

PRE-INCORPORATION CONTRACTS: STATUTORY REFORM*

CAROLINE B NCUBE

Lecturer, University of Cape Town

INTRODUCTION

South African company law is undergoing a major two-stage overhaul that will culminate in the coming into force of the Companies Act 71 of 2008. The first stage was completed with the coming into force of the Corporate Laws Amendment Act 24 of 2006 on 14 December 2007 (Proc 47 GG 30594 of 14 December 2007) and the second stage will be completed with the coming into force of the Companies Act, 2008. This Act has been assented to by the President and was published for information on 9 April 2009 (GN 421 GG 32121 of 9 April 2009). Section 225 of this Act provides that it will come into force on a date fixed by the President by proclamation in the Gazette, which may not be earlier than one year following the date of presidential assent. The earliest that the Act can come into force is therefore 9 April 2010. This note examines certain aspects of the regulation of pre-incorporation contracts contained in s 21 of the Companies Act, 2008, read with the definition of the term 'pre-incorporation contract' contained in s 1. The policy considerations underlying the current provision regulating this issue (s 35 of the Companies Act 61 of 1973) and some of the difficulties of interpretation that section has presented will be considered, with a view to evaluating whether there is any policy shift evident in s 21, and whether its provisions represent an improvement on its predecessor. The formulation of s 21 draws on the provisions of its counterpart in the recently amended New Zealand Companies Act, 1993, and so consideration will also be given to those provisions.

This note finds that although the imported provisions relating to pre-incorporation contracts are based on a more balanced and nuanced

* I am indebted to Professor Richard Jooste, the late Professor Michael Larkin and Graham Bradfield for their invaluable comments on earlier drafts of this note. The usual disclaimer applies.

policy, our importation of these provisions is less than ideal, as it duplicates problematic provisions which ought to have been avoided. The note therefore concludes that the proposed reforms relating to pre-incorporation contracts are in principle commendable, but suffer from some defects which should have been rectified before enactment.

This note does not purport to be a comprehensive analysis of pre-incorporation contracts. Rather, it seeks to offer insights on some aspects of s 21. As a result, several issues fall beyond the scope of this note. Such issues include an analysis of its provision for shareholder protection, and an examination of how, if at all, s 21 protects unsophisticated promoters and regulates the interim period between conclusion of the pre-incorporation contract and the incorporation of the company.

SECTION 35 OF THE COMPANIES ACT

Pre-incorporation contracts are currently regulated by s 35 of the Companies Act, which was recently amended by s 8 of the Corporate Laws Amendment Act. Section 35 now reads:

‘Any contract made in writing by a person professing to act as agent or trustee for a company not yet incorporated shall be capable of being ratified or adopted by or otherwise made binding upon and enforceable by such company after it has been duly incorporated as if it had been duly incorporated at the time when the contract was made and such contract had been made without its authority: Provided that the memorandum on its registration contains as an object of such company the ratification or adoption of or the acquisition of rights and obligations in respect of such contract, and that such contract, has been lodged with the Registrar together with the lodgement for registration of the memorandum and articles of the company.’

This section creates a form of statutory agency by providing for the ratification by a company after its incorporation of a contract concluded on its behalf by a person professing to be its agent or trustee before its incorporation. (See H S Cilliers, M L Benade, J J Henning, J J du Plessis, P A Delpont, L de Koker, J T Pretorius *Cilliers & Benade Corporate Law* 3 ed (2000) para 5.04 (hereafter *Cilliers & Benade*); M S Blackman, R D Jooste, G K Everingham, M Larkin, C H Rademeyer, J L Yeats *Commentary on the Companies Act* vol 1 (Revision Service 2007) 4-4-4-13 (hereafter *Commentary*); Tshepo Mongalo *Corporate Law & Corporate Governance: A Global Picture of Business Undertakings in South Africa* (2003) 104-8). At common law this would not be possible: one cannot act as an agent for a non-existent principal nor can the principal, once it comes into existence, ratify such acts retrospectively (*Kelner v Baxter* [1866] LR 2 CP 174 incorporated into South African law by *McCulloch v Fernwood Estate Ltd* 1920 AD 204; *Cilliers & Benade* paras 5.02-5.03; *Commentary* 4-6 and 4-10-1; Wilfred M Estey ‘Pre-incorporation contracts: the fog is finally lifting’ 2000 *Canadian Business LJ* 3 at 7; *Kantey & Templer (Pty) Ltd v Van Zyl* NO 2007 (1) SA 610 (C) para 38). A pre-incorporation contract can be effectively ratified under s 35 provided the stipulated requirements are met. First, the promoter must

expressly disclose that he is contracting on behalf of a prospective company, as ‘trustee’ or ‘agent’. Secondly, the pre-incorporation contract must be reduced to writing. Thirdly, the memorandum of the company upon registration must list the ratification of that contract as one of its objects. Fourthly, the contract must be lodged with the Registrar of Companies together with the memorandum and articles of association when the application for the incorporation of the company is made. (Prior to 14 December 2007, two copies of the pre-incorporation contract, one of them notarized, were required — see s 8 of the Corporate Laws Amendment Act, 2006). Finally, ratification under s 35 by a company with a share capital is possible only after the company becomes entitled to commence business (*Commentary* 4-10-1; *Cilliers & Benade* paras 5.06–5.11).

