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Disposing of the undertaking or the greater part of the assets of a company

The Turquand rule versus section 228 — an old conflict resurfaces

Introduction

Section 228 of the Companies Act 61 of 1973 is one of the provisions restricting the powers of the directors. The synthesis between this section and the Turquand rule has been the subject of academic gymnastics for some while. Prior to the commencement of the Act, the Van Wyk De Vries Commission realized this problem and recommended that section 70dec(2) of the Companies Act 46 of 1926 (the predecessor of s 228) be amended to protect the interest of third parties (Main Report RP/1970, Recommendation 104, as referred to by Lionel Hodes ‘Disposal of assets — s 228’ 1978 South African Company LJ F-6 at F-12). But nothing was done in section 228 to give effect to this recommendation.

Proponents of the Turquand rule contend that this rule should prevail. However, supporters of section 228 advocate the conservative approach that the intention of Parliament should take precedence, unimpeded by the Turquand rule or estoppel.

The conflict between these two schools of thought featured once more in Farren v Sun Service SA Photo Trip Management (Pty) Ltd [2003] 2 All SA 406 (C). The parties entered into a contract of sale in terms of which the company sold its immovable property to Farren. This property was the company’s sole asset. Klages represented the company in concluding this transaction. She was the sole director of the company and held a minority interest in it. Most of the shares in the company were held by a German company controlled by her mother. Later, the company (through Klages) informed Farren that it would no longer continue with the sale. Farren rejected the repudiation and applied urgently for specific performance of the sale contract. She claimed that the company should take all steps necessary to ensure the signing of the requisite documents to effect transfer of the property to her. On the return date, the company raised the following defences in respect of its non-performance:

- In terms of the addendum to the contract of sale, Farren agreed to acquire shares in the
company instead of taking transfer of the property.

- No general meeting of the company was called or held to approve or ratify the sale. Nor was the transaction subsequently ratified or approved.

The court’s decision of the first argument was based purely on the interpretation of the contract. I shall not discuss it here but merely say that I think the court was right in dismissing it. The addendum in no way suggested that the parties intended Farren to acquire shares instead of the property. Nor shall I discuss whether Farren was entitled to succeed on the basis of estoppel.

The second argument triggered the dispute over section 228 and the Turquand rule. The applicant argued that Klages represented at all material times that she had the necessary authority to bind the company. Although the applicant did not specifically plead the Turquand rule (namely, that Farren did not know that the approval of the general meeting was not obtained and so was entitled to assume that all internal requirements had been complied with), the court assumed that Farren did. So the court had to decide whether the Turquand rule or section 228 should prevail.

After a careful analysis of academic and judicial writings on this question, Cleaver J concluded that section 228 took precedence over the Turquand rule.

Here I shall examine these conflicting views. Although I do not necessarily disagree with the court’s finding, I have no doubt that section 228 should be amended for the proper protection of parties involved in a similar transaction. A balance needs to be struck between the interests of the beneficiaries of section 228 and the innocent victims of directors’ non-compliance with this section.

### Section 228 of the Companies Act

Section 228 of the Act reads in part as follows:

‘(1) Notwithstanding anything contained in its memorandum or articles, the directors of a company shall not have the power, save with the approval of a general meeting of the company, to dispose of —

(a) the whole or substantially the whole of the undertaking of the company; or

(b) the whole or the greater part of the assets of the company.

‘(2) No resolution of the company approving any such disposal shall have effect unless it authorizes or ratifies in terms the specific transaction.’

Section 70dec(2) of the 1926 Act was materially similar to the current section 228. Framed in the positive, section 228 prescribes that directors need the approval of the general meeting

- to dispose of
- the whole undertaking or assets of the company, or of
- substantially the whole of the undertaking or the greater part of the assets of the company.

The approval must authorize or ratify a specific transaction (s 228(2)). Thus the authorized transaction must be ‘capable of being exactly named or indicated’ (Ally & others NNO v Courtesy Wholesalers (Pty) Ltd & others 1996 (3) SA 134 (N) at 146).

