Kentucky Law Journal

Volume 91 | Issue 4 Article 3

2003

Business Law Reform in South Africa: The Right Path, the Right Reason

Allan W. Vestal
University of Kentucky

Business Law Reform in South Africa: The Right Path, the Right Reason

BY ALLAN W. VESTAL*

TABLE OF CONTENTS

I. INTRODUCTION

Dean Johan Henning's Order of the Coif lecture at the University of Kentucky College of Law was an interesting presentation and a valuable reminder of the correct reason for business law reform.[1] It could serve as a much-needed cautionary note for those of us in the United States involved in such reforms.

As Dean Henning relates the story, business entity reform in South Africa was a response to the economic and political situation in that nation. Informed first by the need for business entity laws to facilitate economic development in South Africa's peculiar economy, and informed somewhat later by the need for business entity laws to facilitate the political development of the post-apartheid society, the South African reforms present a practical and creative response to foster generally-accepted social goals.

---

* Dean and Professor of Law, University of Kentucky College of Law. The assistance of the Order of the Coif in bringing Dean Henning to the United States for the Order of the Coif lecture is gratefully acknowledged.

[1] Johan J. Henning, *Reforming Business Entity Law to Stimulate Economic Growth Among the Marginalized: The Modern South African Experience*, 91 KY. L.J. 773 (2003).

The story of business entity reform during the same period in the United States presents something rather different.[2] Our reworking of business entity law appears much less to do with the pursuit of generally-accepted social goals and much more to do with the combination of academic ideology and private advantage.

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

II. THE SETTING FOR BUSINESS LAW REFORM IN SOUTH AFRICA

On one level, business law reform in South Africa can only be meaningfully discussed with reference to the legal history of the country. By the early 1980s, it had become clear that the incorporation of small businesses under the Companies Act of 1973 was too difficult and complex and that reform was required. Dean Henning traces these developments which resulted in the Close Corporations Act of 1984, " 'a first rate piece of "black letter" law.' "[3]

But the modern legal history, in turn, cannot be understood without reference to the political, social, and economic conditions of the country, especially as the Close Corporations Act of 1984 has been enhanced by the National Small Business Act of 1996.[4] For American readers, several chronological reminders may be helpful. The United Democratic Front formed in 1983, giving voice to the economic and political program of the majority population. Contemporaneous with the 1984 enactment of the Close Corporations Act,[5] which culminated the business statutory reform process of the early 1980s, the ruling Nationalist Party implemented the reactionary Constitution of 1984 that at once increased the political participation of Asian and "coloured" populations but hardened the exclusion of the black population. Subsequently, the economic pressures

---

[2] Allan W. Vestal, *". . . Drawing Near the Fastness?"—The Failed United States Experiment in Unincorporated Business Entity Reform*, 26 J. CORP. L. 1019 (2001) [hereinafter Vestal, *Drawing Near the Fastness?*].

[3] Henning, *supra* note 1, at 784 (quoting *1984 Annual Survey of South African Law* 322).

[4] It is, of course, beyond the scope of this Essay to recount the transformation of South Africa through the curse of apartheid. It is sufficient to note that the business law reform effort in South Africa has proceeded from a common desire to create a more inclusive economic structure.

[5] Henning, *supra* note 1, at 781.

faced by South Africa intensified. The Congress of South African Trade Unions was formed in 1985 as the economic situation in South Africa continued to deteriorate and the political dimension of the black labor front continued to rise. Nelson Mandella was released from prison on February 11, 1990. In 1991, the first national conference in South Africa of the African National Congress ("ANC") was held. On May 10, 1994, Nelson Mandella was inaugurated as the President of the Republic of South Africa. In 1996, the new constitution was approved by the Constitutional Court.

It is against this background that in 1996 South Africa passed the National Small Business Act, establishing the National Small Business Council and the Ntsika Enterprise Promotion Agency.[6] The process of business law reform essentially bookends the process of political reform.[7]

III. PUBLIC POLICY AND LAW REFORM IN SOUTH AFRICA

The South African policy connection cited by Dean Henning is simple: small and micro business[8] are important engines of economic progress,[9] an enabling environment is required for such enterprises to survive,[10] and government can contribute to such an enabling environment by making available a choice of appropriate business forms.[11]

---

[6] *Id.* at 16.