The interpretation of this section has proved to be problematic in certain respects. For example, it is debatable whether a ratified pre-incorporation contract comes into force retrospectively from the date of its conclusion (Richard Jooste ‘When do pre-incorporation contracts have retrospective effect?’ (1989) 106 *SALJ* 507 at 50; *Commentary* 4-10-1). *Peak Lode Gold Mining Co Ltd v Union Government* 1932 TPD 48 at 51–2 held that pre-incorporation contracts ratified under s 71, the predecessor to s 35, could not have retrospective effect. On the other hand, the current general consensus of academics is that ratified pre-incorporation contracts have retrospective effect unless the parties agree otherwise (*Cilliers & Benade* para 5.19; *Commentary* 4-10-4-11; Mongalo op cit at 108; Maleka Femida Cassim ‘Pre-incorporation contracts: reform of section 35 of the Companies Act’ (2007) 124 *SALJ* 364 at 387–9; Jooste op cit; Jennifer A Kunst, Piet Delpont & Quintus Vorster (eds) *Henochsberg on the Companies Act* 5 ed vol 1 (Issue 24) 63–4 (hereafter *Henochsberg*)). As stated above, the purpose of s 35 is to overcome the general difficulty of agency at common law, one aspect of which relates to ratification (Jooste op cit at 508; Cassim op cit at 364). Therefore, if s 35 is complied with, pre-incorporation contracts ought to have retrospective effect unless the parties agree otherwise. This makes ratification in terms of s 35 consistent with ratification at common law (*Cilliers & Benade* para 5.19; H R Hahlo *South African Company Law through the Cases* 6ed (1999) 106).

POLICY CONSIDERATIONS

Before discussing the proposed reforms it is instructive to consider the current policy considerations underpinning s 35. This will provide the backdrop to my assessment as to whether a policy shift is necessary, and if so, what modifications to s 35 are appropriate under the new company law dispensation.

It appears that the main aim of s 35 is the protection of the promoter (Cassim op cit at 368; *Henochsberg* 62) by providing a mechanism to avoid personal liability on a pre-incorporation contract. However, such protection

is at the expense of the third party ‘who bears the full risk of non-ratification’ (Cassim *op cit* at 368). Section 35 leaves third parties particularly vulnerable because it does not provide for any obligation of a promoter prior to ratification or upon non-ratification due to non-incorporation of the prospective company, or a post-incorporation refusal to ratify the contract by the company (*Henochsberg loc cit*). In the present socio-economic context of post-apartheid South Africa, both government policy and practice encourage and facilitate increased entrepreneurial activity by historically disadvantaged and often unsophisticated people. Consequently, to expose third parties to the risks of s 35 is inequitable (Cassim *op cit* at 368–9).

The counter-argument to the position just presented would be that although s 35 does not provide for the liability of promoters, it does offer some protection for third parties, as it requires a promoter to disclose or ‘profess’ that he represents an unincorporated company. Such disclosure is in effect a warning to third parties — one which should accordingly place them on their guard. It alerts them to the need to negotiate with promoters and thereby secure accountability or liability of the promoter should the pre-incorporation contract fail. The obvious retort to this argument is that such a warning does not assist an unsophisticated third party who would not know how, and perhaps even why, he should ensure the inclusion of a promoter’s liability clause in a pre-incorporation contract (see Cassim *op cit* 378 on the third party’s lack of appreciation of the complexities of pre-incorporation contracts).

Clearly, a policy shift is necessary to achieve a more balanced treatment of potentially predatory promoters and third parties — possibly unsophisticated entrepreneurs — who enter into pre-incorporation contracts. Third parties can be placed in a better starting position by way of clearly stipulated protection, out of which the parties could then contract if they agreed to do so. This would ensure that vulnerable third parties are not left to their own devices in determining the scope and content of the protection for which they must ask in contracting with promoters. Promoters, who are usually better-equipped, ought rather to bear such responsibility (Cassim *op cit* at 368). In striving to achieve a balance in this manner, care must be taken with the regulation of exemption clauses in pre-incorporation contracts, because such clauses take away the protection the law has extended to third parties. Two conflicting policy concerns emerge here, namely freedom of contract and the protection of third parties (Natasha M Johnson *Pre-incorporation Contracts in Company Law: A Comparative Study* (unpublished LLM thesis, University of the Western Cape, 2000) 183). Promoting freedom of contract exclusively would mean that it would be left entirely up to the parties to exclude a promoter’s liability and to enforce all such clauses in all circumstances. But unsophisticated third parties are unlikely to appreciate the full import of exemption clauses; therefore the position needs to be mitigated by factoring in the protection of third parties.

