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HOLDING COMPANIES ACCOUNTABLE - THE TURQUAND RULE

Article by CGF Research and reviewed by Cliffe Dekker Hofmeyr Inc.

South Africa's democracy has now almost completed its second decade of transformation, and the country has seen much needed change across many of its social, civil and business sectors. But, political commentators and business critics may argue that some of the changes in South Africa have indeed caused certain matters to regress in practical terms. The typical examples of this criticism may be found in the county's high levels of crime and corruption, stubbornly high unemployment rates, poor municipal service delivery, growing social unrest, civil turmoil, political uncertainty and an ailing education system. And while business leaders cite their growing concern around these issues, it is becoming abundantly clear that many companies may not have fathomed yet another looming challenge in the new Companies Act, 71 of 2008 which they will need to address if they are to survive the might of a more informed and empowered consumer, or a third party wishing to take their company to task and adding yet further to their woes.

With the introduction of the Companies Act, 71 of 2008 ('the Act'), a number of significant changes were brought about which were beneficial for the formation, administration and general functioning of a company. These changes were necessary to also improve the company's corporate governance and its efficiency, by aligning the Act with international best practices and safeguarding the interests of the company and its stakeholders. While the Act now includes a number of protection mechanisms for shareholders, employees and other stakeholders, the company is -- through the Act -- now legally compelled to regulate its internal affairs and procedures through the introduction of the *Memorandum of Incorporation* ('MOI'), which is the new term ascribed to the company's constitution.

"The rule which later came to be known as the doctrine of indoor management [Turquand Rule] was carved out so as to prevent the doctrine of constructive notice, used by companies to their advantage, from becoming an impediment to trade and commerce as otherwise third parties would be seriously affected if constructive notice was applicable in all cases."

Source: Evolution of the Doctrine of Indoor Management | Law

Rather surprisingly, many companies have overlooked the importance and function of their MOI, a document which now fulfills the role that the company's Memorandum and Articles of Association had under the previous Companies Act, 61 of 1973 ('old Act'). To make matters worse, the MOI has -- in some instances -- simply been "brushed over" by the company's internal legal departments or company secretariat, and they have missed its significant importance as a practical tool to guide the actions and behavior of mostly their directors, board committees and prescribed officers. Expectedly, there are a number of compulsory matters which must be contained in a company's MOI, but in addition to these, many companies have failed to include the manner in which they will deal with the Act's so-called *alterable provisions* (i.e. provisions which can be adapted and modified by the company in its MOI) which cover issues such as corporate governance (in particular the procedures of the board and the shareholders), delegated power of authority, separation of duty and limitations on the board's powers which it has under the Companies Act, to mention a few.

As boards of directors begin to reflect upon the implications of the Act, including their MOI which may currently lack the required detail for its company officers to clearly understand their boundaries of authority, respective mandates and expected behavior; they may well have reason to be concerned. In the previous era of the old Act, some directors may typically have sought board approval for their actions -- which were in fact contrary to the rules and policies of the company -- to have their wrong-doing "quietly condoned". Most often this approval was granted by the board *after* the deed had already taken place, and perhaps sometimes as a "cover-up" to protect both the director and the company. This practice was rife, and whilst the Act has now toughened up its stance on unauthorised actions of directors, it is most likely still being done as directors remain "ignorant" of their violations in order to benefit the company or themselves in one way or another. It is worth noting that the new Companies Act 2008 has singled out the issue of acting without authority as a particular concern. In section 77, specific statutory personal liability is created in respect of directors and other officers for knowingly acting without authority (and "knowingly" in the Act means not only actual subjective knowledge but also captures those situations where the director *ought reasonably to have known* of his lack of authority). In section 78, which deals with the competence of companies to indemnify or insure their directors and officers, one of the specific exceptions to this competence is where the liability is incurred pursuant to the director / officer knowingly acting without authority.

As boards and directors may have momentarily taken their eye off the ball and perhaps not kept abreast of the changes in the Act, they should be reminded that the *doctrine of disclosure, the doctrine of constructive notice and the Turquand rule* are significant items for consideration. Some brief background and context to the *Turquand* rule (which originated in the old English case of *Royal British Bank v Turquand (1856) 6 E&B 327 - o*rdinarily, if an unauthorised agent (purports to) act on behalf of the principal, the principal is not bound. Of course, strict application of this general rule in the sphere of companies would be unfair to third parties and detrimental to commerce, thus the *Turquand* rule was developed as long ago as the 1850's to protect third parties; the rule held that a *bona fide* third party is entitled to accept that the company's internal processes and requirements were duly met in order for the agent to act properly on behalf of the company.