The term ‘disposition’ is not defined in the Act. So the term is given its ordinary meaning: ‘to part with or get rid of’ something. The disposition intended is that which has the effect of permanently depriving the company of its right to ownership of the property (Ally supra at 145). Whether the ‘whole or substantially the whole undertaking or assets of the company’ are being disposed of seems to be a question of fact which varies from case to case (see Hodes op cit for a discussion of these concepts). The test applied to determine whether the greater part of the company’s assets is disposed of is the test of value (Novick & another v Comair Holdings Ltd & others 1979 (2) SA 116 (W) at 145):
'the price which the assets under consideration would fetch in a bona fide sale between a willing buyer and a willing seller, both of whom are reasonably well informed about the transaction, and neither of whom is under extraordinary pressure to buy or to sell, as the case may be'.

The resolution required for the disposition is an ordinary resolution, not a special resolution. The main difference between the two kinds of resolution is that ordinary resolutions are passed by a simple majority of shareholders and are not registered by the Registrar of Companies. Special resolutions, by contrast, must be passed by a two-thirds majority and must be so registered (ss 199–200 and 202–203). The effect of this registration is that the special resolution thus becomes a public document of the company and that, in terms of the doctrine of constructive notice, third parties dealing with the company will be deemed to have knowledge of its contents (see my conclusion below).

It is worth noting that approval may be given after the conclusion of the contract (s 228(2)).

Section 228 limits the power of directors to dispose of the undertaking of the company; it does not limit the capacity of the company to do so (Basil Wunsh 'Disposing of the undertaking or assets of a company' (1971) 88 SALJ 351 at 352). The intention of Parliament is to protect shareholders ‘who have placed the control of the company in the hands of directors’ (Farren supra at 411).

The Turquand rule

The Turquand rule is derived from an English case: The Royal British Bank v Turquand (1856) 5 E & B 248 (119 ER 474), affirmed in 6 E & B 327 (Exchequer Chamber) (119 ER 886). The rule was accepted as part of South African law in The Mine Workers’ Union v JJ Prinsloo; The Mine Workers’ Union v JP Prinsloo; The Mine Workers’ Union v Greyling 1948 (3) SA 831 (A) (see Levy & others v Zalrut Investments (Pty) Ltd 1986 (4) SA 479 (W) at 487).

Generally, a third party who contracts with the directors (as representatives of the company) may hold the company liable to the contract only if —

- the company has the capacity to enter into the said contract, and
- the directors have the necessary authority to bind the company.

The directors’ power to enter into certain contracts may be limited or even excluded. The articles of association may, for example, provide that directors may not conclude particular contracts without the approval of the general meeting. (The articles of association are regarded as a public document (by virtue of their being registered) and so everyone dealing with the company is deemed to have knowledge of their contents.) A third party who reads the articles would know that the approval of the general meeting is required, but would be uncertain whether it was actually obtained, because ordinary resolutions are not public documents. But for the Turquand rule, he would not be able to hold the company liable under the contract. To limit the third party’s duty to inquire, the Turquand rule provides that if that party deals with the company in good faith (not knowing that the necessary approval was not given), and the circumstances are not such that he should have suspected that the approval had not been given, then he is entitled to assume that all internal formalities have been complied with. So the company cannot argue that it is not bound to the contract because directors had no authority or exceeded their authority.

The present conflict

Wunsh (op cit at 353) submits that the resolution of a general meeting required by section
70dec(2) of the 1926 Act is an act of internal management, and that ‘the case of directors disposing of the undertaking of a company without such approval is indistinguishable from the position in Turquand’s case, save that the limitations on the directors’ powers are derived from a statute’. If one takes the provisions of section 228 of the 1973 Act, beginning with the words ‘the directors’ in subsection (1), and puts them in the articles of association, they attract the Turquand rule like any other internal formality. Essentially, then, the only difference between section 228 and other internal formalities is that the latter are contained in the articles whereas the former is contained in a statute. But ‘[i]n both cases the powers of the directors are limited by a document of which the public is deemed to have notice and the power can be supplemented by an act of internal management’ (idem at 353). Making a great deal out of this distinction, the court in Farren held (at 413): ‘For reasons which the legislature considered sound, it was decided that the provisions in question should be embodied in a statute, thus giving them far more weight’.

