate largely unheeded.

Yet again the reform could have been a chance to thoroughly question the GmbH-structure as it is and engage on a broader debate – even on a closely-held version of the GmbH. On the other hand this example shows that Germany seems to assume that closely-held structures need special attention. Yet another tiny step towards a close-corporation legislation for continental Europe.

Simple founding procedures, which are of utmost importance to small businesses, require some sort of standard form. The current lack thereof in South African company law has been criticised in chapter D.I.1. already. The example of the German simplified foundation procedure that requires just one two-paged document should be an encouragement to take the task of providing simple, short and suitable standard forms for small and/or closely held companies in South Africa very seriously.

#### 4. Internal Structure

Unlike the close corporation<sup>364</sup> the GmbH consists of at least two compulsory organs,<sup>365</sup> the general meeting of members (*Gesellschafterversammlung*)<sup>366</sup> and at least one director (*Geschäftsführer*).<sup>367</sup> The distinction between those two organs and their respective powers has to be drawn even in a GmbH where the only member is also the only director (*Einpersonen-GmbH*), although in this case

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363 The memorandum simply states that with more members “typically the need for legal advice grows too strong”; RegBegr MoMiG at 27.

364 Pointed out by Olbrisch/Plessis (note 317) at 319.

365 Hueck/Windbichler (note 321) § 36 I at margin no. 1 f.

366 §§ 45 ff. GmbHG.

367 §§ 6 and 35 ff. GmbHG.

some simplifications concerning meetings and decision-making apply.<sup>368</sup> In contrast to the AG there is no compulsory supervisory board (*Aufsichtsrat*), as far as company law is concerned. Depending on the size and business of the GmbH the laws of co-determination (*Mitbestimmung*) can require a supervisory board,<sup>369</sup> but this is irrelevant to small and medium businesses.<sup>370</sup> Although the members (meeting of the members) have a lot of influence on the management<sup>371</sup> the GmbH is represented solely by the director(s).<sup>372</sup> Due to its ideal-typical character the GmbHG, somewhat like the close corporations Act, provides a fairly accessible legal framework in the absence of any special member's agreements.

## 5. Conclusion

Even though the internal structure of the GmbH is very flexible the fact remains that the GmbH – like the company – has to have at least two separate organs with separate powers and liability risk. To put it bluntly: the GmbH suffers to a large degree from the same structural weakness concerning closely-held membership and management structures as the South African company. Therefore the above-mentioned criticism of artificial regulations for closely-held businesses that flow from this separation<sup>373</sup> is largely valid for the GmbH as well. The main reason why this deficit has not caused too many problems for the German GmbH so far might very well be the fact that only a few years ago the GmbH was out of reach for most small entrepreneurs because of the high minimum capital.<sup>374</sup> Now that more and more UGs are being incorporated and the number of small, closely-held UG/GmbHs is rising probably more and more shortcomings of the classic GmbH-model will surface. Keeping in mind that the GmbH serves an ideal-type business that is not strictly speaking closely-held probably just adding more exceptions will not help the fact that the separation of ownership and control is inappropriate for German small entrepreneurs.

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368 See Hueck/Windbichler (note 321) § 35 III at margin no. 32 f. The exemptions are similar to the ones granted by the Companies Act 71 of 2008, see chapter D.II.1.b.i.aa above.

369 § 1 I MitbestG; § 1 I Nr. 3 DrittelbG.

370 The GmbH needs to have more than 500 (DrittelbG) or 2000 employees (MitbestG), respectively.

371 In contrast to the AG the members can instruct the directors on questions of the day-to-day running of the GmbH, see § 37 I GmbHG.

372 § 35 I GmbHG; see also Hueck/Windbichler (note 321) § 36 I 2 b at margin no. 5.

373 See chapter D.II.b above.

374 See chapter E.II.2 above.

So even if the GmbH and especially the UG share some features with the close corporation Germany still falls short of providing a corporate entity truly designed to fit the needs of small and closely-held businesses. Maybe it is time for Germany to embark on a broad discussion, to take off the blinders of 'traditional' corporate law, and to learn from the experiences of others. By de facto abandoning the requirement of a minimum capital<sup>375</sup> and introducing the first provision specifically for closely-held businesses<sup>376</sup> Germany has taken the first step to cautiously following the ideas of Naudé and ultimately South Africa. Ironically at almost exactly the same time South Africa has now chosen to not further pursue the concept of a closely-held business vehicle. Given the criticism outlined in chapter D. above it remains to be seen if South Africa by doing so is once again one step ahead – or if it is simply following in the footsteps of the United Kingdom.

