When the close corporation structure was phased out, the reason given by the Department of Trade and Industry was that it was ‘necessary to move away from the largely artificial separation between the different business forms [closed corporations and companies], to recognise only one formal business vehicle and to provide for a simple, easy company formation process’ (‘South African company law for the 21st century – guidelines for corporate law reform’ GenN 1183 GG 26493/23-6-2004). The extent to which the new Companies Act 71 of 2008 provides for a cheaper, simpler incorporation process for small companies is, however, debatable. Those looking for alternatives may instead consider a trading trust. This was referred to by the court in Nieuwoudt and Another NNO v Vrystaat Mielies (Edms) Bpk 2004 (3) SA 486 (SCA) as ‘a newer type of trust’ that has comparatively recently come into our law with the rise in popularity of the trust as an estate planning tool.

Using a trading trust to run a business

One of the obvious benefits of using a trust in this manner is that trusts, like companies, provide limited liability to trustees and subsist in perpetuity. Trusts can be sequestrated in their own right, without creditors looking to trustees, beneficiaries or the founder of the trust. Trusts may also provide a tax advantage.

Trading trusts are generally not subject to the same strict requirements as regular, or ‘passive’, trusts. Where trusts are used as business vehicles they must be able to take the normal risks that directors could take in the course of running a company. There must, however, be provision for this in the trust deed. No powers are given to trustees by either the common law or legislation and the common law rule that trustees must always act in the best interests of

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In Land and Agricultural Bank of South Africa v Parker and Others 2005 (2) SA 77 (SCA) the court decided that it is possible to apply the doctrine of piercing the veil to trusts where there is an insufficient separation between control and enjoyment of trust assets (at para 29). This means that trustees must still act in the interests of the beneficiaries of the trust, and can be held personally liable for breach of this duty. This may be coupled with a delictual claim if a loss has been suffered, except where this has been caused by factors beyond the control of the trustees. This suggests that, even if the trust deed makes provision for normal business risks to be taken by the trustees of a trading trust, trustees are likely to remain more risk averse than directors of a company. This can retard the growth of the business and prevent the large returns that a company may produce. Thus, for certain types of business such a structure may not be a viable option.

Amendment of trust deeds

Amending a company constitution, while not necessarily an easy process, is a feasible exercise. Amendments may be effected by shareholders or members by way of special resolution, which usually requires a 75% majority. Trust deeds on the other hand may be very difficult, if not impossible, to amend. This greatly reduces the practicality of using a trading trust in lieu of a company.

In our law, amendment of an inter vivos trust must be done in accordance with contractual principles, unless the trust deed provides otherwise. As confirmed in Potgieter and Another v Potgieter NO and Others 2012 (1) SA 637 (SCA) there must be consent of all parties to the trust deed, including the trustees, founder and vested beneficiaries. However, if there are a large number of beneficiaries, it may be impossible to obtain unanimous consent to an amendment. A testamentary trust is even more difficult to amend because it is created in accordance with the law of succession and subject to the almost hallowed principle of freedom of testation.

Although the trustees can be given the power to amend a trust deed, this must be limited by objectively ascertainable criteria. The trust deed may also give the founder the power to amend the trust unilaterally. In practice, however, this is rarely done. Section 3(3)(d) of the Estate Duty Act 45 of 1955 provides that, when a deceased had control over property immediately prior to his or her death, in that he or she could have disposed of such property, that property is deemed to be included in his or her estate for estate duty purposes. Thus, if a founder has the power to amend the trust unilaterally, the saving of estate duty - one of the most important benefits of creating a trust - is lost.

A trust deed may also be amended by a court in terms of s 13 of the Trust Property Control Act 57 of 1988 (TPCA) where circumstances arise that were unforeseen by the founder of the trust at the time that the trust was created. A change in circumstances must either render the terms of the trust prejudicial to beneficiaries, be against public policy or be likely to defeat the objects of the founder in creating the trust. Cases such as Minister of Education and Another v Syfrets Trust Ltd NO and Another 2006 (4) SA 205 (C) and Curators, Emma Smith Educational Fund v University of KwaZulu-Natal and Others 2010 (6) SA 518 (SCA), have focused on public policy and public interest, arguing that the provisions of the trust deed were unconstitutional and out of touch with modern reality.

Whether the section could apply to the situation where there is simply a refusal to amend by a beneficiary is still undecided. Although the common law ob causum necessarium rule, which has essentially the same character as s 13, has been applied to vary the terms of a trust deed in the past, the courts have been somewhat erratic in their application of the rule and this is a precarious route to follow.