[7] It should, of course, be noted that there are critics from the left of the general political developments associated with the statutory reforms outlined by Dean Henning. Some former left allies of the ANC are particularly strong in their condemnation of ANC policies. *See, e.g.*, Laurence Coates, *South Africa: Interview with Nimrod Sejake: "The ANC has sold out!", at* http://www.socialisterna.org/rs_eng/texts/nimrod.htm (last visited Feb. 25, 2003) (calling for a socialist alternative to the ANC); Felix Kreisel, *ANC government versus black liberation, at* http://www.mit.edu/people/fjk/essays/anc.html (Trotskyist analysis of ANC policies as of 1994) (last visited Feb. 25, 2003).

[8] Interestingly, the National Small Business Act of 1996 contains a schedule that classifies businesses within eleven Standard Industrial Classification sectors or subsectors into "medium," "small," "very small," and "micro" classifications. In each sector or subsector the classification is by the number of employees, the total annual turnover, and the total gross asset value excluding fixed property. *See* National Small Business Act Schedule, *at* http://www.acts.co.za/ntl_small_bus/schedule.htm (last visited Feb. 25, 2003).

[9] Henning, *supra* note 1, at 775-76.

[10] *Id.* at 776.

[11] *Id.*

The policy reasons to support small business formation became even more imperative as South Africa moved to an inclusive economic structure.[12] Dean Henning makes the point with commendable precision:

> [T]he introduction of the close corporation is evidently aimed at a potentially more informal sector of the economy. The close corporation can be seen as giving more power to a lower class so that they may become more of a capitalist middle class. The previous relatively simple enterprise of yesteryear has turned into conglomerates and multinationals of frightening size and complexity. The lower classes cannot exercise real power because there are too many of them, and they are not adequately trained to run an industrial society, least of all able to operate under the complex Companies Act. In this respect the Close Corporation Act can be seen as a moral achievement of a couple of mercantile law experts of South Africa, comparable to the work of the Wiehahn Commission on Labour Law Reform, which was acknowledged by the United Nations.[13]

Dean Henning goes another step by suggesting that the simplification pervading the new legal structure is itself a class victory:

> People in society who have the intellectual and organizational equipment (i.e., wealth) to deal with complex problems are a class of people who benefit from problems being perceived as complex. None more so the case than in company law. The wide-spread sham compliance with company law can be interpreted as the result of accepting the norms of the elite for the whole society. In a very definite sense it is founding prosperity on the oppression of other people. The apparatus with which the rest of society was run was more elaborate than the rest of society needed. The Close Corporations Act dismantles this apparatus in a sense and mitigates its oppressive character. "Thus the legal system looks beyond the class interests of the business elite, doing justice to all classes, applying the moral imperative."[14]

What defines an appropriate business entity for small and micro business? Dean Henning cites five factors: (1) a cheap, fast, and easy start-

---

[12] It may be helpful for American readers to remember the challenge by reading Nelson Mandela's inaugural speech, reproduced in Appendix A.

[13] Henning, *supra* note 1, at 783.

[14] *Id.* at 783-84 (quoting Dirk C. DuToit, *Applying the Moral Imperative: The Close Corporation*, 9 J. JURID. SCI. 1, 108 (1984)).

up, (2) a clear and simple regulatory framework, (3) the removal of legislative impediments, (4) the creation of a good business environment, and (5) continuing reforms to foster entrepreneurship.[15]

The essence, according to Dean Henning, is to put small business first in the attentions of policy makers. "The golden thread underlying government policy dealing with small enterprises should be: 'think small first.' It follows that government should be committed to identifying the needs, characteristics, and problems of small businesses and by putting the needs of these enterprises at the centre of any policy making."[16]

The South African business entity reforms of which Dean Henning speaks, and the policy of thinking small first, which the reforms advance, are at once well-suited to both the economic and the political situation in South Africa. What about the American experience?