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375 See chapter E.II.2.b above.

376 See chapter E.II.3 above.

## F. Final Remarks: Think Small Through - Thoroughly

Most major policy decisions that somehow affect small businesses claim to have thought small first – in the European Union, Germany, the United Kingdom and South Africa. But what is small? What does small need? And what does it want? Surprisingly these essential questions largely remain unanswered. And as simple as they sound – these questions are highly complex and (inter-)dependent. For instance there is not even such a thing as 'the' small business. As this thesis argues the definition of what is small depends on the purpose the definition is formulated for. For rural development schemes other indicators are relevant than for tax- or labour protection purposes. For the purposes of corporate law the main relevant indicator seems to be a closely-held structure, in most cases amounting to a total personal union of owners and managers.

In this sense the way the new Companies Act is structured and most of all the probably artificial distinction between ownership and control does not seem to be favourable for small businesses. Where there is a high degree of linkage between directors and shareholders, the internal structure of a company which was initially designed to accumulate risk-capital, does not seem appropriate. The simple fact that this did not cause much problems so far can be explained by the informal way many small businesses operate. But sham-compliance and open disrespect for legal provisions are symptom for inappropriate law that ultimately could severely effect the acceptance of law generally. This is not to say that the new Companies Act entirely fails small businesses. The Act has been streamlined, simplified and is more accessible in some respect. What is now important is a simple standard form for small, closely-held and private companies that might help to overcome some of the remaining shortcomings.

But since South Africa was in the favourable position of already having a special corporate structure for closely-held businesses the question has to be raised why the door was shut for the close corporation after all. As the examples of continental Europe show there are no logically consistent arguments that require just one type of incorporated structure. Especially the argument that a one-

company-fits-all approach helps businesses evolve can hardly be supported by statistical evidence. It has been speculated that the close corporation is probably being abolished on grounds of political transformation, since it was invented by a non-democratically elected Apartheid government.<sup>377</sup> And still the close corporation is predominantly the business form of choice for the well-established small to medium businesses which are mostly owned by the white middle-class.<sup>378</sup> As mentioned in the introduction corporate law for SMMEs is of no concern to informal and survivalist entrepreneurs who are still predominantly African.<sup>379</sup> This could explain why the close corporation is not the preferential tool for economic transformation and large-scale poverty alleviation in South Africa – but this is highly speculative.

And probably the reason why the close corporation is being abolished is much simpler and much less political. Like the GmbH the close corporation follows an ideal-typical approach to corporate law, whereas the company depicts the ideal of an ever-growing and changing business that requires flexible structures. From the latter point of view it makes perfect sense not to have any alternative structure – because the one provided should be so flexible as to cater for any needs imaginable. Most drafters of the New Companies Act came from the same legal (anglo-american influenced) background that favours flexibility over ideal types. So probably the whole discussion about whether or not the close corporation should co-exist with a flexible company law regime is subliminally influenced by two completely different points of view on corporate law. Neither of them being perfectly right or wrong. As chapter E. has shown this is not a South African phenomenon. Even though it was decided on the most fundamental reform of the GmbH since its invention the German legislator (and the legal professionals) eschewed thoughts that would have been outside the box. Why not abolish the concept of a minimum capital entirely? Why strictly still insist on a distinction between members and directors?

Without objectively exploring the questions what small is, what it wants and needs policy makers and professionals are likely to be caught in their own

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<sup>377</sup> Du Plessis (note 52) at 271.

<sup>378</sup> Deley, cited through DTI (note 4) at 24; contrary Henning (note 8) at 783 who states that the Close Corporation might be a bridging between formal and informal economy.

<sup>379</sup> According to the DTI (note 4) at 69 f. around 90 % of informal businesses are owned by Africans, whereas they own only 30 % of formal SMMEs.

mindset, restricting themselves to solutions that may make sense – but are probably not the best imaginable. To “Think Small First” we need to really think small through – without wearing blinders of any kind.

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