An appropriate way to do this would be to balance freedom of contract and protection of third parties by enforcing only those exemption clauses

that are simply and clearly worded (Cassim op cit at 378). This would be in accordance with the treatment of exemption clauses generally at common law, which employs strict and narrow construction (Francois du Bois (ed) *Willie's Principles of South African Law* 9 ed (2007) 811–14; Robert Sharrock *Business Transactions Law* 7 ed (2002) 209, citing *First National Bank of SA Ltd v Rosenblum and Another* 2001 (4) SA 189 (SCA) and *Barnard v Protea Assurance Co Ltd t/a Protea Assurance* 1998 (3) SA 1063 (C); see also *Durban's Water Wonderland (Pty) Ltd v Botha* 1999 (1) SA 982 (SCA) at 989 H–I and *Drifters Adventure Tours CC v Hircocock* 2007 (2) SA 83 (SCA) para 10). This policy is informed by the need to protect vulnerable third parties from contracting parties who seek to limit their usual liability at law. The law is wary of such exclusions of liability because they may be abused to the detriment of third parties. In view of the already precarious position of third parties entering into pre-incorporation contracts, they perhaps deserve more protection than the general common law approach to exemption clauses. Indeed, some commentators have argued for the creation of standard exemption forms or clauses that are clearly and simply worded to ensure meaningful third party protection (Cassim op cit at 378).

THE REFORM OF SECTION 35

Section 1 of the Companies Act, 2008 begins the reform of s 35 with the following definition of a 'pre-incorporation contract':

'[A]n agreement entered into before the incorporation of a company by a person who purports to act in the name of, or on behalf of, the company, with the intention or understanding that the company will be incorporated, and will thereafter be bound by the agreement.'

This definition is extremely important because it clearly indicates that the Act only applies when a promoter purports to act as an agent, not as a principal, when concluding a pre-incorporation contract. Currently, it is not indisputably clear that s 35 applies to agency situations alone, because it also refers to 'professed' trustees who generally act as principals (*Cilliers & Benade* para 5.08; *Sentrale Kunsmis Korporasie Bpk (Edms) v NKP Kunsmisverspreiders (Edms) Bpk* 1970 (3) SA 367 (A) at 398B). The implication is that where a promoter purports to act as a principal, the position will be regulated by the common law rules of *stipulatio alteri*. The promoter's agency status will be discussed further in a subsequent part of this note.

Formalities

Section 21's first and most striking departure from s 35 is the omission of the formal requirements relating to lodgement of the pre-incorporation contract with the Registrar and listing its ratification as one of the company's objects in the memorandum of incorporation (memorandum). The requirement that pre-incorporation contracts be reduced to writing is retained. The possible reasons for the retention of this requirement and the omission of the lodgement and objects clause requirements are discussed in turn below.

Written pre-incorporation contracts

Section 35 requires, for certainty's sake, that a pre-incorporation contract must be reduced to writing before it may be susceptible to ratification. A written contract is an important component of a company's records, and ensures full and accurate disclosure within the company, for example from promoter to the directors (A J Easson & D A Soberman 'Pre-incorporation contracts: common law confusion and statutory complexity' (1992) 17 *Queen's LJ* 414 at 447; Estey *op cit* at 12 note 34). Section 21 retains this requirement through subsec 1, which reads (my emphasis):

'A person may enter into a *written agreement* in the name of, or purport to act in the name of, or on behalf of, an entity that is contemplated to be incorporated in terms of this Act, but does not exist at the time.'

The retention of this requirement is commendable because it is dictated by the need for certainty and full disclosure.

Stipulation in the objects clause requirement

In so far as it relates to the capacity of a company, the proposed removal of the s 35 requirement that the ratification of pre-incorporation contracts be listed as an object in the objects clause of a company's memorandum is understandable. Currently, a company has limited capacity and can only validly do what its memorandum's objects clause permits it to. Section 19(1)(b) of the Companies Act, 2008 proposes to change this by giving companies the capacity of a natural person as far as it is possible for a juristic person. A company's memorandum will therefore not need to state a main object (Cassim *op cit* at 394). As a result, there should be no need to list the ratification of a particular pre-incorporation contract as a specific object of a company.