IV. PUBLIC POLICY AND LAW REFORM IN THE UNITED STATES

As South Africa was reforming its close corporations' legal structure to include formerly excluded populations from the economic life of the nation, the United States was undertaking a fundamental reworking of its non-corporate business organizations' legal structures.[17] Prior to the reformation of our laws, firms could be organized as general partnerships, limited partnerships, or corporations. After the transformation, traditional general partnership law has been reworked: general partnerships have mutated into limited liability partnerships, limited partnerships into limited liability limited partnerships, and a new form, the limited liability company, has been created.[18] Work has been completed on fundamental revisions to limited partnership law. Finally, the process of combining the separate business organization forms into a single unified form has begun.

One might ask whether the American experiment was as justified by sound public policy, or as successful, as the South African experience. The answer on both counts is, I believe, that the South African record is superior to ours.

As to the policy motivation, I have argued that the American changes were essentially bereft of any legitimate policy justification and that the

---

[15] *Id.* at 775-76.

[16] *Id.* at 778 n.18.

[17] *See* Allan W. Vestal, *"Assume a Rather Large Boat . . . ": The Mess We Have Made of Partnership Law*, 54 WASH. & LEE L. REV. 487, 513-33 (1997) [hereinafter Vestal, *Assume a Rather Large Boat*].

[18] *Id.* at 513.

decade of revision in American unincorporated business entity law was a period "of great change and little accomplishment."[19] There were three essential failures in this regard.[20] First, the revision efforts proceeded without any underlying theory, without any consensus-based theoretical justification.[21] Of course, this is not to say that none of the participants had a coherent theory, only that there was no consensus. As one commentator observed:

> The ongoing revolution in small business structure is driven by the belief that limited liability should be available to businesses without a tax penalty. Some reformers are motivated by a perception that tort liability is out of control; others are motivated by a perception that a corporate level income tax is irrational.[22]

It goes without saying that there is absolutely no consensus that limited liability should be available without taxation, that current patterns and elements of tort liability are inappropriate, or that the taxation of corporations is unjustified. Nor is there consensus on the foundational question of whether business entity statutes for partnership-like firms should be based on a contractual or on a tort model. It is fair to say that the revisions adopt a more contractual model;[23] it is incorrect to suggest that such a move is based on a consensus among the commentators.

The proposition that the process was not initiated with any sweeping policy consensus is demonstrated if one compares the initial charge for the revisions of the Uniform Partnership Act with the end product of the Revised Uniform Partnership Act. The initial charge called for a very limited range of largely technical amendments.[24] The end includes fundamental changes in partnership law, including basic changes in fiduciary concepts and the creation of limited liability partnerships.[25]

---

[19] Vestal, *Drawing Near the Fastness?*, *supra* note 2, at 1019.

[20] *Id.* at 1019-20.

[21] *Id.* at 1020-23.

[22] Dale A. Oesterle, *Subcurrents in LLC Statutes: Limiting the Discretion of State Courts to Restructure the Internal Affairs of Small Business*, 66 U. COLO. L. REV. 881, 881 (1995) (citation omitted).

[23] Vestal, *Assume a Rather Large Boat*, *supra* note 17, at 528-33.

[24] Uniform Partnership Act Revision Subcommittee of the Committee on Partnerships and Unincorporated Business Organizations, American Bar Association, *Should the Uniform Partnership Act be Revised*, 43 BUS. LAW. 121, 123 (1987).

[25] ROBERT W. HILLMAN, ALLAN W. VESTAL & DONALD J. WEIDNER, THE REVISED UNIFORM PARTNERSHIP ACT 189-207 (fiduciary duties), 347-71 (limited liability partnerships) (2002).

