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Pragmatic Reform: Lessons from the South African Experiment

BY J. WILLIAM CALLISON*

Dean Johan Henning's article, *Reforming Business Entity Law to Stimulate Economic Growth Among the Marginalized: The Modern South African Experience*, is a thoughtful and thorough analysis of recent changes to South African business entity laws. Dean Henning's article does not use the term "democracy." However, one suspects that Henning and others hope that increased popular participation in the South African economic structure will foster a democracy and possibly diminish or eliminate a caste system.¹ Some scholars have noted that corporate law

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¹ In my view, the heart of Dean Henning's article is found in the following paragraph:

According to a discerning commentator, the 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 Labor Law reform, which was acknowledged by the United Nations. 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

has played a role in the democratization of the United States,² but a more

founding prosperity on the oppression of other people. The apparatus with which the rest of society was run was more elaborate than the rest of society needed. The Close Corporations Act dismantles this apparatus in a sense, and thus mitigates its oppressive character. "Thus the legal system looks beyond the class interests of the business elite, doing justice to all classes, applying the moral imperative."

Johan J. Henning, *Reforming Business Entity Law to Stimulate Economic Growth Among the Marginalized: The Modern South African Experience*, 91 KY. L.J. 773, 783-84 (2003) (quoting Dirk DuToit, *Applying the Moral Imperative: The Close Corporation*, 9 J. JURID. SCI. 108 (1984)). Henning notes that these underlying political goals do not mean that the South African Close Corporations Act is merely a "vicissitude of political expediency," and that the Act is a "first rate piece of black letter law," but the fact that the Act is both carefully crafted and of broad application does not detract from its power. *Id.* at 784. The Act is designed in part to propel economic and social change in post-apartheid South Africa by enabling marginalized people to enter into the South African economic system, thereby giving them a stake in their society.

² See, e.g., Stephen B. Presser, *Thwarting the Killing of the Corporation: Limited Liability, Democracy, and Economics*, 87 NW. U. L. REV. 148 (1992). Presser notes that the expansion of corporate limited liability protections to small business enterprises was instrumental in nature:

The popular democratic justification for limited liability is rarely observed by modern scholars. Nevertheless, it appears that to the nineteenth-century legislators in states such as New York, who mandated limited liability for corporations' shareholders, the imposition of limited liability was perceived as a means of encouraging the small-scale entrepreneur, and of keeping entry into business markets competitive and democratic. Without limitations on individual shareholder liability, it was believed, only the very wealthiest men, industrial titans such as New York's John Jacob Astor, could possess the privilege of investing in corporations. Without the contributions of investors of moderate means, it was felt, the kind of economic progress states like New York needed would not be achieved.

The author of the most comprehensive study of New York legislative policy toward corporations in the nineteenth century concluded that New York's policy of limited liability, and its policy of encouraging incorporation by persons of modest means "facilitated the growth of a viable urban democracy by allowing a wide participation in businesses that could most advantageously be organized as corporations." "More importantly," he suggested, New York's general incorporation statutes "helped equalize the opportunities to get rich. The passage of general incorporation laws for business corporations was the economic aspect of the political and social forces that democratized the United States during the Age of Jackson, 1825-1855." This historian's insight has escaped modern legal economists.

Id. at 155-56 (internal citations omitted).

applicable American equivalent would have been the use of business entity law as a means of integrating African-Americans into political and economic structures in the post-Civil War Reconstruction period.³ Although drawing cross-cultural historical parallels is a risky business at best, one is led to wonder whether the failure of American Reconstruction demonstrates that democracy and freedom cannot be obtained by private entrepreneurial initiative alone (regardless of whether it involves free labor or capital), but instead require a powerful national state guaranteeing equal standing in the polity and equal opportunities in the economic system. If that is indeed the case, one wonders whether South Africa is willing to depart from libertarian conceptions of economic liberalism, forging its own path toward a more inclusive society and a more vital democracy.