However, to the extent that there were any other reasons for the enactment of this requirement, perhaps there is a need to retain it, albeit not as an object but simply as a disclosure requirement. Disclosing the ratification of a pre-incorporation contract in the company's memorandum and the lodgement of the relevant pre-incorporation contract serve as an important protection of outsiders who may wish to extend credit to or invest in the company (Cassim *op cit* at 394). Potential creditors or investors intending to transact with a particular company can determine its pre-incorporation commercial activities from that company's memorandum. This enables them to make informed decisions about whether to transact with or invest in that company. But the corollary of such potential creditor/investor protection is that such disclosure requirements are prejudicial to companies, as will be apparent from the discussion below (*Cilliers & Benade* 63; Cassim *op cit* at 394).

The pertinent question therefore is whether the protection that this requirement purports to offer outweighs the potential prejudice to companies. In selecting to remove this requirement, Parliament has decided that the potential prejudice to companies outweighs outsider protection. This

decision is justifiable because outsider protection can be achieved by other means. For example, the financial status of some companies may be ascertained through the perusal of their audited annual financial statements filed at the Registrar of Companies' offices upon payment of the prescribed fees. In other instances, assurances of a company's liquidity and solvency or an overview of its commercial undertakings can be requested directly from that company. If false or inaccurate information is given by a company in order to induce a third party to enter into a contract, that third party will also have ordinary contractual remedies upon discovery of the misrepresentation.

Lodging copies of pre-incorporation contracts

The removal of the lodgement formality by the Companies Act, 2008 raises an interesting related point. Section 8 of the Corporate Laws Amendment Act, 2006 amended s 35 to remove the formal requirement of the lodgement of two copies, one notarized, of pre-incorporation contracts. Companies now only have to lodge 'the contract'. This seems to be a reference to the original pre-incorporation contract because, prior to its amendment, s 35 expressly required copies of the pre-incorporation contract. It may be that one uncertified copy of the relevant pre-incorporation contract would suffice, but if that is the case the provision should have said so expressly. It is not clear why this amendment was deemed necessary, as ultimately s 21 removes the lodgement requirement altogether. Modifying a requirement that will soon be abolished is confusing: affected persons are required to adapt to new laws which are, in any event, due to be abandoned within three years of their introduction.

The Corporate Laws Amendment Act was intended to deal with urgent matters that could not be delayed until the enactment and coming into force of the new Companies Act. Consequently, the only justification for so modifying the lodgment requirement prior to its ultimate removal by the new Companies Act would be that it is currently highly prejudicial or onerous. This is certainly not the case here, because it is not very onerous to secure certification of a contract by a notary public. Further, promoters can resort to other common law methods of securing pre-incorporation contracts if they consider this requirement onerous.

The removal of the lodgement requirement

The ultimate removal of the lodgement requirement contemplated by the Companies Act, 2008, is a welcome and overdue development because it is inequitable to companies and their co-contracting parties alike (*Cilliers & Benade* para 5.22). Lodging copies of pre-incorporation contracts robbed companies and their contractual partners of confidentiality, and possibly exposed them to unfair practices such as undercutting by competitors (*Cassim op cit* at 394). Admittedly, the removal of the lodgement requirement prioritizes the protection of companies, and the third parties with whom they enter into pre-incorporation contracts, over the protection of potential creditors/investors. However, there is no other way to obviate

the potential prejudice to companies and their contractual partners. By contrast, as previously stated, there are other ways of acquiring information for, and protecting potential creditors/investors. In addition, one must remember that promoters are also subject to fiduciary duties (Cassim *loc cit*).

Disclosure of promoter's agency status

Section 35 currently provides for the ratification of a pre-incorporation contract concluded by a person 'professing to act as agent or trustee' of an unincorporated company. This phrase is not used in s 21. Before assessing the new formulation in relation to the capacity in which the promoter professes to act in s 21, it is instructive to comment on the s 35 formulation. To 'profess' literally means 'to declare openly; announce or affirm; avow or acknowledge' (*Dictionary.com Unabridged (v 1.1)* available at <http://dictionary.reference.com/browse/profess>, last accessed on 3 June 2009). However, in the context of s 35 its definition as part of the composite phrase 'professing to act as an agent or trustee' has been problematic. This is due to the confusion relating to what is meant by the phrase 'professing to act as a trustee'. In *Sentrale Kunsmis* (*supra*) at 397 Trollip JA stated that it 'connotes that, whilst the person declares that he is acting as a trustee, he is in fact or in law not one'. In other words, Trollip JA was saying that the section applies only in those circumstances where the promoter is not in fact acting as a trustee but merely 'professing' to act as such. Ultimately, then, the promoter would in reality be acting as agent. This interpretation has been criticized, and it has been suggested instead that the section also applies to situations where the promoter is in fact a trustee. This would mean that the section is applicable to promoters acting either as agent or trustee/principal (J D Swart 'Pre-incorporation contracts' 1977 *SACLJ* F-36 at F-42; *Cilliers & Benade* para 5.08 relying, *inter alia*, on *McCullugh v Fernwood Estate Ltd* (*supra*) at 207; Cassim *op cit* at 367 and 395; and see also Johnson *op cit* 24–36). It also has been pointed out that the word 'professing' is an inadequate translation of the Afrikaans word 'verklaar' used in the authentic text and that 'declares' is a more accurate translation (Swart *loc cit*).