The question whether statutory provisions carry more weight than the provisions of the articles of association falls outside the scope of this article. For a discussion of why the Turquand rule should apply, see Basil Wunsh ‘Section 228 of the Companies Act and the Turquand rule’ 1992 TSAR 545.

In Levy supra at 487, Van Zyl J held that ‘there is likewise no indication that the public interest or public policy played any part in the intention of the legislature when it enacted ... s 228. A third party involved in a transaction relating to the said disposal will hence undoubtedly be able to enforce such transaction, provided he is not aware thereof that the company in general meeting has in fact not approved of the transaction.’

The court in Levy relied in this case on the Turquand rule. This view was shared by Wunsh (1992 TSAR 548) (see also Michele von Willich ‘Die uitwerking van a 228 van die Maatskappywet 61 van 1973 op die ‘Turquand-reël’ (1988) 10 Modern Business Law 7). But some doubt whether this conclusion can be reconciled with the intention of Parliament in section 228 (PE) Brooks ‘Section 228 of the Companies Act’ (1987) 50 THRHR 226 at 228-229; JSA Fours ‘Verkoop van die onderneming van die maatskappy — het artikel 228 van die Maatskappywet nog betekenis?’ 1992 TSAR 1; Hodes op cit at F12-F13). It is common cause that section 228 is directed at protecting the interest of shareholders. Allowing the third party to obtain the undertaking of the company will accordingly not be in the interest of shareholders. Von Willich (op cit at 14) argues that the interests of innocent third parties should prevail against those of shareholders, as the latter are entitled to claim damages from the errant directors for breach of fiduciary duty.

The court in Farren held (at 413):

‘If it is accepted that the objective of the legislature was to protect the shareholders, then surely that intention should be given effect to, for otherwise “admitting the application of the Turquand rule may resolve the dilemma, but will nullify the efficacy of section 228 and will defeat the object of the legislature”... ’.

So Von Willich’s implied view that Parliament intended to limit the directors’ authority while preserving the effect of the Turquand rule was dismissed.

**Conclusion and comments**

Farren has confirmed the invidious position in which third parties find themselves when directors contravene section 228. The court seems to have based its finding on the fact that if an internal management rule is incorporated in a statute, it carries more weight. Whether this is justifiable I am not sure. But as I indicated earlier, legislative intervention is necessary to curb the conflict between section 228 and the Turquand rule. In my opinion, the rationale of the Turquand rule also applies squarely when the undertaking or the greater part of the assets...
of the company is sold. A purchaser who reads section 228 would still be uncertain whether the general meeting had approved such a sale, since ordinary resolutions are not registered. So there is no reason why the third party’s duty to inquire should not be restricted in this instance, nor is there any reason why he should not assume that the directors have complied with the Act.

The judgment has far-reaching implications for a person who deals with a company. To determine whether section 228 applies, the purchaser will be required to inquire:

- whether the relevant transaction is a ‘disposition’; and
- whether the object of the sale is ‘substantially the whole of the undertaking or the greater part of the assets of the company’.

I feel that it might be difficult for the purchaser to determine whether the object of the sale is the ‘whole undertaking’ or the ‘whole assets’ of the company.

Having determined the above, the purchaser will then know whether the transaction requires a resolution of shareholders in terms of section 228. If it does, he should then find out whether the necessary resolution was passed.

This process is, I feel, unjustifiable. It is difficult to conclude that Parliament intended these consequences. What is clear, though, is that in trying to protect shareholders, Parliament failed to strike a balance between the interests of shareholders and of innocent third parties.

I suggest that the present conflict may be averted if section 228 were amended so that the relevant disposition could be completed only by way of a special resolution. The purchaser would then be protected, because a special resolution must be registered in order to be effective (s 203(1)). The purchaser would then have constructive notice of that resolution, since it will be open for inspection by the public. Similarly, shareholders would retain control over the disposition of their investments; they would also be more protected than they are in terms of the existing section 228, because section 199 requires a greater majority of votes to pass a special resolution than does an ordinary resolution.

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