The second essential failure of the revision effort was that, because they lacked an agreed-upon theoretical justification, the revision authors engaged in nonpurposeful duplication and the adopting jurisdictions produced an unjustified lack of uniformity.[26] The revision effort is brought into question by its own excess. Why, at the end of the day, did we end up with both limited liability companies and limited liability partnerships? Why have both limited liability partnerships and limited partnerships? The want of an underlying theory has also resulted in wide divergence between the states in their adoptions of the new forms.[27]

The third essential failure of the revision effort was that there was no calculation of a justifiable social exchange in the process; social costs have been imposed without any demonstrable and compensating social benefit.[28] Who were the beneficiaries of this unexamined transfer of social costs? These beneficiaries were partners, including lawyers and accountants, in the form of limited liability; owners involved in the management of firms, in the form of favorable tax treatment and some limitations on liability; and owners who wished to become involved in the management of firms, in the form of limitations on liability. But of course it is not a zero-sum game: losers included potential claimants against the firm, including tort claimants, and society generally from the reductions in tax revenues. The transfers were all but unexamined at the time of the revisions.[29] Even now, as this is written in 2002, the lack of serious policy debate seems especially unfortunate. One wonders what would be the contemporary public reaction to limiting the liability of lawyers and accountants in the midst of Enron, Arthur Anderson, and the other corporate scandals. Would state legislators see the loss of state tax revenues from the creation of LLCs and LLPs as being more important now, in the midst of mounting state budget deficits and an ever-softening economy, than they did in the 1990s?

These were the three essential failures of the American revision effort: it proceeded without any consensus-based theoretical justification, the revision authors engaged in nonpurposeful revisions and the adopting

---

[26] Vestal, *Drawing Near the Fastness?*, *supra* note 2, at 1023-28.

[27] *Id.* at 1026-28; Vestal, *Assume a Rather Large Boat*, *supra* note 17, at 517-28.

[28] Vestal, *Drawing Near the Fastness?*, *supra* note 2, at 1028-29; Vestal, *Assume a Rather Large Boat*, *supra* note 17, at 516-17.

[29] There were commentators who pointed to the policy problems with the revisions. Professor Bob Hamilton pointed to the broad-form LLC liability shield as an example of "gross overreaching by members of the legal profession." Robert W. Hamilton, *Registered Limited Liability Partnerships: Present at the Birth (Nearly)*, 66 U. COLO. L. REV. 1065, 1090-91 (1995).

jurisdictions created an unjustified absence of uniformity because they lacked a theoretical rationale, and the revisions went forward without a resolution of the associated social exchange.

Professor Henning's discussion points us to a fourth serious cost, indicated by the South African admonition to "think small first." The American experimentation in business entity revision is striking in its repeated failure to focus first on the needs of small, unsophisticated firms.[30] This is seen in decisions as basic as the adoption of a contract-oriented conception of the partnership relationship[31] and the adoption of the entity theory of the partnership form.[32]

V. CONCLUSION: THE LESSONS WE SHOULD TAKE FROM THE SOUTH AFRICAN BUSINESS LAW REFORM EXPERIENCE

At the outset of his talk, Dean Henning identified the importance of small and micro-small companies to South Africa, the predicate for South Africa's business organizations law strategy: "Particularly in a country where unemployment levels are high, small enterprises play a valuable role by creating new job opportunities, providing stability, eliminating poverty, improving competitiveness, promoting the development of labour skills, and ensuring economic growth."[33]

What is true for South Africa is no less true for the United States, particularly for the Commonwealth of Kentucky.[34] A primary engine for economic growth and development in this nation and this state is small business. We should be concerned that the American law reformers did not follow the guiding principle of the South African experience: think small, first.

We should be even more concerned that the business law revision effort in America proceeded without any consensus as to a public policy reason for the reforms and without any debate as to the social exchange embodied in the revisions.

It would be a mistake to conclude that American jurisdictions should slavishly follow the South African model of business entity reform. The

---

[30] Allan W. Vestal, *Fundamental Contractarian Error in the Revised Uniform Partnership Act of 1992*, 73 B.U. L. REV. 523, 571-73 (1993).

[31] *Id.* at 572-73.

[32] *Id.* at 572 n.223.

[33] Henning, *supra* note 1, at 775.

[34] Dean Henning is correct in noting the parallel record in the European community. *Id.* at 775 n.1.

historic, economic, and political settings for reform are quite different. However, it would be equally erroneous to conclude that we have nothing to learn from our South African friends.