In view of such debates, it is prudent for the Companies Act, 2008 to attempt to reach a conclusive resolution by reformulating s 35. Section 21(1) of the Companies Act, 2008 provides (my emphasis):

'A person may enter into a written agreement in the name of, or *purport* to act in the name of, or on behalf of, an entity that is contemplated to be incorporated in terms of this Act, but does not yet exist at the time.'

Instead of the phrase 'professing to act as agent or trustee', s 21 refers to a person who 'purports to act in the name of or on behalf of, a company'. It is noteworthy that instead of using the recommended or suggested words 'declares' or 'states', s 21 uses the term 'purport[s]'. Determining its meaning is essential to an assessment of whether it is an adequate substitution for both 'professing' and 'declares'. When used as a verb, as it is in this case, 'purport' means to 'represent intentionally either *expressly or by implication*, a certain

state of affairs or status' (my emphasis) (*Dictionary.com Unabridged (v 1.1)*, available at <http://dictionary.reference.com/browse/purport>, last accessed on 3 June 2009). On the other hand, to 'declare' is to make an express statement. 'Purport' therefore has a wider meaning than 'declare' in that it also refers to an implied representation. One may argue that practically speaking, broadening the ambit of s 21 in this manner does not add much value given the difficulty of proving an implied representation by a promoter. However, the mere fact that an implied representation may be difficult to prove does not mean that it is impossible. Moreover, proof of an implied representation is ultimately a question of fact that is dependant on the circumstances of the particular case. It would therefore be imprudent, on the ground of mere difficulty, to exclude what could potentially be a useful avenue of redress for a third party. Therefore it seems that 'purports' is an appropriate word to use instead of 'declares', as it extends the section to situations where a promoter implies that he is acting on behalf of, or in the name of, a future company and thus provides remedies for a class of third parties for whom the law had previously not catered. It also eliminates the debate about the meaning of 'profess'.

As previously noted, a reading of s 21 with the s 1 definition of a pre-incorporation contract leads one to the conclusion that s 21 applies only in those cases where a promoter has disclosed or implied that he or she is the agent of an unincorporated company. This is because s 1 provides that a pre-incorporation contract is concluded in the name of, or on behalf of, an unincorporated company. Section 21 reinforces this by also providing that the promoter must purport to contract in the name of, or on behalf of, such a company. A trustee does not act 'in the name of, or on behalf of' another; rather, a trustee contracts as principal in his own name. Although s 21 applies only to promoters acting as agent, where a promoter acts as principal it will still be possible for the company to adopt the relevant pre-incorporation contract under the common law rules relating to stipulatio alteri (*McCulloch* (supra) at 207; *Swart* op cit at F-42; *Johnson* op cit at 32).

The exclusion of principals from s 21 is in stark contrast to the position under s 35. As shown above, s 35 can also be interpreted to apply to promoters acting as principals. This coverage of trustees or principals is beneficial to the extent that it provides an additional means of ratification. The company set to benefit from the pre-incorporation contract is afforded an additional avenue of ratification by s 35. It can choose to ratify under the common law or under s 35.

However, s 35 does not regulate the liability of the promoter in any way. The liability of the promoter acting as trustee or principal is thus determined in accordance with the contract between the third party and the principal (*Henochsberg* 63). The main criticism levelled against s 35 is its failure to provide for promoter liability, which leaves third parties vulnerable. The main advantage s 21 has over s 35 is its provision for promoter liability, which is discussed further below. However, s 21 does not apply to promoters acting as principals. This is unfortunate because third parties concluding pre-incorporation contracts with promoters acting as principals do not have

the same protection as is extended to those who contract with promoters who act as agents. There does not seem to be a convincing reason for this distinction. In order to provide uniform third party protection, s 21 should have included promoters acting as principals.