Dean Henning's article evidences a pragmatic view that business organization law should not be a matter of orthodox ideology imbedded in an unchanging set of principles, but instead, like a coral reef, should grow by accretion over time and should be hospitable to living things. His pragmatic approach has American parallels. American pragmatic philosophy is based on a belief that ideas are tools devised by people "to cope with the world in which they find themselves," that ideas are produced by groups of individuals, that ideas are social constructs and are dependent on their human carriers and their environment, and that the survival of ideas depends on their adaptability.⁴ Business corporations do not exist independ-

³ Rather than business entity laws designed to permit participation of former slaves in the economic system, "free labor" was considered a means for establishing freedom and some economic integration. See ERIC FONER, *RECONSTRUCTION: AMERICA'S UNFINISHED REVOLUTION 1863-1877* (1988). Foner writes:

[I]t remains true that [the Radical Republicans] hoped to reshape [American] Southern society in the image of the small-scale competitive-capitalism of the North. As Carl Schurz put it, "a free labor society must be established and built up on the ruins of the slave labor society." While many moderates shared this goal, few wished to hold Reconstruction hostage to such a transformation. To Radicals, however, the South's political and social "regeneration" formed two sides of the same coin. "My dream," one explained in 1866, "is of a model republic, extending equal protection and rights to all men. . . . The wilderness shall vanish, the church and the school-house will appear; . . . the whole land will revive under the magic touch of free labor."

Id. at 235.

⁴ LOUIS MENAND, *THE METAPHYSICAL CLUB* xi-xii (2001). Menand also notes that, regardless of [the pragmatic philosophers'] view of ideas' provisionality, pragmatic philosophy was designed to support a democratic political system in which everyone is equally in the game, and that ideas should constitute an ever-

ently of some idea of the “corporation.” The pragmatic view of corporate law is that ideas about the social construct called a corporation change over time as the device is adapted to present and future social and political realities. South Africa’s business entity laws are a powerful reminder that the idea of the corporation, or of any other business entity form, is not immutable and can be an ends-driven tool for meeting social needs.

Dean Henning’s article also reflects an understanding that the corporation is not merely an instrument for facilitating a market economy, but is also a significant social and political institution. In American law, the corporation is treated as a person such that it can contract, own property, sue and be sued, and is subject to income tax liability (except when it is not, such as the S corporation). Notwithstanding this recognition of legal personality, there has been controversy over the place of the corporation in contemporary American society. The principal issues at stake in the continuing debate about corporate law theory involve individual responsibility and obligations, wealth distribution and redistribution, and the use of state power to govern what might be perceived as private relationships. This debate over whether the corporation is essentially a private contractual arrangement, or whether the corporation is a public institution with public obligations, is not new,⁵ and it has not been

changing means to this democratic end. *See id.* at 439-42.

⁵ For example, the *Dartmouth College* case involved a suit by the board of Dartmouth College, a Federalist-dominated private institution in Hanover, New Hampshire, against its former treasurer, who had defected to Dartmouth University, a Republican-dominated public university in Hanover, New Hampshire, to recover the College’s original charter and corporate property. *Dartmouth College v. Woodward*, 17 U.S. (4 Wheat.) 518 (1819). The New Hampshire legislature, then dominated by Republicans, had rewritten the College’s charter to replace the original trustees, rename the school, mandate religious freedom, reappoint a Republican school president, and establish a board of overseers to represent this public interest; in short, the legislature attempted to accomplish a state takeover of a private institution by changing the corporation’s organic documents. *Id.* at 539-44, 554. The replaced trustees argued that the original charter constituted a contract between Dartmouth College and the state, and that the legislature’s actions violated the United States Constitution’s Contract Clause, which provides that no state may pass a law “impairing the Obligation of Contracts.” *Id.* at 557. The New Hampshire Supreme Court distinguished between “private corporations,” which are protected from government intervention through the Contract Clause, and “public corporations,” which are established to benefit the public and therefore are subject to public control. *Id.* at 562-75. The court held that Dartmouth College was a public institution; therefore, the Contract Clause did not prevent the people, acting through their elected representatives, from intervening in corporate governance

resolved.⁶

American business organization law has undergone significant change over the last dozen years, with the promulgation of a new Uniform Partnership Act and a new Uniform Limited Partnership Act, and the creation and widespread adoption of the limited liability company, limited liability partnership, and limited liability limited partnership business entity forms. Dean Allan Vestal laments that these changes were made without any underlying theory, that the drafters of the new statutes engaged in nonpurposeful duplication that produced an unjustified lack of uniformity, and that social costs were imposed by the new statutes without any demonstrable social benefits.⁷ While I agree with these conclusions, I view the underlying problem as a failure to recognize the public nature of business organizations, to consider and define the social ends to be achieved, and to pragmatically draft legislation relevant to those ends. The new business organization statutes adhere to the individualistic, contractarian stance that has dominated academic discourse over the last generation, and the statutes are based on an overarching commitment to property rights. Under this property rights conception, it is believed that shareholders, partners, members, and other business owners should not be compelled to forego their right to maximize profits except to the extent that they have *ex ante* contracted for limitations on these rights. The freedom-of-contract approach to business organization law focuses on the extent to which legal

matters. *Id.* at 624.

