Corporate & Commercial

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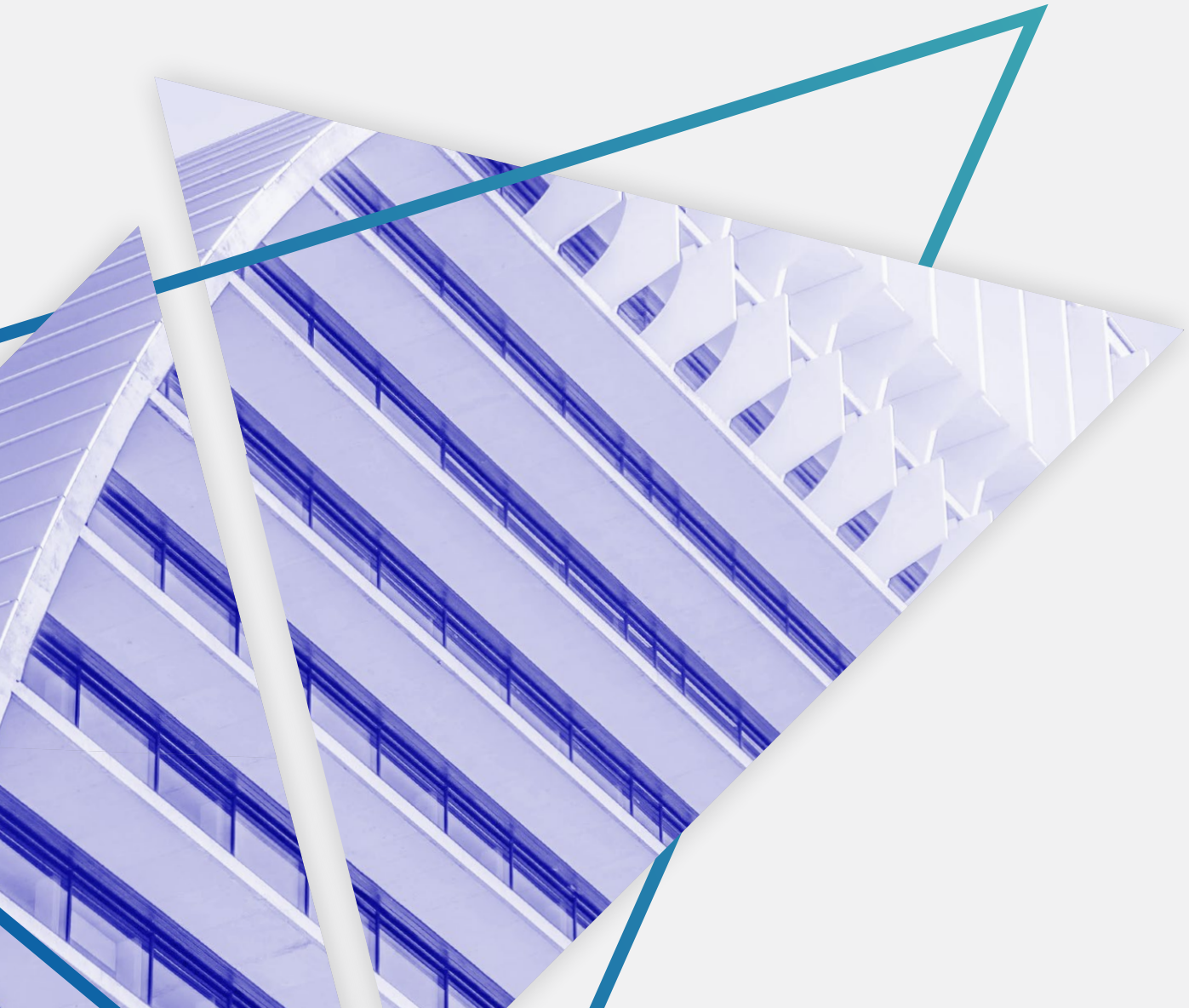

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SOUTH AFRICA

No blissful ignorance for non-compliance: The Turquand rule and section 20(7) in the context of special resolutions and fundamental transactions