Repudiation

Section 21(4) grants companies a three-month period after incorporation within which to ‘completely, partially or conditionally ratify or reject any pre-incorporation contract’ entered into on their behalf. Section 21(4) has thus retained the s 35 provision for ‘a positive step of ratification’ (a phrase used by Cassim *op cit* at 383) by providing that a company must ratify a pre-incorporation contract it wishes to perform. Two issues immediately stand out as noteworthy in the consideration of this section. The first is the significance of the provision for a three-month period during which a company is to decide whether or not to ratify a pre-incorporation contract. Section 35 does not have a similar provision. Generally, companies should ratify pre-incorporation contracts within the contractually agreed time or, in the absence of such an agreement, within a reasonable time. However, the determination of a reasonable time is ultimately made by courts and is dependent on the facts of each matter. Consequently, those third parties who are party to pre-incorporation contracts that do not stipulate a time period for ratification may find their affairs being held in limbo for lengthy periods of time whilst they wait for a company to decide whether or not to ratify the pre-incorporation contract in issue. In addition, they may have to resort to litigation to compel a company to make the decision, which ultimately may not be made in their favour. Section 21’s modification of the current position by its provision for a specified period within which companies are to decide whether to ratify pre-incorporation contracts is in the interests of third parties and companies. It accords companies a fair amount of time within which to order their affairs post incorporation and to consider their pre-incorporation contracts. At the same time, third parties will benefit from this provision because they will have to wait a maximum of three months for a company’s decision in this regard.

The second issue is that, like s 35, s 21(4), whilst providing for positive ratification (or rejection), does not provide for the manner of ratification or rejection. It is therefore entirely up to a company to determine the manner of ratification or rejection. In the interests of certainty, it may have been prudent to provide for a manner of ratification in the same way as do s 53(2) of the South African Close Corporations Act 69 of 1984 and ss 180 and 182(4) of the New Zealand Companies Act.

The Close Corporations Act provides that ratification ‘shall be in the form of a consent in writing of all the members of the corporation, given within a time specified in the contract or, if no time is specified, within a reasonable time after incorporation’ (s 53(2)). The New Zealand Companies Act provides that ratification be similarly effected in writing by the directors (ss 180 and 182(4)). Such express provision for the manner of ratification is

desirable because it increases the level of certainty for all parties involved. Although neither the Close Corporations Act nor the New Zealand Companies Act provide for a manner of rejection, it is submitted likewise that for the sake of completeness the manner of rejection also ought to have been stipulated in the Companies Act, 2008.

Importantly, s 21(5) provides that if a company fails to ratify or reject a pre-incorporation contract within the three-month period, it will be 'regarded to have ratified that agreement'. This section complements s 21(4). As already stated, s 21(4) grants companies three months within which to decide whether to ratify or reject a pre-incorporation contract and to take appropriate action. Section 21(5) then provides for the consequences of a company's failure to act within this three-month period by providing for deemed ratification after the expiry of that period. Currently, both in terms of s 35 and the common law, there is no deemed ratification of pre-incorporation contracts. Section 21(5) is thus novel. A number of comments can be made about the significance of this section.

At first sight, s 21(5) appears almost punitive in nature — companies that fail to decide on pre-incorporation contracts within the stipulated time do so on the penalty of being bound by those contracts. However, any apparent harshness is mitigated by the three-month grace period which companies are afforded by s 21(4). Secondly, s 21(5) provides necessary protection for third parties, as it holds lax companies to pre-incorporation contracts. It forces companies to apply their minds to pre-incorporation contracts and take appropriate action within three months. Thirdly, the section provides some relief for promoters in its imposition of secondary liability on companies. This is because the promoter is freed from liability once the company is deemed to have ratified the pre-incorporation contract, and the company thus becomes liable to the third party. Such a transfer of liability from the promoter to the company is particularly helpful where the failure to make a decision timeously is not attributable to any fault of the promoter. To continue to hold the promoter liable in such circumstances would be unfair to promoters. Sections 21(4) and (5) have equitably balanced the interests of third parties, companies and promoters, and as such they constitute a marked improvement on s 35.

Retrospective effect of ratified pre-incorporation contracts

As already mentioned, whether s 35 provides for the retrospective effect of pre-incorporation contracts is debatable. The Companies Act, 2008 therefore attempts to clarify this matter once and for all by means of s 21(6)(a) which provides (my emphasis):

'To the extent that a pre-incorporation contract or action has been ratified or regarded to have been ratified in terms of subsection (5) the agreement is as enforceable against the company *as if the company had been a party to the agreement when it was made.*'

The wording of this provision follows the popular formulation employed by the legislation in a number of other jurisdictions (see Cassim *op cit* at

388). For example, it is quite similar to s 182(3) of the New Zealand Companies Act, which provides '[a] contract that is ratified is as valid and enforceable as if the company had been a party to the contract when it was made'. Unfortunately, this formulation has not proved to be problematic because it does not indisputably provide for retrospective effect (Cassim loc cit). Scholars have debated the import of such formulations, with some arguing that it meant ratified pre-incorporation contracts were retrospective to the date of their conclusion, and others arguing that they are retrospective to the date of the company's incorporation. Any reform should therefore use clear and unambiguous wording to resolve such debates conclusively. I suggest that the section should read 'pre-incorporation contracts have retrospective effect and are binding from the date of their conclusion'. Such wording would clearly remove any potential for confusion. It would also ensure that ratification under s 21 corresponds with ratification at common law as outlined above.