The United States Supreme Court, then Federalist-dominated, reversed and held that the New Hampshire legislature's actions were "repugnant to the constitution of the United States." *Id.* at 654. In his concurring opinion, Justice Story repudiated the "public" and "private" definition established by the New Hampshire Supreme Court. *Id.* at 668-77. "[P]ublic corporations are such only as are founded by the government, for public purposes. . . . If, therefore, the foundation be private, though under the charter of the government, the corporation is private, however extensive the uses may be to which it is devoted. . . ." *Id.* at 669-70. Thus, *Dartmouth College* became the basis for claims that the Contract Clause protects corporate affairs from state regulatory intervention, and people who wished to subject corporations to public accountability were required to find other (less direct) means for doing so.

⁶ See J. William Callison, *Federalism, Regulatory Competition, and the Limited Liability Movement: The Coyote Howled and the Herd Stampeded*, 26 J. CORP. L. 951, 965-78 (2001) (noting dominance of economic efficiency theory and contract theory in corporate law, and recognizing the existence of alternative approaches, including communitarian theory, to corporation law).

⁷ Allan W. Vestal, *Business Law Reform in South Africa: The Right Path, the Right Reason*, 91 KY. L.J. 829 (2003).

rules facilitate private ordering. The law essentially becomes a set of default rules designed to approximate the rules that would be adopted by most people entering into a business relationship in the absence of a particular, private agreement.

The dominant view that business organizations essentially are creatures of private contract is found in the recent extension of limited liability protections to all firm types, specifically to unincorporated business organizations in which some or all owners previously had unlimited personal liability, and in new statutory rules concerning owners' fiduciary duties to the firm and their co-owners. Theoretical justifications for expansive limited liability protection are grounded both in economic efficiency theory and in the theory that business firms constitute a nexus of private contracts (real and hypothetical) in which the government has a minimal regulatory role.⁸ A conversation concerning the extension of limited liability protection could have included discussions about the extent to which utilitarian theories should apply and the extent to which business organizations should be viewed as an extension of their owners that do not separate owners from broader responsibilities to those affected by the firm's activities. This conversation was not held, and the primary beneficiary of limited liability extension was the private business owner rather than the commonwealth.

Similarly, although a more robust conversation was held concerning the nature of fiduciary duties in unincorporated business organizations, the various new statutes adopted an overarching premise that business organizations are private structures, and therefore that fiduciary duties are primarily a private contract matter rather than a collection of socially determined rules of conduct.⁹ Thus, in most of the new business organization statutes, the fiduciary duty of good faith and fair dealing has been changed to a contract-based obligation, and the remaining fiduciary duties have been limited in scope and have been made broadly amendable or waiveable by contract.¹⁰ In the fiduciary duty arena, the last decade has witnessed a privatization of business organization law in which broader social values largely have been deemed irrelevant.

⁸ Callison, *supra* note 6, at 965-78.

⁹ See J. William Callison, *Blind Men and Elephants: Fiduciary Duties Under the Revised Uniform Partnership Act, the Uniform Limited Liability Company Act, and Beyond*, 1 J. SM. & EMERG. BUS. L. 109, 117-23 (1997).

¹⁰ See, e.g., *id.* at 116 (noting that "RUPA drafters believed that the good faith and fair dealing obligation arises from the partners' contractual relationship" and "does not treat it as an independent fiduciary duty.").

Dean Henning traces the rapid development of South African close corporation statutes. Indeed, the American unincorporated business organization statutes also developed and changed rapidly over the last decade, and American business entity law continues to develop at a rapid pace. However, one is struck by the multidimensional thinking that was incorporated in the South African drafting process. While recent American drafters limited their focus to the perceived private nature of business organizations, the South African drafters recognized that laws governing private business relationships can be a means to accomplish a public good beyond profit maximization. Further, while American drafters seemed to ignore history and to assume that it was the then-dominant corporate law theory that fixed the role of business organizations, the South African drafters recognized that they lived in history, acknowledged the historical setting in which they operated, and attempted to draft legislation to fit that dynamic setting. The lessons of the South African experience, particularly its pragmatism and its recognition that business organization law has a robust public dimension, should form a backdrop for the continuing American business entity law reform process.