APPENDIX A

Nelson Mandela's Inaugural Address[**]
May 10, 1994

Your majesties, your royal highnesses, distinguished guests, comrades and friends:

Today, all of us do, by our presence here, and by our celebrations in other parts of our country and the world, confer glory and hope to newborn liberty.

Out of the experience of an extraordinary human disaster that lasted too long must be born a society of which all humanity will be proud.

Our daily deeds as ordinary South Africans must produce an actual South African reality that will reinforce humanity's belief in justice, strengthen its confidence in the nobility of the human soul and sustain all our hopes for a glorious life for all.

All of this we owe both to ourselves and to the peoples of the world who are so well represented here today.

To my compatriots, I have no hesitation in saying that each one of us is as intimately attached to the soil of this beautiful country as are the famous jacaranda trees of Pretoria and the mimosa trees of the bushveld. Each time one of us touches the soil of this land, we feel a sense of personal renewal. The national mood changes as the seasons change.

We are moved by a sense of joy and exhilaration when the grass turns green and the flowers bloom.

That spiritual and physical oneness we all share with this common homeland explains the depth of the pain we all carried in our hearts as we saw our country tear itself apart in terrible conflict, and as we saw it spurned, outlawed and isolated by the peoples of the world, precisely because it has become the universal base of the pernicious ideology and practice of racism and racial oppression.

We, the people of South Africa, feel fulfilled that humanity has taken us back into its bosom, that we, who were outlaws not so long ago, have today been given the rare privilege to be host to the nations of the world on our own soil.

[**] Nelson Mandela's Inaugural Address, *available at* http://www.facts.com/cd/d94338.htm (last visited Feb. 11, 2003).

We thank all our distinguished guests for having come to take possession with the people of our country of what is, after all, a common victory, for justice, for peace, for human dignity.

We trust that you will continue to stand by us as we tackle the challenges of building peace, prosperity, non-sexism, non-racialism, and democracy.

We deeply appreciate the role that the masses of our people and their democratic, religious, women, youth, business, traditional and other leaders have played to bring about this conclusion. Not least among them is my second deputy president, the honorable F. W. de Klerk.

We would also like to pay tribute to our security forces, in all their ranks, for the distinguished role they have played in securing our first democratic elections and the transition to democracy, from bloodthirsty forces which still refuse to see the light.

The time for the healing of the wounds has come. The moment to bridge the chasms that divide us has come. The time to build is upon us. We have, at last, achieved our political emancipation. We pledge ourselves to liberate all our people from the continuing bondage of poverty, deprivation, suffering, gender and other discrimination.

We succeeded to take our last steps to freedom in conditions of relative peace. We commit ourselves to the construction of a complete, just and lasting peace. We have triumphed in the effort to implant hope in the breasts of the millions of our people. We enter into a covenant that we shall build the society in which all South Africans, both black and white, will be able to walk tall, without any fear in their hearts, assured of their inalienable right to human dignity—a rainbow nation at peace with itself and the world.

As a token of its commitment to the renewal of our country, the new interim government of national unity will, as a matter of urgency, address the issue of amnesty for various categories of our people who are currently serving terms of imprisonment.

We dedicate this day to all the heroes and heroines in this country and the rest of the world who sacrificed in many ways and surrendered their lives so that we could be free. Their dreams have become reality. Freedom is their reward.

We are both humbled and elevated by the honor and privilege that you, the people of South Africa, have bestowed on us, as the first president of a united, democratic, nonracial and nonsexist South Africa, to lead our country out of the valley of darkness.

We understand it still that there is no easy road to freedom. We know it well that none of us acting alone can achieve success. We must therefore

act together as a united people, for national reconciliation, for nation building, for the birth of a new world.

Let there be justice for all. Let there be peace for all. Let there be work, bread, water and salt for all. Let each know that for each the body, the mind and the soul have been freed to fulfill themselves.

Never, never, and never again shall it be that this beautiful land will again experience the oppression of one by another and suffer the indignity of being the skunk of the world. The sun shall never set on so glorious a human achievement. Let freedom reign. God bless Africa.