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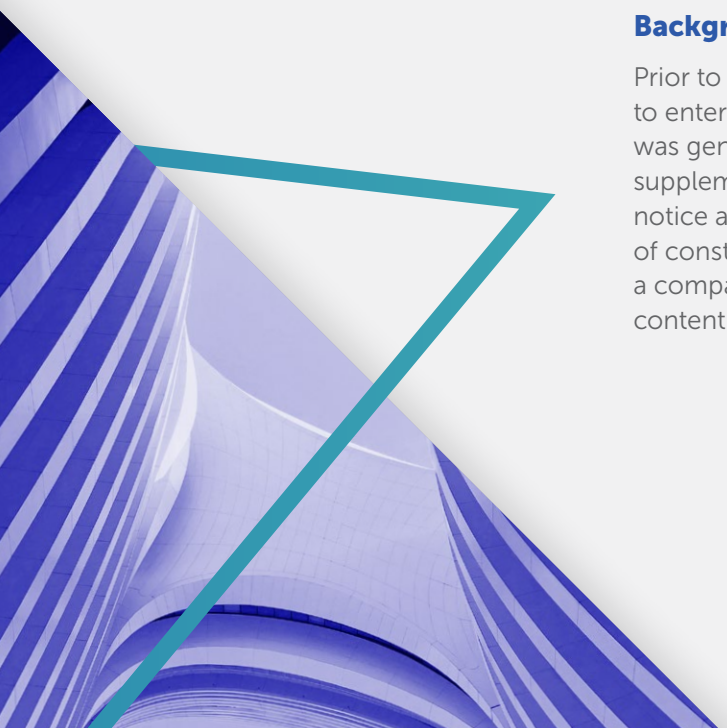
No blissful ignorance for non-compliance: The Turquand rule and section 20(7) in the context of special resolutions and fundamental transactions

The Turquand rule has been discussed and fairly applied in the South African jurisprudence. However, an interesting question remains as to whether the Turquand rule or section 20(7) of the Companies Act 71 of 2008 (Companies Act) can be used to compel a party to implement a transaction where the party has not complied with the applicable provisions of the Companies Act requiring a special resolution of shareholders for the disposal of all or a greater part of the company's assets or undertaking, amalgamation or merger, or a scheme of arrangement (fundamental transactions). The jurisprudence has adopted the take-no-prisoners approach so far.



Background

Prior to the Companies Act coming into effect, the authority to enter into an agreement on behalf of a company was generally governed by applicable agency principles supplemented by the common law doctrine of constructive notice and the common law Turquand rule. The doctrine of constructive notice provided that a person dealing with a company could not argue that they did not know the contents of the public documents of that company.

As a result of the doctrine of constructive notice, a person had no legal recourse if a company refused to implement a transaction on the basis that the implementation would conflict with requirements in its public documents. As such, this doctrine could potentially allow a company to evade liability or renege on an agreement.

The English courts formulated the Turquand rule, named after the case of *Royal British Bank v Turquand*, as a means to mitigate the harsh effects of the doctrine by providing that persons contracting with a company and dealing in good faith can assume that acts within the company's constitution have been properly and duly performed and are not required to enquire whether acts of internal management have been regular. Although distinguishable, section 20(7) of the Companies Act provides a similar remedy, which includes that a person is entitled to presume that the company, in making any decision in the exercise of its powers, has complied with all of the "*formal and procedural requirements in terms of the Companies Act, its memorandum of incorporation and any rules of the company*".

Section 20(7) in the context of special resolutions

It is uncertain whether a person can contend that they are protected by section 20(7) on the basis that a special resolution is a formal or procedural requirement and they are entitled to presume that the requirement has been complied with. Section 20(7) does not address the validity of a possible invalid transaction due to non-compliance with the Companies Act. Therefore, the answer to this question would depend on the interpretation of "*formal and procedural requirements*".