But prior to the new Companies Act, the *Turquand* rule had an important and significant counter: the doctrine of disclosure and doctrine of constructive notice favoured the company and its unauthorised agent. To illustrate this point through a simple example; prior to the new Act a third party may have approached a company's director (or any agent of the company) with a legitimate intention of conducting business with a company, but may not have been aware that the director was not authorised to transact on behalf of the company. Expectedly, in such a circumstance, should the company have indeed benefitted through the transaction with the third party -- despite that fact that the actions of the director were *ultra vires* -- everyone would have been pleased and the matter would simply have been over-looked and closed. But, let's say the transaction turned out to be disadvantageous to the company? Of course the company would have quickly informed the third party that the transaction was void and that the company was not bound by the contract because the director in question was not authorised to transact on behalf of the company. In short, the company would have claimed (rightly so) that the transaction was not valid and that it was the third party's responsibility to ensure that he had in fact checked that the director of the company was indeed authorised to transact, in terms of the company's constitution (which would typically not have given a single ordinary board member the authority to transact on behalf of the company without board approval). Besides the fact that the third party would have most likely suffered some form of financial loss as a result of this unfortunate situation, one does need to question whether or not the third party was *actually* able to determine -- or know -- whether or not the director was good for business in the first place? Besides, in this example, this was a director of a company and similar to the third party, one would have assumed that at this level, it would have been reasonable to believe and trust the level of the director's seniority and that the director had the power to transact. Not so! In using its corporate advantage against the third party, the company would have relied on the doctrines of disclosure and constructive notice, stating that it was the third party's duty to inform himself whether or not the director was authorised to transact. In this vein, under the doctrine of disclosure, it would have been incumbent upon the third party to also familiarise himself with the contents of the company's public records. The company's defence would have claimed that the third party was deemed to have knowledge of the company's public records, including its constitution. It soon came to be realized that this doctrine was quite unrealistic and untenable, especially considering the fact that a third party may not have had access to the necessary information due to the fact that such information may not have been made fully available by the company in the first place. Understandably, a third party as illustrated under the old Act in this example was pretty much at the mercy of the company. But, in the new Act, things have changed to favour the third party with a great line of defence against company behaving in this manner.

The *Turquand* rule has now been codified in the new Companies Act in an arguably stricter form, and further the doctrine of constructive notice has been abolished save for very limited exceptions (which are referred to below, in the context of "special / restrictive conditions"). In short -- with the exception where a third party knew or ought to have reasonably known that they were dealing with a person in a company who was not authorised to transact, a third party may now safely presume that the people within the company are complying with both the Companies Act and their own internal procedures and policies. Moreover, that people who say they are authorised to transact on behalf of the company are in fact authorised to do so. If any person in the company claims their authorisation falsely, or does so regardless of the company's procedures or permissions, the company may find itself having to honour its obligations contained through such a contract which is now legally enforceable. The company would then have to pursue appropriate recourse against its unauthorised agent, whether those be disciplinary measures or claims for damages under the sharpened personal liability provisions of the Act.

For this reason, it is imperative that all the company's officers are fully informed of the contents of the MOI and that they abide with its provisions, especially when it comes to matters concerning those who can or cannot bind the company, and the procedures which must be followed. Interestingly, when a third party discovers that the person who acted *ultra vires* of the company's rules and signed a contract without the authority to do so -- known as a *limping contract* -- the third party may then have a claim for damages against the company (if the company was at fault for allowing its unauthorised agent to go on a frolic of his own). Save for the third party knowing (or being reasonably expected to have known) that it was dealing with a person in the company who did not have the authority to bind the company, the only other area wherein a company could have a defence against unauthorised actions on the part of its employees, would be where the company indicates special or restrictive conditions to which the attention of a third party must be drawn. It is in this area where the doctrine of constructive notice is retained by the Act and continues to play a limited role. Such attention to these provisions is known as *"ring fencing"* and the company must indicate this by way of endorsing the letters "RF" to the name of the company and clearly drawing attention to such provisions in its notice of incorporation, as well as making reference to the special conditions within the company's MOI. However, with the legal-technical nuances of the doctrine of *ultra vires* and the *Turquand* rule as set out in the Act, even reliance on the "RF" defence may be fraught with difficulties.

Clearly, companies will need to pay a lot more attention to the provisions of their MOI, and being careless about its construct and provisions for unambiguous lines of authority and delegated powers will surely lead to increased risks and unwanted exposure for potential damages. Moreover, if the company has not clearly marked its RF clauses, it will have very little, if any, defence against a third party who resorts to the Turquand rule, unless the company can prove that the third party had knowledge, or ought to have had knowledge of the company's non-compliance of their internal rules and policies and that the third party acted in bad faith.

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