Public policy and the residual rules

Use of the trading trust structure also has certain drawbacks for the general public. At common law, trustees are required to act jointly in making decisions that affect the trust unless the trust deed provides otherwise, as they are considered to be co-owners of the trust property. If trustees do not act jointly, the act is void. This mechanism was put in place for the protection of beneficiaries and tends to work well in a traditional trust setting. In a trading trust, however, this can be a disadvantage for those attempting to contract with the trust. Unfortunately the TPCA provides no guidance when it comes to holding a trust bound to a contract.

In company law there are well-developed principles covering a situation where a person contracting with a company is unaware of internal irregularities or breaches of the company’s constitution. These are known as the residual rules and have been developed by the common law. In line with this, s 19(4) of the 2008 Companies Act excludes the doctrine of constructive notice, except in very specific circumstances, and confirms and expands on the common law Turquand rule. The doctrine of constructive notice states that an outsider contracting with a company is deemed to know the contents of the company’s...
constitutions, Sections 207(7) and (8) of the Act allow the Turquand rule to be applied by a company outsider in order to hold a company to a contract if that contract is not in fact binding on the company because of some internal irregularity that the outsider could not, and did not, know about. These provisions ensure that an innocent outsider is protected when contracting with a company.

In the Parker case (at para 32) the court warned that outsiders must be careful when dealing with trusts. Because trust deeds are often couched in obscure language and are difficult to access, the primary responsibility for compliance with internal formalities and ensuring that contracts are concluded within the authority conferred by the trust deed, lies with the trustees. The courts and the master also have a role to play in ensuring that the trust form is not abused and that contracts are run in accordance with principles of business efficacy, sound commercial accountability and the reasonable expectations of outsiders that deal with them (at para 37).

What this means in practice is unclear. Although the court in the Parker case appeared reluctant to apply the doctrine of constructive notice to trusts because of the potential for abuse of the trust form, there is no definite pronouncement to this effect and no indication what a court may decide in future.

The application of the Turquand rule to trusts is similarly unclear. In the Parker case the court stated that this rule may apply to trusts, but did not pronounce on it. In the Nieuwoudt case (at para 8) the court found it unnecessary to decide the question, although it did state that the ‘newer type of trust’ is troubling and may be problematic, given that trusts are not held personally liable for trust deeds.

Lack of regulatory mechanisms

Regulation of trusts, save from a tax and financial perspective, has traditionally been sparse in our law. Although the growing popularity of trusts for estate planning purposes has made legislation dealing with the creation of trusts necessary, the state’s traditional suspicion of such vehicles as a means of tax avoidance has contributed to the lack of legislation.

Although the TPCA does regulate certain aspects of trusts, it gives no guidance as to trustees’ powers, which must derive from the trust deed itself. As a result trust deeds may contain very different provisions, with only a few judicial decisions as guidance. Trust companies generally have standard trust deeds, but foundries may require the insertion of specific alternative provisions to standard ones.

Another problem is that a trading trust need not be audited, except when required by the master or the trust deed. Although this makes a trading trust cheaper and easier to run, this lack of oversight may be detrimental to an outsider contracting with the trust.

Trusts are of course able to be flexible long-term planning tools – NOVEMBER 2013

Parker case the court stated that this

Proposed tax reforms

In the 2013 budget speech delivered on 27 February 2013, the Minister of Finance remarked that the budget review ‘outlines various measures proposed to protect the tax base and limit the scope for tax leakage and avoidance. The taxation of trusts will come under review to control abuse’ (www.treasury.gov.za/documents/national%20budget/2013/speech/speech/pdf, accessed 10-10-2013). The unpredictability of future reforms that may affect the ability of a trust to act as a meaningful alternative to a company means that using a trading trust to run a business becomes inherently problematic, given that trusts are long-term planning tools and may be difficult to terminate.

Conclusion

Whatever impact the stance taken in the budget review has on the creation of trading trusts, it is certainly less risky to run a business through a company structure. Whether a trading trust is a viable alternative to a company also depends on the type of business the trust conducts. For smaller businesses a trading trust may be useful, provided that the trust deed is clearly drafted and made available to prospective customers. This process should ensure that the trading trust does not become subject to time-consuming litigation, and that trustees who act with reasonable care and skill are not held personally liable for trust debts.