Remedies: promoter and company liability

If the entity on whose behalf a pre-incorporation contract was concluded is not incorporated, or, if it is incorporated, it repudiates the pre-incorporation contract, the third party can seek relief against the promoter in terms of s 21(2). In addition, it seems that s 21(2) extends liability for the failure of a pre-incorporation contract to persons in addition to, or instead of, a promoter. It provides (my emphasis):

'A person who does anything contemplated in subsection (1) is jointly and severally liable with *any other such person* for all liabilities created as provided for in the pre-incorporation contract while so acting, if—

- (a) the contemplated entity is not subsequently incorporated; or
- (b) after being incorporated, the company rejects any part of such an agreement or action.'

The first half of the section is a clear reference to promoters acting as company agents. It is not clear to whom the phrase 'any other such persons' in the second half of the section refers. The use of the word 'such' suggests that the identificatory criteria applicable to promoters are also applicable to these other persons. If they are, then 'any other such person[s]' are simply promoters acting as company agents who, if not legally appointed as such, are de facto occupying such positions. As already stated in the previous section on the promoter's agency status, s 21 in its entirety is applicable only to those situations where promoters act as agents. This is the clear import of the s 1 definition of pre-incorporation contracts, when read with s 21(1).

The reasons for the inclusion of the reference to 'any other such person' in s 21(2) are unclear. It may have been included to cater for circumstances where there are two or more promoters, but the pre-incorporation contract in issue is signed by only one of them. Without this subsection, only the promoter who executed the contract would be liable. The subsection may also have been intended to deal with the situation in which there is more than one promoter, and to provide that instead of such persons being jointly

liable so that a third party would have to sue each one for their pro rata share of the liabilities, one of them could be sued as being jointly and severally liable for the entire amount of those liabilities, leaving that promoter to recover pro rata shares from the others involved. As already stated, s 21 does not apply to a promoter acting as trustee. Hence, such promoters could not be included in this category of 'any such persons'. As discussed above, this position is inequitable, since third parties contracting with promoters who as agents are protected by s 21, whilst those who contract with promoters acting as principals or trustees are denied the same protection.

Section 21(3) and (6)(b) provides that promoters will be released from liability where novation or (actual or deemed) ratification occur, respectively. The significance of this provision is that, in addition to novation or actual ratification, a promoter will also be released from liability when the company is deemed to have ratified the pre-incorporation contract in issue. These provisions achieve fair treatment of promoters by releasing them from liability on the three grounds stated above. Of these three grounds, deemed ratification is novel. I have commented on it in the part of this note entitled 'Repudiation' above. I will also revisit it in a subsequent section entitled 'Third party protection' below.

Section 21(7) then provides that a promoter who bears liability after a company rejects a pre-incorporation contract may lay a claim against the company concerned for any benefit it has received or *is entitled to receive* under the pre-incorporation contract. This section provides protection for a promoter who finds himself accountable to a third party in circumstances where the company has received some benefit under a repudiated pre-incorporation contract. The promoter will, after discharging his liability to the third party, be able to obtain full or partial reimbursement from the company under this section. In other words, if a company has rejected a pre-incorporation contract, it must return any benefit it had acquired under the contract. These benefits are not defined or more precisely described in the Act, but it would be reasonable to assume that a company would have to return the exact goods or services acquired under the pre-incorporation contract, or, if this is not possible, their value in money. A company that is unable to return the exact goods or services should thus not be compelled to ratify the contract, because it has the option of reimbursing the promoter financially. If a company is unable to pay the monetary equivalent of the goods or services in question, it may face sequestration. Further, if it is possible to identify or quantify other benefits related to a pre-incorporation contract, they would also have to be restored by the company to the promoter, who would in turn have to restore them to the third party.

The Act rightly requires the return of benefits acquired under a rejected pre-incorporation contract, for a company would otherwise be unjustifiably enriched at the expense of the promoter or the third party. However, in practice compliance with this section will be difficult where the return of exact goods is sought from the promoter whilst the goods are still in the possession of the company. In such a scenario it is impossible for the

promoter first to satisfy the third party's claim and thereafter to seek recourse from the company. The promoter simply cannot return the goods to the third party. The best way for the promoter to proceed would be to seek a joinder of the company to the litigation or application so that the court can order the company to return the goods directly to the third party. Another option is for a promoter to anticipate this situation by seeking the return of the exact goods from the company as soon as the company rejects the pre-incorporation contract. This would place the goods in the promoter's possession so that he or she is able to meet the third party's inevitable claim when it is instituted.