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First, it is difficult to perceive a requirement for a special resolution for a fundamental transaction in terms of section 115 as "*formal and procedural*". These provisions are substantive and their applicability will depend on the nature of the transaction itself. Secondly, if the coming into effect of the transaction is dependent on the ultimate approval of the shareholders it cannot be a mere "*formality*" or "*procedure*". However, matters such as the period of notice, the quorum and the voting procedure can be seen as formal or procedural, but not the decision itself.

Through the courts

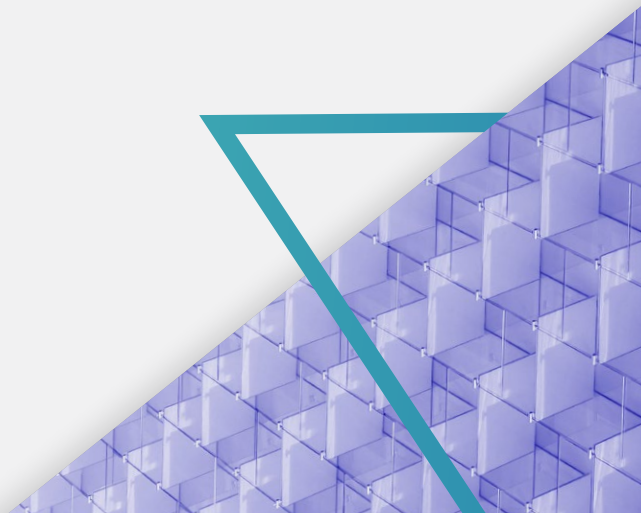
The court held in *Farren v Sun Service SA Photo Trip Management (Pty) Ltd* that, the Turquand rule did not operate in the context of section 228 of the Companies Act 61 of 1973 (1973 Companies Act), which was the equivalent of section 112 read with section 115 of the Companies Act. In a case decided under the Companies Act, *One Stop Financial Services (Pty) Ltd v Neffensaan Ontwikkelings (Pty) Ltd*, the court found that "*formal and procedural requirements" in section 20(7) must be construed "consistently with the conventional scope of Turquand*". Therefore, at the very least, a resolution of the shareholders must have passed despite the irregularities thereof (resolution irregularities).

Similarly, in *Stand 242 Hendrik Potgieter Road Ruimsig v Göbel*, the decision was reached based on the interpretation that the objective of section 228 of the 1973 Companies Act was to protect the shareholders, and to admit that the application of the Turquand rule would nullify the efficacy of section 228, would defeat the object of the legislature.

These judgments raise the question of the extent to which the principles therein can be extended to the numerous other instances in the Companies Act where a special resolution is required for fundamental transactions.

Practical considerations

If the findings would be equally applied in superior courts, which is not certain, it can be agreed that in all the instances where a special resolution is required in the context of fundamental transactions, the Turquand rule or section 20(7) would not apply. Provisions requiring shareholder resolutions in terms of the Companies Act are contained in legislation which a contracting party must be aware of or take legal advice on to avoid disputes regarding the implementation of the transaction at a later stage.



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It is imperative to seek guidance from legal advisors to draft for the uncertainty by making the transaction agreement subject to suspensive conditions to be fulfilled prior to the transaction becoming effective and crafting appropriate warranties in the transaction agreement in respect of corporate approvals required for a particular transaction.

Although section 20(7) may be available in the event of resolution irregularities, in order to avoid initiating legal proceedings to utilise the provision which may be lengthy and costly, it may be worth conducting a due diligence investigation to consider the constitutional and other relevant documents of the company to ensure that the corporate approvals given do not contain resolution irregularities. The due diligence investigation may also assist in determining whether the transaction is a fundamental transaction, and thereby requires a special resolution.

While the Turquand rule or section 20(7) remains a useful defence, it is no excuse for ignorance of the law despite the innocence or oversight in omitting to procure the required special resolutions for fundamental transactions. The affected party may have to resort to other remedies available in law.

Thandiwe Nhlapho

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Our BBBEE verification is one of several components of our transformation strategy and we continue to seek ways of improving it in a meaningful manner.

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