The import of the phrase 'entitled to receive' in this section is worthy of comment. At first glance, it appears to confuse matters: if a company has rejected a pre-incorporation contract, it has rendered that contract a *nullity* and as a result should not be entitled to receive any benefits under it. This explains why all benefits received under such contract should be returned. However, the phrase 'is entitled to receive' presupposes that such a rejected contract is still valid. It is thus necessary to consider whether a rejected contract could ever be treated as valid. Arguably, s 21(2)(b) answers this query by providing for partial rejection of a pre-incorporation contract. Where a company has partially rejected the contract it will be entitled to receive some benefits under the partially rejected contract. The remaining question then is why such benefits should be returned. Surely there is no need to return those benefits, as the company would have accepted that part of the pre-incorporation contract, and would be willing to make payment for them? Indeed, in some cases the company may already have made payment for that benefit. I accordingly suggest that this phrase be deleted from s 21(7).

Third party protection

Section 21 of the Companies Act, 2008 protects third parties through the promoter's automatic personal liability provided for by s 21(2), and the deemed ratification provided for by s 21(5).

As already stated, s 21(2) holds a promoter liable under a pre-incorporation contract if the prospective company is not incorporated, or is incorporated but rejects the pre-incorporation contract. As argued above in the section on policy considerations, s 21(2) places third parties in a better position than s 35 because it provides for clearly stipulated protection. However, promoters can contract out this position through the use exclusion clauses. Therefore our courts will have to be very vigilant when dealing exclusion clauses in this context to ensure adequate protection for third parties.

Section 21(5)'s provision for deemed ratification has already been discussed above. This is an important innovation which gives third parties two significant benefits. First, they only have to wait for a maximum of three months for companies to decide whether or not to ratify pre-incorporation contracts. Secondly, they do not have to litigate to hold companies liable on pre-incorporation contracts where those companies fail to take action in the

three months period. This avoids the expenses and delays attendant on litigation which would otherwise deter third parties from enforcing their rights. Further, promoters also benefit from the provision for deemed ratification in that they are released from liability when companies fail to ratify or reject pre-incorporation contracts in the stipulated three-month period. Finally, companies are also fairly treated as they are given a reasonable period of three months after incorporation to act before liability is imposed on them. This section equitably balances the interests of companies, third parties and promoters.

CONCLUSION

Section 21's reforms are commendable because they provide better protection for a third party who enters into a pre-incorporation contract through the promoter's personal liability and the company's deemed ratification provisions. There clearly has been a policy shift towards a more balanced and nuanced treatment of third parties. At the same time, promoters and companies are also equitably treated. However, s 21 has some deficiencies. For example, it fails to clarify the issue of retrospectivity of pre-incorporation contracts, because it does not state in express terms that ratification is retrospective in effect and instead uses a formulation that has proved to be problematic in New Zealand and other jurisdictions. Secondly, unlike s 53(2) of the South African Close Corporations Act and s 182(4) of the New Zealand Companies Act, s 21 does not provide for the manner of ratification. Thirdly, s 21 does not apply to promoters acting as principals and thus denies third parties who contract with such promoters the benefit of the protection it offers.




... opening access
to research

Search - Publisher copyright policies & self-archiving

One journal found when searched for: **south african law journal**

Journal: [South African Law Journal](#) (ISSN: 0038-2388, EISSN: 1996-2177)

RoMEO: This is a RoMEO white journal

Author's Pre-print:  author **cannot** archive pre-print (ie pre-refereeing)

Author's Post-print:  author **cannot** archive post-print (ie final draft post-refereeing)

Publisher's Version/PDF:  **subject to Restrictions below**, author **can** archive publisher's version/PDF

Restrictions:

- 6 months embargo

General Conditions:

- On institutional repository affiliated with the author
- Publisher's version/PDF must be used
- On a non-profit server
- Publisher copyright and source must be acknowledged with citation
- Must link to publisher version

Mandated OA: *(Awaiting information)*

Copyright: Not available online

Updated: 01-May-2014 - [Suggest an update for this record](#)

Link to this page: <http://www.sherpa.ac.uk/romeo/issn/0038-2388/>

Published by: [Juta Law](#) - [White Policies in RoMEO](#)

This summary is for the journal's *default* policies, and changes or exceptions can often be negotiated by authors.

All information is correct to the best of our knowledge but should not be relied upon for legal advice.

RoMEO Colour

Archiving policy

Green	Can archive pre-print <i>and</i> post-print or publisher's version/PDF
Blue	Can archive post-print (ie final draft post-refereeing) or publisher's version/PDF
Yellow	Can archive pre-print (ie pre-refereeing)
White	Archiving not formally supported

[More on colours and restrictions](#)

or [View all publishers](#)

Use this site to find a summary of permissions that are normally given as part of each publisher's copyright transfer agreement.

The RoMEO Journals database is supplemented with information kindly provided by:

- the British Library's [Zetoc](#) service hosted by MIMAS,
- the [Directory of Open Access Journals](#) (DOAJ) managed by Infrastructure Services for Open Access,
- the [Entrez](#) journal list hosted by the NCBI.